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SWITZERLAND

LIMITATION ON BENEFITS IN THE NEW US–SWITZERLAND TREATY

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Although the new US–Switzerland treaty was signed on 2 October 1996, it shall not take effect until it has been ratified by both the United States Senate and the Swiss Parliament.[1]

I. INTRODUCTION

As a rule, the new treaty applies to persons who are residents of either the United States or Switzerland.[2] The Limitation on Benefits article (hereafter: LOB) provides an exception to this rule by restricting the personal scope of application of the treaty to residents which meet certain predetermined criteria.[3] Indeed, by inserting an LOB provision, the treaty partners agree that certain residents do not qualify for treaty benefits. Thus, a distinction is made between ordinary residents and qualifying residents, LOB provisions effectuate that only qualifying residents are eligible for treaty benefits.

The basic policy of the LOB provision is to deny treaty benefits to taxpayers using so-called "treaty shopping" techniques, i.e. taxpayers which set up an entity that is a resident in one of the contracting states in order to take advantage of treaty relief. The entity in this situation merely acts as a conduit for residents of some third country.[4] Since it is relatively easy for residents of third countries to establish a conduit entity in a contracting state, without an LOB provision, a favourable treaty with one contracting state may become a treaty with the entire world.[5] This not only defeats the object of treaty negotiations on a bilateral level, but may also hinder treaty negotiations with non-treaty states who are less inclined to make treaty concessions since their residents can reap the benefits of existing treaties.

Although neither the OECD Model nor the UN Model contain a provision similar to the LOB article, all US tax treaties which have entered into force since 1979 contain such a provision. Indeed, the United States now insists on the insertion of an LOB provision since it maintains that "the law of almost any country by design, by mistake, or for some other reason, may lend itself to treaty shopping".[6] Nevertheless, the specific provisions of the LOB article contained in US tax treaties vary from treaty to treaty.

The following analyses the conditions which are to be fulfilled for a resident of either contracting state to qualify for treaty benefits. A clear distinction has been made between residents who qualify for total treaty benefits, residents who qualify for partial treaty benefits in the form of a reduced withholding tax on dividends, interest and royalties, as well as relief in triangular cases and discretionary relief.

II. TOTAL TREATY BENEFITS

A. Introduction

If a resident of one contracting state fails to meet the conditions laid down by the LOB provision with regards to total treaty benefits, relief is denied on income which is derived from the other contracting state (see Appendix A).

However, the question must be raised as to whether that resident shall be denied all the benefits of the treaty. For example, it could be argued that the articles pertaining to the exchange of information, non-discrimination, or the mutual agreement procedure should not be considered as "benefits" and that they should therefore apply regardless of LOB provisions. The answer to this question has been the subject of much discussion in light of LOB provisions in treaties signed by the United States with other treaty partners and is at present unclear in the US–Switzerland context.

1. This article is based on the documents officially available on 2 October 1996 which include the treaty itself as well as the Protocol and Memorandum of Understanding which clarify the terms of the active trade or business test and the predominant interest test.
2. Art. 1, para. 1 and Art. 4 US–Switzerland treaty.
3. Art. 22 US–Switzerland treaty.
4. Arnold B.J., McIntyre M.J., *International Tax Primer* (Den Haag: Kluwer, 1995, at 116).
5. Vogel K., Shannon H. A., Doernberg R.L., *United States Income Tax Treaties* (Deventer: Kluwer) Part II. Commentary Art. 16-11.
6. Loengard Jr R. O., "A (modest) proposal to reconsider the "limitation on benefits" provision of US tax treaties", in Alpert H.H., van Raad K., *Essays on International Taxation*, Kluwer (Series on International Taxation 15), Devénter, 1993.

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B. Individuals

Individuals who are residents of either of the contracting states are entitled to the benefits of the treaty without further examination.

Nevertheless, in order for individuals to be considered as residents, the treaty has introduced the condition that they must be subject to ordinary Swiss income tax with respect to all US source income.[7] This specifically aims at disqualifying individuals from treaty relief when they take advantage of the so called "lump-sum taxation" whereby Swiss income tax is levied on the basis of expenses (i.e. standard of living) rather than on taxable income.[8] In order to comply with this condition in other treaties, a "modified method of calculation" has been introduced by which the income tax liability under lump-sum taxation is at least as high as the ordinary income tax which would have been levied on the total income received from the other contracting state as well as Swiss source income. It is probable that this "modified method of calculation" shall be applied *mutatis mutandis* in order to comply with the conditions laid down in the US–Switzerland treaty.

C. Public establishments

Contracting states themselves, along with their political subdivisions or local authorities thereof (or any agency or instrumentality of such states, political subdivisions or authorities), are treated in the same manner as individuals since they are granted full treaty benefits without being required to fulfil any tests.

D. Companies

In order for companies to qualify for treaty relief under the US–Switzerland treaty, they must be able to fulfil *one* of the following tests: The active business or trade test, the headquarters test, the stock exchange test, or the predominant interest test.

The first two tests analyse the activities of the company which is claiming tax relief on the basis of the treaty. The idea behind these two tests is to determine whether the company has invested sufficiently in the contracting state of which it claims residency so as to be considered as a qualifying resident for treaty purposes. The second two tests go a step further and look through the company to determine whether the ultimate shareholders of the company may be considered as qualifying residents. In other words, the availability of treaty benefits depends on whether the persons controlling the company would themselves be entitled to claim treaty relief.

Although the active trade or business test is the first to be covered, it is probably the most difficult test to interpret and apply in practice. In addition, this test applies separately to each item of income whereas a company which satisfies any of the other tests is entitled to treaty benefits with respect to all of its income. Therefore, when applying LOB provisions to specific situations, all other tests should be analysed *prior* to the active trade or business test. If a company qualifies for treaty benefits under any of the other tests, no inquiry will be made under the active trade or business test.

1. Active trade or business test[9]

The active trade or business test not only requires that the income recipient should be engaged in an active trade or business in its state of residence, but also that the income derived from the other contracting state must be derived "in connection with" or be "incidental to" that trade or business. In addition, if it is derived from a related party "in connection with" the trade or business in the state of residence, that business must be "substantial" in relation to the income-producing activity (see Appendix B).

The assumption underlying this test is that taxpayers are unlikely to incur the expense of establishing a substantial trade or business in Switzerland or the United States primarily to avail of the benefits of the treaty.[10] If the conditions of this test are fulfilled, it is therefore presumed that the investor has a valid business purpose for becoming a resident of one of the contracting states.

The LOB provision does not define what an active trade or business is, except with respect to banks, insurance companies and registered securities dealers and by excluding the business of making, managing, or simply holding investments.

However, as per the protocol, "whether the activities of a foreign corporation constitute an active trade or business must be determined under all the facts and circumstances. In general, a trade or business comprises activities that constitute (or could constitute) an independent economic enterprise carried on for profit. To constitute a trade or business, the activities conducted by the resident ordinarily must include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit. A resident of a Contracting State actively conducts a trade or business if it regularly performs active and substantial management and operational functions through its own officers or staff of employees. In this regard, one or more of such activities may be carried out by independent contractors under the direct control of the resident. However, in determining whether the corporation actively conducts a trade or business, the activities of independent contractors shall be disregarded".

The active conduct of a trade or business may involve manufacturing, sales or services. However, income received from the business of making, managing, or merely holding invest-

7. Art. 4, para. 5 US–Switzerland treaty. Similar rules apply in the Swiss treaties with Germany (Art. 4, para. 6a), Austria (Art. 4, para. 4), Belgium (Art. 4, para. 2), Italy (Art. 4, para. 5b) and Norway (Art. 4, para. 4).

8. For a more detailed explanation, see Oberson X., Hull H.R., *Switzerland in International Tax Law* (Amsterdam: IBFD Publications BV, 1996, at 42).

9. Sometimes referred to as the activity test or the substantial trade or business test.

10. Van Herksen M., "Limitation on Benefits and the Competent Authority Determination", 50 *Bulletin for International Fiscal Documentation*, 1 (1996) at 24.

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ments does not qualify. It has been argued that this exclusion lacks any reasonable justification since the placement or management of investments can very well constitute an active trade or business.[11] The Memorandum of Understanding does however specify that this provision does not affect the status of investment advisors or others who are actively conducting the business of managing investments that are beneficially owned by others.

It is not necessary for the company claiming the benefits to be directly engaged in a trade or business since it may very well be deemed to be so engaged through the activities of related parties that are residents of one of the contracting states. Hence, a Swiss holding company may be deemed to be engaged in a trade or business if it has a subsidiary which fulfils this criterion. There is at present no specific definition of "related parties" for the implementation of this provision, however, we can imagine that the notions developed under the predominant interest test could be applied *mutatis mutandis* with regards to parent-subsidiary relationships, and that the notion of "common control" could be applied to sister companies.

Income is derived "in connection with" a trade or business if the income producing activity in a contracting state is a line of business that "forms a part of" or "is complementary to" the trade or business conducted in the other contracting state.[12] No further explanation is currently available. However, in the context of the US–Netherlands treaty, the Treasury Explanation interprets "forms a part of" as meaning "the design, manufacture or sale of the same 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".

In light of these explanations, it can be considered for example that where a Swiss manufacturing company receives treaty favoured income from its US distributor, the products are the same. Therefore, the income producing activity in the United States forms a part of the trade or business carried out in Switzerland. In addition, for example if Swissair has a US subsidiary which is active in the hotel business, the income producing activity in the United States may be regarded as complementary to the trade or business carried out in Switzerland.

Where the income is derived from a related party "in connection with" the trade or business in the state of residence, that business must be "substantial" in relation to the income-producing activity. There is deemed to be a related party transfer of income if the recipient owns, directly or indirectly 10 per cent or more of the shares (or other comparable rights) in the payer.

The active business in the income recipient's state must therefore be substantial in relation to the active business in the state in which the income is produced. Thus, for example, a small hot dog stand in Switzerland will not qualify as a Swiss holding company to receive dividends from a large US sausage making business.[13] However, the treaty does not contain a safe harbour to determine whether the "substantiality condition" is fulfilled and it is easy to imagine a lot of grey areas. Hence, the protocol specifically indicates that "whether a trade or business is substantial will be determined on the basis of all the facts and circumstances. Such determination will take into account the comparative sizes of the trades or businesses in each Contracting State (measured by reference to asset values, income and payroll expenses), the nature of the activities performed in each Contracting State, and, in cases where a trade or business is conducted in both Contracting States, the relative contributions made to that trade or business in each Contracting State. In making each determination or comparison, due regard will be given to the relative sizes of the US and Swiss economies".

The three ratios which are used to determine the relative size of the trades or businesses in each contracting state compare separately, the amounts of assets, gross income, and payroll in the income recipient's state to the amounts in the income-producing state. There are currently no safe harbour rules which determine the acceptable ratio requirement in order to comply with this test.

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).[14]

This article is left open to much interpretation. If, for example, a private Swiss manufacturer of drugs should decide to expand and diversify by buying all or part of a US chemical company, will dividends from its investment be regarded as "incidental to" its Swiss business?[15]

2. Headquarters test

Headquarters companies (Hereafter: HQ companies) qualify for treaty benefits for as long as they fulfil the following conditions (see Appendix C):

(a) *Overall supervision and administration*

The HQ company must provide a "substantial portion" of the overall "supervision and administration" of the group. A significant number of functions for the group must therefore be performed, such as group financing (which cannot be the principal function), pricing, marketing, internal auditing, internal communications, and management. These activities must be performed in the state of residence of the HQ company.

There are no further explanations of this condition in the Protocol or the Memorandum of Understanding. However, in the

11. Beck'sche Steuerkommentare, The new US–Germany Double tax treaty, at 465.
12. Para. 4, Memorandum of Understanding.
13. A Commentary to the United States–Netherlands Tax Convention, *Intertax*, 1993/4-5, at 201.
14. Para. 5 Memorandum of Understanding.
15. See *supra* note 6.

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Memorandum of Understanding relating to the US–Netherlands treaty, it is understood that in determining if a substantial portion of the overall supervision and administration of the group is provided by the HQ company, the activities it performs as a headquarters company for the group it supervises must be substantial in comparison to the same activities for the same group performed within the multinational. For example, if a multinational company has two or three headquarters companies which monitor and control different geographical locations but, neither the other two HQ companies, nor any other related company besides the parent company perform any other of the above mentioned headquarters activities with respect to the group of companies that the Swiss HQ company supervises, the Swiss HQ company will be considered to provide a substantial portion of the overall supervision and administration of the group it supervises.

(b) *Active trade or business*

In order to qualify, the HQ company must manage a group of corporations resident in, and engaged in active businesses in, at least five countries (or five groupings of countries). In addition, each of the five must generate 10 per cent or more of the group's gross income.

Only the activities of corporations qualify. Consequently, fewer than five corporations operating in more than five different countries through local branches do not constitute an international group. In determining which companies belong to the multinational group, the actual management structure of the group seems to be decisive.[16] All companies under the supervision of the headquarters company are included in the multinational group provided that they carry on an active business. They need not be subsidiaries of the HQ company. It is not necessary for the group that is supervised to include persons in the other contracting state.

If the gross income requirement is not met for a taxable year, the taxpayer may satisfy this requirement by averaging the ratios for the four years preceding the taxable year (four-year averaging).

(c) *Single country limitation*

No more than 50 per cent of the gross income of the group may come from the business activities carried on in any one country (other than the country of residence of the HQ company). This requirement reflects the idea that, if a group's centre of gravity is clearly in some country other than the state of residence of the HQ company, the HQ company might more logically be located in that country, were it not for treaty shopping concerns.[17]

If the gross income requirement is not met for a taxable year, the taxpayer may apply four-year averaging (see above).

(d) *Other state gross income limitation*

No more than 25 per cent of the gross income of the HQ company may be derived from the other contracting state

If this gross income requirement is not met for a taxable year, the option of four-year averaging is again available.

(e) *Independent discretionary authority*

The HQ company must have, and exercise, "independent, discretionary authority". In other words, it cannot simply execute the orders or implement the instructions of a parent company.

For the application of this condition in other treaties signed by the United States, the determination of the "independent discretionary authority" is made individually for each function. For instance,[18] an HQ company could be nominally responsible for group financing, pricing, marketing and internal auditing functions, but another entity could be actually directing the HQ company as to the group financing function. In such a case the HQ company would not be deemed to have independent discretionary authority for group financing, but it might have such authority for the other functions. Functions for which the HQ company does not have and exercise independent discretionary authority are considered to be conducted by an entity other than the HQ company for purposes of the LOB provision.

(f) *Income taxation rules*

The HQ company must be subject to generally applicable rules of taxation in its state of residence.

Thus, if one of the contracting states introduces special tax legislation that allows for a lower rate of income tax on HQ companies than is levied on ordinary operational companies engaged in the active conduct of a trade or business, or would provide for an artificially low taxable base for such companies, an HQ company subject to those rules would not be entitled to the benefits of the Convention under this paragraph.

Swiss resident HQ companies are often subject to corporate income tax on the basis of a notional profit which is generally deemed to be at least 10 per cent of total expenses incurred for the provision of the services to affiliates or one sixth of the total local payroll costs.[19] This is not strictly speaking a tax concession, but merely a simplified method of calculating taxable profits which is justified by the fact that it is often very difficult to determine the effective taxable income generated by an HQ company. Companies who are assessed to tax in this manner should therefore continue to qualify for treaty benefits. However, certain Swiss cantons levy corporate income tax on HQ companies at substantially low tax rates. Companies who take advantage of this favourable treatment would therefore probably not qualify for treaty relief.

(g) *In connection with or incidental to trade or business*

The HQ company's income from the other contracting state must be derived in connection with, or be incidental to a trade or business supervised by the HQ company. Therefore, the HQ company can only earn treaty-favoured income connect-

16. See *supra* note 13, at 203.
17. Id.
18. Technical explanation to the US–Netherlands Tax convention.
19. Hull H. R., "Switzerland: Income Tax Incentives for Corporations", 50 *Bulletin for International Fiscal Documentation* 1 (1996), at 29.

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ed with (or incidental to) the businesses it manages (e.g. dividends or interest from a subsidiary it manages). Interest income derived from an unrelated party would normally not satisfy the requirement of this subparagraph. Reference is made here to the treaty provision dealing with the active trade or business test in which there is also the condition that the income derived from the other contracting state be in connection with or incidental to the trade or business in the first mentioned state.

3. Stock exchange test[20]

(a) *Direct stock exchange test*

A company that has primary and regular trading in its principal class of shares on a recognized securities exchange is a qualified person. Indeed, if a company's shares are regularly and primarily 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 (see Appendix D).[21]

This serves as a complete safe harbour.[22] Indeed, there is no additional requirement that the company satisfy a base erosion or any other test. The publicly traded company safe harbour applies "regardless of where its actual owners reside or the amount or destination of payments it makes".[23]

The treaty does not contain a definition of the term "principal class of shares". In other treaties signed by the United States, this term covers the single or most valuable class of common stock of a company, provided that this class represents the majority of the voting power and value of the company. If there are multiple classes of shares, difficulties will arise where values of various classes shift disproportionately and where different classes of stock have special or limited voting rights.[24]

The term "primarily and regularly" is not defined in the treaty but is certainly meant to convey that the mere public listing of stock is not sufficient to satisfy the publicly-traded company test.[25] Nevertheless, it is not required that all of the principal class of shares be listed. For the moment, there are no rules requiring a minimum turnover.

With regards to the definition of "recognized stock exchange", an exhaustive list is given in the LOB provision. Reference is made thereto.

(b) *Indirect stock exchange test*

Much of the treaty-favoured income may not be received directly by a publicly traded company, but rather by one of its subsidiaries. Therefore, subsidiaries of publicly traded parent companies also qualify for treaty relief for as long as one or more companies which meet the direct stock exchange test are the ultimate beneficial owners of a predominant interest in the subsidiary. The following paragraph explains the notion of "predominant interest" in more detail.

4. Predominant interest test[26]

Under the predominant interest test, persons who are entitled to the benefits of the Convention under the foregoing paragraphs (other than on the basis of the active trade or business test) must be the ultimate beneficial owners of a predominant interest in the company in the form of a participation or otherwise (see Appendix E).

This test is designed to ensure that there is at least one level of taxation imposed by the residence state at some point on the income of the entity. Thus, even if the residence state does not impose a significant tax on the income of residence state entities, the residence state will tax the income when distributed to its shareholders.

Here, the importance is placed on the "ultimate beneficial owners". The test therefore looks through one or more entities to the ultimate beneficial owners. This can often prove difficult to apply in practice since the management of the company may have little knowledge of the ownership.

The term "predominant interest" is not defined. Nevertheless, it appears from the examples given in the Memorandum of Understanding that a person is deemed to have a predominant interest when he or she owns more than 50 per cent of the beneficial interest in the resident company. Equity interests are taken into consideration as well as other contractual interests.

This test is very similar to the 50 per cent transfer limit in the Swiss 1962 Abuse Decree whereby it is inappropriate to use more than 50 per cent of treaty favoured income to pay off claims to persons not entitled to treaty relief. In this context, rights and claims are defined as transfers of income other than dividends. They include interest, royalty, sales, publicity, administration, research and development as well as income used to write off assets which have been acquired directly or indirectly from persons not entitled to treaty relief.[27]

It should be added that this disposition does not include a time frame. Therefore, it might be possible for an entity to meet the ownership requirements for one day or one moment during the relevant taxable year.

E. Partnerships

Under the US–Switzerland treaty, partnerships do not fall under the general definition of companies.[28] They are however considered as residents of either of the contracting states to the extent that the income derived by the partnership is

20. Sometimes referred to as the publicly traded test or the public company test.
21. See *supra* note 10, at 23.
22. *Supra* note 5, at Commentary Art. 16-61.
23. Senate report United States–Finland cited *supra* note 22.
24. *Supra* note 13, at 197.
25. *Supra* note 5, at Commentary Art. 16-41.
26. Sometimes referred to as the more than 50 per cent beneficial ownership test.
27. See comments hereafter concerning the base erosion test.
28. Art. 3, para. 1(b) US–Switzerland treaty.

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subject to tax in one of the contracting states in the same manner as the income of a resident of that state, either in its hands or in the hands of its partners.[29]

If such is the case, partnerships are required by LOB provisions to satisfy the conditions laid down in the active trade or business test. Reference is therefore made to the observations given here above.

F. Trusts and estates

Trusts and estates must comply with the conditions laid down in the predominant interest test in order to qualify for treaty relief. Reference is therefore made to the observations already made.

G. Family foundations

Swiss resident family foundations qualify for total treaty relief unless the founder, or the majority of the beneficiaries, are not Swiss resident individuals, or if more than 50 per cent of the income earned by the family foundation could benefit persons who are not Swiss resident individuals. Most of the observations regarding the predominant interest test can be applied *mutatis mutandis* in determining whether family foundations qualify under LOB provisions.

H. Pension trusts and not-for-profit organizations

Pension trusts and not-for-profit organizations are entitled to full treaty relief provided that more than 50 per cent of the beneficiaries, members or participants, if any, are qualifying persons.

Pension trusts include any organization which is maintained exclusively to administer or provide pensions, retirement or employee benefits, that is established or sponsored by a person resident in a contracting state.

A not-for-profit organization is one which is established and maintained for religious, charitable, educational, scientific, cultural or other public purposes.

III. LIMITED TREATY BENEFITS

A. Introduction

Although a company which is a resident of one of the contracting states may not comply with the above mentioned LOB provisions, it may nevertheless qualify for treaty relief on dividends, interest and royalties received from the other contracting state if it cumulatively fulfils the following shareholder tests and the base erosion test (see Appendix F).

B. Shareholder tests

Under this test, certain EC residents are treated as comparable to residents of the contracting states. Indeed, if only 30 per cent or more of the ultimate beneficial owners of the aggregate vote and value of all shares are qualified persons in a contracting state (other than on the basis of the active trade or business test), treaty relief may nevertheless be granted if more than 70 per cent of all such shareholders are qualified individuals and persons that are residents of Member States of the European Union, of the European Economic Area or parties to the North American Free Trade Agreement.

The beneficial owners in third states are taken into consideration provided that they would have been able to apply for similar relief in the absence of the intermediary company resident in the contracting state. To ensure this, the following four conditions must be fulfilled:

- a tax treaty must exist between the state of residence of the beneficial owner and the state of source of income;
- the beneficial owner must be entitled to all the benefits provided by the above mentioned treaty;
- the tax at source due under the above mentioned treaty must be at least as low as the rate applicable under the new US–Switzerland treaty;
- the beneficial owner must qualify for the total treaty benefits under the LOB provision in the new US–Switzerland treaty if applied *mutatis mutandis*.

C. Base erosion test

Even if an entity satisfies the above ownership tests, it is still possible for the income earned by an entity in a contracting state to escape full taxation in that state and leave no income for distribution to the equity owners by eroding the tax base with deductible payments. In effect, the earnings of the entity may be stripped out to debt-holders who are not qualifying persons as defined under the shareholder tests.

It is difficult to consider the beneficiary of income as the real beneficial owner of the underlying assets when most of the income is transferred to non-qualifying persons. Therefore, as per the base erosion test, it is considered as inappropriate to use more than 50 per cent of gross income to make deductible payments to persons not entitled to treaty relief.[30]

Deductible payments include transfers of income other than dividends, such as interest, royalty, sales, publicity, administration, research and development etc. In addition, it is probable that income used to write off assets which have been acquired directly or indirectly from persons not entitled to benefit from a treaty is also taken into consideration (As is the case in Article 2, paragraph 2 (a) 1962 Abuse Decree).[31] This concerns the writing off of immovable property which has been acquired at an earlier time from non-qualifying per-

29. Art. 4, para. 1 (d) US–Switzerland treaty.
30. Note that this article does not refer to gross treaty favoured income as in the Swiss 1962 Abuse Decree.
31. See Oberson X., Hull H. R., *Switzerland in International Tax Law* (Amsterdam: IBFD Publications BV, 1996, at 140).

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sons. In these situations, the payment of the acquisition price is considered to be an anticipated distribution of future income. Deductible payments in this context include interest or royalties but does not include an arm's length purchase price or rental of tangible property in the ordinary course of business or arm's length remuneration for services rendered in the contracting state in which the payer is a resident.

Liabilities do not include the repayment of principal or any other outlay that does not reduce the entity's taxable income in the contracting state. Accordingly, non-deductible interest, non-deductible rents, etc. should not be counted in the base erosion test. A liability is considered "met" in the year the satisfaction of the liability gives rise to a tax benefit (e.g. a deduction).[32]

This article does not look through the person receiving the payment to the ultimate beneficiaries. Accordingly if an entity of a contracting state makes interest payments to a corporate lender resident in the same state, those interest payments do not count against the entity for purposes of the base erosion test even if the lender is owned by third state shareholders.[33]

The 50 per cent transfer limit does not mean that the remaining 50 per cent of treaty favoured income must be subject to income tax. First, administrative expenses and taxes may be deducted. Second, such income may be subject to a reduced tax rate under specific domestic tax laws.

It has been argued that the substance of this test is unreasonable in the context of increased globalization, which often leads to situations where a company must use more than 50 per cent of its gross income to meet liabilities to persons resident in other countries.[34] This being said, it would appear more appropriate if the 50 per cent transfer limit did not represent an excessive burden on the activities of a bona fide commercial company. Hence, if such companies have justifiable reasons for exceeding the 50 per cent transfer limit, the competent authorities should grant the requested treaty relief. Whether they will do so in practice remains to be seen.

IV. TRIANGULAR CASES

Triangular cases covered by the LOB provision concern income earned by a permanent establishment of a resident of one contracting state from a source situated in the other contracting state, the permanent establishment being situated in a third state. This provision is designed to discourage the use of branch financing structures where a resident enterprise is not taxed on the profits realized by a permanent establishment situated in a third state (see Appendix G).[35]

As per this disposition, treaty relief is only granted by the state of source if the tax in both the state in which the permanent establishment is situated and the state of residency of the beneficiary of such income is higher than 60 per cent of the tax that would be imposed if such income were not attributable to the permanent establishment (i.e. if the income had passed directly from one contracting state to the other).

If the 60 per cent threshold is not satisfied, the state of source will impose a 15 per cent tax on the gross amount of any dividends, interest or royalties. Any other income will be subject to tax under the domestic laws of the state of source.

Nevertheless, full treaty relief is granted if:

- in the case of royalties, the royalties are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself; or
- in the case of any other income, the income derived from the other contracting state is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third jurisdiction (other than the business of making, managing or simply holding investments for the person's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer).

V. DISCRETIONARY RELIEF[36]

Although a person may not qualify for treaty relief under the above LOB provisions, the contracting state of source of income may nevertheless grant treaty relief on a discretionary basis. This possibility, which puts the credibility of the other LOB provisions in question, is only possible after consultation with the competent authority of the state of residence of the beneficiary of the income.

We can only hope that this shall be used in situations where the residents of a contracting state have perfectly justifiable reasons for failing to fulfil the conditions of the other LOB provisions. In principle, it is not necessary to obtain an advance ruling from the competent authorities in order to rely on this provision to obtain treaty relief. Nevertheless, until the tax administrations' practice has been clearly defined, an advance ruling would clearly be advisable.

If this provision is applied in a similar fashion to the way in which discretionary relief is applied in other US treaties containing LOB provisions the "principal purpose" of the structure shall serve as the criterion for qualifying for the relief. Therefore, if the competent authority of one of the contracting states concludes that obtaining treaty relief is not the "principal purpose" of the structure, an entity may qualify for discretionary relief.

Since the question of intent is often difficult to determine, the Memorandum of Understanding to the US–Netherlands treaty introduces six intent factors which serve as criteria to help determine the underlying intention of the taxpayer:

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

32. *Supra* note 5, at Commentary Art. 16-33.
33. Id.
34. *Supra* note 11, at 469.
35. Delattre O., "France–US New Tax Treaty", 49 *Bulletin for International Fiscal Documentation*, 1 (1995) at 65.
36. Sometimes referred to as the grace clause, subjective test or competent authority relief.

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2. The continuity of the historical business and ownership of the corporation.
3. The business reasons for the corporation residing in its state of residence.
4. The extent to which the corporation is claiming special tax benefits in its country of residence.
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.
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.

VI. CONCLUSION

The concept of "qualified resident" is very complicated and, regardless of the limited explanations in the Protocol and the Memorandum of Understanding, many issues are still outstanding. It should be noted that these provisions are supposed to be self executing and do not require an advance competent authority ruling or approval, but, due to the problems which are sure to arise, prior rulings shall certainly become commonplace.

In addition, the LOB provision introduces mechanical tests which a taxpayer may fail to satisfy even though it is not engaged in treaty shopping. Such provisions may therefore force a taxpayer to structure its transactions carefully in order to avoid losing treaty benefits to which one would think it is legitimately entitled.

Lastly, it remains to be seen to what extent withholding agents will be held responsible for ascertaining whether foreign beneficiaries are qualified residents for purposes of respective LOB provisions.

At the present time, it is too early to tell how the LOB provision shall be applied in practice. We can only hope that its implementation shall not have the effect of sharply reducing the value of the US–Switzerland treaty as a whole.

APPENDICES A - G FOLLOW

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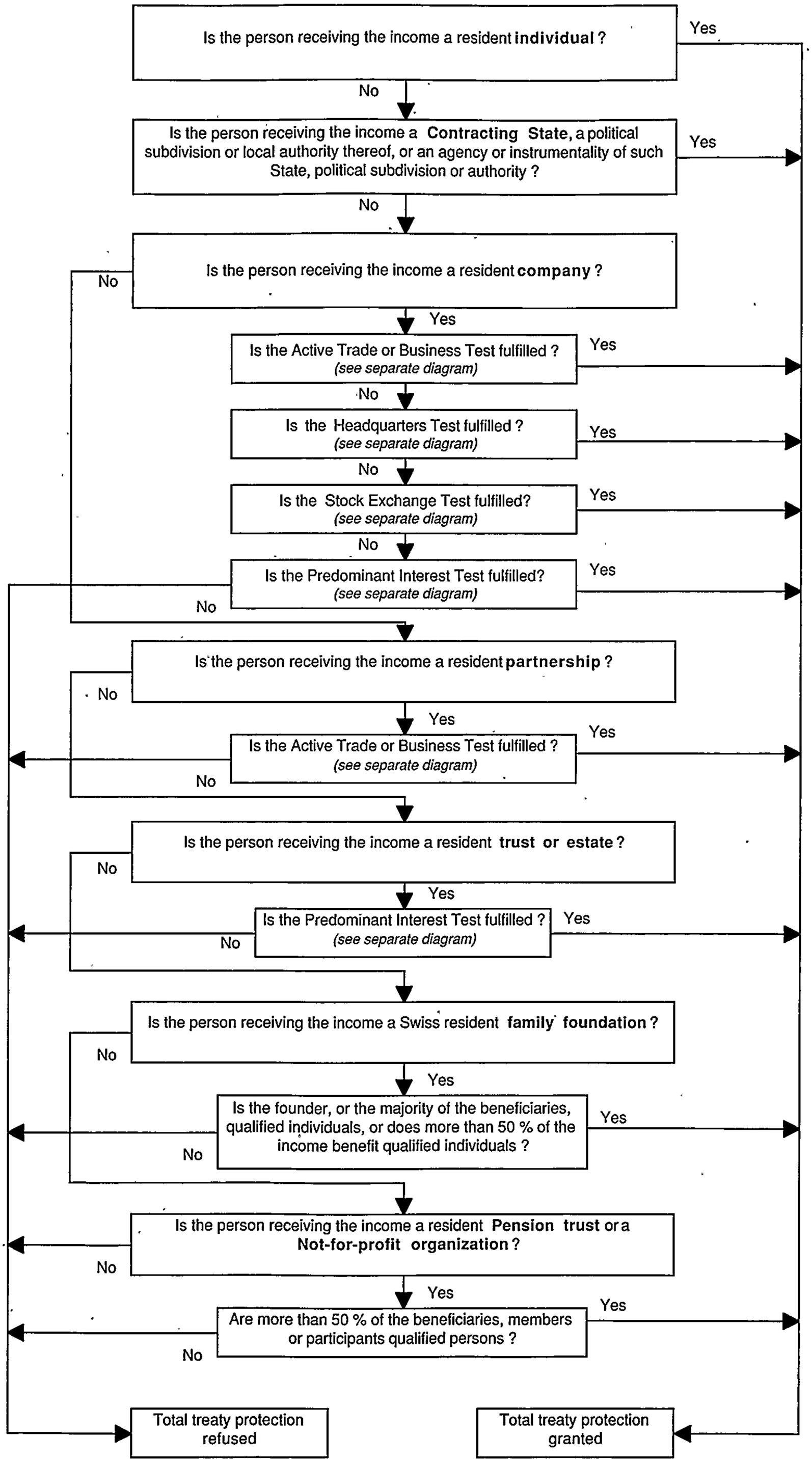
Appendix A

Total Treaty Benefits



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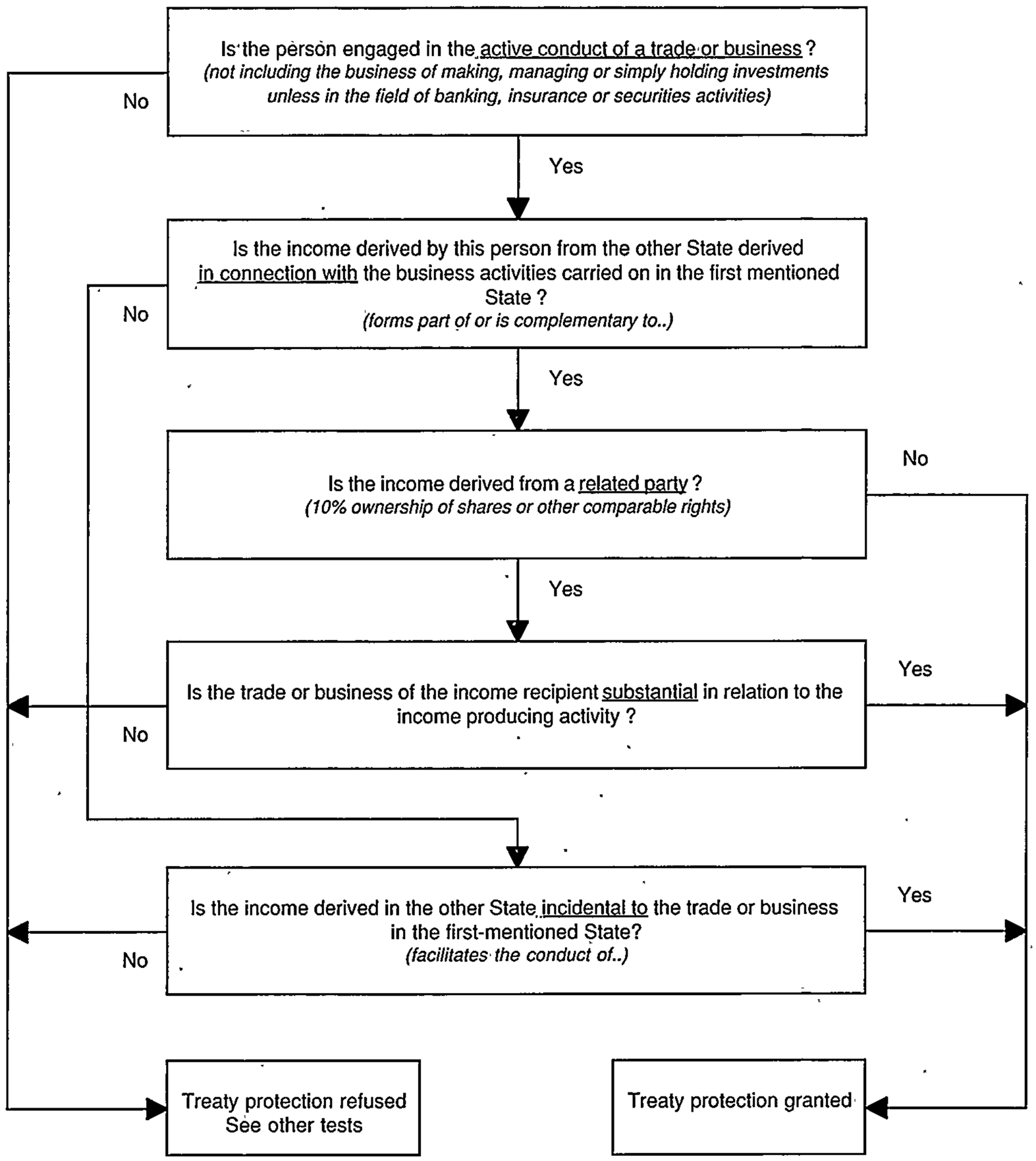
Appendix B

The Active Trade or Business Test



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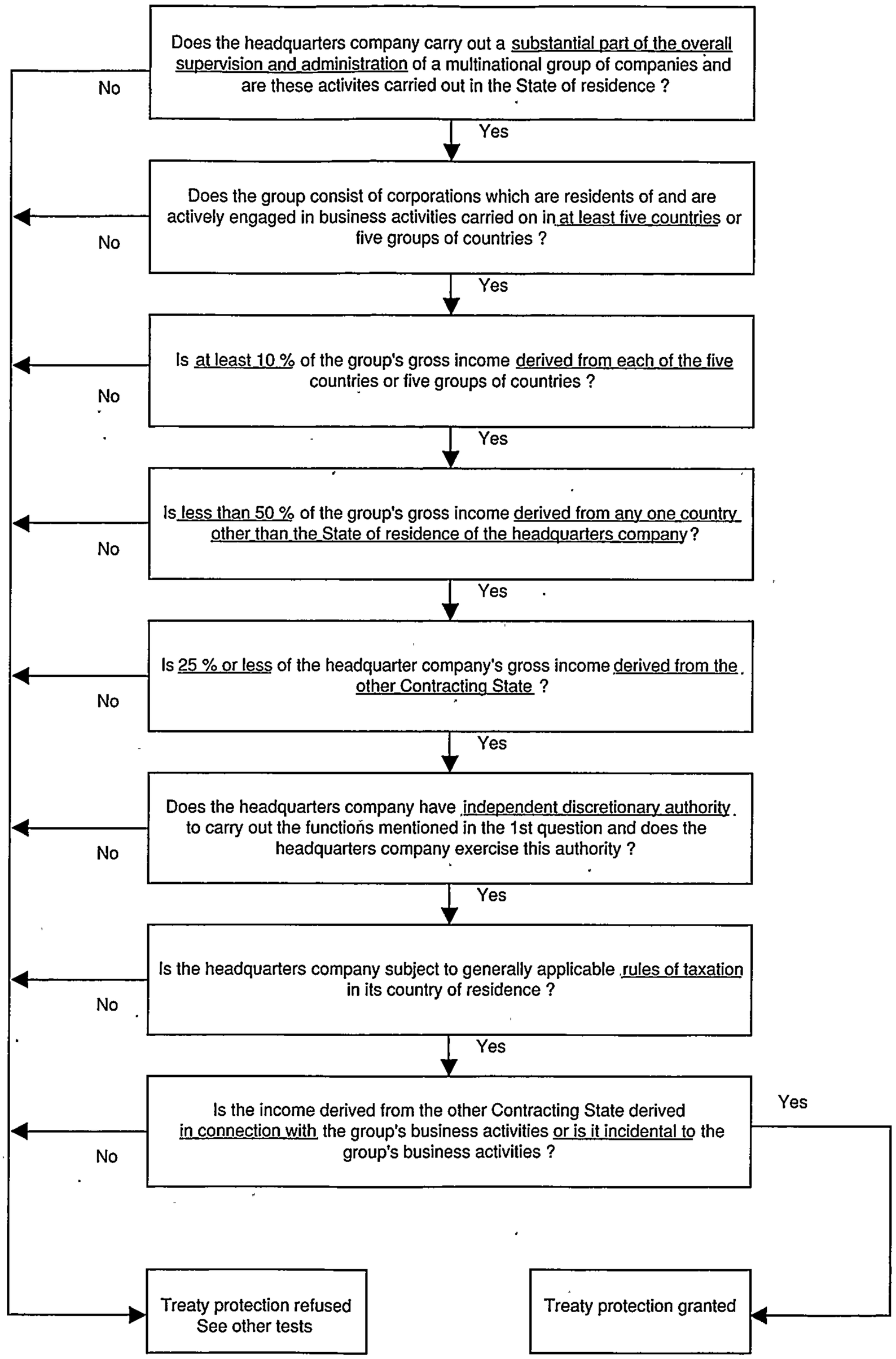
Appendix C

The Headquarters Test



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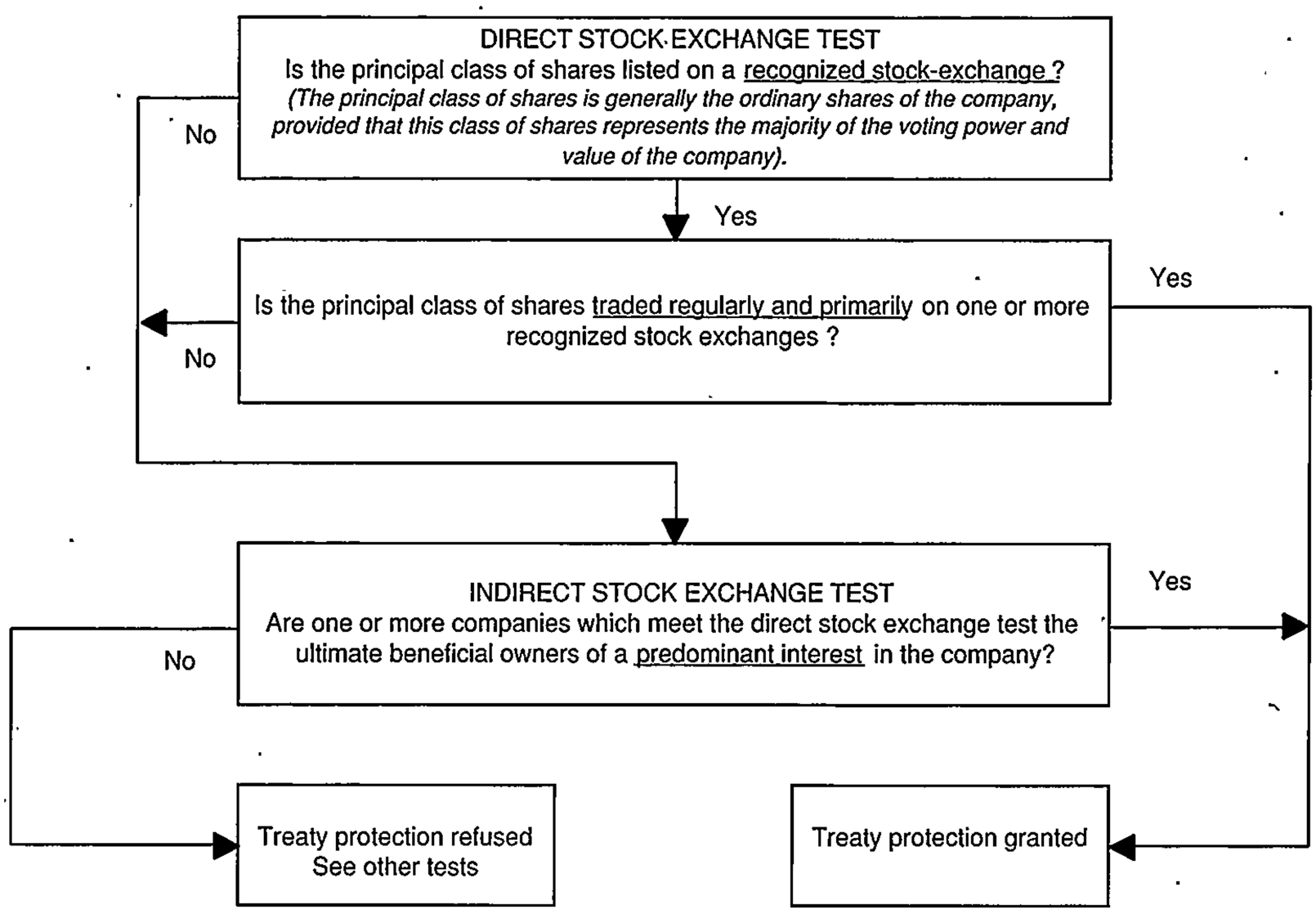
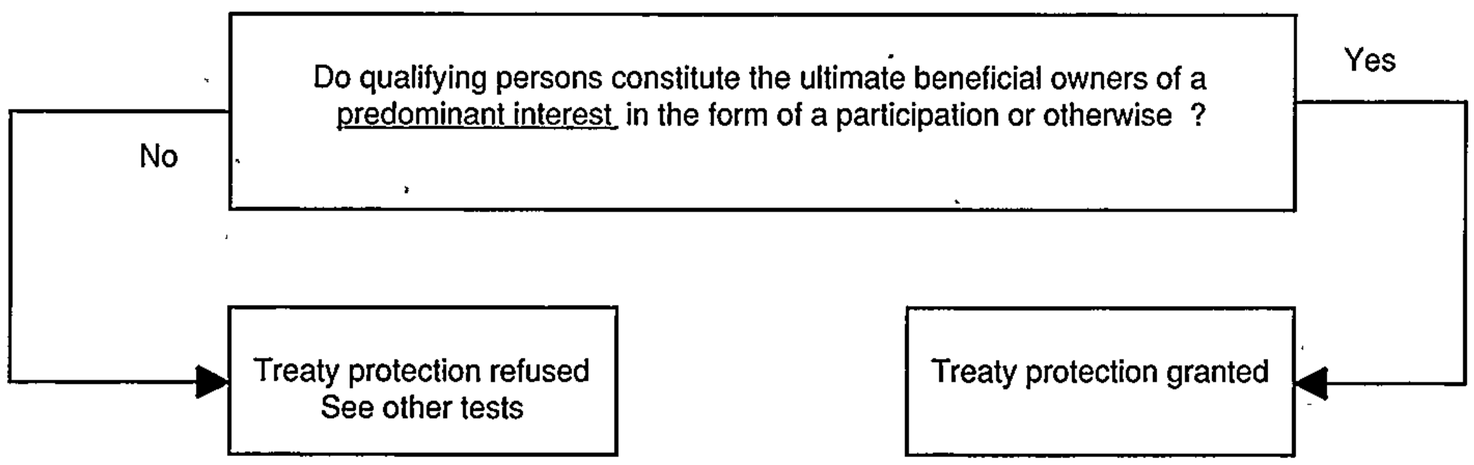
Appendix D

The Stock Exchange Test



Appendix E

The Predominant Interest Test



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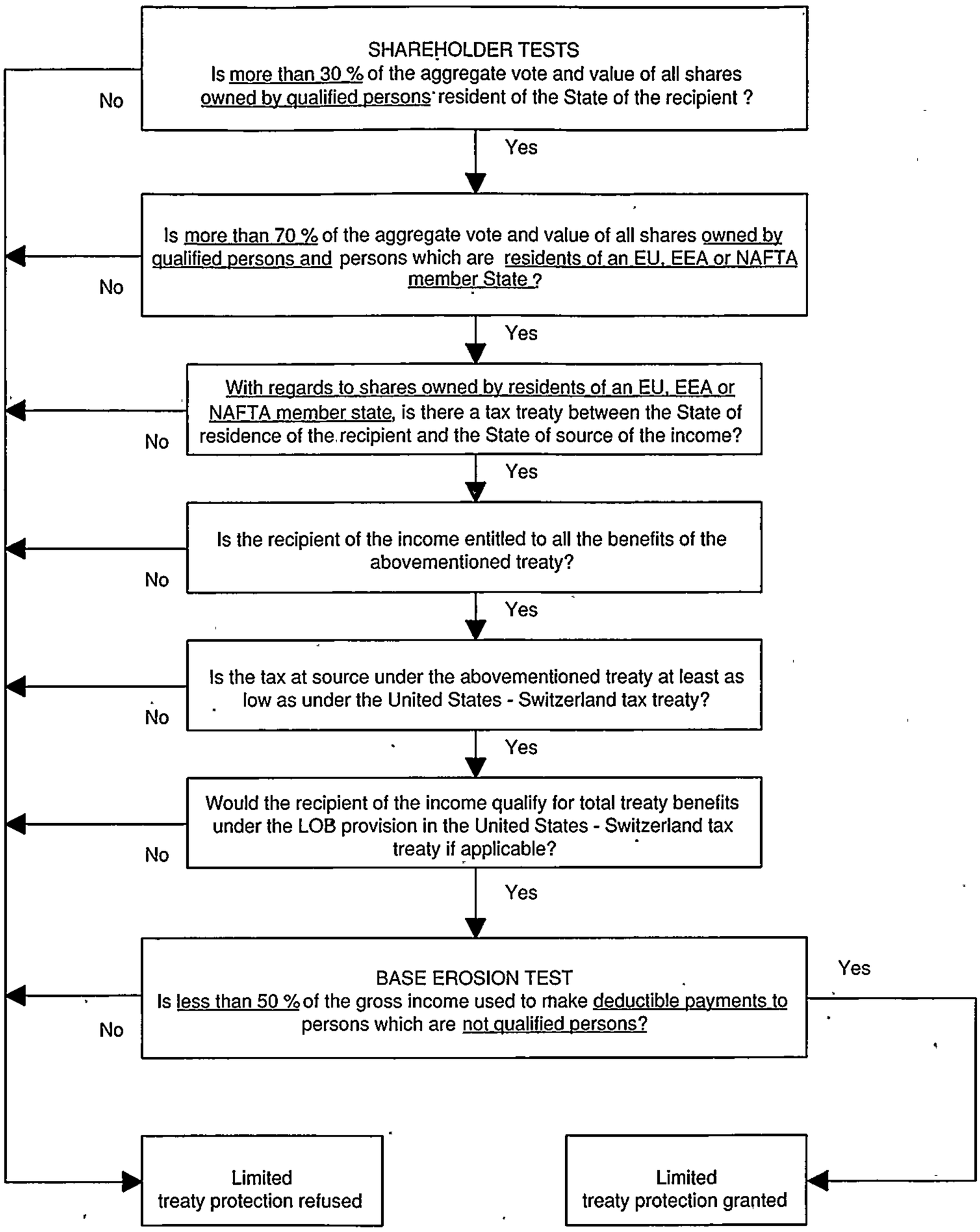
Appendix F

Limited Treaty Benefits



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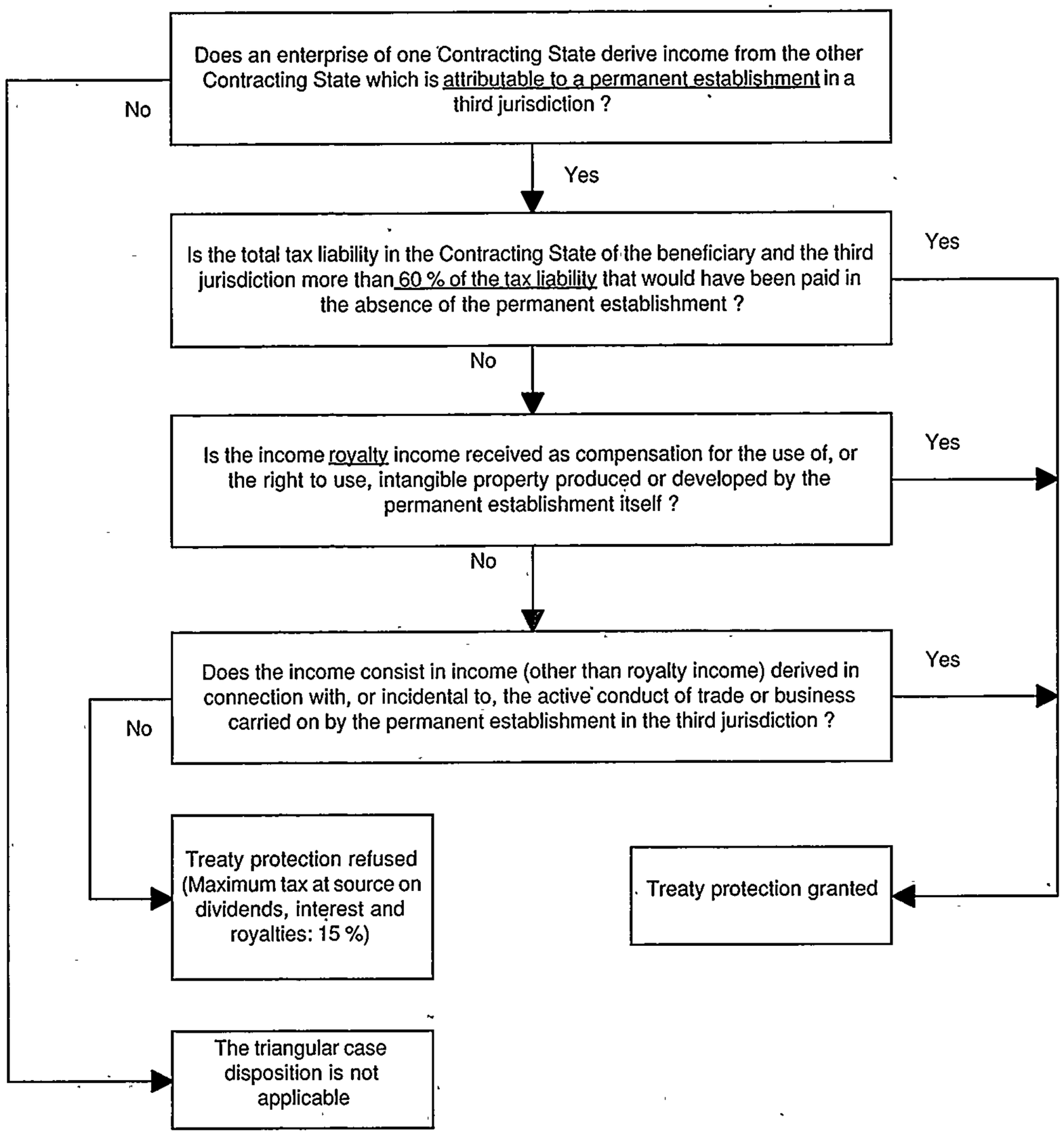
Appendix G

Triangular Cases



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BELGIUM

SAFE HARBOUR RULINGS FOR BELGIAN SERVICE CENTRES

Peter Verhaeghe and Caroline Docclo

Avocats; Akin, Gump, Strauss, Hauer & Feld, Brussels

I. INTRODUCTION

Although Belgium has a relatively high corporate income tax rate (39 per cent plus 3 per cent crisis contribution, i.e. 40.17 per cent), it has over the past 15 years successfully developed a number of tax incentives to compete with its neighbouring countries in the race to attract investment from multinational enterprises.

The principal examples of this Belgian tax policy[1] are the adoption of the Belgian coordination legislation[2] and the Belgian distribution centres tax circular.[3]

Coordination centres must apply to the Belgian Government for recognition. They can only be established by large multinational groups which meet certain criteria.[4] Banks, financial institutions and insurance companies are not allowed to set up a coordination centre. The activities of a coordination centre must remain limited to those specifically included in its recognition decree. However, the permissible activities cover a wide variety of intra-group financial services, headquarters-type coordination and back office support functions.

Coordination centres are subject to the regular corporate income tax at the normal rate. However, their taxable basis is not their actual income but a notional income. That notional income is determined as a percentage (usually 8 to 10 per cent) of the centre's operational costs other than payroll expenses and financial charges. The average taxable basis of operating coordination centres was 3.34 per cent and 2.19 per cent, respectively, of their fiscal year profit in 1990 and 1991. Coordination centres also benefit from certain other tax exemptions such as the exemption from withholding tax on interest and dividends paid by coordination centres to banks and other companies.

The main drawbacks of the coordination centre regime are the requirement to engage ten full-time employees within two years from the start of their activities and the fact that they can only be established by truly large international groups.

Coordination centres have been successfully set up by numerous multinational groups, a large majority of which are US controlled. Since 1983, more than 350 coordination centres have been recognized of which more than 250 are currently operational, mainly as group finance centres.

In 1989, the Belgian tax authorities issued a circular modelled after the Dutch regime applicable to *distribution centres*. Under the circular, Belgian distribution centres remain subject to the ordinary corporate income tax regime but the transfer prices applied between the distribution centre and other affiliated companies benefit from a safe harbour. The safe harbour implies that the tax authorities will not challenge the inter-company prices of the distribution centre provided the distribution centre's turnover is at least equal to 105 per cent of its operational expenses. Initially, the distribution centre regime applied only if the centre's activities were limited to the storage and handling of raw materials or inventories for the benefit of affiliated companies. In addition, the tax base for the calculation of the safe harbour was not clearly defined. In an effort to rectify these perceived flaws first an amended circular and then a new circular expanded the range of permissible activities and defined more accurately "operational expenses". This "clarification" has led to distribution centres being set up by several leading multinational groups.

More recently, a circular dated 26 July 1996 introduced a new *service centre regime* similar to the distribution centre regime. Essentially, it provides for a safe harbour with respect to transfer prices between the service centre and other affiliated companies. The range of permissible activities is similar to permissible coordination centre activities. The service centre regime may attract groups which either do not meet the requirements for establishing a recognized coordination centre or do not wish to establish a coordination centre because, for example, the ten-employee requirement or home-country legislation makes it unattractive to have a coordination centre. More importantly, however, the new service centre regime should interest multinational groups that are per se interested in a safe harbour with respect to the transfer pricing applied between their (regional) service support centre and affiliated companies.

Inspired by the Dutch ruling practice, the 1996 circular draws flexible guidelines for negotiations with the tax authorities on the conditions of operation of the service centre. It rests with the group to describe its business, goals and the expected

1. Other tax incentives have been granted to enterprises on the basis of their location (enterprises established in the so-called *employment zones*, *T-zones* or *reconversion zones*) or on the basis of their activities (*innovation companies* carrying out highly innovative technological processes).
2. Royal Decree No. 187 of 30 December 1982 relating to the creation of coordination centres, as amended, and implementing legislation.
3. Circular of 30 November 1996 relating to distribution centres
4. The group (companies under common control and linked by a 20 per cent shareholding) must have an annual consolidated turnover of BEF 10 billion and a consolidated equity of BEF 1 billion; in addition, the group must have four affiliated companies in four different countries, and realize a consolidated turnover of BEF 5 billion or 20 per cent of its worldwide turnover and have a consolidated equity of BEF 500 million or 20 centre of its worldwide equity outside the home country of the parent company.

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development in the levels of employment. Subsequent to negotiations with the group, the tax authorities can decide on the specific permissible activities of the service centre and on the minimum profit margin it is expected to realize. In other words, service centres are allowed to set their inter-company prices at such a level that the book profit equals the negotiated cost-plus. Obviously, the goal of any group will be to set as low a price as permitted, and consequently reduce their taxable profit down to the negotiated mark-up, since the ruling protects them from inter-company price adjustments.

Hereafter follows a more detailed description of the service centre regime.

II. TERMS AND CONDITIONS

A. Qualifying entities

A service centre can be established either as a Belgian company or as a separate Belgian branch of a foreign company. It must belong to a group.[5]

The group is defined by reference to the definition of affiliated companies in the annex to the Royal Decree of 8 October 1976[6] relating to the annual accounts of enterprises.[7] A company is affiliated to another when it controls the other company, it is controlled by the other company, or both companies are subject to a common control. For the purpose of this definition, control is the legal or actual power to exercise a significant influence on (i) the appointment of the majority of the company's directors or managers, or (ii) the management policy of the company. A company holding more than 50 per cent of the voting rights in a subsidiary is irrefutably presumed to control that subsidiary.

If one decides to establish a service centre as a branch, and the service centre only renders auxiliary and preparatory services for the benefit of the company of which it is part, it probably will not constitute a permanent establishment in Belgium under the applicable double tax treaty provision (Article 5, paragraph 4, of the OECD Model Tax Treaty). In such case, one must bear in mind that the service centre may be totally exempt from Belgian income tax and the application for a service centre ruling would not serve any purpose.

B. Permissible activities

The common feature of the permissible service centre activities is their administrative nature. A service centre is not allowed to carry out marketing or manufacturing activities. At first sight, permissible service centre activities are akin to coordination centre activities. However, the definition of service centre activities is more flexible, since service centres are allowed, to a certain extent, to have contacts in their own name with group members' customers. In addition, a service centre's permissible activities are negotiated with the tax authorities on a case-by-case basis. These activities must fall into one of the following four categories:[8]

1. Preparatory and auxiliary activities

The terms "preparatory and auxiliary activities" are defined by reference to Article 5, paragraphs 4(d)&(e) of the OECD Model Tax Treaty.

The service centre cannot carry out activities which constitute or are part of the group's core business. In addition, these activities must not, in principle, contribute any added value to the goods or services supplied by the group.

Permissible activities include, for example: maintaining a data bank of travel-miles for an airline group; management of internal (between group members) or external communication flows, exclusive of commercial contacts; central purchasing for the account of group members; and scientific research of a preparatory or auxiliary nature.

2. Information to customers

This category includes support services to a group's customers, such as computer help lines and information on goods and services supplied by group members.

3. Passive sales-related activities

A service centre cannot bear any business risk. It acts *in the name and on behalf* of the group members in the capacity of a passive agent. It cannot negotiate or accept orders from the customers but it can collect and confirm orders in the name of group members.

4. Active sales-related activities

A service centre may be allowed to act in its *own name but for the account* of their group members. The business risk that it bears must however remain minimal. In order to ensure that this requirement will be satisfied, the tax authorities require the applicant to submit the draft agreements under which the centre is expected to operate.

The terms and conditions of any servicing, or supplying of goods to customers must be directly negotiated between the customers and group members. A service centre cannot promote the goods or services supplied by group members. An example of an activity that would qualify under this heading is re-invoicing.

This fourth category of permissible activities distinguishes service centres from coordination centres since coordination centres are not allowed to contact non-group members in their own name.

C. Intra muros

A service centre's services are designed to be for the exclusive benefit of the members of its group. A service centre

5. It can only operate for the benefit of group members (see below).
6. Chapter III, Sec. 1, item IV. A.
7. Service centres may be the alternative solution for groups which intend to set up their regional headquarters in Belgium but which do not satisfy the multinational test for the purposes of coordination centre legislation (see above).
8. These categories appear to overlap each other somewhat.

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cannot supply information or assistance to customers of a non-group member.

The intra-muros requirement is not applicable to the supplies provided to the service centres. A service centre can freely buy the goods and services it needs to carry out its activities. In this context, it is worth noting that the intra muros rule does not preclude the service centre from acting as a central purchaser for the group since it buys for the benefit of group members.

D. Recognition

A service centre must be officially recognized as such before it can benefit from the special tax regime. Rulings stating the permissible activities and the applicable mark-up (see below) are obtained through negotiations with the tax authorities.

Requests must be filed with the Central Administration of Direct Taxes. Applicants must include all information regarding the seat, the nature of the purported activities, the nature and the extent of the risks borne by the service centre, and a copy of the agreements between the service centre and the group members.

Requests in French must be mailed to:

Administration centrale des contributions directes
Direction II/2
Tour des Finances
Boulevard du Jardin Botanique 50, bte 32
1010 Bruxelles

Requests in Dutch must be mailed to:

Hoofdbestuur der directe belastingen
Directie II/1
Financietoren
Kruidtuinlaan 50, bus 32
1010 Brussel

The request must be filed before the establishment of the service centre if the service centre is to qualify from commencement. Existing entities may also apply for the ruling regime. In such case, the request must be filed prior to the first fiscal year to which the ruling applies.

III. SCOPE OF THE SAFE HARBOUR RULING

A. Service centres are subject to the regular corporate income tax rules

The taxable basis of a service centre is determined according to the regular corporate income tax rules. It includes the service centre's retained earnings, disallowed expenses and dividend distributions, less tax exempt items and carried over losses. The regular tax rates apply (i.e. 40.17 per cent in most cases).

Service centres are also subject to regular transfer pricing rules. Any abnormal or gratuitous advantage granted by the service centre to another enterprise is added to its taxable income.

B. Safe harbour

The 1996 circular provides service centres with a safe harbour: the tax authorities will consider that a service centre has not granted any abnormal or gratuitous advantages to its group members provided that the service centre realizes a book turnover corresponding, at a minimum, to the notional amount calculated according to the circular and set forth in the ruling. Should a service centre's book turnover be, however, less than the notional minimum turnover, the difference will be deemed to be an abnormal and gratuitous advantage granted to its group members and will be added to its taxable basis.

C. Cost-plus and resale-minus ruling

The safe harbour must be negotiated with the tax authorities based upon the following principles:

1. Preparatory and auxiliary activities; customer information; passive sales-related activities: cost-plus

When a service centre's activities do not include any active intermediary role in the sales or services provided by group members, the compensation for its services must be at least equal to its operational costs relating to its activities increased with a certain mark-up.

The mark-up is agreed to by the tax authorities on a case-by-case basis, depending on the type and volume of the activities actually carried out. The circular provides a list of indicative mark-ups:

a. Preparatory and auxiliary activities: 5%
b. Customer information: 10%
c. Passive sales-related activities: 15%

Operational expenses include the costs booked to accounts 60 to 64 of the Belgian Minimum Standard Chart of Accounts (i.e. consumable goods, services and other goods, payroll expenses, depreciation, write-offs, provisions for liabilities and charges, other operating charges). They do not include the turnover of group companies flowing through the service centre, expenses whose deduction is not allowed for tax purposes, and taxable reserves.

The tax authorities may agree that payroll expenses and third party charges can be charged back with a zero mark-up. Personnel expenses include all costs related to personnel. Costs of services supplied by third parties to the service centre qualify if they could have been billed as such directly to group members and provided they are billed by the supplier with a normal profit margin.

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2. Active sales-related activities: resale minus

When a service centre acts in its own name and for the account of the group members, the minimum compensation is determined as the profit that a service centre should make on its total sales.

The turnover cannot be less than the aggregate costs booked to accounts 60 to 64 of the Belgian Minimum Standard Chart of Accounts (including personnel expenses), excluding disallowed expenses and items included in taxable reserves.

The profit margin is determined on a case-by-case basis and should not exceed 5 per cent.

Service centres carrying out different types of activities must allocate the costs to each activity before applying the proper computational method.

IV. DURATION OF THE SAFE HARBOUR RULING

Although not clearly stated in the 1996 circular, the regime applies as from the date of establishment of the service centre if the request has been filed prior thereto, or as from the beginning of the first fiscal year commencing after the filing of the request.

The regime applies for five years unless the service centre expands its activities beyond the tax authorities' recognition. The circular does not specify when the regime actually terminates if the end of the fifth year does not coincide with a fiscal year closing date.

V. CONCLUSION

The safe harbour regime for service centres is attractive in that it provides a multinational group the opportunity to obtain more certainty with respect to its transfer prices for certain service support functions that it wishes to centralize in a service support centre. The central location of Belgium in the EU, its well trained labour force and its excellent infrastructure make it an attractive site for an European service centre.

Conference diary

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

JANUARY 1997

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.

Transfer Pricing, Hyde Park Hotel, London, 5-6 February 1997 (English):

AIC Conferences Limited, 2nd Floor, 100 Hatton Garden London EC1N 8NX, Tel.: 44-171-242 2324, Fax: 44-171-242 2320.

MARCH 1997

Trusts and "Stiftungen", Amsterdam, 6-7 March 1997 (English):

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

APRIL 1997

International Tax Planning Techniques, Amsterdam, 10-11 April 1997 (English):

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

International Partnerships & Joint Ventures, Vienna, 18 April 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

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AUSTRALIA

HAVE THE GHOSTS OF SECTION 260 COME BACK TO HAUNT THE COMMISSIONER OF TAXATION?

Dr Julie Cassidy

LL B (Hons), Ph.D. Barrister and Solicitor. Associate professor of Law, Deakin University.

Latest developments

As this edition was going to print the High Court of Australia handed down its determination of the appeal from the Full Court of the Federal Court's decision in *Spotless v. FCT* (1995) 95 ATC 4775. The appeal was limited to, in essence, determining the correctness of Cooper J's conclusion (with which Northrop J concurred) that the taxpayer's dominant purpose was to obtain the maximum return on the money invested after the payment of all applicable costs, including tax, and not to obtain a "tax benefit". As noted in this article, this conclusion was reached even though the Court concluded that, but for the consequent tax benefit, the taxpayer would not have entered into the subject scheme.

The High Court, in a unanimous decision, upheld the Commissioner's appeal. The Court noted that Cooper J's references "on the one hand to a 'rational commercial decision' and on the other to the obtaining of a tax benefit as 'the dominant purpose of the taxpayers in making the investment' suggest the acceptance of a false dichotomy". While the High Court accepted that a "particular course of action may be ... both 'tax driven' and bear the character of a rational commercial decision", it stressed that the "presence of the latter characteristic does not determine the answer to the question whether ... a person entered into or carried out a 'scheme' for the 'dominant purpose' of enabling the taxpayer to obtain a 'tax benefit'." Rather, the crux lay in identifying what purpose dominated. In the subject case the High Court concluded that "the dominant purpose in the adoption of the particular scheme was the obtaining of a tax benefit ... [V]iewed objectively, it was the obtaining of the tax benefit which directed the taxpayers in taking steps they otherwise would not have taken by entering into the scheme".

I. INTRODUCTION

Tax avoidance has been a problem that governments have had to try to combat since the very introduction of taxes.[1] In the 13th century taxpayers tried to avoid property levies by placing their assets outside the sheriff's geographic area,[2] while in the 17th century taxpayers sought to avoid the Window Tax[3] by blocking up their windows until the tax collector had been and gone.[4] Tax avoidance is not, however, confined to the English taxation system. Across the globe, the Australian Taxation Office (ATO) has had to grapple with more sophisticated forms of tax avoidance and tax evasion than that involved in the above illustrations.

In the 1970s the magnitude of the problem increased to disastrous levels[5] with tax accountants and legal practitioners openly marketing and selling tax avoidance schemes.[6] While at this time the Income Tax Assessment Act 1936 (Cth) (ITAA) contained a general anti-avoidance provision, Section 260,[7] the Australian judiciary's interpretation of this provision rendered Section 260 largely ineffective.[8] As a result of the Australian High Court's excessively literal interpretation[9] of the provision and the development of judicial extrapolations further limiting its scope, even cases of blatant tax avoidance seemingly slipped through Section 260's reach.[10]

1. Cf. RH Woellner, TJ Vella and L Burns, *Australian Taxation Law*, 5th ed. (CCH Australia Ltd, Sydney, 1994) at 1-080. See also A Thompson, "Some Thoughts on Tax Avoidance" (1978) 128 *New Law Journal* at 629.
2. G Lehmann and C Coleman, *Taxation Law in Australia*, 3rd ed. (Butterworths, Sydney, 1994) at 1.8.
3. Under this tax the extent of a householder's wealth was measured by the number of windows in his/her house.
4. *Supra* note 1 at 1-080.
5. Dr Y Grbich estimated that at least AUD 10,000m was lost through tax avoidance during the 1970s: "Problems of Tax Avoidance in Australia" in JG Head (ed.) *Tax Issues of the 1980s* (Australian Tax Research Foundation, 1983) at 413.
6. Grbich, id. at 416 and 424-426; Woellner, *supra* note 1 at 1-090.
7. Hence it would be thought that the Australian courts would not need to follow the lead of their English brethren and develop judicial anti-avoidance principles such as the doctrine of fiscal nullity. See *Furniss v. Dawson* [1984] AC 474. The High Court has held the doctrine to be inapplicable to the Australian context: *John v. FCT* (1989) 89 ATC 4101 at 4110.
8. See further *FCT v. Peabody* (1993) 93 ATC 4104 at 4110; *John v. FCT* id. at 4108; *Davis v. FCT* (1989) 89 ATC 4377 at 4399; *Case W58* (1989) 89 ATC 524 at 533.
9. Under the lead of Barwick CJ. See, for example, *Mullens v. FCT* (1976) 135 CLR 290; *Patcorp Investments Ltd v. FCT* (1976) 140 CLR 247; *Slutzkin v. FCT* (1977) 140 CLR 319; *Cridland v. FCT* (1977) 140 CLR 330; *FCT v. Westraders Pty Ltd* (1980) 80 ATC 4357 esp. at 4358. Contrast Murphy J's approach in *FCT v. Westraders Pty Ltd* (1980) 80 ATC 4357 at 4369-4370.
10. Under the choice principle, discussed below, that the transaction was entered into deliberately to obtain a tax benefit did not prevent a taxpayer taking advantage of this "exempting" doctrine. See in particular *Cridland v. FCT* id. at 339 and 340.

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With a change in the public attitude towards tax avoidance in the early 1980s,[11] the government seized the opportunity[12] to enact a new general anti-avoidance measure, Part IVA. Part IVA of the ITAA was to be the Commissioner of Taxation's "white knight" in the fight against tax avoidance. The new provisions, applying to schemes entered into after 27 May 1981,[13] replaced Section 260 and purported to bury the doctrines that had rendered Section 260 almost useless.[14] Part IVA in fact went further, its broadly drafted provisions potentially providing the legislation with an unlimited scope, extending beyond even Parliament's[15] and the ATO's[16] intentions.

The Commissioner's "white knight" has not, however, met its expectations. Despite the Commissioner "saving" Part IVA for over a decade for what was believed by the ATO to be an obvious case of tax avoidance, the application of Part IVA to that long awaited case, (i.e. *Peabody*,[17]) has brought the Commissioner nothing but grief. While there is still a dearth of judicial[18] discussion of Part IVA, the few cases that have considered its provisions have all severely limited its scope.[19] The Commissioner was dealt yet another blow in the recent decisions in *Spotless Services Ltd v. FCT*[20] (*Spotless No. 1*) and *FCT v. Spotless Services Ltd*[21] (*Spotless No. 2*). These decisions not only highlight the current uncertainty underlying elements of Part IVA, but suggest that the problems inherent in Section 260 have resurfaced in the context of the new legislation. In the latter of the two decisions Cooper J, with whom Northrop J agreed, took many steps towards resurrecting the "choice principle" and the "antecedent situation test" which, it will be seen, played a major part in the "downfall" of Section 260.

This article considers the Courts' comments on the application of Part IVA in *Spotless*[22] and suggests that while some of the limitations imposed by the Courts appropriately ensure that, at least legally,[23] Part IVA cannot be used by the Commissioner to interfere with legitimate commercial decision making, other aspects of the decisions indicate that the ghosts of Section 260 have come back to haunt the Commissioner. While Part IVA was introduced to overcome such judicial inventions, the choice principle and the antecedent situation test may continue to play a major part in the operation of Part IVA.

Before considering the facts in *Spotless*,[24] a brief outline of Section 260 and Part IVA is detailed below.

II. SECTION 260

A. Elements of Section 260

For Section 260 to apply there must be:
- a contract, agreement or arrangement;[25]
- made or entered into;[26]
- orally or in writing;
- purporting to have the purpose or effect[27] of;
- directly or indirectly,
  - altering the incidence of tax;
  - relieving a person from paying tax;
  - defeating, evading or avoiding any duty or liability under the Act; or
  - preventing the operation of this Act.[28]

The illegitimate purpose of, in essence, tax avoidance need not be the sole, or even principal, purpose underlying the arrangement.[29] It is sufficient that this purpose is "not inessential or merely incidental".[30]

11. Previously, the Australian public had a "Robin Hood" mentality about tax avoidance, viewing it as an acceptable and almost "praiseworthy" way of taking from the government. Subsequent studies revealed, however, that such tax avoidance was undertaken by the wealthy with the result that the tax burden was being borne by PAYE (pay as you earn) taxpayers. See for example the Royal Commission on the Activities of the Federated Ship Painters and Dockers Union (Costigan Royal Commission), *Final Report*, Vol 1 at 100-102.
12. Spurred also by the significant revenue losses arising from tax avoidance: Grbich, *supra* note 5 at 413.
13. See Sec. 177D.
14. See further *FCT v. Peabody supra* note 8 at 4110; *John v. FCT supra* note 7 at 4108; *Davis v. FCT supra* note 8 at 4399 and *Case W58 supra* note 8 at 533.
15. While in his Second Reading Speech introducing the legislation the then Treasurer, Mr Howard, stressed that Part IVA does not apply to ordinary family or commercial arrangements, but rather was designed to catch schemes of a "blatant, artificial or contrived kind", potentially Part IVA extended beyond cases of blatant tax avoidance. See Hansard, House of Representatives, 27 May 1981 at 2683-2684.
16. While in his speech entitled "Part IVA: Ordinary Business or Family Dealings" Mr Boucher, the then Commissioner of Taxation, stated that if family or commercial reasons underlay the scheme this would serve to exclude Part IVA from an arrangement, even though the application of what is known as the "subscheme" approach would have allowed Part IVA to apply to many such cases. The speech is detailed in the Supplement to *Taxation in Australia*, August 1981. See also Second Commissioner Nolan's paper "The interpretation of Part IVA" given at the Taxation Institute of Australia's Intensive Seminar on Part IVA, Adelaide, 15 June 1990. Cf. also *IT Ruling 2330*.
17. *Peabody v. FCT* (1992) 92 ATC 4585 (Federal Court); *Peabody v. FCT supra* note 8 (Full Court of the Federal Court) and *FCT v. Peabody* (1994) 94 ATC 4663 (High Court).
18. There have been some relevant decisions by the Administrative Appeals Tribunal, most notably, *Case W58 supra* note 8.
19. See also *Osborne v. FCT* (1995) 95 ATC 4323.
20. (1993) 93 ATC 4397 (Lockhart J).
21. (1995) 95 ATC 4775 (Full Court of the Federal Court).
22. *Spotless No. 1 supra* note 20 and *Spotless No. 2* id.
23. The inability of many taxpayers to challenge unfavourable assessments will undoubtedly ensure that in practice, some ATO representatives will continue to purport to apply Part IVA to arrangements that clearly do not fall within its parameters.
24. *Spotless No. 1*, *supra* note 20 and *Spotless No. 2*, *supra* note 21.
25. The inclusion of the word "arrangement" gives the section an added scope beyond formal agreements: *Newton v. FCT* (1958) 96 CLR 578 at 630; *Jaques v. FCT* (1924) 34 CLR 328. Any concerted action designed to produce a particular result will suffice to satisfy this element of Sec. 260.
26. By the taxpayer or his/her agents such as the taxpayer's accountant/lawyer: *FCT v. Gregrhon Investments Pty Ltd* (1987) 87 ATC 4988.
27. The phrase "purpose or effect" has been read conjunctively; requiring the arrangement to have, not only the effect of altering the incidence of tax, but also to have been intended to have such a result: *Bayly v. FCT* (1977) 77 ATC 4045; *Newton v. FCT supra* note 25 at 8.
28. In determining whether an arrangement falls within the terms of Sec. 260, the Australian courts have used the "predication test", espoused by Lord Denning in *Newton v. FCT* id. at 8: "In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it is implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealings, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section."
29. *Davis v. FCT supra* note 8 per Hill J.
30. *Hollyock v. FCT* (1971) 125 CLR 647 at 657; *FCT v. Gulland*; *Watson v. FCT*; *Pincus v. FCT* (1985) 160 CLR 55 at 67 and 105; *Davis v. FCT* id.; *Bunting v. FCT* (1989) 89 ATC 5245; *Case Y31* (1991) 91 ATC 312 at 317.

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If Section 260 is applicable, the arrangement will be absolutely void for taxation purposes. Section 260 has the effect of annihilating the whole arrangement. There is no provision for reconstruction.[31] The arrangement is, however, nullified only for the purposes of taxation.

B. Choice principle

With respect to the above mentioned judicial extrapolations that severely constrained the operation of Section 260, perhaps the two most limiting doctrines developed by the courts,[32] under the lead of Barwick CJ, were the choice principle[33] and the antecedent transaction/situation test.[34]

Under the choice principle, Section 260 could not apply if the taxpayer had merely taken advantage of a choice provided for under the Act. Under the broad formulation of this rule,[35] the taxpayer could take advantage of any provision of the Act that may enable a person to lower his tax liability. Under the broad formulation:[36]

> "[the choice principle] is not confined to cases in which the Act offers two alternative bases of taxation; it proceeds on the footing that the taxpayer is entitled to create a situation by entry into a transaction which will attract tax consequences for which the Act makes provision and that the validity of the transaction is not affected by Section 260 merely because the tax consequences which it attracts are advantageous to the taxpayer and he enters into the transaction deliberately with a view to gaining that advantage."

Thus in the leading decision *FCT v. Cridland*[37] the taxpayer, an engineering student, was held to be able to take advantage of income-averaging provisions[38] extended to primary producers by investing in a unit trust that was carrying on the business of primary production.[39] The Court held Section 260 did not apply even though the transactions "were explicable only by reference to a desire to attract the averaging provisions of the statute and the taxation advantage which they conferred".[40]

In what are known as the "Doctor cases",[41] however, Gibbs CJ and Wilson J gave the choice principle a very narrow interpretation. They held the choice principle did not allow a taxpayer to elect to have his personal exertion income taxed through a family trust rather than through, in that case, an ordinary medical practice. The choice principle, they said, was only applicable where the Act provides the taxpayer with specific choices between one or more options.[42] Hence, under the narrow view, it is necessary for the Act to give the taxpayer a specific choice between two approaches before the choice principle will be applicable. It is not sufficient that the Act, for example, recognizes entities, such as companies and trusts, for the taxpayer to legitimate his/her use of these entities under the choice principle.

From this brief discussion it will be apparent that the broad formulation of the choice principle annihilated Section 260. As long as the tax benefit derived from the arrangement stemmed from a provision of the Act, the taxpayer could plead that he/she was merely making use of a choice provided by the Act and hence Section 260 could not apply. Even if tax considerations provided the dominant reason for entering into the arrangement, Section 260 was inapplicable. On the other hand the narrow formulation of the choice principle significantly diminished the impact of the principle. However, whether the narrow interpretation *or* the broad one espoused in *FCT v. Cridland*[43] is correct remains unclear given Deane J's dissent in the "Doctor cases"[44] on the basis that the broad choice principle validated the arrangement.[45]

C. Antecedent transaction/situation test

A wealth of authority[46] provides that Section 260 cannot apply in the absence of an antecedent transaction or situation where the taxpayer previously derived the subject income. Thus in *Europa Oil (NZ) Ltd v. IRC*[47] the Privy Council declared:

> "The section does not strike at new sources of income or restrict the right of the taxpayer to arrange his affairs in relation to income from a new source in such a way as to attract the least possible liability to tax."

31. *Newton v. FCT supra* note 25 at 10; *Casuarina Pty Ltd v. FCT* (1970) 70 ATC 4069 at 4077 – 4078; *Bayly v. FCT supra* note 27 at 4056 – 4057; *Jones v. FCT* (1977) 77 ATC 4058 at 4064 – 4065; *FCT v. Kareena Hospital Pty Ltd* (1979) 79 ATC 4667 at 4671 and 4673.
32. The purely annihilatory force of Sec. 260 has also proven to be a significant limitation. As there is no power of reconstruction, it is possible that if Sec. 260 were to strike down an arrangement the ATO could be faced with a problem, there being no structure left to derive the income: see *FCT v. Phillips* (1978) 78 ATC 4361 at 4380-81; *Bayly v. FCT* id.; *FCT v. Kareena Hospital Pty Ltd* id.; *FCT v. Casuarina* id. at 4077-8. See also *IT Ruling 2330* point 7(9) which provides that there must be a surviving arrangement with respect to which the general law of income tax can operate.
33. *Mullens v. FCT supra* note 9; *Patcorp Investments Ltd v. FCT supra* note 9; *Slutzkin v. FCT supra* note 9; *Cridland v. FCT supra* note 9; *FCT v. Gulland*; *Watson v. FCT*; *Pincus v. FCT supra* note 30; *Tupicoff v. FCT* (1984) 84 ATC 4851.
34. See *Europa Oil (NZ) Ltd v. IRC* [1976] 1 WLR 464 at 475; *FCT v. Kareena Hospital Pty Ltd supra* note 31 at 4686; *FCT v. Gulland* id. at 73 and 111; *Case T4* (1986) 86 ATC 123 at 129, 130, 134 and 135; *FCT v. Bunting supra* note 30 at 4363; *Rippon v. FCT* (1992) 92 ATC 4186 at 4191-4192; on appeal, (1992) 24 ATR 119. The antecedent transaction test was recently reaffirmed in *Osborne v. FCT supra* note 19 at 4329.
35. See *Mullens v. FCT supra* note 9; *Patcorp Investments Ltd v. FCT supra* note 9; Slutzkin v. FCT *supra* note 9; *Cridland v. FCT supra* note 9.
36. *Cridland v. FCT* id. at 338-339.
37. Id.
38. Contained in Div. 16 of Part III of the ITAA.
39. Sec. 157(3) provided that where a trustee of a trust estate carried on a business of primary production, a beneficiary presently entitled to income under that trust was deemed also to be carrying on a business of primary production.
40. *Cridland v. FCT supra* note 9 at 340.
41. *FCT v. Gulland*; *Watson v. FCT*; *Pincus v. FCT supra* note 30.
42. See also Fisher J in *Tupicoff v. FCT supra* note 33. Note, however, that Deane J dissented in *FCT v. Gulland*; *Watson v. FCT*; *Pincus v. FCT* id., asserting that the choice principle validated the subject arrangement.
43. *Supra* note 9.
44. *FCT v. Gulland*; *Watson v. FCT*; *Pincus v. FCT supra* note 30.
45. While the failure of Dawson and Brennan JJ to indicate which of the competing views they preferred also leaves the matter uncertain. Given that they held Sec. 260 to be applicable to the subject facts they must have either rejected the choice principle entirely or adopted the narrow formulation.
46. Including *Europa Oil (NZ) Ltd v. IRC supra* note 34 at 475; *FCT v. Kareena Hospital Pty Ltd supra* note 31 at 4686; *FCT v. Gulland*; *Watson v. FCT*; *Pincus v. FCT supra* note 30 at 73 and 111; *Case T4 supra* note 34 at 129, 130, 134 and 135; *FCT v. Bunting supra* note 30 at 4363; *Rippon v. FCT supra* note 34 at 4191-4192; *Osborne v. FCT supra* note 19.
47. Id. at 475.

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In *Rippon v. FCT*[48] Heerey J held the use of the subject corporate trustee to conduct an engineering consultancy business was a new enterprise and therefore fell outside Section 260. Despite the taxpayer being previously employed as an engineer, Heerey J believed the injection of capital and the use of other persons' efforts made the subject consultancy a new enterprise. In the course of so concluding he stressed that the need for an antecedent situation is "firmly entrenched in the jurisprudence of Section 260".[49]

More recently, in *Osborne v. FCT*[50] Olney J held that Section 260 did not apply to the subject arrangement, the conduct of a valuation business through a corporate trustee, as the taxpayer had never previously derived the valuation business' income in a personal capacity.[51] The relevant test according to his Honour was whether the arrangement "alters the incidence of income tax in a case in which the taxpayer is in receipt of income".[52] Here, as the valuation income was a new income stream, there had been no diversion of income from the taxpayer to the corporate trustee.[53] "The 'arrangement' changed nothing so far as the applicant's liability for tax was concerned."[54]

The jurisprudence on the operation of this aspect of Section 260 has developed a distinction between what is known as the antecedent transaction test and the antecedent situation test. The antecedent transaction test requires an excessive degree of exactness between the previous scenario and the arrangement under scrutiny. It requires that the entity deriving the income under the new arrangement derive the same income from the same source(s).Under the antecedent situation test, however, there does not have to be an exact correspondence between the pre-existing source of income and the subsequent income stream. This test would be satisfied if the same type of income is derived, even though such income stems from, for example, contracts with a different pool of clients. It is this more flexible approach which has been accepted by the Australian courts as the appropriate test.[55] While the antecedent situation test does not require the exactness of the antecedent transaction test, it still significantly limits the operation of Section 260. Where the subject arrangement involves a new income stream Section 260 cannot apply even if tax considerations were the dominant consideration underlying the arrangement.

III. PART IVA

A. Elements of Part IVA

For Part IVA to apply there must be:

- a "scheme" as defined in Sections 177A(1) and (3);
- which provides the "relevant taxpayer";
- with a "tax benefit" as defined in Section 177C; and
- the person must enter into the scheme for the "sole or dominant purpose" of enabling the relevant taxpayer to obtain a tax benefit (Sections 177D and 177A(5)).

If these elements are satisfied the Commissioner may cancel any tax benefit stemming from the arrangement (Section 177F).

B. Scheme

For Part IVA to apply there must be a scheme. "Scheme" is defined in exceptionally broad terms in Section 177A(1):

> "(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable by legal proceedings and;
> (b) any scheme, plan, proposal, action, course of action or course of conduct."

This definition is extended by Section 177A(3) to include unilateral schemes. Given the breadth of the definition in Section 177A, in most cases the existence of a "scheme" will be readily satisfied.

Identifying the scheme is important as, *inter alia*, for Part IVA to apply the person must enter into the scheme for the dominant purpose of obtaining a tax benefit for the relevant taxpayer (Section 177D). This purpose must be the dominant reason underlying the scheme as a whole, not just a part of the scheme,[56] known as a sub-scheme.[57]

C. Relevant taxpayer

The "relevant taxpayer" is the person who obtains the tax benefit, if any, stemming from the scheme (Section 177D). Section 177D makes it clear that the relevant taxpayer need not be "the person, or one of the persons, who entered into or carried out the scheme ... enabling the relevant taxpayer ... to obtain a tax benefit ...". Thus the relevant taxpayer may merely be a passive recipient of any tax benefit.

48. *Supra* note 34 at 4192.
49. Id. at 4191.
50. *Supra* note 19.
51. Id. at 4330.
52. Id. at 4329, quoting Gibbs J in *FCT v. Gulland*; *Watson v. FCT*; *Pincus v. FCT supra* note 30 at 73.
53. Id. at 4330.
54. Id.
55. *FCT v. Gulland*; *Watson v. FCT*; *Pincus v. FCT supra* note 30 at 73 and 111; *FCT v. Bunting supra* note 30 at 4363; *Osborne v. FCT* id. at 4329-4330.
56. *Peabody v. FCT supra* note 8 at 4111; *FCT v. Peabody supra* note 17 at 4670.
57. Some commentators originally believed that Part IVA might be applied to a sub-scheme: RI Rosenblum "Part IVA of the Income Tax Assessment Act", presented at the First National Taxation Institute Retreat, Port Douglas, 15-18 July 1993 at 9-10; RI Rosenblum "Anti-avoidance: Part IVA of the ITAA" (1994) 29(1) *Taxation in Australia* 24 at 42-43; T Murphy, "Part IVA: Back to the Beginning" (1993) 2 *Taxation in Australia* 75 at 77 and 78. The author suggested to the contrary that Part IVA could only apply to the scheme as a whole. See further J Cassidy, "Case W58: The Death Knell for Family Companies and Trusts?" (1992) 26 *Taxation in Australia* at 479; J Cassidy, "Observations on the Application of Part IVA: Peabody v. FCT" (1993) 21 *ABLR* 424 at 430-431.

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D. Tax benefit

As noted above, before a scheme may be held to be subject to Part IVA it must provide the relevant taxpayer with a "tax benefit".[58] Subsection 177C(1) defines "tax benefit" in terms of either:

- the non-inclusion in the taxpayer's assessable income of an amount that would or might reasonably be expected to be included in the taxpayer's income; or
- the allowance of a deduction which would or might not have been allowable, but for the scheme.

To date, the most controversial aspect of Section 177C(1) has been the interpretation of the phrase an amount that "would have been included, or might reasonably be expected to have been included" in the taxpayer's assessable income (Section 177C(1)(a)). More specifically, the major question has been the degree of probability by which it must be established that the taxpayer would have earned the income, but for the scheme.

Section 177C also has an exclusionary limb that provides that a tax benefit attributable to a declaration, election or option expressly provided for by the Act is excluded from the definition of tax benefit (Section 177C(2)). Subsection 177C(3) deems a tax benefit to be attributable to such a declaration, election or option where the income would not have been included, or the deduction not allowed, if the declaration, election or option had not been "made, given or exercised". Prior to *Spotless*[59] there had been no judicial[60] comment on the meaning of this exclusionary limb.

The use of imperative language in Section 177C[61] suggests this definition is exhaustive.

E. Dominant purpose

Finally, Part IVA only applies where, having regard to the eight factors listed in Section 177D(b),[62] it would be concluded that a person entered into or carried out the scheme for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit (Section 177D).

IV. FACTS

The successful public float of Spotless Services Ltd left the taxpayer companies, Spotless Services Ltd and Spotless Finance Pty Ltd, with a surplus of funds. They sought to invest this AUD 40m in a suitable short term investment vehicle. An investment adviser provided them with the details concerning investing with a bank in the Cook Islands, European Pacific Banking Co Ltd ("EPBCL"). This documentation detailed that a series of transactions were to occur if the investor wished to invest with EPBCL. These steps, in effect, ensured the source of the interest would be in the Cook Islands. By telex the taxpayers received an offer from EPBCL for the investment of their funds in the manner outlined in this documentation. The taxpayer companies accepted the offer and invested the AUD 40m. They sent one of their officers to the Cook Islands as attorney with authority to draw and deliver a cheque for the amount to EPBCL, receive the certificate of deposit and, on maturity, surrender the certificate in return for the principal and interest (AUD 2.96m), less withholding tax.

The taxpayer companies claimed in their taxation returns that the interest was exempt from Australian tax under the former Section 23(q) ITAA, which exempted foreign source income that was taxed in the source country. The Commissioner issued assessments on the basis that (i) the interest was Australian sourced or (ii) Part IVA applied and rendered the interest assessable. The taxpayers objected and appealed from the Commissioner's refusal to allow their objections to the Federal Court.

V. ISSUES

In relation to the above mentioned elements of Part IVA, the dispute in *Spotless* raised, *inter alia*, five important issues:

(i) the meaning of "scheme";
(ii) is the Court bound by the scheme as identified by the Commissioner;
(iii) the meaning of "tax benefit";
(iv) does Part IVA include the choice principle; and
(v) how is the dominant purpose determined under Section 177D(b).

Each of these issues are considered in turn in light of counsels' submissions, the Courts' approaches to these submissions and a critical evaluation of the Courts' findings.

VI. MEANING OF SCHEME

A. First instance

While Lockhart J believed the definition of "scheme" contained in Section 177A was "cast in very wide terms",[63] he held that the Commissioner's formulation of the scheme was

58. Sec. 177D.
59. *Spotless No. 1 supra* note 20; *Spotless No. 2 supra* note 21.
60. It was suggested in *Case W58 supra* note 8 that this exclusionary limb embodied the narrow interpretation of the above mentioned choice principle.
61. I.e. " ... a reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme *shall* be read as a reference to ...".
62. The eight factors to which reference is to be made are:
(i) the manner in which the scheme was entered into or carried out;
(ii) the form and substance of the scheme;
(iii) the time when the scheme was entered into and the length of the period during which the scheme was carried out;
(iv) the result achieved but for Part IVA;
(v) any change in the financial position of the taxpayer as a result of the scheme;
(vi) any change in the financial position of any person who has a connection (whether family or business) with the taxpayer as a result of the scheme;
(vii) any other consequences for the relevant taxpayer or any other person referred to in sub-paragraph (vi);
(viii) the nature of any connection (whether family, business or other) between the taxpayer and a person referred to in subparagraph (vi).
63. *Supra* note 20 at 4412.

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too narrow. The Commissioner had confined the scheme to the officer travelling to the Cook Islands with the relevant authority to effect the transactions.[64] This formulation, Lockhart J said, wrongly ignored other aspects of the arrangement.[65] While not detailing how the scheme is identified under Section 177A, Lockhart J suggested that in this case the relevant scheme was "the offer and the acceptance together with the intervening acts and probably the steps commencing with the receipt by the taxpayers of the information memorandum and other documents" prior to the making of the offer.[66] The Commissioner could not select out of these facts one part or step in the broader arrangement and classify that as the scheme.[67] Consequently, the scheme as formulated by the Commissioner did not satisfy the definition of scheme for Part IVA purposes.

B. Full Court of the Federal Court

On appeal, a majority[68] of the Full Court of the Federal Court rejected the Commissioner's original formulation of the scheme and two new formulations pleaded on appeal.

Cooper J, with whom Northrop J concurred, agreed with Lockhart J that the Commissioner's original formulation of the scheme did not satisfy this definition of scheme. Applying the test espoused by the High Court in *FCT v. Peabody*,[69] Cooper J held that this scheme is "not capable of standing on its own and having practical meaning ... if it is severed from the antecedent conduct, including the offer, or from the subsequent conduct in concluding the loan agreement in the Cook Islands" and hence did not satisfy the definition of "scheme".[70] To this end he believed that the definition in Section 177A "requires that the parties to the scheme, in so far as they are known, must be identified and the terms or content of any agreement, arrangement, understanding, promise or undertaking and the steps or stages of any course of action or proposal in so far as they are relevant, be identified".[71]

Cooper J also stressed that the scheme must be identified by the Commissioner on the basis of existing "fact and reality", not the Commissioner's speculation as to "a hoped for fiscal outcome" or the "Commissioner's view of the facts and their legal effect".[72] Cooper J believed both of the Commissioner's new formulations[73] did not satisfy these prerequisites. They were based on an assumption that the funds that were invested with EPBC or EPBCL would have in the ordinary course been invested in Australia but, as part of the scheme, it was agreed between the parties that the transaction was to take place in the Cook Islands to attract Section 23(q).[74] This wrongly represented that the taxpayers had a choice whether to invest with EPBCL in Australia or the Cook Islands.[75] To the contrary, Lockhart J had found that if the taxpayers wished to invest with EPBCL that company required that the transaction occur at its place of business, the Cook Islands.[76] Moreover, Lockhart J found that there was no agreement between the taxpayers and EPBCL in Australia,[77] much less one to ensure that the transaction was situate in the Cook Islands.

Further, the Commissioner's statement that the location of the lending arrangement was not "the location in which it would be made on the basis of usual commercial considerations"[78] was mere speculation and hence should not be used in the context of Section 177A.[79] The Commissioner's statement that the transaction was only "ostensibly ... entered into on a commercial basis"[80] also indicated that the Commissioner's new formulations were based on an opinion, namely that the arrangement was a sham.[81]

Cooper J agreed with Lockhart J that one way of formulating the facts to constitute a scheme within Section 177A was the "offer and the acceptance together with the intervening acts and probably the steps commencing with the receipt by the taxpayers of the information memorandum and other documents" prior to the making of the offer.[82] Alternatively, the scheme could be identified as the taxpayers' "proposal to invest AUD 40m on deposit in the Cook Islands and to pay Cook Islands withholding tax on the interest earned", coupled with all the necessary steps taken to implement the proposal.[83] It will be seen, however, that Cooper J only further considered the latter of these formulations, ultimately concluding that this scheme was not entered into for the dominant purpose of obtaining a tax benefit.

Beaumont J, in his dissent, rejected Lockhart J's conclusion that the Commissioner's original formulation did not satisfy the definition of scheme,[84] asserting that the Commissioner could rely on narrow formulations of the scheme when applying Part IVA. Beaumont J does not, however, specifically apply Part IVA to the Commissioner's various formulations of the scheme, but rather concentrates on a wider scheme akin to that formulated by Cooper J. He asserts that "[a]ll these dealings, that is, from the handing over of the Information Memorandum to the issue of the certificate of deposit and its subsequent redemption, constituted a plan of action which could be fairly described as a "scheme" within Section 177A(1)(a) or (b)".[85] Unlike Cooper J, however, Beaumont J

64. See id. at 4416.
65. Id.
66. Id.
67. Id. at 4413 and 4416, applying *Peabody v. FCT supra* note 8.
68. Cooper and Northrop JJ, Beaumont J dissenting.
69. *Supra* note 17 at 4670, quoting *IRC v. Brebner* [1967] 2 AC 18 at 27.
70. *Supra* note 21 at 4805.
71. Id.
72. Id.
73. Both of these schemes were expressed as being, in essence, an agreement between the parties to locate in the Cook Islands what would have been in the ordinary course of business an Australian transaction: id. at 4796 and 4804.
74. Id. at 4805.
75. Id. at 4796.
76. Id.
77. Id.
78. See id.
79. Id. These matters were to be determined under Sec. 177D(b), not Sec. 177A, and not "in a vacuum divorced from the facts as found".
80. See id.
81. Id.
82. *Spotless No. 1 supra* note 20 at 4416, quoted by Cooper J in *Spotless No. 2* id. at 4805.
83. Id.
84. Id. at 4794 and 4796.
85. Id. at 4797.

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concluded that this overall arrangement was based on dominant tax considerations.

C. Evaluation

1. The Commissioner's original formulation

As noted above, the High Court in *FCT v. Peabody*[86] held that the facts constituting the scheme must be capable of "standing on their own without being "robbed of all practical meaning".[87] If the purported scheme fails this test it constitutes part of the scheme, or a sub-scheme, to which Part IVA may not be applied.[88] It is submitted that Lockhart J, at first instance, and Cooper and Northrop JJ, on appeal, correctly held[89] the taxpayers' officer travelling to the Cook Islands with authority to enter into the lending agreement lacks "all practical meaning" when isolated from (i) the prior agreement of the taxpayer companies to invest the funds with EPBCL and (ii) subsequent actions and events, including the officer concluding the loan agreement in the Cook Islands, surrendering the certificate of deposit on maturity and the consequent payment of the principal and interest, less withholding tax.

Cooper J's statement that Section 177A "requires that the parties to the scheme, in so far as they are known, must be identified and the terms or content of any agreement, arrangement, understanding, promise or undertaking and the steps or stages of any course of action or proposal in so far as they are relevant, be identified"[90] does not necessarily add to the High Court's definition. This "check list" of relevant facts provides, however, an important reminder that when formulating the scheme those parts of an arrangement that may be based on commercial concerns should not be isolated from those steps that may appear to have tax consequences.

Beaumont J's conclusion that the Commissioner's original formulation satisfied the definition of scheme is, with respect, clearly wrong for the reasons outlined above. In addition, it is submitted that his basis for concluding that it satisfied Section 177A is flawed. Beaumont J stated[91] that his finding was supported by the High Court's decision in *FCT v. Peabody*.[92] Beaumont J suggested that the High Court held in that case that the Commissioner could rely on the narrow formulations of the scheme suggested by O'Loughlin J at first instance.[93] With respect, it is submitted that while the High Court accepted that the Commissioner may identify alternative schemes, which may include a narrower scheme that is part of a wider scheme,[94] it stressed that the narrower scheme must satisfy the above definition of a scheme before it may support an application of Part IVA.[95]

It is submitted that it was also erroneous for Beaumont J to suggest[96] that the High Court adopted the narrow formulations of the scheme suggested by O'Loughlin J[97] at first instance in *Peabody v. FCT*.[98] While the High Court stated that the Commissioner might rely on these narrow, alternative formulations, the High Court did not comment on whether these formulations satisfied the definition of a scheme.[99] The Court simply stated that the Commissioner is not bound by his original formulation of the scheme and may support his assessment by relying on alternatives suggested by the Court.[100]

It was also erroneous of Beaumont J to suggest[101] that the High Court disapproved of Hill J's finding in *Peabody v. FCT*[102] that the Commissioner may not "isolate out of a course of action comprising several steps ... one step and classify that as a scheme".[103] Contrary to Beaumont J's suggestion, on appeal the High Court expressly agreed with Hill J's statements, concluding that a part of a scheme may not be isolated from the overall scheme for the purposes of applying Part IVA.[104]

The Commissioner sought to justify the original formulation of the scheme on the basis that where "there is no commercial advantage" to be gained from an aspect of the arrangement, that aspect is distinct from the broader arrangement and can be isolated as a distinct scheme.[105] As the location of the lending agreement in this case was allegedly based on non-commercial considerations, the Commissioner argued that it could be isolated as a separate scheme for Section 177A(1) purposes.[106] It is submitted that, in effect, the Commissioner's interpretation of the notion of scheme embodies the sub-scheme approach which, as detailed above, both the Full Court of the Federal Court[107] and the High Court[108] have rejected. These Courts have stressed that it is insufficient if a step in a scheme is based on tax considerations if the scheme as a whole has commercial concerns as its overall purpose(s).

86. *Supra* note 17 at 4670, quoting *IRC v. Brebner supra* note 69 at 27.
87. Quoted in *Spotless No. 2 supra* note 21 at 4803 and 4805.
88. *Peabody v. FCT supra* note 8 at 4111; *FCT v. Peabody supra* note 17 at 4670.
89. *Spotless No. 1 supra* note 20 at 4412; *Spotless No. 2 supra* note 21 at 4805.
90. *Spotless No. 2* id.
91. Id. at 4794, 4895-4796.
92. *Supra* note 17.
93. *Supra* note 21 at 4794.
94. *Supra* note 17 at 4670.
95. Id. The facts must be capable "of standing on their own without being 'robbed of all practical meaning'" id., quoting *IRC v. Brebner supra* note 69.
96. *Supra* note 21 at 4794 and 4795-4796.
97. Namely:
- the conversion of certain shares into worthless Z-class shares and consequential transactions; and
- the financing arrangement underlying the purchase of the first mentioned shares and the conversion of these shares into worthless Z-class shares: id. at 4594.

98. *Supra* note 17.
99. In fact the High Court failed to identify what was the scheme in that case.
100. *Supra* note 17 at 4670.
101. *Supra* note 21 at 4794.
102. *Supra* note 8.
103. Id. at 4411, quoted by Beaumont J in *Spotless No. 2 supra* note 21 at 4794.
104. Id.
105. See *supra* note 20 at 4414.
106. A similar view was recently reiterated by Mr Michael D'Ascenzo, Chief Tax Counsel for the ATO. He suggested that as long as the particular transaction is not explicable by commercial reasons it constitutes a separate scheme that may be examined in isolation of any broader facts: "Peabody and Part IVA" Seminar, Deakin University Commercial Law and Policy Centre, Law Institute of Victoria, 3 November 1994. Cf. Waincymer, "Peabody and Part IVA", paper presented at "Peabody and Part IVA" Seminar, Deakin University Commercial Law and Policy Centre, Law Institute of Victoria, 3 November 1994.
107. *Supra* note 8 at 4111.
108. *Supra* note 17 at 4670.

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2. Lockhart J's formulation of the scheme

As noted above, Lockhart J suggested an alternative formulation of the scheme which appears to be confined to acts prior to, and including, the offer and acceptance of the lending agreement.[109] His formulation makes no reference to acts and events subsequent to the conclusion of the lending agreement. For this reason, it is submitted that this formulation also fails to meet the High Court's definition of scheme. If the conclusion of the loan agreement is isolated from the surrender of the certificate of deposit and the consequent payment of the principal and interest, less withholding tax, it is submitted that this course of action is meaningless within the High Court's test. The very basis for the lending agreement cannot be identified when it is isolated from the profit making that flowed from that commercial transaction and the actions subsequent to concluding the agreement that triggered that profit making. Hence Lockhart J's formulation of the scheme may be met with the same criticism as the Commissioner's original narrow formulation.

3. Cooper and Beaumont JJ's formulations of the scheme

By contrast, Cooper J's formulation appears to include the whole arrangement in so far as he suggested the scheme to be everything involved in the "proposal to invest AUD 40m on deposit in the Cook Islands and to pay Cook Islands withholding tax on the interest earned".[110] This would seem to include everything from the receipt of the initial information memorandum to the surrender of the deposit certificate and the consequent return of the principal and interest, less withholding tax. Similarly, Beaumont J suggested as an alternative formulation of the scheme "[a]ll these dealings, that is, from the handing over of the Information Memorandum to the issue of the certificate of deposit and its subsequent redemption ...".[111]

It is submitted that both of these formulations satisfy the High Court's definition as they include all aspects of the broader arrangement, thereby facilitating a balanced appraisal of the scheme's underlying purpose.

4. Commissioner's new formulations of the scheme

It is submitted that Cooper J's requirement that the scheme be confined to matters of established fact is appropriate. The rationale for this principle is surely akin to that underlying the requirement that allegations in originating pleadings must be confined to assertions of fact, rather than legal opinion. The rationale for both principles lies in the difficulty which a party would face if they had to try to dispute an allegation that is founded in opinion rather than fact.

VII. IS THE COURT BOUND BY THE SCHEME AS IDENTIFIED BY THE COMMISSIONER?

A. First instance

As will be apparent from the above discussion of the meaning of scheme that whether a court is bound by the scheme as identified by the Commissioner was vitally important in *Spotless*,[112] particularly given Lockhart J's conclusion that the Commissioner's original formulation of the scheme was too narrow. Lockhart J did not, however, specifically discuss the issue in the context of the case before him. Nevertheless he asserted that *Jackson v. FCT*[113] and *Peabody v. FCT*[114] established that "it is the scheme identified by the Commissioner which is to be considered by the Court".[115] His agreement with this proposition is also implicit in his refusal to consider the application of Part IVA to his alternative, broader formulation of the scheme.[116]

B. Full Court of the Federal Court

While, as noted above, the Court held the Commissioner's new formulations did not satisfy the definition of scheme, it agreed that the Commissioner could rely on new formulations of the scheme, including those developed by the Court. The Court believed it was not bound by the scheme as originally identified by the Commissioner, nor any subsequent formulations.[117]

To this end, in stark contrast to Lockhart J, Cooper J considered the applicability of Part IVA to his new formulation of the scheme.[118] Cooper J ultimately concluded, however, that the dominant purpose underlying this scheme was to maximize the return on the taxpayers' investment after the payment of all applicable costs, including tax, rather than to obtain a tax benefit.[119]

Following the High Court's decision in *FCT v. Peabody*,[120] Beaumont J also held that the Commissioner could rely on alternative formulations of the scheme suggested by the Court.[121] As noted above, he consequently applied Part IVA to a wide formulation of the scheme similar to that formulated by Cooper J.[122] While in all senses the scheme adopted by Beaumont J echoed that considered by Cooper J, Beaumont J concluded that the scheme was "fiscally or tax driven ..."[123] and that "the taxation aspects were [not] merely incidental or consequential".[124]

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109. *Supra* note 20 at 4416.
110. *Supra* note 21 at 4805.
111. Id. at 4797.
112. *Spotless No. 1 supra* note 20; *Spotless No. 2 supra* note 21.
113. (1989) 89 ATC 4429; on appeal (1990) 90 ATC 4990.
114. *Supra* note 8.
115. *Supra* note 20 at 4413.
116. See id. at 4417.
117. *Supra* note 21 at 4794 and 4803, Cooper J quoting at 4803 the High Court in *FCT v. Peabody* id. at 4669-4670.
118. Id. at 4805.
119. Id. at 4811-4812.
120. *Supra* note 17.
121. *Supra* note 21 at 4794.
122. Id. at 4797.
123. Id. at 4797 and 4798. He said that this conclusion was particularly supported by, *inter alia*:
- the emphasis placed on tax considerations in the Information Memorandum;
- the fact that the EPBCL interest rate was less than the domestic interest rate;
- the security risk involved in dealing offshore; and
- the high transaction costs.

124. Id.

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C. Evaluation

The practical import of this issue will be self-evident. If the court is bound by the Commissioner's original formulation of the scheme and that formulation fails to meet the definition of a scheme, the court will be unable to "come to the Commissioner's rescue" with a new scheme to which Part IVA might apply.

The Full Court's finding in *Spotless No. 2*[125] that the Commissioner may rely on alternative formulations of the scheme[126] accords with the High Court's decision in *FCT v. Peabody*.[127] Here the High Court stated that Part IVA was triggered by the factual existence of a scheme that provides the taxpayer with a tax benefit, rather than the Commissioner's opinion as to the existence of such a scheme.[128] As a consequence, the High Court believed that a court might legitimately replace the Commissioner's formulation of the scheme with its own scheme.

It is submitted that the preferable approach is that taken by Lockhart and Hill JJ. Hill J asserted that it was impermissible for O'Loughlin J, at first instance, in that case to identify an alternative scheme to which Part IVA might apply because "when an objection decision is referred by a taxpayer to this Court", the court was confined to the scheme as identified by the Commissioner.[129] The function of identifying the scheme had been committed by the legislature to the Commissioner and "[t]he Court cannot stand in the shoes of the Commissioner" and usurp that function.[130]

This approach recognizes that unlike Section 260, Part IVA does not operate automatically, but rather is based upon the Commissioner determining under Section 177F(1) that the relevant taxpayer has obtained a tax benefit from the scheme.[131] Since part of this determination is the Commissioner's identification of the subject scheme[132] it is submitted that it would be erroneous for the courts to usurp this function.[133] Moreover, such an usurpation would contravene the doctrine of separation of powers[134] as it would involve the court exercising an administrative function.[135] Such an interpretation would also be contrary to the principle of statutory interpretation that taxation legislation must be strictly construed in favour of the taxpayer.[136]

If the Commissioner wishes to rely on a new formulation of the scheme, it is submitted that this should occur through an amended assessment, specifying that new scheme,[137] so that the taxpayer is not caught by surprise. While it has been suggested that this problem could be cured by amending the pleadings[138] or through an adjournment,[139] it is submitted that these do not provide sufficient protection of taxpayers' rights and may operate unfairly on taxpayers.[140]

In practice, the ability to rely on new formulations of the scheme will probably have little impact as any new scheme will often, as in *Spotless*,[141] fail to satisfy the further prerequisites of Part IVA.[142]

VIII. MEANING OF TAX BENEFIT

A. First instance

As Lockhart J concluded that the Commissioner's formulation of the scheme did not satisfy the definition of scheme contained in Section 177A, his judgment contains little discussion of the meaning of a tax benefit. While he noted that in ascertaining whether the requisite tax benefit existed "it was necessary to determine what the expected outcome would be if the scheme adopted had not in fact been entered into or carried out,"[143] he did not apply this test to the facts before him.

B. Full Court of the Federal Court

Cooper J stated that Section 177C(1)(a) required identifying "reasonable expectations," rather than mere possibilities, "as to what would in fact have occurred" but for the identified scheme.[144] He also suggested that what would have been derived but for the scheme must be assessable income, rather than exempt income or a capital gain.[145]

While Cooper J agreed with counsel for the Commissioner that "it is self-evident that the taxpayers would not have left the AUD 40m idle ...", whether there was a "reasonable expectation" and not just "a possibility that the AUD 40m would have been used to produce assessable income in an amount of not less than the income earned in the Cook

125. Id.
126. Id. at 4794 and 4805.
127. *Supra* note 17.
128. Id. at 4670. The crucial fact, the Court held, was "whether a tax benefit which the Commissioner has purported to cancel is in fact a tax benefit obtained in connection with *a* Pt IVA scheme and so susceptible to cancellation at the discretion of the Commissioner": id. (emphasis added).
129. *Supra* note 8 at 4116.
130. Id.
131. Cf. Lockhart J in *Spotless No. 1 supra* note 20 at 4412; Beaumont J in *Spotless No. 2* id. at 4792.
132. See further J Cassidy, "Observations on the Application of Part IVA: Peabody v. FCT" (1993) 21 *ABLR* 424; J Cassidy "FC of T v. Peabody and Part IVA" (1995) 5(1) *Rev LJ* 197.
133. See further Hill J in *Peabody v. FCT supra* note 8 at 4114 and 4116.
134. Under this doctrine courts must only exercise judicial powers: *R v. Kirby; Ex parte Boilermakers' Society of Australia* (1956) 94 CLR 254.
135. See J Cassidy, "FC of T v. Peabody and Part IVA" *supra* note 132. While it could be argued that the above process merely involves the Commissioner re-exercising his administrative function with a little help from the court, it is submitted that in actuality the court is reformulating the scheme.
136. *Cape Brandy Syndicate v. IRC* [1921] 1 KB 64 at 71; *Hepples v. FCT* (1991) 91 ATC 4808 at 4818.
137. "[S]ubject to the limits contained in Sec. 170 of the Act": per Hill J in *Peabody v. FCT supra* note 8 at 4116.
138. *FCT v. Peabody supra* note 17 at 4670.
139. *Osborne v. FCT supra* note 19.
140. Particularly given that, generally, the financial resources that the taxpayer has to commit to "fighting" the Commissioner's assessment will be limited when compared to the ATO's resources.
141. *Spotless No. 1 supra* note 20; *Spotless No. 2 supra* note 21.
142. See further J Cassidy, "FC of T v. Peabody and Part IVA" *supra* note 132.
143. *Supra* note 20 at 4413, citing *FCT v. Jackson supra* note 113 and *Peabody v. FCT supra* note 8.
144. Id. at 4806 and 4807.
145. Id. at 4807.

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Islands as interest"[146] depended on how the term "amount" in Section 177C(1)(a) was interpreted. He rejected counsel for the taxpayers' suggestion that this required that it be established that the same type of income (interest) would have been derived by the taxpayer from the same source (EPBCL).[147] While in some cases, such as where "a pre-existing income stream is diverted, the amount as a particular amount of income remains the same and comes from the same source," Cooper J believed "an amount of income may be identified more generally as the income produced from a particular source or activity", in this case interest from capital investment.[148] While Beaumont J suggested that the taxpayers' case involved a new income stream, he agreed with Cooper J that Section 177C(1)(a) was not confined to diversions of existing income and could apply to new income streams.[149]

Cooper J found this more flexible test was satisfied in this case because he believed that, but for the Cook Islands proposal, the subject funds would have been invested in Australia to earn assessable interest within Section 177C(1)(a).[150] This conclusion was supported by the prior investment of the subject funds on the overnight money market.[151] As the interest rate under the Cook Islands investment was some 4 per cent less than the rates available in Australia, Cooper J believed it was reasonable to expect that, but for the scheme, the taxpayers would have derived an amount not less than the interest it received under the Cook Islands lending agreement in the form of assessable interest.[152] Similarly Beaumont J concluded that given the taxpayer companies' intention to invest the AUD 40m, it "might reasonably be expected that interest of at least that actually earned would have been earned in Australia and would have been included in [the taxpayers'] taxable income".[153]

In accordance with counsel for the Commissioner's submission, both Cooper and Beaumont JJ believed that any possible investment with other off-shore companies to obtain the benefit of Section 23(q) should be ignored.[154] There was "no reason to suppose that [the taxpayers] would, in fact, have embarked upon any of these [offshore] proposals".[155] Moreover, by reason of the tax benefits that could attach to these off-shore investments, Part IVA might be equally applicable to these alternative sources of investment.[156]

As noted above, Beaumont J rejected counsel for the taxpayers' submission that Section 177C(1)(a) would not apply to new sources of income.[157] While he agreed that the taxpayers' case involved a new income stream, he believed Section 177C(1)(a) was not confined to diversions of existing income and could apply to new income streams.[158]

C. Evaluation

The discussion of the meaning of "amount" in Section 177C(1)(a) is reminiscent of the debate that surrounded the antecedent transaction/situation tests. At one end of the scale, counsel for the taxpayers asserted that the Commissioner must establish that the very same income would have been derived from the same source, but for the scheme;[159] thereby echoing the antecedent transaction test. At the other end of the scale, counsel for the Commissioner submitted that no correspondence was required beyond the two incomes[160] having the same quantification in dollar terms.[161] Cooper J's interpretation of "amount" falls somewhere in between these two extreme views and largely accords with Section 260's antecedent situation test. He did not require that both incomes stem from the same transactions with the same parties.[162] "Income" may be more generally identified as long as it was produced from the same "particular source or activity",[163] in this case interest from the same type of investment.[164]

From this discussion it appears that while Part IVA is not confined to the diversion of a pre-existing income stream,[165] the absence of an antecedent situation is nevertheless relevant to Section 177C(1)(a). Both Cooper and Beaumont JJ stressed that for Section 177C(1)(a) to be satisfied it must be established as a matter of reasonable probability, rather than as a mere possibility, that the income would have been derived, but for the scheme.[166] This accords with the findings of Hill J and the High Court in the *Peabody* cases.[167] In the absence of an antecedent situation it is submitted that it will often be difficult to establish as a matter of probability what course of action the taxpayer might have taken and hence what income the taxpayer might have derived. This will be particularly so if the taxpayer had a choice or if there are reasons why the taxpayer would not derive income in the manner suggested by the Commissioner.[168] Moreover, as Cooper J required a correspondence between the type of income derived and the type of income that would have been earned but for the scheme, it is submitted that in the absence of an antecedent situation, the nature of the income that the taxpayer would

146. Id.
147. Id. at 4808.
148. Id.
149. Id. at 4798.
150. Id. at 4808.
151. Id.
152. Id.
153. Id. at 4797.
154. Id. at 4808 and 4797 respectively. Cooper J believed that he could also ignore the possibility of investing in Hong Kong given the taxpayers' security concerns: id.
155. Id. at 4797 per Beaumont J.
156. Id.
157. Id. at 4798.
158. Id.
159. See id. at 4806.
160. I.e. that derived and that which would have been derived but for the scheme.
161. See *supra* note 20 at 4806.
162. He acknowledged, however, that in cases where there has been a diversion of a pre-existing source of income these prerequisites would be met: id. at 4808.
163. Id.
164. Id. at 4808 and 4809.
165. Id. at 4808.
166. *Spotless No. 2* id. at 4797 and 4807.
167. *Peabody v. FCT supra* note 8 at 4111; *FCT v. Peabody supra* note 17 at 4671.
168. In *Osborne v. FCT supra* note 19, for example, the taxpayer's evidence was that without the protection that the corporate trustees' limited liability afforded he would not conduct a valuation business. Hence this provided a basis for undermining the Commissioner's suggestion that, but for the corporate trustees, it was reasonably probable that the taxpayer would have conducted the valuation business as a sole proprietor.

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have derived but for the scheme could not be determined with the requisite degree of probability.

This view also appears necessary given Cooper J's requirement that the quantification of the income that would have been derived but for the scheme correspond with the income actually earned. In the absence of an antecedent situation, in this case a prior investment, it is submitted that it would be impossible to provide the exactness which Cooper J prescribes. When dealing with speculation, rather than actualities, such an exact science could not be achieved in the absence of an antecedent situation. Thus it is submitted that this requirement may at times provide a considerable hurdle for the Commissioner.

How the antecedent situation test may continue to operate in the context of Part IVA is illustrated in the above mentioned decision in *Osborne v. FCT*.[169] As noted above, the Commissioner applied Section 260 to the taxpayer's conduct of a valuation business through a corporate trustee, B Pty Ltd. That valuation business was subsequently taken over by a second corporate trustee, T Pty Ltd. The Commissioner applied Part IVA to this arrangement as the change in ownership of the valuation business occurred during Part IVA's operative dates. In the Federal Court, Olney J suggested that the case did not involve a tax benefit within Section 177C(1)(a) as there had been no alteration in the incidence of the taxpayer's income because the valuation income was previously derived by the corporate trustee, B Pty Ltd, rather than the taxpayer.[170] The absence of an antecedent situation where the taxpayer derived the valuation income in a personal capacity prevented the conclusion that, but for the second corporate trustee, T Pty Ltd, the taxpayer would have derived the income.

Correspondingly, it will be easier to establish a tax benefit within Section 177C(1)(a) where an antecedent situation exists. Despite Beaumont J's conclusion to the contrary,[171] in *Spotless* such an antecedent situation existed. As Cooper J noted, the taxpayers' funds had been invested in Australia in the overnight money market prior to the Cook Islands lending agreement.[172] Hence there was an antecedent receipt of income of the same type, namely interest from the investment of the subject funds.

While even in the absence of an antecedent situation it might be thought reasonably probable that the taxpayer companies would have derived the same income but for the scheme as they "would not have left the AUD 40m idle",[173] it must be remembered that there must be a correspondence in the type of income. As suggested above, in the absence of an antecedent derivation of interest income, how the funds would be used by the taxpayer companies would be a matter of speculation. In this way, it is submitted, Section 177C(1)(a) embodies a modified version of the antecedent situation test. If this view is correct, Part IVA will suffer from the same shortcoming as its predecessor, rarely, if ever, extending to new sources of income.

In regard to the latter point, it is interesting to note that Cooper J stated that Section 177C(1)(a) would not extend to capital gains.[174] If Cooper J is suggesting that Section 177C(1)(a) is confined to income which is assessable under Section 25(1), it is submitted that his conclusion is erroneous. While, as noted above, the definition of tax benefit in Section 177C is exhaustive and it has been suggested[175] that it consequently does not extend to rebates or credits, it is submitted that this definition does not exclude capital gains. Under Section 160Z0 ITAA capital gains are included in a taxpayer's assessable income. Consequently they would appear to be a form of income that may be derived for Section 177C(1)(a) purposes. Alternatively, Cooper J's comment may stem from his suggestion that Section 177C(1)(a) requires the income that would have been derived but for the scheme to be the same type of income as that actually derived.[176] He may, therefore, simply be suggesting that in this case deriving a capital gain would not have been the same type of income as that actually derived, namely interest.

Counsel for the taxpayer suggested that Section 177C(1)(a) could not be satisfied if the subject transaction would not have been entered into but for the tax benefit which the scheme provided. In essence this submission was based on the notion that once the scheme was annihilated under Part IVA, the very means by which the income, here interest, was derived was no longer present.[177] Hence it could not be said that the taxpayers would have derived the income but for the scheme because without the scheme there was nothing left to sustain the derivation of that income[178] and the taxpayers would not have entered into the subject transaction. While this approach appears to give Section 177C(1)(a) a strange operation, it is hard to see how this application of Section 177C(1)(a) can be avoided. If the provision of a tax benefit is central to the decision to enter into a transaction, but for that tax benefit it could not be said that it was reasonably probable that the taxpayer would have derived that same type of income but for the scheme within Section 177C(1)(a). Strangely, the underlying tax considerations could actually work in the taxpayer's favour and prevent Section 177C being satisfied. If this view is correct, Part IVA suffers from a major limitation which would allow the most blatant of cases of tax avoidance to avoid its operation.

IX. DOES PART IVA INCLUDE THE CHOICE PRINCIPLE?

A. First instance

Lockhart J noted that if the relevant provision had been Section 260, rather than Part IVA, the choice principle would have placed a considerable obstacle in front of the Commis-

169. Id.
170. Id. at 4331.
171. *Supra* note 21 at 4798.
172. Id. at 4809.
173. Id. at 4807.
174. Id.
175. See Hill J in *Peabody v. FCT supra* note 8 at 4117.
176. *Supra* note 21 at 4808.
177. See id. at 4806.
178. See id.

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sioner.[179] Lockhart J suggested that the taxpayers may have "simply taken an advantage of a 'right of choice' expressly given by the Act itself, namely, to invest money overseas and derive income from overseas sources, a right specifically granted by Section 23(q)".[180] Lockhart J stated, however, that the choice principle did not continue to operate independently of Part IVA's provisions, except to the extent that Sections 177C(2) and (3) may exclude a tax benefit from Section 177C(1).[181] Whether the exclusionary limb of Section 177C embodied the choice principle, and whether it was applicable on the facts before the Court, was not, however, considered.

B. Full Court of the Federal Court

Cooper J's treatment of Section 177D, rather than Section 177C, suggested that he agreed with counsel for the taxpayers' submission that the taxpayers were merely taking advantage of a benefit provided for in Section 23(q) in a manner akin to the choice principle. While concluding that, but for the Section 23(q) exemption, the investment in the Cook Islands would not have occurred,[182] Cooper J nevertheless held that the dominant purpose underlying the scheme was not to obtain a tax benefit.[183] He stressed that Section 23(q) "enabled the taxpayers to achieve a higher net return on the money after the payment of all costs, including tax, than the taxpayers could have obtained in Australia investing the money on deposit at the current Australian interest rates on offer".[184] Such tax benefits, he said, could legitimately be taken into account when making the "commercial decision [whether] to invest in the Cook Islands in preference to Australia".[185] To this end, he noted that "[w]here the taxation rates on particular investments are different, the incidence of tax as a cost becomes one of the important matters for consideration in coming to an investment decision".[186] He suggested that this was no different from taking advantage of other exemptions provided for under the Act, such as the treatment of income from gold mining as exempt income under Section 23(o).[187] Utilizing this reasoning Cooper J concluded that the dominant purpose underlying the scheme in this case was obtaining the maximum return on the taxpayers' funds.[188]

By contrast, Beaumont J rejected counsel for the taxpayers' submission.[189] He asserted that there was no place for the choice principle in Part IVA for two reasons. First, he believed that "as a matter of form and substance, [Part IVA and Section 260] are quite different" and hence there was no place in Part IVA for a principle developed in the Section 260 jurisprudence.[190] Second, he relied on the statement in Section 177B that "... nothing in the provisions of this Act other than this Part ... shall be taken to limit the operation of this Part".[191]

C. Evaluation

1. Would the choice principle have been applicable in *Spotless*?

Before the question whether Part IVA embodies the choice principle is considered, Lockhart J's suggestion that if Section 260 were applicable the choice principle would have provided a considerable obstacle to applying that section[192] needs further examination. Under the broad choice principle it could be said, in a manner akin to *FCT v. Cridland*,[193] that the taxpayers were "entitled to create a situation by entry into a transaction which will attract tax consequences"[194] that stem from the Act's treatment of income sourced overseas.

It is submitted that the arrangement would not, however, be legitimated under the narrow interpretation of the choice principle. As noted above, in *FCT v. Gulland*; *Watson v. FCT*; *Pincus v. FCT*[195] Gibbs CJ and Wilson J held that the choice principle was only applicable where the Act provides the taxpayer with specific choices between one or more options[196] such as in areas of trading stock and tax accounting. Hence, the narrow choice principle would not allow the taxpayers to source the interest overseas as Section 23(q) did not expressly extend to taxpayers a right to elect whether to have their income treated as Australian or externally sourced income. Rather, Section 23(q) merely specified the consequences if income was externally sourced. As the narrow interpretation of the choice principle appears to be the more authoritative of the two approaches, Lockhart J's suggestion that the taxpayers in *Spotless*[197] would have been able to utilize the choice principle is probably erroneous.

2. Does Part IVA embody the choice principle?

It is interesting that, beyond Lockhart J's comment that the choice principle does not continue to operate outside these provisions,[198] the discussion in *Spotless*[199] as to whether Part IVA embodies the choice principle makes no reference to Sections 177C(2) and (3). It appears that Beaumont and Cooper JJ were considering the existence of the choice prin-

179. *Supra* note 20 at 4417.
180. Id.
181. Id. at 4418.
182. Id. at 4811.
183. Id. at 4811 and 4812.
184. Id. at 4810.
185. Id. at 4811.
186. Id.
187. Id.
188. Id. at 4811 and 4812.
189. Id. at 4798.
190. Id.
191. Id.
192. *Supra* note 20 at 4417.
193. Id.
194. *Cridland v. FCT supra* note 9 at 338-339.
195. *FCT v. Gulland*; *Watson v. FCT*; *Pincus v. FCT supra* note 30.
196. See also Fisher J in *Tupicoff v. FCT supra* note 33. Note, however, that Deane J dissented in *FCT v. Gulland*; *Watson v. FCT*; *Pincus v. FCT supra* note 30, asserting that the choice principle validated the subject arrangement.
197. *Spotless No. 1 supra* note 20; *Spotless No. 2 supra* note 21.
198. Id. at 4418.
199. *Spotless No. 1* id.; *Spotless No. 2* id.

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ciple outside the terms of Section 177C and possibly outside Part IVA as a whole.

To this end Beaumont J was at pains to stress that there was no place in Part IVA for a doctrine that had its roots in Section 260 jurisprudence.[200] It is submitted that Beaumont J's approach to this issue is flawed. First, it is submitted that the "form and substance" of Section 260 and Part IVA are not as different as Beaumont J suggests.[201] Hill J in *Peabody v. FCT*[202] found that the explanatory memorandum to Part IVA made it clear that Part IVA was intended "to restore the law [under Section 260] to what it was thought to be after the decision of the Privy Council in *Newton v. Federal Commissioner of Taxation*". Second, it is submitted that Section 177B does not prevent the language used in Part IVA, whether that be Sections 177C(2) or 177D, embodying notions that have their origins in Section 260. Thus Hill J in *Peabody v. FCT*[203] found that Section 177D incorporated the Section 260 "Predication test".

Cooper J's comments clearly embrace sentiments akin to the broad interpretation of the choice principle. As noted above, he suggests that if the Act treats income differentially by, for example, exempting it under Section 23(q) or some other provision of the Act,[204] taxpayers can legitimately take that fact into account when choosing a course of action.[205] These sentiments echo the principle expressed in *Cridland v. FCT*[206] that "the taxpayer is entitled to create a situation by entry into a transaction which will attract tax consequences for which the Act makes provision ..."

The source of Cooper J's suggestion is unclear, but appears to lie in Section 177D or a source independent of Part IVA, rather than Sections 177C(2) and (3). He states the above principle in the context of determining whether the dominant purpose underlying the scheme was obtaining a tax benefit.[207] Despite making rather damning findings of fact which suggest that obtaining the tax benefit provided by Section 23(q) was the dominant factor underlying the taxpayers' decision to invest in the Cook Islands,[208] Cooper J somehow "converts" this apparently illegitimate objective into a legitimate commercial concern.[209] This conversion allows him to ultimately conclude that "objectively, the dominant purpose of the investor investing off-shore is [not] to get a tax benefit; the purpose is to obtain the maximum return on the money invested after the payment of all applicable costs, including tax".[210]

It may be thought that Cooper J's finding accords with Hill J's statement in *Peabody v. FCT*[211] that Part IVA would "seldom, if ever, ... [apply] where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable". Cooper J's findings of fact, however, suggest that it was not just "some element" of the transaction that was selected to reduce tax. He stressed that, but for the operation of Section 23(q), the investment would not have been made.[212] This suggests that tax benefits were more than just secondary or incidental concerns. The whole arrangement was dominated by the reduction of tax. Thus it is submitted that Cooper J's sentiments involve a considerable expansion of the transactions that fall outside Part IVA's scope.

It is submitted that Cooper J's indirect resurrection of the broad choice principle has the potential to render Part IVA a "paper tiger". In essence Cooper J has transformed tax considerations into commercial considerations that may legitimately predominate entry into an arrangement under Section 177D. His approach allows a taxpayer to plead that he/she was merely taking advantage of a tax benefit to lessen outgoings and hence increase returns. If this is legitimate one must speculate when Part IVA will ever apply?

While the Court in *Spotless No. 2*[213] did not refer to Sections 177C(2) and (3) as a potential source of the resurrection of the choice principle, it is submitted that these provisions might support a very limited version of the choice principle. Subsection 177C(2) excludes from the notion of tax benefit the non-inclusion of income or the allowance of a deduction that is "attributable to the making of a declaration, election or selection, the giving of a notice or the exercise of an option expressly provided for by" the Act, provided that the scheme was not entered into or carried out to create a circumstance or state of affairs "which is necessary to enable the declaration, election, selection, notice or option to be made, given or exercised ...".

The meaning of the exclusionary limb has not been the subject of much judicial comment. Its language would suggest, however, that it embodies the narrow interpretation of the choice principle in so far as a tax benefit attributable to a declaration, election or option expressly provided for by the Act is excluded from the definition of tax benefit.[214] Consequently, while Section 177C(2) would not legitimate the use of a vehicle, such as a trust or company, that is merely recognized by the Act,[215] it would prima facie exempt a tax benefit stemming from the adoption of an express choice provided for in the Act, such as those contained in the trading stock provisions. Unlike the choice principle, however, Section 177C(2) includes an additional caveat. In contrast to the choice principle where the taxpayer is protected even if the arrangement was entered into for the dominant purpose of obtaining the tax benefit,[216] Section 177C(2) will not exempt the tax benefit when the scheme was entered into to enable the tax benefit to be attracted. Thus in *Spotless*,[217] the taxpayers would not be able to rely on this provision as it appeared that they purposely sourced the income in the Cook Islands to enable

200. Id. at 4798.
201. Id.
202. *Supra* note 8 at 4110.
203. Id. See also *FCT v. Peabody v. FCT supra* note 17 at 4672.
204. He also makes reference to Sec. 23(o): *supra* note 21 at 4811.
205. Id.
206. *Cridland v. FCT* supra note 9 at 338-339.
207. See *supra* note 21 at 4810-4812.
208. Id. at 4811.
209. See id. at 4810, 4811 and 4812.
210. Id. at 4812.
211. *Supra* note 8 at 4118.
212. *Supra* note 21 at 4811.
213. Id.
214. Cf. *Case W58 supra* note 8 at 536-7.
215. *Case W58* id.
216. *Cridland v. FCT supra* note 9 at 338-339.
217. *Spotless No. 1 supra* note 20; *Spotless No. 2 supra* note 21.

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them to take advantage of the tax benefit Section 23(q) extended.

Thus it is submitted that Section 177C(2) embodies a very limited form of the narrow choice principle and that Cooper J's broad choice principle must have its source elsewhere.

X. HOW IS THE DOMINANT PURPOSE UNDER SECTION 177D(B) DETERMINED?

A. First instance

Lockhart J asserted that the Commissioner must consider each and every factor detailed in Section 177D(b) before evaluating whether the scheme was entered into for the dominant purpose of obtaining a tax benefit.[218] Lockhart J rejected, however, the taxpayers' suggestion that the Commissioner's statement that factors (v) – (viii) were "not applicable" indicated that the Commissioner had not considered these factors.[219] Rather, Lockhart J suggested that by this comment the Commissioner was merely stating that he gained no assistance from considering these factors.[220] As Lockhart J had concluded that the Commissioner had too narrowly formulated the subject scheme, he did not, however, find it necessary to determine the taxpayers' dominant purpose in light of the application of these factors.[221]

B. Full Court of the Federal Court

On appeal, the Court did not consider the degree to which the factors detailed in Section 177D(b) must be examined. In this regard it is interesting to note, however, that in the course of Beaumont J's application of Section 177D(b) he only mentions one factor, Section 177D(b)(ii), which refers to the form and substance of the scheme.[222] The form and substance of the proposal was, he said, to obtain a tax benefit by ensuring the source of the interest was located in the Cook Islands in order that the taxpayer might rely upon Section 23(q).[223] As noted above, having regard to this factor, he concluded that the dominant purpose underlying the arrangement was "fiscally or tax driven" in the sense that it was based on exempting the income from Australian tax.[224]

In stark contrast to Beaumont J's approach, Cooper J systematically considered the factors detailed in Section 177D(b).[225] Cooper J believed that these indicated that, in essence, the arrangement was not a sham, but rather a form of investment that allowed "the taxpayers to achieve a higher net return on the money after the payment of all costs, including tax, than the taxpayers could have obtained in Australia investing the money on deposit at the current Australian interest rates on offer".[226] As noted above, following on from the application of these factors, Cooper J concluded that "objectively, the dominant purpose of the investor investing off-shore is [not] to get a tax benefit; the purpose is to obtain the maximum return on the money invested after the payment of all applicable costs, including tax".[227]

While Cooper J found that the tax benefits stemming from Section 23(q) were determinative in so far as the investment would not have occurred but for these benefits, as noted above, he believed such tax considerations were matters that may be taken into account when making commercial decisions.[228] Where "the activity under consideration is a bona fide investment of capital funds the tax payable on the interest earned is, for the purpose of deciding whether or not to undertake any particular investment, a relevant consideration".[229]

C. Evaluation

Given that it is now well established that "the Commissioner must have regard to each and every one of the matters referred to in Section 177D(b)",[230] Beaumont J's reference to only one factor is a concerning example of a failure to systematically ensure that each of Part IVA's prerequisites is satisfied. Moreover, it is unfortunate that the Full Court of the Federal Court did not consider the extent to which the application of the factors detailed in Section 177D(b) must be documented.

To date, the only guidance lies with Lockhart J's suggestion that a reference to certain factors as being "not applicable" provides a sufficient basis for inferring that the Commissioner had considered, but rejected, those factors.[231] The correctness of this statement was not tested on appeal and it is submitted that given that the rationale for requiring the Commissioner to consider all factors is to ensure that a balanced opinion is drawn as to the dominant purpose underlying the scheme, it would be inappropriate if the Commissioner could reject certain factors by simply referring to them as "not applicable" and thereby readily isolate, and concentrate on, those factors that weigh against the taxpayer.

As to the Full Court's findings as to the taxpayers' dominant purpose in this case, it is submitted Beaumont J correctly concluded that the dominant purpose of entering into the scheme was to obtain a tax benefit. Given the emphasis placed in the information memorandum sent to the taxpayers on the tax benefits stemming from the investment agreements being concluded in the Cook Islands and Cooper J's damning finding that without the tax benefits provided by Section 23(q) the taxpayers would not have entered into the scheme,[232] there appears to be strong support for Beaumont J's finding. While Cooper J concluded that the overall

218. Id.
219. Id.
220. Id.
221. Id.
222. *Supra* note 21 at 4797.
223. Id.
224. Id.
225. See id. 4810.
226. Id.
227. Id. at 4812. See also id. at 4811.
228. Id. at 4811.
229. Id.
230. Per Hill J in *Peabody v. FCT supra* note 8 at 4113-4114.
231. *Supra* note 20 at 4417.
232. *Supra* note 21 at 4811.

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arrangement was explicable by commercial concerns, namely investing in a manner to ensure the maximum return,[233] this conclusion does not sit comfortably with his continual stressing that without Section 23(q) the taxpayers would not have entered into the scheme.[234] It is consequently submitted that Beaumont J was correct in concluding that these tax considerations were not purely incidental.[235]

XI. CONCLUSION

The potentially limitless scope of Part IVA has been "whittled down to size" by the Australian judiciary. The combined force of the cases[236] that have considered Part IVA suggest that there are significant limitations upon the effectiveness of this legislation:

- for an arrangement to be a "scheme" within Section 177A the circumstances of the purported scheme must be capable "of standing on their own without being 'robbed of all practical meaning'";[237]
- the Commissioner may not "isolate out of a course of action one step and classify that as a scheme" for Section 177A purposes;[238]
- whether the dominant purpose underlying a scheme is to obtain a tax benefit within Section 177D must be determined "in relation to the scheme as a whole";[239]
- it is not sufficient that "an element of [the] scheme [has] a tax advantage" if the dominant purpose(s) underlying the scheme is commercial;[240]
- the Commissioner is "required to supply particulars of the scheme relied on ..."[241] as an "erroneous identification" might lead to the "wrongful exercise of the discretion conferred by Section 177F(1)";[242]
- for there to be a tax benefit within Section 177C(1)(a) it must be "reasonably probable", rather than a "mere possibility", that but for the scheme the taxpayer would have derived the income;[243]
- for there to be a tax benefit within Section 177C(1)(a) it must be established that but for the scheme, the taxpayer would or could reasonably be expected to have derived the same type of income as that actually derived under the subject arrangement;[244]
- for there to be a tax benefit within Section 177C(1)(a) it must be established that but for the scheme, the taxpayer would or could reasonably be expected to have derived at least the same amount of income as that actually derived under the subject arrangement;[245]
- regard must be had "to each and every one of the matters referred to in Section 177D(b)" and the relevant purpose evaluated by examining those factors for and against the taxpayer;[246]
- Part IVA embodies the "Predication test",[247] espoused by Lord Denning in *Newton v. FCT*,[248] and as a result Part IVA will not apply "where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable";[249]
- if the Act treats income differently taxpayers can legitimately take that into account when entering into an arrangement;[250] and
- the Commissioner must establish all of Part IVA's elements before any tax benefit may be cancelled under Section 177F.[251]

While it is submitted that many of these principles appropriately ensure that Part IVA will not inhibit legitimate commercial transactions, many of the developments found in *Spotless*[252] threaten to render Part IVA as ineffective as Section 260. While Cooper J's judgment appears to echo the antecedent situation test, more worrying is the resurrection of the broad choice principle which threatens to render Part IVA a "paper tiger". In effect, his reasoning negates the role of Section 177D. Even where the primary factor underlying entry into a scheme is to obtain a tax benefit, Cooper J suggests that this may simply be viewed as a means of limiting outgoings and hence maximizing returns.[253] It is submitted that this suggests that having regard to the tax benefits that an arrangement may provide is a legitimate commercial concern and hence does not satisfy Section 177D. If such arrangements do not fall within Section 177D, there must be doubts as to whether Section 177D will ever be satisfied.

Thus it appears that the ghosts of Section 260 have not only come back to haunt the Australian Commissioner of Tax, but have knocked his "white knight" off its mount. Given the divergence in the approaches taken by Cooper and Beaumont JJ, however, much will depend on the outcome of the Commissioner's pending appeal to the High Court.

233. Id. at 4812.
234. Id. at 4811.
235. Id. at 4798.
236. *Peabody v. FCT supra* note 8; *FCT v. Peabody supra* note 17; *Osborne v. FCT supra* note 19; *Spotless No. 1 supra* note 20; *Spotless No. 2* id.
237. *FCT v. Peabody* id. at 4670, quoting *IRC v. Brebner supra* note 69 at 27; *Spotless No. 2* id. at 4803 and 4805.
238. *Peabody v. FCT supra* note 17 at 4111; *FCT v. Peabody* id.; *Spotless No. 1 supra* note 20 at 4413.
239. *Peabody v. FCT* id.; *FCT v. Peabody* id.; *Spotless No. 1* id.
240. *Peabody v. FCT* id.; *FCT v. Peabody* id.
241. *FCT v. Peabody* id. at 4670.
242. *FCT v. Peabody* id. at 4669. Where "the error goes to the mere detail of the scheme", however, this would not have such grave consequences: id. at 4669.
243. *Peabody v. FCT supra* note 8 at 4112, citing *Davies v. Taylor* [1974] AC 207 at 212 and 219; *FCT v. Peabody* id. at 4671, citing *Dunn v. Shapowloff* [1978] 2 NSWLR 235 at 249; *Spotless No. 2 supra* note 21 at 4797 and 4807.
244. *Spotless No. 2* id. at 4808-4809.
245. *Spotless No. 2* id.
246. *Peabody v. FCT supra* note 8 at 4113; *Spotless No. 1 supra* note 20 at 4417; *Spotless No. 2* id. at 4810.
247. *Peabody v. FCT* id. at 4110.
248. *Supra* note 25 at 9.
249. *Peabody v. FCT supra* note 8 at 4118.
250. *Spotless No. 2 supra* note 21 at 4811.
251. *Osborne v. FCT supra* note 19 at 4331.
252. *Supra* note 21.
253. *Supra* note 21 at 4812.

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INDIA

TAXATION OF SERVICES: SOME POLICY IMPERATIVES FOR INDIA

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I. INTRODUCTION

Sales taxes in India are confined almost exclusively to goods; services subject to a few exceptions contained in the State List of the Constitution are exempt. The exceptions which the states have the power to tax are: electricity, transportation, entertainment and professional services. There is no such power under the Union List but under the provisions of the residuary entry of the Constitution the Union Government has pre-empted the power to tax services. As of today, it levies tax on foreign travel,[1] hotel expenditure,[2] telephones, stockbrokers, non-life insurance, advertising, couriering and radio paging.

Notwithstanding the attempts of the Union as well as the states to levy tax on a few select services, revenue from the tax on services has been insignificant. The contribution of this tax to the total tax revenue which stood at 8.82 per cent in 1970-71 declined to 7.18 per cent in 1980-81 and to 6.8 per cent in 1990-91. By 1994-95 it had fallen to just 5.69 per cent (see Table 1).

In view of the insignificant and declining share of revenue from the tax on services, this paper presents an analysis of the existing structure of taxes on services and examines their system of administration. In addition, it sets out the reforms needed before the government resorts to further taxation of services. The paper is structured as follows: Section II presents the economic rationale of taxing services. This is followed by an analysis of the structure and coverage of taxes on services in other countries. Section IV examines the evolution of the taxation of services in India. The next section analyses the potential base of service taxation in India. Section VI purports to present the salient features of the administration of the existing service tax and points out the reforms that must be carried out prior to imposing a general tax on services. The final section summarizes the conclusions and recommendations of the study.

Table 1
Fiscal Importance of Tax on Services

(INR in million)

Tax on Services	1970-71	1980-81	1990-91	1994-95
A. State Taxes on Services				
Taxes on Passengers and Goods (PGT)	678.4	2,718.0	10,618.1	16,643.5
Taxes on Motor Vehicles (MVT)	1,047.0	4,149.3	15,662.7	28,761.2
Entertainment Tax	575.2	2,553.8	4,308.7	5,532.1
Electricity Duty	671.6	2,282.7	11,849.1	20,605.5
Total State Taxes on Services	2,972.2	11,703.8	42,438.6	71,542.3
	(8.82)	(7.18)	(6.38)	(5.08)
B. Central Taxes on Services				
Expenditure Tax	–	–	750	2,100
Service Tax	–	–	–	4,000
Foreign Travel Tax	–	–	1,580	2,600
Total Central Tax	–	–	2,330	8,700
			(0.42)	(0.01)
C. Grand Total	2,972.2	11,703.8	44,768.6	80,242.3
	(8.82)	(7.18)	(6.8)	(5.69)

Note: Figures within parentheses indicate per cent to the total tax revenue.

Source: Reserve Bank of India, *RBI Bulletin*, Bombay, various issues, and Government of India (1994), *Indian Public Finance Statistics*, Ministry of Finance, New Delhi.

1. With effect from 15 October 1971, the Central Government levied a tax on foreign and inland travel under the Foreign Travel Tax Act, 1971.
2. A tax on hotels was levied through the Expenditure Tax Act 1987. This was levied on the basis of amounts charged for accommodation in certain classes of hotels and for food and drinks in such hotels. The constitutionality of this tax has been upheld by the Supreme Court as a tax on "expenditure" and not on services as such. (*Federation of Hotels v. Union of India*, AIR 1990 SC 1637).

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II. RATIONALE OF TAX ON SERVICES

From the point of equity there is a good case for bringing services into the tax net.[3] Since most services tend to be luxuries, taxing services means taxing luxuries. This is corroborated from the pattern of consumption expenditure on services which indicates a positive relationship between income and the proportion of expenditure on services. As the marginal propensity to spend on services exceeds the average, the expenditure on services as a percentage of total expenditure increases, the greater one's expenditure. The data on consumption expenditure from the National Sample Survey (NSS) indicate that the proportion of expenditure in rural areas increases from 2.93 per cent in the INR 0 to 15 expenditure group to 14.56 per cent in the expenditure group of INR 100 and above. The trend is similar in the urban areas where the expenditure on services increases from 5.44 per cent in the INR 15 to 28 expenditure group to 19.87 per cent as one moves to the expenditure group of INR 100 and above.

Non-taxation of services accentuates the distributional impact of taxation and increases the costs to the taxpayer including the deadweight loss associated with these taxes.[4] This is due to the fact that when an area of consumption is untaxed, the tax rates applied to other spendings need to be higher to raise a given amount of revenue. Also, resource allocation is distorted by the exemption of services because the exclusion affects the relative prices of goods vis-à-vis services. Given the high price elasticity of demand for the latter, this distortion artificially stimulates and encourages the demand for services and leads to a skewed allocation of resources. In addition, most services are labour-intensive. Encouraging their consumption through exemption of tax could have a disproportionately large effect on the employment of labour vis-à-vis the use of capital.

The inclusion of services in the tax net would yield greater revenue and make the existing commodity tax structure more income-elastic. The empirical estimates of income-elasticity of services vis-à-vis goods indicate that the former is generally higher than unity while the latter is invariably less than unity.[5]

The taxation of services and goods on an equal footing simplifies administration because it is very difficult to distinguish between goods and services. Taxing the entire turnover saves the administration from having to distinguish between goods and services. For example, repair shops at present bill parts (components treated as goods) and labour (service component) separately to minimize tax. This encourages dealers to increase the exempted component of the transaction to reduce their tax liability.

As in theory there is no economic distinction between goods and services, there is no reason to impose tax on goods but not on services. The tendency to do so is more a historical accident. It is high time that the tax on services is given its due place. Taxing services would have the advantages of rationalizing the tax structure and raising resources for the government.

III. TAXATION OF SERVICES IN OTHER COUNTRIES

Most countries levy tax on services. In general, two approaches are adopted, viz. the integrated approach and the selective approach. Under the former approach, all the services are taxed except those specifically exempt and under the latter approach some stipulated services alone are singled out for taxation.

Among the countries adopting VAT, the integrated approach is prevalent in those countries that had a turnover tax prior to the introduction of VAT. The exemptions include health care, education, social security, philanthropic or cultural institutions and public postal services. The selective approach is prevalent in countries that adopted VAT from a manufacturer's form of sales tax. In this form the services singled out for taxation include personal services (e.g. dry cleaning, beauty shops, hair dressers), restaurant, entertainment, repair, leasing, telecommunication, transport, publicity and legal services.

In OECD countries there is much diversity in the treatment of different services, particularly in the following areas: transport of passengers, entertainment, hotels and restaurants (Table 2). Advertising, telecommunications and the liberal professions are usually taxed at the standard rate but the latter are fully exempt in Finland and Norway. In Sweden, services in the cultural area (artists, performers), in education, doctors, dentists and other liberal professions (lawyers etc.) have become subject to taxation since 1991. In Belgium services performed by doctors, lawyers and bailiffs are exempt. The same holds for the services of doctors, dentists and certain other medical services in the Netherlands and Germany. Insurance premiums and betting and gambling are exempt in most countries, but nearly always subject to a separate tax. In New Zealand gambling and general and fire insurance are both taxable at the standard rate and in addition certain gambling activities are subject to specific duties. Services which are generally exempt from VAT include banking and financial services, cultural, educational and medical services, rental payments and postal services. Finally, there are substantial variations in the VAT treatment of residential housing and the services related to housing.[6]

3. Various scholars as well as Government Committees have in the past advocated taxing services. See, e.g. Government of India (1978), *Report of the Indirect Taxation Enquiry Committee*, New Delhi, at 245-246; Lakadawala, D.T. and K.V. Nambiar (1972) *Commodity Taxation in India*, Ahmedabad, Sardar Patel Institute of Economic and Social Research, at 89-96; and Purohit, Mahesh C. (1975), "Sales Tax Exemptions in India", 10 *Economic and Political Weekly*, (March 8), No. 10, at 445-452.

4. See for an estimation of deadweight loss in the United Kingdom, Kay J.A. and E.H. Davis, "The VAT and Services" chapter 6 in Gillis, Shoup and Sicat (1990), *Value Added Tax in Developing Countries*, World Bank.

5. Gandhi, Ved P. (1977), *Sales Taxation of Services in Developing Countries*, DM/77/114, International Monetary Fund, Fiscal Affairs Department, Washington, DC, USA; Due, John F. and John L. Mikesell (1983), *Sales Taxation, State and Local Structure and Administration*, The John Hopkins University Press, London.

6. See OECD (1988), *Taxing Consumption*, Paris, at 83-85; and OECD (1994) *General Consumption Taxes in OECD Member countries*, Paris.

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The treatment of services among the non-OECD countries (Table 3) is quite similar to that prevailing in the OECD countries. However, some of the countries tax services separately, without taxing them as part of the VAT system. The countries that followed the old system of French consumption taxes (viz. a multi-stage turnover tax) generally include a broad range of services in their tax bases, which contain only a few enumerated exemptions. On the other hand, the countries that followed the former British system of taxation, generally exclude services from the ambit of general sales tax but levy separate excise duties on a few select services and at rates often specific, varying from one service to another. Such a treatment is followed in Australia, some provinces of Canada, many countries of English speaking Africa and some countries of the Far East and South Asia.

Table 2
Taxation of Services in OECD Countries

Country	Exemption other than "standard exemptions"[1]	Taxation of "standard exemptions"
Austria	Telecoms	Culture (lower rate). Letting (lower rate). Hospitals (lower rate)
Belgium	Law	–
Canada	Child care, legal aid, ferry, road and bridge tolls, standard municipal services	Lotteries and gambling, sales and leasing of commercial land and buildings
Denmark	Passenger transport, sports, burials, sale of newly constructed buildings and travel agents.	Radio and television broadcasting, theatre and cinema
Finland	Water and all services other than restaurant services and telecommunication and services that are connected with goods	–
France	None (legal services have been taxed since 1991)	Sale of building sites and new buildings. Renting of fitted premises
Germany	Telecoms	–
Greece	–	Culture (lower rate)
Iceland	Sports, passenger transport, authors, composers, burials	–
Ireland	Transport, broadcasting, supply of water by public authorities	Long-term letting of commercial immovable property
Italy	Municipal passenger transport, burials	Supply of commercial land and buildings[2] (standard rate), building enterprises, letting immovable property[3] (standard rate)
		Letting (standard rate)
Japan	Social services	
Mexico	The sale of national and international currency and gold; transport, managerial, agricultural or fishing activities developed by individual taxpayers[4]	Postal services and insurances[5]. Letting of immovable property[6]
Netherlands	Telecoms, burials, cremations, public broadcasting, sports	–
Norway	Sports, passenger transport, law, burials, television, accomodation in hotels, certain services rendered by intermediaries, services rendered by consultants and advisors	–
Portugal	Agriculture	–
Spain	–	Some cultural goods, e.g. newspapers, books and some cultural services provided consumers pay for them
Sweden	Television	–
Switzerland	Reusable containers, certain postal services, stamps, social services provision of agency workers under certain condition, certain second-hand goods	Short-term parking for cars, certain banks services, prosthesis denture

Notes

1. "Standard Exemptions" are the following: postal services; medical care; dental care; charitable work; education; non-commercial activities of non-profit making organizations; cultural services; insurance and reinsurance; letting of immovable property; financial services; lotteries and gambling; supply of land and buildings.
2. Lower rates for houses both to reside.
3. Lower rates for residential housing.
4. Individual taxpayers devoted to managerial, agricultural or fishing activities have income of up to 77 minimum wages and assets of not more than 15 minimum wages in the earlier year, the VAT exemption is applied.
5. Life and farming risk insurances and reinsurance are the only type of insurances exempt..
6. Only the letting of housing is exempt.

Source: OECD (1994), *General Consumption Taxes in OECD Member Countries*, Paris.

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Table 3
VAT Treatment of Selected Services in Non-OECD Countries

Country/Services	Laundry Beauty Shops	Hotels Restaurants	Amusement Entertainment	Telecommu-nication	Repair Maintenance of Movable goods	Advertising Admn.
Hungary	2	2/S	X/2	E	L	S
Iceland	S	S	S	S	S	S
Norway	S	S	E*	S	S	S
Indonesia	E	E*	S	E	S	E/S
Israel	S	S	S	S	S	S
Japan	S	S	S	S	S	S
Korea	S	S	E/S	E*	S	S
New Zealand	S	S	S	S	S	S
Philippines	S	S	S	S	S	S
Taiwan	S	S	S	E	S	S
Argentina	S	S	S	S	S	E
Bolivia	S	A	S	S	S	S
Brazil (States)	TS*	TS*	TS*	E*	TS	TS
Chile	S	S	S	S	S	S
Colombia	E	S	E/S*	L	S	E
Equador	S	S	S	E	S	E
Peru	S	E*	E*	E	S	S
Uruguay	S	L	S	E	S	S
Costa Rica	S	S	S	S	S	E
Dominican Republic	E	S	E	S	E	E
Grenada	S	S	S	S	S	S
Guatemala	S	S	S	S	S	S
Haiti	S	S	S	S	S	S
Honduras	S	S	S	S	E	S
Mexico	S	S	E/S/H	S*	S	S
Nicaragua	H	H	S/H	E	S	H
Peru	S	S	S	S	S	S
Panama	E	E	E	E	E	E
Algeria	TS	TS	TS	E	E	TS
Cote d' Ivoire	TS	TS	TS	E	E	E
Guinea	TS	TS	TS	E	E	E
Madagascar	S	S	S	S	S	S
Mauritius	E	E*	E	E	E	E
Morocco	S	L	E/S*	L	S	S
Niger	S	S	L	L	S	S
Senegal	TS	TS	TS	TS	E	E
Tunisia	S	L	S	S	S	S

Notes:
S = Normally liable to standard rate of VAT.
L = Normally liable to lower rate of VAT.
H = Normally liable to higher rate of VAT.
Z = Not normally liable to VAT.
E = Normally exempt from VAT.
TS= Services taxed separately.
* = Normally liable to excise or separate tax on services.

Source: Purohit Mahesh C. (1993), *Principles and Practices of Value Added Tax: Lessons for Developing Countries*, Delhi, p.54.

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Table 4
Retail Sales Tax on Services in the USA

State	Service Category 1970	1982
Alabama	5	5
Arizona	4	4
California	5	3
Colorado	5	5
Connecticut	5	4
Florida	3	3
Georgia	5	5
Hawaii	1	1
Idaho	5	5
Illinois	5	5
Indiana	5	5
Iowa	2	2
Kansas	3	3
Kentucky	5	5
Louisiana	3	3
Maryland	5	5
Massachusetts	5	5
Michigan	5	5
Minnesota	5	5
Mississippi	3	3
Missouri	5	5
Nebraska	5	5
Nevada	5	5
New Mexico	1	1
New York	3	3
North Carolina	4	4
North Dakota	5	5
Ohio	5	3
Oklahoma	5	5
Pennsylvania	3	3
Rhode Island	5	5
South Carolina	5	4
South Dakota	2	1
Tennessee	3	3
Texas	5	5
Utah	3	3
Vermont	5	5
Virginia	5	5
Washington	2	2
Wisconsin	3	3
Wyoming	3	3

Notes:

Service categories shown in the Table are as follow:
1 – general taxation of services
2 – broad taxation of services
3 – substantial taxation of services
4 – narrow taxation of services
5 – no taxation of services, beyond utilities, hotels and admissions

Source: Robert A. Bohm and Eleanor D. Craig (1985) "Recent Sales Tax Trends: Services as a Point of Departure", *National Tax Association – Tax Institute of America*, p.57.

Select services are extensively taxed under the retail sales tax system of the United States. A plurality of US states resort to taxation of services (Table 4). Five states have increased their ranking over the years. Of these five, Connecticut and South Carolina have moved from category 5 (no taxation of services beyond utilities, hotels and admissions) to category 4 (narrow taxation of services); Arkansas and Ohio have moved from category 5 to category 3 (substantial taxation of services); and one State (South Dakota) from broad taxation of services (category 2) to the general taxation of services (category 1). The overall trends in the taxation of services in different countries indicate that notwithstanding the variations in the coverage and the rate of taxation of services almost all countries now tax services.

IV. EVOLUTION OF THE TAXATION OF SERVICES IN INDIA

As in other developing countries, in India too, the service sector has been expanding rapidly in recent years. The share of services in gross domestic product, has gone up from 31.81 per cent in 1950-51 to 37.68 per cent in 1960-61. It has further increased to 41 per cent in 1980-81 and to 47.1 per

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cent in 1993-94 (Table 5). However, all services cannot possibly be taxed. Some of these are in the nature of merit goods. There are others such as public administration and defence that do not have the characteristics of a "sale of service". The wholesale and retail trade margins are automatically included in the base of sales tax levied on goods. While welfare considerations demand exemption of community and social services, administrative considerations call for exemption of personal services. Adjustment is also required in regard to electricity, gas and water. Traditionally, these services are classified as industrial in the national accounts. However, for the purposes of taxation they need to be treated as utilities. Accordingly, these services have to be redefined in the national potential base. With all such adjustments an approximate potential base of tax on services in India is estimated to be INR 288,190 million in 1993-94 (Table 6).[7]

Over the last six years the potential base has almost quadrupled. However, it is neither necessary nor administratively feasible to attempt to tax all services. Some of the services may not be taxed for reasons of social welfare or social policy. For example, medical, educational and religious services may not be taxed on account of their importance in social welfare. In addition, administrative expediency makes the taxation of some petty services unfeasible in rural and even in urban areas. In view of administrative and other considerations the *Taxation Enquiry Commission, 1953-54* did not recommend a tax on services.[8] The *Indirect Taxation Enquiry Committee, 1978* also suggested that the revenue potential as well as practical problems of such taxation should be thoroughly examined before resorting to such a tax.[9] The Interim Report of the *Tax Reforms Committee (1991)*, however, recommended that some of the services be taxed at the rate of 10 per cent of the value of the services. The services recommended to be taxed are: advertising services, services of stockbrokers, motor vehicle insurance, insurance of residential property, personnel effects and jewellery, and residential telephone services. A Report of the study team on *Reform of Domestic Trade Taxes in India: Issues and Options* (1994),[10] suggests that "a simple and non-discriminating way of going about this (of selecting services for state taxation) would be to concentrate on services which are integral or incidental to the supply of goods, e.g. installation, works contract, and delivery".

7. Some estimates suggest that for 1968-69 the yield from a low rate of 2.5 per cent tax on services, would have been in the order of INR 200 million {Lakadawala, D.T. and K.V. Nambiar (1972), *Commodity Taxation in India*, Sardar Patel Institute of Economic and Social Research, Ahmedabad, at 95}. Another estimate for the State of Gujarat suggests that a tax on services (at 7 per cent) would have resulted in INR 10 million for the year 1980. {See, NCAER (1970), *Incidence of Taxation in Gujarat*, New Delhi, at 20.}.

8. Government of India (1954), *Report of the Taxation Enquiry Commission: 1953-54*, New Delhi.

9. Government of India (1978), *Report of the Indirect Taxation Enquiry Committee*, Pt II, New Delhi, at 246.

10. IPFP (1994), *Reform of Domestic Trade Taxes in India: Issues and Options*, New Delhi, at 76.

Table 5
Share of Services in Gross Domestic Product

(percentage)

Sl. No.	Sectors	1950-51	1960-61	1970-71	1980-81	1990-91	1993-94
1	Constructions	2.81	4.20	4.92	5.00	5.74	5.6
2	Trade, hotels & restaurants	6.55	7.90	8.83	12.04	12.44	13
2.1	Trade	6.19	7.47	8.30	11.32	11.70	12.2
2.2	Hotels & restaurants	0.36	0.43	0.53	0.72	0.74	0.8
3	Transport, storage & communication	3.50	4.22	4.36	4.68	7.17	8.1
3.1	Railways	1.69	1.97	1.50	0.92	1.36	1.4
3.2	Transport by other means	1.34	1.76	2.19	3.01	4.72	5.3
3.3	Storage	0.07	0.06	0.07	0.10	0.09	0.1
3.4	Communication	0.40	0.43	0.60	0.65	1.00	1.3
4	Financing, insurance, real estate & business services	9.97	11.92	10.03	8.87	8.26	8.5
4.1	Banking & Insurance	0.79	1.07	1.65	2.83	4.20	5.2
4.2	Real estate, ownership of dwellings & business services	9.18	10.85	8.37	6.04	4.06	3.3
5	Community, social & personal services	8.89	9.44	9.69	10.50	11.59	11.9
5.1	Public administration & defence	2.96	3.70	4.37	4.74	5.70	5.7
5.2	Other services	6.03	5.74	5.32	5.76	5.90	6.2
	Total Services	31.81	37.68	37.83	41.09	45.19	47.1

Source: CSO, *National Accounts Statistics* (various issues), Government of India, New Delhi.

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Table 6
Share of Potentially Taxable Services in Gross Domestic Product

Services	Income Originating in Services Sector (INR in million) (1987-88)	Income Originating in Services Sector (INR in million) (1993-94)
Hotel and Restaurant	21,680	55,840
Railways	43,560	182,860
Transport and other services	124,680	375,420
Storage	3,170	5,270
Communication	27,970	92,690
Banking and Insurance	111,430	364,910
Real Estate, Ownership of dwellings and business services	136,130	233,330
Electricity, Gas and Water Supply	62,680	288,190

Source: CSO (1995), *National Accounts Statistics*, Dept. of Statistics, Ministry of Planning, Government of India, New Delhi.

V. POTENTIAL BASE OF SERVICE TAXATION IN INDIA

Although the Union Government through the Finance Act 1994 levied a tax on the services of stockbrokers, non-life insurance companies, and telephone companies, and through the Finance Act 1996 levied tax on advertising, couriering and radio paging, it is suggested that the following services could also be brought within the tax net thus raising resources for the states' tax systems.

A. Computer maintenance and consultancy services

Computer services have developed in India over the last few years. Almost all offices, private enterprises and other institutions of repute need maintenance and consultancy services relating to computers. As this has been a new and growing service, a small tax on it would not affect either the companies nor the consumers. Administratively, there should not be any difficulty because all these companies maintain their complete accounts and are very small in number (Table 7). The available data indicate that only 60 companies have turnover of over INR 0.25 million.

B. Private nursing homes

Medical services provided by private nursing homes seem to be a potential tax base for the taxation of services. Notwithstanding the fact that medical services fall under the category of social and welfare services, the phenomenon of pricing these services in private nursing homes suggests that these institutions charge a rate which could be paid by affluent people only. Private nursing homes whose total receipts exceed INR 0.2 million per annum and/or charge room rent of INR 400 per day and above could be brought under the purview of taxation and a small service charge on their room rent be levied.

C. Transport services

The transport sector is presently being taxed by the state governments via the motor vehicle tax and the passengers & goods tax. Any other tax on motor vehicles would complicate the structure of taxes on vehicles. If necessary, the state governments could always increase the rates of both taxes. However, a close analysis of the structure of these taxes reveals that most of the state governments levying passengers and goods tax are collecting revenue through compounded levies. There is no proper assessment of the base of these taxes. As the number of vehicles has increased from 306 thousand in 1950-51 to 1.86 million in 1970-71, and to 21.31 million by 1990-91 this base has a greater potential for raising resources. However, leaving aside the need to have a separate analysis of the structure of the motor vehicle and passengers and goods tax, it is still pertinent to note that the services provided by the transport companies could be distinguished from the services provided by the vehicles owned by others. A tax on services, provided by the transporters i.e. the transport companies, could therefore be levied.

As the transport companies are large in size and provide public services, all of them maintain their documents meticulously and a small levy on the services of these transport companies would not affect their business. Over the years, there has been a rapid increase in the number of transport companies as well as a substantial increase in their combined turnover. As these companies have come to occupy an important place in the movement of goods all over the country, imposing a small tax on this service would yield a considerable amount of revenue.

D. Motor vehicle repair and servicing

The repairing and servicing of motor vehicles is an important base on which a service tax could be levied. Such a tax exists in most countries. India has numerous small garages on the road side and, therefore, it would not be possible to collect this levy from all types of garages. However, over the years, there has been a tremendous increase in the number of vehicles as well as a corresponding increase in the number of show-rooms and repair shops. All the big show rooms provide for the servicing and repair of vehicles. To begin with, all the shops carrying out the repair and servicing of motor vehicles and having a turnover of INR 0.2 million and above could be brought into the tax net. A small service tax on all these repair shops would not create any problem for administration of this tax, as all these shops have proper accounting systems. As the number of vehicles have increased considerably, this tax would be a lucrative source of revenue for the State.

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E. Rentals from leasing

Sales and leasing are two aspects of the same coin. Non-taxation of leasing creates loopholes in the taxation of sales since taxpayers may camouflage their sales as leasing. Film producers, for example, avoid sales tax by resorting to leasing instead of sale as shown in the case of *A.P. Meiyappan v. CTO*[11] where a film producer avoided tax by entering into an agreement with a distributor whereby the distributor had the right to distribute the films for 49 years. Leasing of plant and machinery could also be used to avoid significant amounts of tax. Administratively, it would be expedient to tax leasing companies having a large turnover since the number of such companies is small.

F. Works contract

Since in the case of a works contract, the sale of goods and services is part of the same transaction, it is easy to tax them together. In the supply of food and drinks in hotels and restaurants, as per the legal interpretation, the term service is included in sub-clause (f) of clause (29-A) of Article 366. Accordingly, a tax on sale or purchase is authorized to be levied on the service element. However, in the case of a works contract, the service element is excluded; no tax is authorized to be levied on the service component of the contract. This makes the levy of tax on such transactions ambiguous and difficult to administer. The numerous cases pending before the various High Courts and Supreme Court challenging the levy of tax on works contracts are a result of the ambiguity created by excluding the service element from the levy of tax. This is the consequence of the decision by the Supreme Court in *the State of Madras v. Gannon Dunkerly and Co. (Madras) Limited*[12] which stated that the labour portion is not taxable. Also, in *Builders Association of India v. Union of India*[13], while adjudging the constitutional validity of sub-clause (b) of clause (29-A) of Article 366, the Supreme Court held that by the Forty Sixth Amendment of the Constitution the powers to levy tax enjoyed by the States prior to Gannon Dunkerly's Case[14] is restored. It would, therefore, be useful to levy tax on the service component of the works contract.[15]

G. Other services

In due course, it might be possible to tax other services such as dry cleaning, dying and related services, beauty shops, video parlours and other professionals such as doctors, lawyers and chartered accountants. However, at this juncture none of the states' administrative machinery is developed enough to be able to successfully levy tax on these services. In fact, even direct tax from professionals has not been collected by the income tax department in any worthwhile quantity.

As regards financial services, it may be noted that these services are generally exempt from value added tax. This is because of problems in measuring the value added these services generate. The price at which the services are sold is not simply a charge for services. The indirect calculation used in the invoice method whereby tax is computed on the price of the service and tax on inputs is subtracted, cannot be a measure of value to financial services. Instead, value added has to be calculated directly, by adding wages, salaries, and profits. This method was introduced in Israel from 1976 through 1979. However, since 1979, the tax on the financial sector has been designated as a separate and distinct tax in Israel. In this context, it is important to note that the *Committee on Value Added Tax, 1989*, of the American Bar Association could not reach a consensus on how to calculate tax on these services or provide credits for business purchasers of these services.[16]

Most countries do not tax these services because it may drive financing "underground". Another reason for the non-taxation of these services is that although in theory, the services may be measured by the spread between the revenue from lending and the cost of borrowing in practice it is often found impossible to determine the margin. Consequently, most of the countries exempt "core" financial services (Table 8) including dealings in money, shares, bonds, lending money, advancing credit, and operating bank accounts. Some countries (e.g. Finland and Norway) also exempt "secondary" financial services.

Table 7
Computer Service Companies Classified by Turnover Group
(Year 1991)
(INR million)

Turnover Group	Number of Companies	Total turnover
5- 15	37	33.3
15- 20	46	145.2
50- 100	22	145.7
100- 250	41	672.9
250- 500	24	835.9
500- 1000	17	1,183.4
1000- 2500	20	3,400.9
2500- 5000	6	2,033.9
5000-10000	5	3,101.8
Over 10000	6	8,565.6
Total	224	20,118.6

Source: *Data Quest*, July 1991.

11. 20 STC 115, Madras.
12. [1958] 9 STC, 353.
13. [1989] 73 STC, 370, (SC).
14. [1958] 9 STC, 353 (SC).
15. The judgement of West Bengal Taxation Tribunal in *Studio Kamalalaya v. Commercial Tax Officer* which held that the photography did not cause any addition, accession or accretion to the goods supplied by the contractors and hence was not liable to tax under a works contract is important for the administration of the tax. (I.e. since, the legal position of other types of contracts where goods of substantial value are used up in the process, like fumigation, chemical treatment etc. might seem to fall within the scope of this judgement. [1993] 89 STC, 307 (WBTT).)
16. American Bar Association, (1989), *Value Added Tax - A Model Statute and Commentary: A Report of the Committee on Value Added Tax*, Taxation Section.

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Table 8
Treatment of Financial Services Under the VAT

Country	Core financial services (dealings in money, shares, bonds, etc. lending money, bank accounts)	Secondary financial services (Fin. advice, debt collection, keeping securities)	Exported financial services	Other Indirect Tax (Rate in brackets if if known)
Austria	exempt	standard rate[1]	exempt	yes
Belgium	exempt	standard rate	zero rate	yes
Canada	exempt	standard rate	zero rate	no[2]
Denmark	exempt	standard rate	zero rate	no
Finland	exempt	exempt	exempt	yes (1.5%)
France	exempt	standard rate	zero rate	yes
Germany	exempt (or taxable for trader if so desired)	standard rate	zero rate	no
Greece	exempt	standard rate	zero rate	yes
Iceland	exempt	standard rate	zero rate	no
Ireland	exempt	standard rate	zero rate	yes[3,4]
Italy	exempt	standard rate	zero rate	no
Japan	exempt	standard rate	zero rate	no
Luxembourg	exempt	lower rate[5]	zero rate	yes
Mexico	exempt[6]	standard rate	exempt	no
Netherlands	exempt	standard rate[7]	zero rate	no
New Zealand	exempt	standard rate[8]	zero rate	no
Norway	exempt	exempt	exempt	no
Portugal	exempt	standard rate	zero rate	yes
Spain	exempt	standard rate	zero rate	no
Sweden	exempt	standard rate	exempt	no
Switzerland	exempt	standard rate	–[9]	n.a.
Turkey	exempt	standard	exempt	yes
UK	exempt	standard rate	zero rate	yes

Notes:
1. The granting, the negotiation, the management of credit and the management of credit guarantees are exempted.
2. However, provinces may levy other indirect taxes on financial services (e.g. Quebec zero-rates on financial services and levies consumption tax on paid up capital (0.35%), insurance premiums (0.15%) and wages (1% or 2.5% depending on the type of financial institution).
3. Interest on certain loans to companies, which attract a low rate of corporation tax, liable to stamp duty at 12%.
4. A fixed levy of Pounds 36m is assessed on banks each year.
5. Recovery of debts is taxed at 15%. Financial advice and the management of securities are taxed at the reduced rate of 12%.
6. Interest on loans for consumption goods.
7. The granting, the negotiation, the management of credit and the management of credit guarantees are exempted.
8. Debt collection is exempt.
9. Core services exempt, secondary zero rate.

Source: OECD (1994), *General Consumption Taxes in OECD member countries*, Paris.

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VI. STRUCTURAL AND ADMINISTRATIVE REFORMS: A PRE-REQUISITE

Although the tax on services has been in existence since the 1960s when the air travel tax was first levied, the tax so far has been levied primarily through sporadic attempts. The recent effort to levy tax on three services (viz. stock brokers, non-life insurance, and telephones), is the first comprehensive attempt to levy tax on services by the Union Government.[17] For this purpose the Service Tax Rules, 1994 have been framed.[18] These rules cover the following areas: registration, maintenance of records, submission of returns and assessments. The department has appointed Central Excise Officers with specified jurisdiction for the purpose of assessment and collection of this tax. The administrative system for the taxation of these services is as follows.

Telephone service: The service tax on telephone bills is collected through the two companies who provide this service to all the consumers[19]. Both these companies are registered with the Commissioner of Central Excise, Delhi. For the purpose of registration an application is submitted in Form ST-1 (under Section 69 of the Act). The Central Excise Officer, after satisfying himself that everything is in order, issues a Registration Certificate (Form ST-2) within seven days of the receipt of such application. The tax is collected every month, but a quarterly return (Form ST-3) is required to be submitted giving detailed information on gross turnover and the amount of tax collected.

Non-life insurance: The tax on non-life insurance is collected through the Chairman (or Chairman-cum-managing director) of the insurance company.[20]

Stockbroker: All stockbrokers are required to be registered with the respective Commissioners of Central Excise in different cities.[21] The registration numbers issued by the Commissioner of Central Excise are independent of the existing Permanent Account Number (PAN) numbers of the income tax department. Payment of tax, as specified in Rule 6, is made in the notified branches of the authorized banks through Form TR-6.[22] Each assessee has to choose one branch in which all the payments are required to be made.

While the powers of assessment are given to the Assistant Commissioner (under chapter V of the Finance Act), the assessing authority or any other officer is prohibited under the Service Tax Circular[23] to undertake any visit or carry out any spot inspection. A special search of premises can only be attempted with the approval of the Commissioner. However in practice such searches are unlikely since no extra staff have been allocated to the new tax.

The needed reforms: In view of the skeletal administrative machinery governing the new service tax levied by the Union Government, it is important that prior to any further extension of this tax to other services the requisite administrative as well as structural reforms are attempted.

The main reform needed relates to the introduction of value added tax (VAT) as a prerequisite to levying tax on services. It is important that the new tax does not fall on inputs so increasing their cost and creating cascading and distortions in the economic system. To avoid these adverse economic effects, it is necessary to provide a full set-off of the tax on services from the further tax liability. In the absence of a VAT, there would be an escalation in the costs and prices in the economy along with other economic distortions. It is, therefore, necessary to have related changes in the tax structure of the country. In this context the Tax Reforms Committee (TRC) has also emphatically stated that *a cascade type of service tax should be avoided at all costs... so that the entire system of indirect taxation..would be devoid of cascading and would cause no distortion in costs or in the allocation of resources*[24]. In fact, the TRC was crystal clear in its intent and prescription when it recommended that once the existing excise system is converted into a VAT, it would be possible to introduce a fairly comprehensive (VAT) system of taxation of services.

In addition, it is important that prior to the introduction of a tax on services organizational and procedural reforms are instituted. The agenda for reforms should include the following :

Exemption limit: At present the administrative coverage of taxpayers under both the excise and sales taxes is extensive. However, under the existing system only a small proportion of dealers actually pay tax. If under the service-tax, each taxpayer had to contribute to the treasury this would involve a tremendous increase in the work load of the department. Hence, the exemption limit has to be redefined. In fact, it is neither practicable nor useful to include all the small taxpayers in the tax net. In the Indian context, given the low level of maintenance of records, the department would entail very high costs of collection. It is, therefore, suggested that we adopt an exemption limit of INR 0.5 million for registration of dealers paying service tax. Indeed in other countries similar exemption thresholds exist.[25]

Tax Identification Number (TIN): An important step is to establish a master file for each taxpayer based on a unique tax identification number (TIN) – a code to differentiate one tax-

17. The Union Budget of 1996 has in addition levied tax on three other services. These are advertising, radio paging and couriering. However, no detailed procedures are yet available.
18. For details see Government of India (1994), *Service Tax*, Customs & Central Excise, New Delhi.
19. The excise department has in consultation with the telephone department decided that regional offices would also become assessees. If approved by the Central Board of Excise and Customs, this would create a large number of assesses.
20. The tax is paid by the two assessees (viz. General Insurance Company and the New India Insurance Company Ltd.) in Bombay; one assessee (viz. National Insurance Company) in Calcutta; one assessee (viz. Oriental Insurance Company) in Delhi, and one assessee (viz. United India Insurance Company) in Madras. The branches are not registered to pay the tax.
21. The stockbrokers of Haryana also apply for registration to the Commissionaire of Central Excise, Delhi.
22. Form TR-6 means a memorandum referred to in rule 92 of the Treasury Rules of the Central Government.
23. Service Tax Circular No 1/1/1994 dated 29 June 1994 (File No 137/1/94-CX.4), Department of Revenue, Ministry of Finance.
24. Government of India (1991), *Interim Report of the Tax Reforms Committee, Ministry of Finance*, New Delhi, at 123.
25. In France, for example, the exemption limit is low for dealers dealing in goods and high for dealers in services. See Purohit, Mahesh C. *Principles and Practices of Value Added: Lessons for Developing Countries*, Gayatri Publications, Delhi-110 052.

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payer from the other.[26] The existing registration procedure – which is involved and cumbersome – also needs to be simplified. Furthermore it would be useful to strengthen the verification machinery used to check the credentials of the taxpayers [to enable the department to identify the fictitious (*hawala*) or bogus taxpayers].

Processing of returns: Simplifying the tax return and minimizing the documents required would reduce taxpayer's compliance costs. It would also facilitate the processing of returns. Whereas the additional information increases the compliance costs, a minimum amount of information is necessary for the requisite management information system (MIS). It is essential that a suitable computational technology is adopted to administer the tax.

Assessment of dealers: At present, all dealers are assessed. This is treated as a routine affair. No in-depth audit is attempted to unearth tax evasion. Most tax revenue accordingly comes from "admitted" tax. With a view to increasing compliance it is useful to select a small proportion of the total number of dealers. This could be done in accordance with the criteria of their size supplemented by information available from the cross-checking of invoices. In fact, a selective check of invoices is meaningful to ascertain evasion of tax.

Training and recruitment: An important characteristic of the existing administrative system is the lack of an intensive training programme. The officers are trained to administer, audit, and verify the documents related to a single-point taxation. The levy of a service tax implies a sea change in the system of administration when introduced in the context of VAT. All the officers currently responsible for auditing the service tax would have to be trained afresh.

Deterrent penalties: Whereas it is essential to have a simple structure and a helpful administration to enable the taxpayer to pay its dues, it is equally important that deterrent penalties are imposed on the erring dealers. At present the penalties are negligible. Furthermore, in most cases these are left to the discretion of the assessing authority. In fact it is advisable to have greater transparency in the system of penalties.

VII. SUMMARY OF CONCLUSIONS AND POLICY IMPERATIVES

The general system of commodity taxes in India is at present confined mainly to goods; services are excluded from the purview of taxation. Although some services are taxed under the specific provisions of the Constitution (such as taxes on passengers and goods carried by road and inland waterways, taxes on luxuries including amusements and taxes on betting and gambling), neither of the Lists under the Constitution expressly enumerates taxation of services. However, by virtue of Entry 97 of the Union List, the Union Government has pre-empted all the powers necessary to levy tax on this source.

In recent years the Union has exercised this power and some services, viz. foreign and inland travel, accommodation in hotels, stock brokers, telephone, general insurance, advertising, couriering and radio paging have already been taxed by it. The fiscal role of the taxes on services has so far been negligible. In fact the share has declined over the years. These taxes in all yield approximately 6 per cent of the total taxes in 1994-95.

The rationale of equity suggests that the taxes on services which primarily fall on luxuries make the structure progressive. From the point of allocative efficiency, service tax would help lower the tax rate on the existing base it would also reduce the other costs including deadweight loss. Furthermore the general introduction of such a tax would have a positive effect on relative prices and resource allocation. The income elasticity of the tax system is estimated to be higher in tax systems which tax services. From the administrative angle, it helps increase administrative expediency.

Almost all countries levy tax on services either through the integrated or the selective approach. Although the treatment in coverage shows diversity, the trend is towards increasing the scope of taxes on services. In recent years, following the recommendations of the TRC, the Union Government has already levied a service tax on some services. However, it is important that the services related to the transport sector, private nursing homes, computer maintenance, consultancy, automobile repairs, rentals from leasing, advertising and works contracts could be taxed by the state governments. It should be noted that most countries do not levy any tax on financial services and those who do, impose a separate tax (i.e. financial services are not subjected to VAT). Since the Finance Act 1991 India has had an interest tax which now yields over INR 8000 million. In addition, service tax on insurance has already been levied. Hence, it is not desirable to have any additional tax on financial services.

With a view to implementing a tax on services, it is recommended that (i) service tax must be levied only after VAT has been introduced; (ii) the exemption limit and overall coverage of the tax has to be raised to INR 0.5 million for the purpose; (iii) a tax identification number (TIN) must be given to all the dealers. This number must also be cross referenced to the income tax reference; (iv) registration procedures and necessary verification prior to registration with due involvement of the trade associations are important; (v) a simplified tax return and the involvement of the banks in making payment is useful for proper administration; (vi) a requisite MIS must be introduced; and (vii) a selective auditing of accounts, requisite training of staff and deterrent penalties for the defaulters are important for a scientific tax administration.

Services have both a national and a regional basis. Owing to the diverse tax bases, it is necessary that the service tax is introduced both in the Union and the State Lists. Services like insurance, stocks and shares and residential telephones and advertising should fall under the Union List. Other services such as hotel services, works contracts, leasing, computer consultancy, car repairs, dry cleaning, beauty shops and

26. The TIN serves three useful purposes. First, it facilitates the use of computers in detection of slow and non-filers. Secondly, it helps cross-verification of invoices. And thirdly, it helps provide a comparison of tax statistics with the National Accounts Statistics.

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video parlours should fall under the State list. The requisite constitutional amendments and administrative changes are of paramount importance to tap this virgin area.

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IFA NEWS

SOME HIGHLIGHTS FROM THE SECRETARY GENERAL'S 1995/96 ANNUAL REPORT

J. FRANS SPIERDIJK

INTRODUCTION

From the beginning of 1995 onwards David Tillinghast assumed the responsibility of leading the Permanent Scientific Committee, after Augusto Fantozzi left us to become Finance Minister of Italy.

In the meantime it has become clear that Prof. Fantozzi, who is now the Minister for International Trade in his country, is likely to continue to play an active role in Italian politics. During the 1995 Cannes Congress David Tillinghast was formally appointed Chairman of the Permanent Scientific Committee ("PSC") and there is no doubt that under his leadership the Committee will continue to perform its essential function within IFA with great dedication and enthusiasm. Already the PSC has developed ideas for a prestigious new Research Project which will hopefully be presented in some detail during the 1996 Geneva Congress.

This year again we had the pleasure to celebrate at the General Secretariat a twentieth anniversary of employment with IFA. This time Thea van Dijk was complimented for staying with IFA so long and urged to complete at least another 20 year-term with us. Thea has performed many different tasks at the General Secretariat. Among other things she pays special attention to our publications and to financial matters. She was responsible for our membership administration until 1990 when she joined Nel Slingerland to share the more general responsibility of managing our Secretariat.

Also in this year IFA lost a number of its prominent members. On 7 October 1995 Prof. Paul Sibille (Belgium) left us, after many months of illness, at the age of 84. Prof. Sibille has played a very important and extremely active role in our Association.

Prof. Jean-Pierre Lagae, Chairman of our Belgian Branch, pays tribute to this warm and dynamic personality in the 1995 Yearbook. We were very sad to receive the news of the passing away on 31 October 1995 of Dr Gilberto de Ulhôa Canto (Brazil), founder of our Brazilian Branch back in 1949 and the driving force behind many of our Association's activities. He will be very sorely missed as one of the leading international lawyers of Brazil and author of many books and articles. His devoted friend Agostinho Toffoli Tavolaro pays tribute to this distinguished and charismatic man in his In Memoriam in the 1995 Yearbook. Both Prof. Sibille and Dr de Ulhôa Canto had been elected Honorary Members of the Association, in recognition of their valuable contributions towards the activities of our Association.

I also wish to commemorate here an extremely active member of our USA Branch, whose untimely death means a great loss. I am referring to Mr Frank Walsh, past President of the USA Branch and the initiator of many events, including the very successful regional Conference in Hawai in 1991. On 26 February 1996 we lost one of the founding members of our Branch in Peru, Dr Enrique Vidal Henderson, who many of us will remember with respect.

CANNES CONGRESS

The fourth Congress in France, the previous ones being in Paris in 1953, 1963 and 1980, proved to be an unequalled success. This was due to the devoted and untiring efforts of the President of our 49th Congress, Mr Georges Dominjon. Together with Mrs Françoise Dominjon, who put her own indelible stamp on the Congress, and the members of the Organizing Committee, Messrs Robert Baconnier, Manuel Castro, Guy Delorme, Yves-Alain Grouard and Pierre Saumet, he managed to run the Congress with charm, enthusiasm and efficiency. This personal touch gave the Congress a very special atmosphere, so that the small city of Cannes felt like home to the many participants (1438) and accompanying persons (615) who had the privilege of spending a week on the beautiful Côte d'Azur. The Organizing Committee was very ably assisted by Mr F. Erlenbach, Secretary General of the famous annual Film Festival and his experienced daughter Béatrice, as well as by Novatours, Cannes.

As in Florence in 1993 and Toronto in 1994, an early time schedule was observed, which worked very well, and enabled the participants to spend some time at their leisure and to enjoy the beautiful surroundings.

Many of you will remember the Opening Ceremony at the Grand Théâtre Lumière, the famous Auditorium where the Cannes International Film Festival is held every May. The fireworks afterwards only enhanced a grand Ceremony, with wonderful music in a convivial atmosphere. The international evening on the occasion of the Centenary of the cinema was one of the highlights of the Congress. The Gala evening at the Palm Beach, one of the most prestigious venues in Cannes, was a worthy farewell to a wonderful Congress. I must of course make mention of the honour which was bestowed on President Adonnino: the Mayor of Cannes made him an honorary citizen and awarded him the Medal of this City. I can assure you that our President is very proud indeed of this distinction.

I would like to recognize with much gratitude the devoted efforts and excellent contributions of all those who were involved in the scientific programme of the Congress. IFA owes them a great debt of gratitude for their valuable input. The new procedures for the Working Sessions again proved their effectiveness, although there is always room for

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improvement. Prof. J.P. le Gall (France) served as General Reporter, and Prof. DDr H.G. Ruppe (Austria) as Discussion Leader for Subject I "International income tax problems of partnerships". 28 National Reports appear in the 1995 Cahiers. The Panel consisted of Mr W. Burke (USA), Prof. L. Burns (Australia), Prof. Dr A.H.M. Daniels (Netherlands), Dr H.J. Lethaus (Germany) and Mr O. Olsson (Finland). Mr J. Taquet (France) was Secretary. "Tax aspects of derivative financial instruments" appeared as the Main Subject II in the programme, and was very ably prepared and presented by Mr H.D. Rosenbloom (USA), Mr Ch.T. Plambeck (USA) as General Reporters, and Mrs D. Ring (USA) as assistant General Reporter.

29 National Reporters contributed to the Cahiers. Mr R. Briffett (UK) took on the heavy task of Discussion Leader, and members of the Panel were Mr S. Edge (UK), Mr A. Meirelles de Miranda (Brazil), Mrs Y. Miyazaki (Japan), Mr P. Pouliguen (France) and Dr R. Senn (Switzerland). Mr A. Bouin (France) acted as Secretary.

In my previous Annual Report I announced, with much pleasure, the closer collaboration of our Association with the OECD. This teamwork is demonstrated by an annual joint project, a Congress Seminar which in Cannes was entitled "The OECD Model Treaty – 1995 and beyond". Chaired by Prof. Dr K. Vogel this interesting Seminar proved to have a lot of crowd-pulling appeal. IFA Members of the Panel were Mr S.H. Goldberg (USA), Mr A.W. der Kinderen (Netherlands) and Prof. Y. Masui (Japan), while for the OECD Mr T. Fuller (USA), Mr J. Owens (UK), Mr H. Skurnik (Finland), Mr D. Lüthi (Switzerland) and Mr E. Romano (Mexico) gave their contributions. Mr B. Elvin acted as Secretary.

"Dividend access shares (stapled stock)" was the title of Seminar B. Mr P. Derouin (France) chaired the Panel consisting of Mr M. Aidin (UK), Mr P.C. Canellos (USA), Mr H. Marseille (Netherlands) and Mr D. Smith (Canada) and Mr P. Harris (Australia) as Secretary.

Prof. F. Vanistendael (Belgium) was found prepared to sit in the chair of the "VAT in internal markets – European experience" Seminar C. Panellists were Mr M. Aujean (EC), Mrs D. Blou (Denmark), Mr R.G. Hales (UK), Mr A.C. Rodrigues do Amaral (Brazil) and Dr H. Zitzelsberger (Germany). Seminar D dealt with "Taxing regimes applicable to headquarters". Chairman was Mr B. Gouthière (France), assisted by Mr R. Berner (UK), Mr P. van Haute (Belgium), Mr S. Sivalingam (Malaysia), Dr A. Storck (Germany) as Panellists, and Mr F. Le Stang (France) as Secretary. Dr J. Killius (Germany) chaired Seminar E "Taxation of non-resident entertainers". Members of the Panel were Mr S. Carrere (France), Mr R. Dukes (Australia), Mr T. Miyatake (Japan), Prof. D.S. Sandler (Canada), and Mr A. Trivoli (Italy). Dr F. Hey acted as Secretary. Seminar F dealt with "Tax reform on the Southern side of the Mediterranean Sea". Prof. C. David (France) was the Chairman, and the Panel comprised Mr N. Akesbi (Morocco), Mr M. Bouderbala (Algeria), Mr D. Bouzoraa (Tunisia) and Mr C. d'Andria (Italy), with Mr J.P. Andrieux (France) as Secretary.

We are hopeful to publish the proceedings of three of the Seminars in the "IFA Congress Seminar Series". Some of these booklets will be available by the time of the 1996 Congress. Details on where these booklets may be purchased are given in the 1995 IFA Yearbook.

PERMANENT SCIENTIFIC COMMITTEE

In February the PSC enjoyed the kind hospitality of the Swiss Branch at their meeting in Geneva. The discussions, ably led by our newly-appointed Chairman David Tillinghast, were lively and constructive. Prof. Dr J.M. Moessner (Germany) attended the meeting for the first time as fully-fledged member. The Committee noted with regret that Prof. Dr J.M. Rivier (Switzerland), a very productive and long standing member of the Committee, had tendered his resignation after the Geneva Congress. It will be proposed to the Geneva General Council that Me P. Gillioz, well-known as the driving force behind the organization of the 1996 Congress, be appointed as his successor. It will also be suggested to honour the long standing desire of our second-largest Branch, in the Netherlands, that they be represented on this Committee.

Prof. Dr K. van Raad is their designated candidate. Another proposal which will be put to the General Council is that Prof. J. Malherbe (Belgium) become Vice-Chairman of the PSC, to assist Mr Tillinghast with the huge amount of work that needs to be done.

Mr Tillinghast paid tribute, which I wholeheartedly support, to the excellent work and the enormous amount of time Prof. H.J. Ault (USA) has devoted to the activities of our Research Subcommittee for the past five years in his capacity as Chairman. The initiative which was started by the Executive Director of the International Bureau of Fiscal Documentation (IBFD), Prof. H.M.A.L. Hamaekers, of having an IFA researcher work at the IBFD to help develop topics for consideration by the PSC, has been extremely helpful in increasing the quality, relevance and preparation of the Main Subjects and the Seminars that are discussed and presented at our annual Congresses. Prof. Ault has indicated his wish to retire from this function. We owe him and his collaborators, in particular Mrs J. Wheeler of the IBFD, a great debt of gratitude. Prof. K. van Raad was appointed as Prof. Ault's successor, and he will undoubtedly very ably carry on the work.

We were very fortunate to be able to engage Prof. Y. Masui (Japan), as our 1995 research associate. He made an excellent contribution to the work of the PSC, particularly concentrating on potential subjects for our 1997 New Delhi Congress.

Out of six candidates, deriving from Australia, Italy (2), Sri Lanka (2) and the USA, Dr Marco Lombardi (Italy) was selected for the 1996 research associate position. He started working at the IBFD in May 1996 and I wish him success and inspiration in his efforts.

Six young people participated in the Poster programme at the Cannes Congress. This is an excellent way of engaging promising potential members in the activities of our Association, and the programme will be repeated in Geneva.

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The scientific programme of the Geneva Congress promises to be very interesting and stimulating. National Reporters from 33 Branches contributed to 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", for which Prof. Dr P. Athanas (Switzerland) is General Reporter. 29 National Reports were submitted for Subject II "International aspects of thin capitalization", with Prof. Dr D.J. Piltz as General Reporter. Needless to say IFA is greatly indebted to the General and National Reporters for their contributions. The Seminars in Geneva will treat:

A: Taxation issues in a Federal State and economic groupings with concurrent taxing authorities
Chairman: Mr J.S. Hausman (Canada)
B: The influence of corporate law and accounting principles in determining taxable income"
Chairman: Prof. P. Thorell (Sweden)
C: International tax aspects of the economic relations with Eastern Europe
Chairman: Prof. Dr A.J. Rädler (Germany)
D: OECD Model Treaty – 1996 and beyond
Chairman: Prof. Dr K. Vogel (Germany)

Moreover, there will be a special Jubilee Symposium on the topic of "Visions of the tax systems of the XXI Century". Prof. S.O. Lodin (Sweden) will act as Chairman, and we are privileged to have two distinguished Keynote speakers in the persons of Prof. Ch. McLure (USA) and Mr M. King (UK).

The two Main Subjects for the 1997 New Delhi Congress will be:
I: "The taxation of income derived from the supply of technology", with Mr S.R. Lainoff (USA) and Dr R.C. Vaish (India) as General Reporters; and
II: "The taxation of investment funds", for which topic Dr P.J.M. Bongaarts (Netherlands) and Mrs L.J. Ed (UK) have agreed to be General Reporters. The Main Subjects of the London 1998 Congress will be the "Tax treatment of losses", with Prof. A. Michelsen (Denmark) as General Reporter; and "The application of double tax treaties" on which topic Prof. D. Williams (UK) will act as General Reporter.

In close consultation with the Israeli Branch initial discussions were held on interesting and suitable topics for the 1999 Jerusalem Congress.

One of the most exciting issues that was discussed during this PSC meeting was the proposal to launch a Research Project. The idea is that IFA will sponsor an independent research effort under its general supervision and with the participation of the National Branches. The project will be examining the impact of technological and financial innovation on traditional rules of source-basis taxation. While governments and the OECD are studying these problems, it is felt that a non-governmental, scientific study will be a major contribution. This is an excellent way of drawing on the Scientific Fund which has been built-up since 1990 from contributions by Congress Organizing Branches, and I sincerely hope that the General Council in Geneva will give its official approval to this project. More information will be available at the 1996 Congress.

Last but certainly not least, I wish to congratulate our PSC Chairman on the institution of the David R. Tillinghast Lectures on International Taxation, in conjunction with the New York University School of Law LL M in International Taxation Program in May 1996. IFA is proud of this distinguished recognition, which is very well deserved.

EXECUTIVE COMMITTEE

The Swiss proved again to be excellent hosts for the lively and interesting 28 April 1996 meeting of the Executive Committee ("EC"), which took place in Geneva at the Crédit Suisse Forum. President Adonnino welcomed Mr G.D. Andrew (South Africa) and Mr J. Libin (USA) as new members, and Mr H. Birk (Canada) as candidate for membership, who, as proposed, will complete Mr Dart's term until 1998.

As regards the further composition of the EC, for the period 1996-1998 it will be submitted to the General Council for approval that Dr M. Desax (Switzerland), Prof. R.L. Deutsch (Australia), Prof. Dr D. Juch (Netherlands), Mr T. Miyatake (Japan) and Mr J.D.B. Oliver (UK) be re-elected.

It was noted that there was a considerable increase in the costs of the 1995 Cahiers due to their volume, circulation, postage and higher expenses for paper. The General Treasurer's expectation is that this situation will be maintained for the 1996 Congress Volumes. Whilst it was concluded that IFA should not shy away from these costs, the Cahiers being IFA's main scientific achievement, it was recommended that Central IFA continue to follow very closely the new developments in electronic publications as a way of reducing the costs and possibly providing a better service to its members. I am happy to report that the General Secretariat is taking the necessary steps to go on Internet, and the feasibility of providing the Cahiers, and possibly other publications, not in book-form only is being investigated. It goes without saying that I shall keep you posted on any progress made in this regard.

Apart from French newspapers, press coverage of the Cannes Congress again proved to be disappointing, in spite of the devoted endeavours by our French friends to gain interest from the professional and international press. It was concluded that IFA should continue to use its best efforts in getting more results, although it is realized that a scientific Association such as ours will never be in the limelight. The possibility of engaging one of the leading international newspapers in IFA's activities by inviting them to distribute a free copy of their paper to each Congress participant as a way of getting extensive coverage of the Congress, is being looked into. In addition, a report of proceedings will be prepared which will be distributed to the (professional) press, also as a way of giving credit to the extensive work of all the persons actively involved in the Congress, and in particular the Discussion Leaders and Seminar Chairpersons. The intention is to make

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this report available on the Internet as well, so as to introduce people to IFA and its activities.

The EC acknowledged with gratitude the contribution of NLG 50,000 by the Canadian Branch to the scientific fund of the Association, as a result of the organization of the Toronto Congress, and in recognition of Central IFA's supportive efforts to the success of the 1994 Congress. Mr Dominjon announced that the French Branch was likely to decide shortly on a contribution to be made to IFA's scientific fund on similar grounds. In the meantime we have received confirmation that the contribution will amount to FFR 200.000 (approximately NLG 67.000), which will certainly be welcomed enthusiastically by the EC at its next meeting.

MEMBERSHIP FEES

After serious consideration, and with the proviso that the situation will be carefully reviewed again next year, the General Treasurer will propose to maintain the membership fees for 1997 at the level of the previous year, i.e. NLG 105 for individual members of National Branches, NLG 115 for direct individual members, NLG 250 for corporate members, both direct and of National Branches.

I would like to express gratitude to the continuous efforts of Mr J.W.B. Westerburgen and his assistants in dealing with the financial affairs of the Association. I would also like to thank all those Branches who faithfully cooperate in collecting the fees from their members. However, there is room for improvement, and I would again appeal to all Branch Officers to assist in keeping IFA in a financially healthy position by timely remitting the fees that are due.

IFA owes thanks to Mr H. Birk (Canada) for his many years of devoted service as Chairman of the Finance Committee. Because Mr Birk will join the EC, he had to step down from this function.

NATIONAL BRANCHES AND MEMBERSHIP

We did not have the pleasure of welcoming new Branches in our midst at the 1995 Congress. However, we continue to use our best efforts to promote IFA, because the need is felt to engage members residing in certain areas of the world, including Asia, Australasia and the Pacific, and in the former COMECON Countries, more actively in IFA programmes. The Vice Director of the State Administration of Taxation of the People's Republic of China has been invited to participate in our Geneva Congress, with the aim of broadening our activities in this vast and important country.

Unlike last year, I was unfortunately not in a position to undertake much promotional travel in the period under consideration. I did manage to pay some of our Branches a visit, and it is good to witness at first hand how active some of them are. The fact that bilateral meetings are being held at a regular pace is a fact Central IFA can only applaud and encourage. These meetings are usually of a high calibre and thus professionally very rewarding, and attract quite a lot of members in an amicable atmosphere. To give you some examples, the US/Canadian Branches were meeting in Montreal in June 1996, there is a joint meeting between the Italian and Dutch Branches just before the Geneva Congress, at which time the French and US Branches will also get together in Dijon.

In conclusion, let me again refer to the Newsletter which we send quarterly to all National Branches, provided there is sufficient news to convey. I would like to repeat my usual appeal to let us know what is going on in your Branch, for the benefit of other Branches.

CONTACT WITH INTERNATIONAL ORGANIZATIONS

I refer to the reports of our Ambassadors as published in the IFA Yearbook. We are grateful to them for their significant contribution in maintaining close contact with the fiscal activities of these organizations.

Our contacts with CIAT are being carefully maintained. In November 1995 I attended their Technical Conference in Paris. I continue to participate in the meetings of the Tax Committee of the International Chamber of Commerce in Paris. It is important for IFA to be present and active at a forum where the interests of the international business community are represented, such as the ICC Tax Committee, and at places where the voices of government representatives can be clearly heard, such as CIAT Conferences.

In December 1995 IFA was represented by Mr Y. de Coulon of our Swiss Branch at the Geneva meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters of the UN Ecosoc Council.

MITCHELL B. CARROLL PRIZE 1995

Out of five entries, the Jury decided to award the 1995 Prize to Dr Klaus Grossmann (Germany) for his work entitled "Dual residence finance companies in international tax law, with special emphasis on Germany – USA". The main focus of the thesis is an analysis of the tax law implications of dual residence when a double taxation agreement exists. Many of you will remember that this topic was dealt with at the Brussels Congress in 1987.

Five entries have been received for the 1996 Prize.

INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

The relationship with the IBFD continues to be cooperative and productive for both our organizations. Prof. Hamaekers, with his many contacts worldwide, is a valuable source of information at the meetings of our PSC, and as a member of

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the Board of Trustees I have the privilege of being kept informed at first hand about the activities of our Sister Organization.

THE 50TH CONGRESS IN GENEVA, 1-6 SEPTEMBER 1996

After Zurich in 1951, Basle in 1960, and Lausanne in 1973 we now look forward with much anticipation to our 50th Congress in Geneva. Under the inspired and enthusiastic chairmanship of Me Pierre Gillioz, supported by his colleagues, the organization is going smoothly, and a reference to Swiss clockwork is certainly in place! I wish them every success and hope that you will grace the Congress in large numbers.

RESOLUTIONS – 50TH IFA CONGRESS, GENEVA, 1996

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

RESOLUTION (FINAL ORIGINAL VERSION)

The 50th Congress, having regard to the National Reports and the General Report on the Principles for the determination of the income and capital of permanent establishments and their applications to banks, insurance companies and other financial institutions, as published in Vol. 81a of the *Cahiers de Droit Fiscal International*, taking note of the discussions during the Congress, has adopted the following Resolutions.

1. Considering the increased functional independence of permanent establishments pertaining to banks and insurance companies, the allocation of income and capital should be made only by the application of the direct method (and not by indirect methods) and considering the regulatory requirements.

Countries, however, which have a long tradition in applying the indirect method should introduce a period of transition which is sufficient to allow both legislator and banking and insurance industry to change the method without creating new double taxation problems.

2. Allowing for the extended functional independence of permanent establishments of banks and insurance companies, the capital endowment of the branch in accordance with the regulatory requirements has to be respected by the relevant tax authorities.

Any exceeding amount should be respected as a loan granted by the head office to the branch *or* as additional equity – depending on the head office's valid commercial intention.

Losses/Gains on dotation capital caused by a decrease/-increase of the foreign exchange rate have to be recognized in the head office country for tax purposes.

3. The OECD guidelines for the income allocation resulting from loans should be revised putting more emphasis on the criterion of "effective risk bearing".

Allowing for the functional independence of the branches of banks and insurance companies, the transferability of loans should be recognized for taxation purposes if valid commercial reasons can be given for such transfer *or* if the same transfer would have been effected between unrelated third parties.

4. The income resulting from investing the insurance premiums should be allocated to the different branches using the direct method of allocation only, thus giving due consideration to the branches' increased functional independence. If the investment is handled by a centralized treasury centre an arm's length compensation for such service is justified.

An explanatory note on the Resolutions for Subject I by Ian W. Harris, discussion leader for the Panel

The Panel met on three occasions prior to the Congress to formulate the five Resolutions that were presented. In framing the Resolution the Panel found three major areas of concern arising from the National Reports:

1. That as the subject matter was very specialized it was found that in many countries entities were often taxed on a formulatory basis.

2. Both banking and insurance operate in a highly regulated environment which often made no distinction between a branch and a subsidiary in the application of the rules.

3. The Panel was unable to find a common theme to link the five Resolutions, therefore each Resolution stood on its own. However, there were two basic factors running through the Resolutions:

a. As the banking and insurance industries are subject to such stringent and close regulations which are increasingly being imposed, globally this should be recognized for tax purposes.
b. From a management point of view there is often little difference between a branch and a subsidiary, the choice often being dictated by the regulatory authority.

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Resolution No. 1

Resolution No. 1 was the key to the Panel's findings from the National Reports in that it was the Panel's view that the tax profit of a branch should follow that as determined by the regulators. In particular, the Panel considered that the formulatory or indirect method was inappropriate as the separate entity approach is adapted by the regulators. Much of the discussion from the floor and proposed amendments centred on the use of the arm's length method. The Panel responded that the use of the arm's length method produces results different from that determined by the regulators and which the Resolution sought to overcome. A further amendment from the floor permitting any change to be subject to transition rules was accepted by the Panel.

Resolution No. 2

Congress accepted the first part of this Resolution requiring tax authorities to accept the regulatory requirements regarding the capital of a permanent establishment with any excess being treated as a loan. The second sentence engendered considerable discussion with the main objection relating to the freedom of the head office to determine the tax consequences and again the arm's length principle was suggested. However the wording of the sentence was amended to restrict any ability to manipulate the position. The Panel agreed that the final sentence should reflect profits as well as losses.

Resolution No. 3

The term "effective risk bearing" caused difficulty until the Panel was able to explain that this related to the permanent establishment which the regulatory authorities regard as being responsible for the loan. This was contrasted to the legal position where the ultimate responsibility lies with the head office.

Resolution No. 4

Congress considered that the Resolution as it stood contained too many flaws and that as it covered areas beyond the scope of Subject I, it should be subject to further in-depth study. The Resolution was rejected.

Resolution No. 5

In adopting this Resolution it was recognized that it encompassed cases where there was either integrated or decentralized management or where a separate entity was used.

Resolution No. 6

This was introduced from the floor and the Panel considered that if it was adopted it would have effect beyond banks and insurance companies and therefore beyond the scope of Subject I. The Resolution was rejected.

SUBJECT II: INTERNATIONAL ASPECTS OF THIN CAPITALIZATION

RESOLUTION (FINAL ORIGINAL VERSION)

The 50th Congress, having regard to the National Reports and the General Report on International aspects of thin capitalization, as published in Vol. 81b of the *Cahiers de Droit Fiscal International*, taking note of the discussions during the Congress, has adopted the following Resolutions.

1. When applying Article 9 of the OECD Model Convention for the purposes of determining whether an enterprise is "thinly capitalized", the relevant standard 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. A comparison of the level of profit of the borrower or lender with that of independent enterprises cannot be a factor in determining whether a loan is made at "arm's length".

2. 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 (the shareholder's country of residence) should be obliged to accept the re-characterization made by the source country (the company's country of residence) when applying the convention. If interest is re-characterized as a dividend by the source country, the country of residence of the shareholder should apply its rules for avoiding double taxation of dividends.

3. The taxpayer should have the right to prove that its debt-equity ratio is appropriate even if it exceeds a specified fixed ratio.

4. If the application of thin capitalization rules results in double taxation, the countries concerned should be obliged, upon request of the taxpayer, to attempt to eliminate the same whether or not the taxation is in accordance with the provisions of the relevant double taxation convention.

5. Taxpayers should have the right to request a binding ruling from the tax authorities as to whether or not a planned financial transaction triggers the application of thin capitalization rules.

An explanatory note on the Resolutions for Subject II by Bruno Gangemi, discussion leader for the Panel

The draft Resolutions for Subject II and the related Explanatory Statements were drafted by the General Reporter and the Discussion Leader and presented to the Congress for discussion. The Explanatory Statements sought to highlight the

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relationship of the thin capitalization rules with Article 9, with particular reference to whether the thin capitalization issue is appropriately addressed by Article 9(1) of the OECD Model Convention, and the interaction of this conclusion with Article 24. The Explanatory Statements also addressed the practical aspects of the implementation of the thin capitalization rules, as well as the practical difficulties deriving from countries' use of different ratios and discrepancies deriving from countries' definition of capital and debt. The philosophy behind the draft Resolutions presented to the Congress reflected the concerns that the difficulties in applying Article 9 to the issue of thin capitalization could result in the proliferation of cases of double taxation. Accordingly, original Resolution No. 1 would have stated that Article 9 was not a practical yardstick for thin capitalization cases; original Resolution No. 2 would have prohibited the application of thin capitalization rules to countries bound by treaties containing anti-discrimination rules; and original Resolution No. 3 would have restricted the application of thin capitalization rules to cases involving tax haven countries or fraudulent tax planning schemes.

The discussion reflected a consensus that while Article 9(1) was a difficult yardstick to apply to thin capitalization issues, it was nonetheless both a relevant and appropriate standard. A number of amendments in favour and against the original draft Resolutions were proposed (including amendments from Mr Etherington (UK) and Mr Andrade (Brazil)). Mr Diehl (Germany) questioned whether Article 9(1) provided a legal basis for addressing thin capitalization situations. Mr Lopez (Argentina) intervened and noted the significant effects of exchange rate gains or losses on financing in inflationary environments. Mr Herzig (Germany) proposed to delete original Resolutions No. 2 (prohibiting application of Article 9(1) where a non-discrimination article would apply) and No. 3 (restricting application of thin capitalization rules to cases involving tax haven or fraudulent planning).

A Resolution was proposed in approximately the form finally adopted by the Congress as Resolution No. 1 as a substitute for the first three original Resolutions. This Substitute Resolution did not address specifically the issue of discrimination; once it is accepted that the application of a thin capitalization adjustment does not conflict with the arm's length standard of Article 9(1), then, under the terms of Article 24(4), the non-discrimination principle would not apply. The issue of limiting the thin capitalization rules to interest paid to non- or low-tax countries was subsumed within the scope of the Substitute Resolution. A further amendment was adopted that underlined the opposition to the use of profit methods.

Original Resolution No. 4 was adopted without change as Resolution No. 2. The discussion clarified that the Resolution was not to be taken as a description of the current legal position under most treaties, but was intended to serve as a clear statement that, in cases of reclassifications of interest as dividends which are consistent with the applicable convention, it is desirable that the residence country provide full relief.

In the discussion of original Resolution No. 5, it was suggested that the OECD take up the issue of harmonizing the definition of the elements of "debt" and "equity" used in fixed ratios. Original Resolution No. 5, however, was objected to on the grounds that a harmonized "safe haven", which normally would be allowed to be used at the election of a taxpayer, would be extremely difficult to achieve in practice and would have a tendency to reduce the scope of the safe haven to the lowest common denominator. On this basis, the Congress voted to delete the Resolution.

Original Resolution No. 6 was adopted with a clarifying amendment as final Resolution No. 3. During the discussion, it was suggested that the burden of proof be reversed, that is that the tax authorities should have to prove that the debt financing in question did not comply with the arm's length principle. This suggestion was not viewed as feasible, in light of the legal position in the vast majority of countries.

The Congress next turned to original Resolution No. 7 relating to relief from double taxation in thin capitalization cases involving denial of interest deduction. Mr Ward (Canada) proposed an amendment that clarified that the obligation to attempt to eliminate double taxation should apply without regard to whether the taxation was in accordance with the provisions of the convention. This amendment was adopted and the Resolution, as amended, was adopted as final Resolution No. 4.

In the discussion of original Resolution No. 8, Mr Liebman (Belgium) noted that the topic of advance rulings extended beyond thin capitalization and had been addressed to some extent in other conferences. Some possible problems with the use of the word "binding" also were noted. Original Resolution No. 8 was renumbered as Resolution No. 5 and adopted in the form proposed without change.

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Vienna, Linde Verlag Wien GmbH. 1995, pp. 910. ISBN: 3 85122 490 6.
EC manual. The law within the Internal Market. Amongst others, the following issues are discussed: community law, free movement of goods, freedom of settlement, financial institutes, securities, insurances, social law, employment law, environmental law, tax law, competition law, traffic law and the Treaty of Maastricht.
(B. 115.029)

Gulmann, Claus; Hagel-Sørensen, Karsten.
EU-ret.
Copenhagen, Jurist- og Økonomforbundets Forlag. 1995, pp. 452. ISBN: 87 574 1897 7.
The book describes all the basic aspects of the European Union and includes such topics as: the institutions, (including a comprehensive section on the European Court of Justice) and the legal control of the European Union, the law-making process, the sources of EU-law, the application of EU-law, including implementation and enforcement, the internal market, the free movements of goods, persons, services and capital and competition law, the principle of non-discrimination and the principles of solidarity and subsidiarity.
(B. 115.701)

Handbuch des Europäischen Steuer- und Abgabenrechts. Herausgegeben von Dieter Birk.
Herne, Verlag Neue Wirtschafts-Briefe. 1995, pp. 1169. DEM 198. ISBN: 3 482 46591 6.
Manual of the European tax and duties law. The manual tackles, amongst others, issues with respect to the European Union and the European Communities, taxes, customs duties, the prohibition of discrimination, free movement of goods, EC law and international tax law, taxation of EC company forms.
(B. 114.639)

Harmonisierung der Körperschaftsteuersysteme in den EU-Staaten. Herausgegeben von Norbert Herzig.
Cologne, Verlag Dr. Otto Schmidt. 1994. Steuerthemen im Brennpunkt, Band 6, pp. 120. DEM 49. ISBN: 3 504 25096 8.
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(B. 114.215)

Strijd tegen BTW-fraude in de Europese Unie. Handhaving in België en Nederland. Editor J.A.E. Vervaele.
Antwerp, Maklu Uitgevers, Somerstraat 13-15, 2018 Antwerpen, Belgium. 1995, pp. 212. BEF 1650. ISBN: 90 6215 489 1.
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(B. 115.591)

Turner, Sharon; O'Shea, John.
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Derry, Magee College, University of Ulster, Northland Road, Derry, BT48 7JL, Ireland. 1995.
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(B. 115.492)

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Amsterdam, Deloitte Touche Tohmatsu International. 1996, pp. 19.
A survey of the impact on business of the new Single Market VAT rules.
(B. 115.550)

Finland

Korkeimman hallinto-oikeuden vuosikirja 1995. B Verotus.
Helsinki, Oy Edita Ab. 1996, pp. 332.
ISBN: 951 37 1975 8.
Annual of the Supreme Administrative Court 1994; Part B – Taxation. Compilation of tax appeal cases decided by the Supreme Administrative Court during 1995. Issues include national and municipal income taxes, their assessment procedure, advance payment of tax, social security premiums, inheritance and gift tax, turnover tax, value added tax and stamp tax. Topical and chronological indexes in Finnish and Swedish are appended.
(B. 115.587)

Puronen, Pertti.
Perintö- ja lahjaverotus. 6th edition.
Lakimiesliiton Kustannus. 1996, pp. 572.
ISBN: 951 640 896 6.
Inheritance and Gift Taxation. Sixth revised edition of the monograph describing in depth

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the Finnish inheritance and gift tax law as fundamentally revised with effect from 1 January 1996. The book aims to be practice oriented, giving guidance in solving most commonly occurring problems. Special attention is given to the interplay between the inheritance and gift taxation, on the one hand, and the income, net-wealth and stamp taxation, on the other hand. Appendixes include the full law text, tax return forms, an extensive case list and a topical index.
(B. 115.511)

Ryynänen, Olli. .
Förtäckt dividend i beskattningen.
Helsinki, The Swedish School of Economics and Business Administration. 1996.
Ekonomi och samhälle, No. 64, pp. 568.
ISBN: 951 555 484 5.
The taxation of constructive dividends. Doctoral dissertation. This in-depth study analyses the Finnish taxation treatment of constructive dividends in the current environment of imputation system and dual taxation of income (earned income – income from capital). Forms of tax avoidance, cross-border transfers of hidden profit distributions and thin capitalization are also discussed. An English summary is appended. Other appendixes include an extensive bibliography on the relevant topics and a list of relevant cases on final assessment and on advance rulings.
(B. 115.616)

Terra, Ben J.M.; Taipalus, Päivi.
EY:n arvonlisäverotus ja oikeuskäytäntö - Katsaus EY:n ja Suomen arvonlisäverotukseen 1996.
Helsinki, Kauppakaari Oy. 1996, pp. 205.
ISBN: 951 640 872 9.
EU VAT law and case law – a survey of the VAT system of the European Union and that of Finland. The authors discuss the provisions of the 6th VAT Directive in light of the decisions of the European Court of Justice, and describe how the provisions of the directive are reflected in the Finnish VAT law.
(B. 115.753)

France

Bont, Guido de; Essers, Peter; Kemmeren, Eric; a.o.
Fiscal versus commercial profit accounting in the Netherlands, France and Germany.
Amsterdam, IBFD Publications BV. 1996.
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ISBN: 90 70125 91 9.
The book analyses and evaluates possible distortions caused by differences between fiscal and commercial accounting in the Netherlands, France and Germany. The General Section deals with the various consequences of these differences. The Specific Section makes a comparison of the fiscal and commercial treatment of various entries on the balance sheet in the three countries. Subjects concerning the total profit concept are dealt with: the different thin capitalization approaches and the various loss compensation systems in the three countries.
(B. 115.761)

Cozian, Maurice.
Les grands principes de la fiscalité des entreprises. 3rd Edition.
Paris, Editions Litec. 1996, pp. 497. FFR 260.
ISBN: 2 7111 2658 7.
Third edition of monograph dealing with the major principles of taxing business enterprises.
(B. 115.599)

Heering, A.D.G.; Clement, M.J.
Onroerend goed in Frankrijk; kopen, bezitten en ontwikkelen.
Lelystad, Koninklijke Vermande. 1996, pp. 188. NLG 49. ISBN: 90 5458 265 0.
Monograph dealing with investments in real property in France. The following aspects are dealt with: acquisition of real property, legal aspects of construction industry, leasing and dwelling, tax consequences of investing in French real property.
(B. 115.498)

Spengel, Christoph.
Europäische Steuerbelastungsvergleiche Deutschland – Frankreich – Grossbritannien.
Düsseldorf, IDW Verlag GmbH. 1995, pp. 497. DEM 98. ISBN: 3 8021 0687 3.
European tax burden comparison. A comparison between Germany, France and the United Kingdom. Tax burden comparison based on electronic data processing.
(B. 115.160)

Germany

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Bonn, Stollfuss Verlag. 1996, pp. 2388.
DEM 140. ISBN: 3 08 367596 8.
1996 Manual on the Fiscal Code and the Tax Court Code. The manual contains the texts of the laws and related legal regulations, jurisprudence, and administrative guidelines issued by the tax authorities.
(B. 115.459)

Arndt, Hans-Wolfgang; Piltz, Detlev Jürgen.
Grundzüge des Besonderen Steuerrechts. Band 1: Ertragsteuer- und Unternehmenssteuerrecht.
Munich, Verlag Franz Vahlen; Verlag C.H. Beck. 1996.
Lehrbücher für Wirtschaft und Recht, pp. 641.
DEM 68. ISBN: 3 8006 1874 5.
Principles of income tax law and enterprise tax law. The book is primarily addressed to students who need to acquire a thorough knowledge of the tax law.
(B. 115.186)

Aushilfslöhne. Teilzeit- und Aushilfskräfte. Lohnsteuer, Vermögensbildung, Kirchensteuer, Sozialversicherung, Arbeitsrecht. 15. Auflage.
Bonn, Stollfuss Verlag. 1996, pp. 96.
DEM 34.80. ISBN: 3 08 317696 1.
Part-time and temporary employees. New regulations as regards part-time and temporary employees effective 1 January 1996.
(B. 115.154)

Baranowski, Karl-Heinz.
Besteuerung von Auslandsbeziehungen. 2. Auflage.
Herne, Verlag Neue Wirtschafts-Briefe. 1996, pp. 938. DEM 180. ISBN: 3 482 60192 5.
Taxation of cross-border relations. The author explains the regulations which apply in case of emigration of a company to another country. The book deals with double taxation treaties, mutual agreement procedures, and legal assistance and procedures, the German Aussensteuergesetz, the valuation of participations in foreign corporations for income and property tax and special regulations in force for cross-border situations.
(B. 115.620)

Barthel, Klaus; Günther, Karl-Heinz.
Einkommensteuer. 61 praktische Fälle. 12. Auflage.
Achim, Erich Fleischer Verlag. 1996.
Steuer Seminar, Band 2, pp. 277. DEM 43.90.
ISBN: 3 8168 3022 6.
Income tax. The book is designed for students and contains 61 practical cases on the income tax. It includes all relevant issues, i.e. resident and non-resident taxpayers, income categories, assessment years, tax rates, allowances, etc.
(B. 115.340)

Besteuerung wirtschaftlicher Aktivitäten von Ausländern in Deutschland. Herausgegeben von Lutz Fischer.
Cologne, Verlag Dr. Otto Schmidt. 1995, pp. 162. ISBN: 3 504 61507 9.
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(B. 115.041)

Bierhaus, Werner; Mannek, Wilfried.
Anteilsbewertung zum 31.12.1994 und zum 31.12.1995.
Cologne, Peter Deubner Verlag. 1996.
Steuer-Telex Beratungsschriften, pp. 111.
ISBN: 3 88606 189 2.
Valuation of participations in companies and partnerships. Comments on and practical application of the regulations which are in force.
(B. 115.474)

Birkenfeld, Wolfram; Daumke, Michael.
Das neue aussergerichtliche Rechtsbehelfsverfahren. 2. Auflage.
Cologne, Verlag Dr Otto Schmidt. 1996, pp. 312. DEM 64. ISBN: 3 504 22203 4.
Appeals against decisions of the Tax Administration. The authors explain which

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decisions of the Tax Administration may be appealed against and what can be done if a taxpayer does not agree with an appeal decision or when the Tax Administration does not deal with the complaint.
(B. 115.618)

Bont, Guido de; Essers, Peter; Kemmeren, Eric; a.o.
Fiscal versus commercial profit accounting in the Netherlands, France and Germany.
Amsterdam, IBFD Publications BV. 1996.
IBFD International Tax Topics, pp. 150.
ISBN: 90 70125 91 9.
The book analyses and evaluates possible distortions caused by differences between fiscal and commercial accounting in the Netherlands, France and Germany. The General Section deals with the various consequences of these differences. The Specific Section makes a comparison of the fiscal and commercial treatment of various entries on the balance sheet in the three countries. Subjects concerning the total profit concept are dealt with: the different thin capitalization approaches and the various loss compensation systems in the three countries.
(B. 115.761)

Brandmüller, Gerhard.
Der GmbH-Geschäftsführer im Gesellschafts-, Steuer- und Sozialversicherungsrecht. 8. Auflage.
Bonn, Stollfuss Verlag. 1996, pp. 318.
DEM 51.80. ISBN: 3 08 315808 4.
Fiscal and social security law for the manager of a close company. The author explains the consequences of recent important jurisprudence concerning pension rights, the employee contract of a manager, the liability risks (before registration and in case of liquidation) and environmental legislation.
(B. 115.513)

Crezelius, G.; Seewald, H. Chr.; Spiegelberger, S.; Wassermeyer, F.
Unternehmenssicherung. Gestaltungsplanung für den Erbfall und nach dem Erbfall.
Bonn, Stollfuss Verlag. 1996.
Beratungs Akzente, No. 14, pp. 171. DEM 98.
ISBN: 3 08 440014 8.
Enterprise continuance. Tax planning on successions. The book gives detailed information and analysis on the taxation of heirs. A specific chapter is dedicated to succession cases which have a foreign connection.
(B. 115.234)

Crezelius, G.; Seewald, H. Chr.; Spiegelberger, S.; Wassermeyer, F.
Unternehmenssicherung. Unternehmensgestaltung durch Gesellschafterwechsel.
Bonn, Stollfuss Verlag. 1995.
Beratungs Akzente, No. 13, pp. 153. DEM 98.
ISBN: 3 08 440013 X.
Enterprise continuance. Structuring an enterprise through a change in shareholders. The book tackles civil law, in particular company and inheritance tax law, as well as tax law issues with respect to a change of shareholders either by way of succession or inter vivos.
(B. 115.153)

Dankmeyer, Udo; Welter, Monika.
Steuer-Leitfaden für die neuen Bundesländer. Stand April 1996. 6. Auflage.
Bonn, Stollfuss Verlag. 1996, pp. 392.
DEM 35.80. ISBN: 3 08 320296 2.
Income tax, corporation tax, trade tax and value added tax. The book gives an overview of special regulations which apply to the new Länder of the former GDR, especially of incentives, tax-free amounts, tax rates and transitional law.
(B. 115.512)

Das grosse Gerichtsverzeichnis.
Cologne, Verlag Dr. Otto Schmidt. 1996, pp. 862. DEM 98.19. ISBN: 3 504 19200 3.
Tax Court registry. Addresses of tax courts, public prosecutor offices, penal institutions, labour courts, finance courts, social courts and administrative courts. Also of the European Court of Justice and the notary and lawyers organizations.
(B. 115.231)

Die Steuerrechtsordnung in der Diskussion. Festschrift für Klaus Tipke zum 70. Geburtstag. Herausgegeben von Joachim Lang.
Cologne, Verlag Dr Otto Schmidt. 1996, pp. 738. DEM 178. ISBN: 3 504 06015 8.
Liber Amicorum for Klaus Tipke concerning the tax law in the context of the constitution, interpretation of the tax system, criminal tax law and European and foreign tax law.
(B. 115.619)

Dötsch, Ewald.
Das neue Umwandlungssteuerrecht ab 1995. Umstrukturierung von Unternehmen, Verschmelzung, Spaltung, Formwechsel, Einbringung. 2. Auflage.
Stuttgart, Schäffer-Poeschel Verlag. 1996, pp. 423. DEM 78. ISBN: 3 8202 1090 3.
The 1995 Restructuring Tax Law.
Commentary on the revised Restructuring Tax Law of 28 October 1994 which applies to restructurings which become effective as of 31 December 1994.
(B. 115.232)

Einkommensteuergesetz. Kommentar. 15. Auflage. Herausgegeben von Ludwig Schmidt.
Munich, Verlag C.H. Beck. 1996, pp. 2383.
DEM 164. ISBN: 3 406 39935 5.
Income tax in Germany. The book contains an explanation and commentary of all articles of the German income tax as of January 1996. Moreover a summary of the decisions of the German Supreme Court and the opinions of authors is given.
(B. 115.567)

Engelmeyer, Cäcilie.
Die Spaltung von Aktiengesellschaften nach dem neuen Umwandlungsrecht.
Cologne, Verlag Dr. Otto Schmidt. 1995.
Rechtsfragen der Handelsgesellschaften, Heft 82, pp. 520. DEM 79. ISBN: 3 504 64634 9.
Division of corporations according to the new Reorganization Law of 28 October 1994. The book gives an in-depth description of the new Reorganization Law effective 1 January 1995.
(B. 114.884)

Falterbaum, H.; Beckmann, H.
Buchführung und Bilanz. 16. Auflage.
Achim, Erich Fleischer Verlag. 1996.
Grüne Reihe, Band 10, pp. 1170. DEM 96.
ISBN: 3 8168 1106 X.
Standard book for the practitioner and for students on accounting, commercial and tax balance sheet and profit determination for tax purposes. Case law and administrative guidelines are as at 1 October 1995.
(B. 115.157)

Familienleistungsausgleich 1996. Gesetze – Begründungen – Kommentierung – Materialien. Bearbeitet von Gerd Berlebach.
Bonn, Stollfuss Verlag. 1996, pp. 457.
DEM 72. ISBN: 3 08 368396 0.
1996 Family equalization law. The manual contains the law, parliamentary history, comments and other materials with respect to the family equalization law which has been introduced effective 1 January 1996.
(B. 115.286)

Feil, Erich.
Eigenkapital ersetzende Gesellschafterdarlehen in Lehre und Rechtsprechung.
Vienna, Linde Verlag Wien GmbH. 1996, pp. 47. ATS 118. ISBN: 3 85122 596 1.
Requalification of loans (provided to a company by the shareholders) into equity. The book describes the rules of the German and Austrian Supreme Courts with regard to this requalification and the opinions of German and Austrian authors.
(B. 115.534)

Fleischer, Erich; Thierfeld, Rainer.
Stille Gesellschaft im Steuerrecht. 6. Auflage.
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DEM 54. ISBN: 3 8168 4036 1.
Taxation of the "atypische stille Gesellschaft". The book deals with the tax object, the tax subject, profit calculation, tax accounting, the establishment and liquidation of this legal form, foreign aspects and the taxation of participating employees.
(B. 115.516)

Friedl, Peter-Joachim.
Kapitalflussrechnung und Liquiditätsanalyse. Die Praxis der Cash-Flow Statements nach deutschem und österreichischem Handelsrecht.
Vienna, Linde Verlag Wien GmbH. 1995, pp. 247. ATS 478. ISBN: 3 85122 483 3.
Cash flow accounting and analysis. The book presents models and solutions for cash flow accounting and analysis with respect to Germany and Austria.
(B. 115.084)

Gasper, Richard.
Die Lifo Bewertung. Zielsetzung, GoB Konformität, Verfahren.

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Düsseldorf, IDW Verlag GmbH. 1996, pp. 339. DEM 98. ISBN: 3 8021 0686 5.
Valuation according to the LIFO method. Effective 1 January 1990, the LIFO method has been accepted in Germany for tax purposes. The author discusses various topics related to the LIFO method when used in the tax balance sheet. The book also contains a chapter on the LIFO method as applied in the United States.
(B. 115.162)

Gehre, Horst.
Steuerberatungsgesetz. Kommentar. 3. Auflage.
Munich, Verlag C.H. Beck. 1995, pp. 536. DEM 168.
Commentary on the various laws governing the profession of tax advisors.
(B. 114.648)

Grass, Arno.
Unternehmensformneutrale Besteuerung.
Berlin, Duncker & Humblot GmbH. 1992. Schriften zum Steuerrecht, Band 42, pp. 191. DEM 74. ISBN: 3 428 07399 1.
Tax-neutral taxation of enterprises. The book discusses the issue of whether there is any justification in taxing corporations and partnerships differently.
(B. 111.978)

Hahn, Volker; Kortschak, Hans-Peter.
Lehrbuch der Umsatzsteuer. 7. Auflage.
Herne, Verlag Neue Wirtschafts-Briefe. 1996, pp. 395. DEM 58. ISBN: 3 482 74817 9.
Handbook concerning all aspects of VAT in Germany.
(B. 115.598)

Hakelmacher, S.
Hakelmachers ABC der Finanzen und Bilanzen.
Cologne, Verlag Dr. Otto Schmidt. 1995, pp. 205. DEM 48. ISBN: 3 504 0192 5.
ABC of finances and balances. A book on tax and accounting terms.
(B. 115.233)

Holding Handbuch. Recht – Management – Steuern. 2. Auflage. Herausgeber Marcus Lutter.
Cologne, Verlag Dr. Otto Schmidt. 1995, p. 800. DEM 238. ISBN: 3 504 48001 7
Manual for holding companies. The book elaborates on several issues as regards holding companies, e.g. legal forms, internal and external control, financing, national and international tax matters, foreign locations for holding companies.
(B. 115.042)

Hüffer, Uwe.
Aktiengesetz. 2. Auflage.
Munich, Verlag C.H. Beck. 1995, pp. 1542. DEM 178. ISBN: 3 406 38709 8.
The Corporation Law. Commentary to the Corporation Law including all recent amendments, e.g. the law on the restructuring of corporations of 28 October 1994.
(B. 114.814)

Jasper, L.Th.; Kracht, R.; Schwartzkopff, Chr.
ABC steuergünstige Geldanlagen 1996. Gestaltungen, Rendite, Risiko.
Bonn, Stollfuss Verlag. 1995, pp. 408. DEM 51.80. ISBN: 3 08 214096 3.
Tips on how to invest money advantageously. The book provides information on the tax treatment of capital investments as regards income tax, net wealth tax, inheritance tax, and gift tax. Specific topics discussed are investment abroad, tax-free capital gain appreciation, tax bribery, interest withholding tax.
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Karakitis, Alexandros.
Die ertrag- und vermögensteuerrechtliche Behandlung von Gewerbebetrieben mit Betriebsstätten in Deutschland und Griechenland im Lichte des deutsch-griechischen Doppelbesteuerungsabkommens.
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Income and property taxation of business activities of companies with permanent establishments in Germany and Greece, including the Greece–Germany tax treaty. The investigation focuses specially on problems concerning the division of profits and the exercising of taxation power by the state where the permanent establishment is situated in the context of Article 52 of the EC Treaty.
(B. 115.602)

Knief, Peter.
Körperschaftsteuer 1996. Gesamtdarstellung mit Beispielen. 3. Auflage.
Bonn, Stollfuss Verlag. 1996, pp. 440. DEM 48.80. ISBN: 3 08 213103 4.
Corporation tax. Handbook concerning the taxation of corporations. An overview is given of all regulations, especially the distribution of profits, the imputation system, the capital division, the solidarity surcharge, the taxation of foundation merger, split-up and transfer of legal form.
(B. 115.529)

Kommentar zum Umwandlungsrecht. Umwandlungsgesetz – Umwandlungssteuergesetz. Herausgebers Klaus Goutier, Rüdiger Knopf und Anthony Tulloch.
Heidelberg, Verlag Recht und Wirtschaft GmbH. 1996, pp. 1346. DEM 290. ISBN: 3 8005 2019 2.
Restructuring law and restructuring tax law. Extensive commentary to the new Restructuring Law of 28 October 1994, effective 1 January 1995.
(B. 115.191)

Lindberg, Klaus.
Die Besteuerung der Kapitaleinkünfte.
Munich, Verlag C.H. Beck. 1996, pp. 264. DEM 88. ISBN: 3 406 40352 2.
Taxation of capital income. The book explains the tax law concerning capital income especially the calculation of the income, the tax subject, acquiring expenses which are deductible and the part of the income which is tax free (tax free amount) for resident and non-resident taxpayers and the situation under tax treaties.
(B. 115.546)

Linssen, Rudolf B.
Das neue Einspruchsverfahren.
Cologne, Peter Deubner Verlag. 1996. Steuer Telex Beratungsschriften, pp. 102. DEM 77.60.
The new complaint procedure. Text, comments and practical application.
(B. 115.475)

Lohr, Jörg-Andreas; Graetz, Jörg.
Die Besteuerung ausländischer Investmentfonds bei privaten Kapitalanllegern.
Düsseldorf, IDW Verlag GmbH. 1996, pp. 269. DEM 78. ISBN: 3 8021 0672 5.
The taxation of income from non-resident investment funds on the resident private investor. The book contains profound information on the tax treatment of shares and other securities in non-resident investment funds.
(B. 115.161)

Lück, Wolfgang.
Rechnungslegung nach Handels- und Steuerrecht. 7. Auflage.
Bonn, Stollfuss Verlag. 1996, pp. 603. DEM 44.80. ISBN: 3 08 372996 0.
Commercial and fiscal accounts. The book deals with the fiscal accounting rules, the calculation of fiscal profits and their committing to a fiscal year. Moreover, the treatment of losses and the fiscal valuation rules are taken into account. The book also contains an overview of the rules which apply to groups.
(B. 115.514)

Meyer, Oliver.
Die Besteuerung grenzüberschreitender Verschmelzungen.
Berlin, Dunker & Humblot GmbH. 1995. Schriften zum Steuerrecht, Band 49, pp. 200. DEM 88. ISBN: 3 428 08240 0.
Taxation of cross-border mergers. Thesis dealing with the civil and fiscal conditions which have to be met in order to bring cross-border mergers within the EC Merger Directive. The author concludes that Sec. 14 of the German law concerning the change of legal form in combination with the tax treaties, already meet most of the requirements for a successfull cross-border merger.
(B. 114.505)

Pietsch, Reinhart; Bader, Franz-Josef.
Besteuerung von Gesellschaften. 82 praktische Fälle. 7. Auflage.
Achim, Erich Fleischer Verlag. 1996. Steuer-Seminar, Band 7, pp. 624. DEM 68.80. ISBN: 3 8168 3077 3.
Practical case studies on all tax aspects regarding corporations, partnerships, limited liability companies, and divisions in Germany.
(B. 115.133)

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Pietsch, Reinhart; Schulz, Burghard.
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(B. 115.207)

Ranft, E.; Lange, H.
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(B. 115.438)

Rechnungslegung nach International Accounting Standards.
Düsseldorf, IDW Verlag GmbH. 1995,
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Accounting complying with the International Accounting Standards. Practical guidance for the setting up of profit and loss statements of corporations and groups in Germany.
(B. 115.087)

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Anniversary volume for Rainer Ludewig dealing with various aspects of German accounting, controlling and consultancy practice.
(B. 115.563)

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(B. 115.152)

Reis, Monique.
Die Körperschaftsbesteuerung des Konzerns als wirtschaftliche Einheit. Mögliche Alternative zur Einzelbesteuerung?
Frankfurt am Main, Verlag Peter Lang. 1996.
Europäische Hochschulschriften, Reihe V, Volks- und Betriebswirtschaft, Vol. 1872, pp. 373. DEM 95. ISBN: 3 631 49466 1.
Corporation tax for groups as an economic entity. In this book the author explains the existing treatment of group companies. They are separately taxed except when they meet the requirements of the "Organschaft". An alternative could be the regarding of groups as an economic entity, whereunder the group companies are permanent establishments of the parent company. The author deals with foreign regulations concerning countries where groups are regarded as one economic entity. In the last part, the author gives her own solutions for the commercial concern balance sheet.
(B. 115.722)

Rekow, Erich.
Der neue Solidaritätszuschlag bei Kapitalgesellschaften und deren Gesellschaftern.
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Schröder, Susanne.
Steuerlastgestaltung der Aktiengesellschaften und Veranlagung zur Körperschaftsteuer im Deutschen Reich und den USA von 1918 bis 1936.
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ISBN: 3 428 08735 6.
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(B. 115.544)

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DEM 48.60. ISBN: 3 8168 3132 X.
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Spengel, Christoph.
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(B. 115.694)

Steven, Gerhard.
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The use of financing corporations set up abroad in order to finance foreign subsidiaries of German resident multinational enterprises. Analysis of possibilities and limitations when using financing corporations abroad as regards

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the tax burden of the non-resident subsidiary and the resident parent company.
(B. 114.892)

Thoms-Meyer, Dirk.
Grundsätze ordnungsmässiger Bilanzierung für Pensionsrückstellungen.
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Schriften des Instituts für Revisionswesen der Westfälischen Wilhelms-Universität Münster, pp. 314. DEM 98. ISBN: 3 8021 0700 4.
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(B. 115.561)

Tipke, Klaus.
Die Steuerrechtsordnung. 3 Bänden.
Cologne, Verlag Dr Otto Schmidt. 1993, pp. 1593. ISBN: 3 504 20101 0.
Publication comprising 3 volumes dealing with justice in tax regulations. The author expresses the opinion that a tax is not justified merely because of the fact that the revenues are needed. Therefore, tax should be levied following justified principles, which should result in an equal treatment. The existing regulations are of importance, because tax may only be levied in case of an existing regulation. However, the legislation does not always use general law principles when proposing new laws. This could result in an unfair levying of taxes. The author deals with the question, to what extent is the tax system in accordance with the legal order, and has investigated when tax laws can be qualified as fair. Furthermore, he tries to indicate which requirements a tax system has to meet in order to be qualified as legal. The tax bearing principle is used. The author closes with a fundamental explanation of the juridical basis for the levying of taxes. Tipke concludes that regularly unsystematic and complex regulations are enacted which conflict with justice.
(B. 115.686)

Troll, Max.
Vermögensübertragungen 1995 und 1996. Schenkung- und Erbschaftsteuer nach den Entscheidungen des Bundesverfassungsgerichts.
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The transfer of net wealth in 1995 and 1996. Inheritance and gift tax issues after the decisions of the Constitutional Court of 22 June 1995 which declared taxation of real estate as not in accordance with the German constitution.
(B. 115.062)

Unternehmensfinanzierung im Internationalen Steuerrecht. Herausgegeben von Detlev J. Piltz und Harald Schaumburg.
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Forum Internationalen Besteuerung, No. 9, pp. 210. DEM 89. ISBN: 3 504 61508 7.
Enterprise financing in international tax law. The book contains contributions on the following topics: international capital markets, affiliated companies, financing corporations, thin capitalization, treaty shopping, requalifying interest, hybrid financial instruments, resident parent companies – non-resident subsidiaries, non-resident parent companies – resident subsidiaries.
(B. 115.418)

Zimmermann, R.; Reyher, U.; Hottmann, J.
Die Personengesellschaft im Steuerrecht. 5. Auflage.
Achim, Erich Fleischer Verlag. 1995, pp. 1206. DEM 168. ISBN: 3 8168 4095 7.
Taxation of partnerships. The book contains all aspects with regard to civil and fiscal law concerning partnerships. The establishment of a partnership, it's taxation, the treatment of losses, the participation in another company, the split-up, merger, liquidation, transfer of legal form and aspects of inheritance tax are explained.
(B. 115.515)

Greece

Karakitis, Alexandros.
Die ertrag- und vermögensteuerrechtliche Behandlung von Gewerbebetrieben mit Betriebsstätten in Deutschland und Griechenland im Lichte des deutsch-griechischen Doppelbesteuerungsabkommens.
Berlin, Duncker & Humblot GmbH. 1996.
Schriften zum Steuerrecht, Band 52, pp. 220. DEM 86. ISBN: 3 428 08547 7.
Income and property taxation of business activities of companies with permanent establishments in Germany and Greece, including the Greece–Germany tax treaty. The investigation focuses specially on problems concerning the division of profits and the exercising of taxation power by the state where the permanent establishment is situated in the context of Article 52 of the EC Treaty.
(B. 115.602)

Hungary

Financial risks and opportunities in Central Europe.
Amsterdam, FAA – Finance Association Amsterdam, Roetersstraat 11, Room EO.12, 1018 WB Amsterdam, the Netherlands. 1995, pp. 180.
Report of a student research project conducted by the FAA in 1995. The studies concentrate on the banking and financial sectors in Hungary, the Czech Republic and the Slovak Republic.
(B. 115.487)

Ireland

Cooney, Terry; McLaughlin, Jim; Martyn, Joe.
Taxation summary Republic of Ireland 1996/97.
Dublin, The Institute of Taxation in Ireland, 19 Sandymount Avenue, Dublin 4, Ireland. 1996, pp. 370. ISBN: 0 902565 07 9.
Fully updated edition reflecting the changes made by the Finance Act 1996 and other regulations in the law affecting income tax, corporation tax, double taxation agreements, anti-avoidance and revenue powers, capital gains tax, stamp duties/ property tax, VAT, and tax amnesty.
(B. 115.682)

Foreign nationals working in Ireland.
Amsterdam, Coopers & Lybrand. 1996, pp. 52.
Comprehensive overview of the key tax issues which need to be considered by expatriates working on assignment in Ireland. It also serves as a general guide for foreign nationals relocating to Ireland. The booklet reflects tax law and practice in Ireland as at 1 April 1996.
(B. 115.481)

Lynch, Irene; Marshall, Jane; O'Ferrall, Rory.
Corporate insolvency and rescue. Law and practice.
Dublin, Butterworth (Ireland) Ltd. 1996, pp. 372. IEP 55. ISBN: 1 85475 1662.
Full exposition of the law and practice relating to liquidations and receiverships in the area of corporate insolvency with particular reference to the 1990 legislation on commercial abuse and corporate reorganisations. Designed for practitioners and students alike.
(B. 115.553)

Luxembourg

Winandy, Jean-Pierre.
Les impôts sur le revenu et sur la fortune. 3rd Edition.
Luxembourg, Editions Promoculture. 1996, pp. 711. ISBN: 2 87974 017 7.
The handbook treats the Luxembourg taxation regime of income and capital in Luxembourg as applicable on 1 January 1996. This edition is not merely an update of the 1992 version, but has a considerably wider scope. The following taxes are treated in this manual: income tax, capital tax, commercial communal tax and the real estate tax. In addition, where needed, the author has given due attention to international and European aspects.
(B. 115.594)

Netherlands

Ambergen,W.J.A.; Pas, W.E.M.
Wet bestrijding onroerend goed constructies.
Deventer, Fed. 1996.
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ISBN: 90 6002 701 9.

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Booklet dealing with a new law to combat VAT evasion structures in leasing transactions with respect to real estate.
(B. 115.613)

Asjes, Pieter; Bedee, Henk; Nieuwenhuizen, Wilbert.
Sport en fiscus.
Deventer, Kluwer. 1996.
Kluwer Belastingwijzers, No. 35, pp. 200.
NLG 35. ISBN: 90 200 1772 1.
Monograph dealing with taxation of individual sportsmen and organizations involved in sport activities. Sportsmen can perform as employee, but they can also be employer: these different forms are described from the point of view of income taxes, social securities and old age provisions. Attention is paid to the tax liability of sport clubs and the tax implications of sponsoring.
(B. 115.560)

Belastingtarieven 1996. Voorzien van toelichtende aantekeningen.
Arnhem, Gouda Quint BV; Deventer, Kluwer. 1996, pp. 146. ISBN: 90 387 0446 1.
1996 tax rates with explanatory notes. Tax rates covered comprise individual and corporate income taxes, wage tax, net wealth tax, dividend tax, inheritance and gift tax, VAT, registration duties, motor vehicles duties and social security contributions.
(B. 115.612)

Bont, Guido de; Essers, Peter; Kemmeren, Eric; a.o.
Fiscal versus commercial profit accounting in the Netherlands, France and Germany.
Amsterdam, IBFD Publications BV. 1996.
IBFD International Tax Topics, pp. 150.
ISBN: 90 70125 91 9.
The book analyses and evaluates possible distortions caused by differences between fiscal and commercial accounting in the Netherlands, France and Germany. The General Section deals with the various consequences of these differences. The Specific Section makes a comparison of the fiscal and commercial treatment of various entries on the balance sheet in the three countries. Subjects concerning the total profit concept are dealt with: the different thin capitalization approaches and the various loss compensation systems in the three countries.
(B. 115.761)

Bovenberg, Lans A.; Heijdra, Ben J.
Environmental tax policy and intergenerational distribution.
Rotterdam, Erasmus University. 1996.
OCFEB Research Memorandum 9605, pp. 37.
This paper integrates both the efficiency and intergenerational distributional aspects of environmental taxes by not only exploring the efficiency case for environmental taxes but also investigating the intergenerational implications of environmental tax reform.
(B. 115.718)

De Moor Bundel. Het verloren paradijs van de eenvoud. Opstellen, op 12 januari 1996 aangeboden aan Prof.Mr. A.E. de Moor ter gelegenheid van zijn afscheid als hoogleraar aan de Erasmus Universiteit te Rotterdam.
Deventer, Kluwer. 1996, pp. 222.
ISBN: 90 200 1802 7.
Festschrift under the general title "Lost paradise of simplicity", published in honour of prof. De Moor.
(B. 115.496)

Dijck, J.E.A.M. van.
Vervanging van inkomsten. 5th Edition.
Deventer, Fed. 1996.
Fed Fiscale Brochures, pp. 189. NLG 65.
ISBN: 90 6002 671 3.
Fifth edition of monograph dealing with the concept "receipt of replaced income" under the Individual Income Tax Law.
(B. 115.614)

Flexibele arbeidsrelaties en arbeidsbeloningen. Pre-advies voor de 42ste jaarvergadering van de Nederlandse Orde van Belastingadviseurs. Pre-adviseurs: J.O.M. Beke, W.H.Kanbier, M.A. van der Zande en W.G.Zandvliet. Coördinator C.W.M. van Ballegooijen.
Amsterdam, IBDB International Bureau of Fiscal Documentation.
NOB Nederlandse Orde van Belastingadviseurs, Pre-adviezen, No. 13, pp. 188. ISBN: 90 70125 83 8.
Publication in the series NOB dealing with legal and tax implications of flexible labour relationships: part-time and short-term employment and also cross-border employment, employee stock ownership and legal protection. References are made to case law, legislation and literature as of 15 March 1996.
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Fris, P.; Kater, J. de; Reuvers, M.R.; Veldt, J.A.
Verrekenprijzen bij grensoverschrijdende transacties (intercompany pricing). 5th Edition.
Deventer, Kluwer; The Hague, Fenedex. 1996.
Fiscale, juridische en financiële documentatie voor internationaal zakendoen, No. 2, pp. 133.
NLG 65. ISBN: 90 200 1803 5.
Fifth revised edition, extended with recent case law and a new chapter examining possibiblities for a multi-discipline concept of intercompany pricing.
(B. 115.497)

Gids voor de vennootschapsbelasting 1996. Editors E. Aardema, R.P. van den Dool and R.M. Kavelaars-Niekoop.
Deventer, Kluwer. 1996, pp. 424.
ISBN: 90 200 1774 8.
Practical guide to the corporate income tax as of 1996. Separate chapters deal with residents and non-residents, tax rates, and participation exemption, fiscal unity, insurance companies, dividend tax, administrative duties and information duty.
(B. 115.411)

Happé, R.H.
Drie beginselen van fiscale rechtsbescherming.
Deventer, Kluwer. 1996.
Fiscale Monografieën, No. 77, pp. 444.
NLG 86.50. ISBN: 90 200 1833 7.
Commercial edition of dissertation dealing with the three principles of taxpayer protection: legitimacy in levying of taxes, trust and equality principle.
(B. 115.542)

Heering, A.D.G.; Clement, M.J.
Onroerend goed in Frankrijk; kopen, bezitten en ontwikkelen.
Lelystad, Koninklijke Vermande. 1996, pp. 188. NLG 49. ISBN: 90 5458 265 0.
Monograph dealing with investments in real property in France. The following aspects are dealt with: acquisition of real property, legal aspects of construction industry, leasing and dwelling, tax consequences of investing in French real property.
(B. 115.498)

Huige, J.W.J.; Vijfeijken, I.J.F.A. van.
De nieuwe regelgeving inzake tijdelijke genotsrechten en blote eigendom.
Deventer, Kluwer. 1996.
Fiscaal Actueel, pp. 78. NLG 39.50.
ISBN: 90 200 1831 0.
Monograph describing the new regime introduced as of 1 January 1996 by the Income Tax Act and the Net Wealth Tax Act with respect to the temporary beneficial- and legal ownership.
(B. 115.431)

Jaarboekje voor de ambtenaren der directe belastingen, in- en uitgaande regten en accijnsen in Nederland. Eerste jaargang, 1833. (Gedeeltelijk opnieuw uitgegeven bij gelegenheid van het 150-jarig bestaan van deze uitgave en uitgebreid met een beschouwing door P.L.H. Crasborn.
Arnhem, Noorduijn BV. 1983, pp. 103.
Special reprint on the occasion of the 150th anniversary of the yearbook for purposes of the tax administration and tax consultants.
(B. 115.706)

Kamerling, Robert; Dekker, Peter.
Belastingcontrole. 5th Edition.
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Kluwer Belastingwijzers, No. 17, pp. 302.
ISBN: 90 200 1614 8.
Revised and updated edition of monograph describing the means of control by the tax authorities. This fifth edition includes the recently introduced law on identification duty and law on administrative duty.
(B. 115.556)

Kamerling, R.N.J.
Derdenonderzoeken en verschoningsrecht.
Deventer, Kluwer. 1996.
Fiscale Monografieën, No. 76, pp. 146.
NLG 56. ISBN: 90 200 1815 9.
Monograph dealing with certain powers and control methods used by tax authorities, such as investigation of a third-party and the right to be excused. Relevant cases before the Supreme Court are discussed.
(B. 115.543)

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Niessen, R.E.C.M.
Tijdelijke genotsrechten op zaken in de inkomstenbelasting.
Arnhem, Gouda Quint BV.1996.
Actuele Fiscale Bibliotheek, No. 5, pp. 75.
NLG 34. ISBN: 90 387 0476 3.
Monograph describing the practice of the new regime applicable to temporary beneficial- and legal ownership. Description of the rules before 1996 is given, as well as a short overview of how to tax an increase in market value of the legal ownership, exemptions and deductions, and civil law aspects within family relationships.
(B. 115.500)

Paardt, René van der; Vos, Roel; Wilson, John.
Horeca en fiscus. 4th Edition.
Deventer, Kluwer. 1996.
Kluwer Belastingwijzers, No. 23, pp. 187.
NLG 35. ISBN: 90 200 1736 5.
Revised edition of book on all tax aspects arising from hotel and restaurant businesses.
(B. 115.495)

Rijkers, A.C.
Rente, regels and realisme.
Belastingadviseursdag 1996.
Deventer, Fed. 1996.
Serie Belastingadviseursdagen, No. 41, pp. 111. NLG 35. ISBN: 90 6002 980 1.
The book contains contributions of a conference of the Nederlandse Federatie van Belastingadviseurs and faces problems concerning interest. Prof.dr. A.C.Rijkers explains the economic and fiscal approach with regard to interest and the most important decisions of the Supreme Court with regard to interest. Moreover an overview of the treatment of interest in various situations is given, e.g. bills of exchange, zerobonds, deep-discount bonds, escapes, lions, reset-notes, strips, swaps, etc. The article ends with some recommendations concerning the deductibility of interest, especially mortgage interest. Drs. F.J.Schuurbiers faces the problems concerning an equitable division between situations in which interest should be deductible and cases in which it should not, Mr. C.B. Bavinck indicates that the legal relationship should be decisive for determing whether an interest payment should be deductible. For this judgement the provisions of civil law may be neglected but not the intention of the related parties. Moreover, he argues for the introduction of a (partial) capital gains tax.
(B. 115.501)

Smit, J.A.
Nationale ombudsman en fiscaliteit. 2nd Edition.
Deventer, Fed. 1996.
Fed's Actualiteiten No. 18, pp. 113. NLG 52.
ISBN: 90 6002 676 4.
Second edition of monograph examining the work of the national "ombudsman" with emphasis on taxation.
(B. 115.554)

Snoodijk, A.A.
Douaneplanning. 2nd Edition.
Deventer, Kluwer; The Hague, Fenedex. 1996.
Fiscale, juridische en financiële documentatie voor internationaal zakendoen, No. 17, pp. 98.
ISBN: 90 200 1845 0.
Second completely revised and updated edition of monograph designed to explain to businessmen customs regulations with respect to the importation of goods.
(B. 115.564)

Sommerhalder, Ruud A.
Comparing individual income tax reforms. A Dutch perspective.
Amsterdam, International Bureau of Fiscal Documentation. 1996, pp. 471.
In this dissertation the author compares, from a Dutch perspective, the individual income tax reforms carried out from 1986 to 1991 in six countries. In Part I, he discusses the background of the international trend in tax reform, describes the Dutch perspective and explains the tax expenditure concept. Part II discusses the tax reform of each country and gives a classification in terms of the tax expenditure concept. Part III compares the country analyses by reference to the tax expenditure model, and Part IV contains an analysis of the results of the tax reform and conclusions.
(B. 115.396)

Strijd tegen BTW-fraude in de Europese Unie. Handhaving in België en Nederland. Editor J.A.E. Vervaele.
Antwerp, Maklu Uitgevers, Somerstraat 13-15, 2018 Antwerpen, Belgium. 1995, pp. 212.
BEF 1650. ISBN: 90 6215 489 1.
The book contains the elaborated contributions presented at the international congress on VAT-fraud in the European Union held in Utrecht - The Netherlands on 17 and 18 November 1994.
(B. 115.591)

Vetter, J.J.; Wattel, P.J.
Hoofdzaken invordering. 4th Edition.
Deventer, Fed. 1996.
Fiscale Studieserie, No. 2, pp. 274. NLG 75.
ISBN: 90 6002 644 6.
Revised and updated edition of monograph describing the principles of tax collection.
(B. 115.725)

Vijfeijken, I.J.F.A. van.
Inkomsten uit vermogen. 2nd Edition.
Deventer, Kluwer. 1994, pp. 99.
ISBN: 90 200 1699 7.
Brochure containing some excerpts from the author's dissertation on the income tax aspects of usufruct of property rights.
(B. 115.562)

Poland

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Torún, Dom Organizatora. 1996, pp. 750.
ISBN: 83 85709 66 5.
Compilation of legal texts related to taxation in force as of 1 January 1996. The following tax provisions are dealt with: tax obligation, individual and corporate income tax, VAT, agricultural and forestry tax, inheritance and gift tax, gambling duties, local taxes and duties, stamp duties and tax procedures.
(B. 115.759)

Olesi´nska, Agnieszka.
Odpowiedzialnosc osób trzecich za zobowiazania podatkowe.
Torún, Dom Organizatora. 1996, pp. 95.
ISBN: 83 86850 04 3.
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(B. 115.757)

Orzeczenia sadow w sparwach podatkowych. Editors B. Brzezinski, M. Kalinowski and A. Olesinska.
Torún, Dom Organizatora. 1996, pp. 275.
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(B. 115.756)

Orzeczenia sadow w sprawach podatkowych. Editors B. Brzezinski and M. Kalinowski.
Torún, Dom Organizatora. 1996, pp. 261.
ISBN: 83 85709 99 1.
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(B. 115.758)

Slovak Republic

Financial risks and opportunities in Central Europe.
Amsterdam, FAA - Finance Association Amsterdam, Roetersstraat 11, Room EO. 12, 1018 WB Amsterdam, the Netherlands. 1995, pp. 180.
Report of a student research project conducted by the FAA in 1995. The studies concentrate on the banking and financial sectors in Hungary, the Czech Republic and the Slovak Republic.
(B. 115.487)

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Guia del nuevo impuesto sobre la renta.
Valencia, Editorial Ciss S.A. 1991, pp. 517.
ISBN: 84 87410 162.
Guide to the individual income tax of Spain.
(B. 115.565)

Derecho financiero y tributario Español.
Normas basicas. 5th Edition.
Valladolid, Editorial Lex Nova S.A., Avda Reyes Católicos 11, 47006 Valladolid, Spain. 1993, pp. 1051. ISBN: 84 7557 332 0.
Basic norms of the Spanish tax and finance law. This 5th edition (up to September 1993)

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contains the basic provisions in the different laws relating to taxation and finance (e.g. the constitution, the budgeting law, the general tax law and the text of direct and indirect taxes and several administrative regulations).
(B. 115.726)

Sweden

Dahlman, Roland S.; Sjögren, Peter.
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Washington, Tax Management Inc. 1996.
Tax Management Foreign Income Portfolio, No. 985-2nd, pp. 110.
Second edition of portfolio analysing in detail the statutory and procedural framework of Swedish income taxation as applied to individuals and corporations, both resident and non-resident. In addition to a detailed explanation of the Swedish system of income taxation, it discusses the local taxes, the VAT, and other taxes.
(B. 115.597)

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Guide to provide potential foreign investors with fundamental information about the Swedish tax system, including tax planning, employment and labour, financing, importing, exporting, and accounting.
(B. 115.696)

Switzerland

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(B. 115.600)

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(B. 115.601)

Huber, Pius M.
Internationale Rechtshilfe in Strafsachen und internationale Amtshilfe in Steuersachen.
Bern, Cosmos Verlag. 1995, pp. 662.
ISBN: 3 85621 089 X.
International legal assistance in criminal matters and international administrative assistance in criminal matters.
(B. 115.026)

Oberson, Xavier; Hull, Howard R.
Switzerland in international tax law.
Amsterdam, IBFD Publications BV. 1996, pp. 270. NLG 245. ISBN: 90 70125 90 0.
An introduction to Swiss international tax law, its characteristics and guiding principles. Particular attention is paid to the special tax relief granted to Swiss resident individuals and corporations, as well as to the complex rules for the avoidance of treaty abuse. The authors also discuss the Swiss case law developed for the avoidance of intercantonal double taxation, the tax credit and the Swiss approaches both to transfer pricing and the implementation of mutual agreement procedures.
(B. 115.762)

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UNITED STATES

TAX ADMINISTRATION IN THE UNITED STATES OF AMERICA: A DECENTRALIZED SYSTEM[1]

Harley T. Duncan and Charles E. McLure, Jr.

Harley T. Duncan is Executive Director, Federation of Tax Administrators and **Charles E. McLure, Jr.** is Senior Fellow, Hoover Institution, Stanford University. This paper was originally prepared for publication in a monographic issue of *Hacienda Pública Española* devoted to "Tax Administration in a Multi-Level Public Sector".

I. INTRODUCTION

Under the US Constitution the individual states retain sovereignty over all matters not explicitly assigned to the federal government or prohibited by the Constitution or federal law.[2] Thus tax policy and tax administration in the United States are perhaps as decentralized as in any country in the world. Subject only to quite broad constitutional limitations (dealing primarily with due process and the sanctity of interstate and international trade) and minor legislative restrictions, American states have virtually unlimited discretion in the design and execution of tax policy. They can participate in programmes for the exchange of information and other assistance, both horizontally (with other states) and vertically (with the federal government), but are not required to do so. This system of "independent legislation and administration" provides maximum autonomy and flexibility for state governments, but also can create economic distortions, complexity and confusion, and duplication of tax administration and compliance.[3]

This paper describes the mechanisms of coordination and collaboration between federal and state tax administrations – and the lack thereof. Section II sets the stage by describing the constitutional and political frameworks within which this coordination and collaboration occurs. Sections III and IV provide a brief summary of the salient features of the tax systems used at the federal, state and local levels in the United States and the diversity found in state systems. Section V describes the mechanisms of coordination and collaboration among tax administrations. Section VI appraises the suitability of the American model for use in other countries.

II. THE CONSTITUTIONAL AND POLITICAL ENVIRONMENT

A. The constitutional setting

In contrast to the constitutions of many countries, the Constitution of the United States places only one explicit restriction on the taxing power of state governments.[4] It has been interpreted as also placing two additional significant limitations, plus several less important ones. The Constitution explicitly prohibits state taxes on imports and exports. Also, the Commerce Clause, which grants to Congress the power "to regulate Commerce with foreign Nations and among the several States and with the Indian Tribes", has been interpreted to impose restrictions on state taxation of interstate and foreign commerce. Although originally interpreted as implying that interstate commerce could not be taxed at all, the modern interpretation of the Commerce Clause is that state taxation cannot impose an undue burden on interstate commerce and must meet four criteria. First, there must be substantial nexus between the taxing state and the person, property, or transaction being taxed. Second, the tax must be *fairly apportioned* to activities carried on by the taxpayer in the state. Third, the *tax must not discriminate* against interstate commerce. Fourth, there must be a *rational relation* between the tax and

1. The authors wish to thank Ron Fisher, Walter Hellerstein, and Ben Miller for their useful comments on an earlier draft of this paper. However, the authors bear full responsibility for the views expressed here.

2. This reflects the fact that the federal government was created by the original colonies. By comparison, local governments are legally creatures of the states, having only the powers accorded to them by state constitutions and laws. Like virtually all other aspects of the US system, these powers can vary from state to state.

3. For use of the term "independent legislation and administration" to denote the system used in the United States and described in this paper, see Charles E. McLure Jr., "Revenue Assignment and Intergovernmental Fiscal Relations in Russia," in Edward Lazear, editor, *Economic Reform in Eastern Europe and Russia: Realities of Reform* (Palo Alto, CA: Hoover Institution Press, 1995), at 199-246.

4. For a brief description of the constitutional limitations on state taxing powers, see Walter Hellerstein, "Constitutional Limitations on State Tax Exportation," *American Bar Foundation Research Journal*, No. 1, (Winter 1982), or (in the more restricted area of taxation of natural resources) Walter Hellerstein, *State and Local Taxation of Natural Resources in the Federal System: Legal, Economic, and Political Perspectives* (American Bar Association, 1986), at 141-195; for a more comprehensive analysis of these issues, see Jerome R. Hellerstein and Walter Hellerstein, *State Taxation* Vols. I and II (Warren Gorham Lamont, 2d ed., 1993). Given the nature of this paper, this summary is necessarily brief, neglecting many nuances. Thus we lump together the prohibition of duties on tonnage with the prohibition of taxes on imports and exports.

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services provided by the state. The Due Process Clause of the Fourteenth Amendment has also been construed to limit the taxing power of states.[5] Over time, the Due Process requirements have been interpreted as being substantially similar to the Commerce Clause requirements, but also to impose certain basic procedural obligations on the states.[6]

Despite the constitutional grant of power to the Congress to regulate interstate and international trade, the Congress has shown considerable reluctance to legislate restrictions on state taxing power. For the most part, Congress has confined its activities to limiting state taxation of interstate transportation industries and interstate commerce workers.[7] It has steadfastly refused (or been unable politically) to legislate in broader areas, such as requiring a uniform state method of taxing corporate income, limiting use of unitary combination, or expanding the reach of state taxation to allow taxation of interstate mail-order sales. (See descriptions below.)

Because of the substantial taxing power of the states under the Constitution, and the relatively general wording of the restrictions imposed on that power, there has been a steady stream of litigation testing the limits of what is permissible.[8] For the most part, when taxpayers believe that state laws (or their administrative interpretations) are inconsistent with the US Constitution or federal law, they can petition to the US Supreme Court once they have exhausted their remedies at the state level.[9] During the last twenty years the US Supreme Court has decided a number of important cases, especially in the area of state corporate income taxation. While the Supreme Court has occasionally struck down state statutes (or their application in particular cases), for the most part it has been reluctant to do so. Indeed, it has repeatedly noted that under the US Constitution the Congress is fully competent to restrict state powers if it finds current state practices inappropriate.[10] As a result of this wide latitude, states have sometimes pursued policies that have upset the trading partners of the United States (both foreign multinational corporations and their governments of resident), as well as domestic residence taxpayers.

During the 1980s, dissatisfaction with state use of worldwide unitary combination reached the point that President Ronald Reagan instructed Treasury Secretary Donald Regan to convene a Working Group on Worldwide Unitary Taxation charged with "producing recommendations... that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states."[11] Composed of representatives of state government (including tax administrators), multinational corporations, and the federal government, the Working Group had only the force of moral suasion. Its report did, however, prove to be influential in alleviating this perceived problem, as noted in Section IV.

Although the states have substantial legal authority to choose whatever tax systems they want, economic interdependence increasingly limits the use of this authority, as it does the sovereignty of nations. Income taxes that are too far out of line may repel capital and highly educated labour, and high sales taxes and excises may lead to cross-border shopping and mail order sales. Such tax competition, especially in the income tax field, is seen in some quarters as a welcome brake on the growth of government that makes state governments more responsive to the desires of citizens.[12] Others, however, have decried the states' efforts to outdo each other in offering tax benefits to attract businesses on the ground that it erodes the states' tax base and leads to a "race to the bottom."[13]

B. The structure of Congress

The US Constitution provides for a Congress comprised of two houses. The lower House of Representatives consists of 435 members apportioned among the states in relation to population (with no state having less than one representative). In the Senate, each state has two members. Members of both the House and the Senate are popularly elected in contemporaneous elections – the former in Congressional districts and the latter in state-wide elections. House members serve two-year terms, while Senators serve for six years. There is no constitutional limitation on the number of terms a member of Congress can serve, but some states have recently introduced such limits, the constitutionality of which is currently being tested.

Though having somewhat different constituencies and slightly different powers and procedures, the House of Representatives and the Senate are essentially co-equal partners in the enactment of legislation; to become law, legislation must be

5. The US Supreme Court has held that the Due Process Clause of the Fourteenth Amendment, which limits state power, incorporates many of the limitations imposed on the Federal Government by the Bill of Rights. These include, in particular, the obligation not to interfere with the freedom of speech, freedom of religion, and freedom of the press.

6. The US Supreme Court has held, however, that the Commerce Clause's nexus requirement, which protects the integrity of the interstate market, may in some circumstances be more demanding than the Due Process Clause's nexus requirement, which requires only fairness to the individual taxpayer.

7. Among these are measures requiring that interstate transportation industries not be treated differently than other commercial and industrial property for property tax purposes, limiting taxation of some transportation workers to the state in which they reside (rather than where the services are performed), and requiring that certain taxes on interstate transportation be administered in a particular fashion. (See discussion of the International Fuel Tax Agreement in Section V.)

8. By comparison, Supreme Court cases involving federal taxation generally deal with quite narrow issues of statutory construction.

9. Supreme Court jurisdiction, however, is discretionary; the Court accepts less than 2 per cent of the petitions for certiorari that are filed. As a general matter, moreover, unless specifically authorized by law, federal courts may not assume original jurisdiction over a matter of state tax law if the taxpayer is afforded a "plain, speedy and efficient" remedy in state court.

10. While the Supreme Court has generally allowed the states great leeway in designing a tax system, it has without exception struck down tax schemes which have as their intent or effect favouring in-state business over interstate commerce. Examples of schemes struck down include preferential tax rates for products made or activities conducted in a particular state, varying business tax rates based on the amount of in-state activity, and imposition of special taxes on interstate activities.

11. On this episode, see US Department of the Treasury, *The Final Report of the Worldwide Unitary Taxation Working Group* (Washington, 1984) and Charles E. McLure, Jr., "Unitary Taxation: The Working Group's Contribution," *Tax Notes*, Vol. 24, No. 9 (27 August 1984), at 879-83, or Charles E. McLure, Jr., "Federal Law and State Corporate Income Taxes," *Vanderbilt Journal of Transnational Law*, Vol. 18, No. 2 (Spring 1985), at 275-310.

12. See Charles E. McLure, Jr., "Tax Competition: Is What's Good for the Private Goose also Good for the Public Gander?" *National Tax Journal*, Vol. 39, No. 3 (September, 1986), at 341-348.

13. See, e.g. Note, "A Proposal to Prohibit Industrial Relocation Subsidies," *Texas Law Review*, Vol. 72, No. 3 (1994), at 669-713.

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approved by a majority of both houses and signed by the President. (In the case of a Presidential veto, legislation can be enacted with the support of two thirds of the members of each house.) The Constitution does not give the Senate a special role in defending the interests of the states or in settling disputes between levels of governments. Even so, because each state has two of the 100 Senators, but some have as few as one of the 435 members of the House, the Senate has reflected the views of the less populous and politically conservative Western states, while more urban and more liberal Eastern states have dominated the House, at least until recently.

The Constitution provides that legislation dealing with revenue should originate in the House of Representatives. In fact, however, congressional procedures have developed in such a way that matters affecting taxation can originate in either house. Also, tax legislation is often based on recommendations made by the President.

The Constitution specifies that the President may make treaties with other nations, "by and with the advice and consent" (de facto, the approval) of the Senate. This is relevant for present purposes because international agreements regarding exchange of information and cooperation with tax authorities of foreign countries are contained in tax treaties. In addition, in 1978 an unsuccessful attempt was made to include prohibition of worldwide unitary taxation (described in Section IV) in the tax treaty with the United Kingdom.

III. THE ACTUAL ASSIGNMENT OF TAXES

The federal government accounts for roughly two thirds of all tax receipts in the United States, state governments account for about one fifth, and local governments for about one eighth. (See Table 1.) Just under one half of federal tax revenues is derived from the individual income tax; corporate income taxes provide just under 10 per cent of federal revenues. The next most important source of federal revenues are the payroll taxes that finance social security; they provide more than one third of federal revenues. Excise taxes and customs duties comprise about 6 per cent of tax receipts, and estate and gift taxes just 1 per cent.

Table 1
Distribution of Tax Revenues in the United States
1992

Percentage Distribution by Level of Government

	Federal %	State %	Local %	Total %
Individual income	81	18	2	100
Corporate income	81	17	2	100
General sales	0	82	18	100
Property	0	0	100	100
Excises	50	42	8	100
Estate & gift	71	29	0	100
Social insurance	91	9	0	100
Other	14	68	18	100
Total	64	22	14	100

Percentage Distribution by Type of Tax

	Federal %	State %	Local %
Individual income	45	28	5
Corporate income	9	6	1
General sales	0	29	10
Property	0	0	76
Excises	6	15	5
Estate & gift	1	1	0
Social insurance	38	11	0
Other	1	9	4
Total	100	100	100

Notes
Totals may not sum to 100 per cent, due to rounding.
Source: Authors' computations based on data provided in Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, Vol. 2: Revenues and Expenditures* (Washington: ACIR, 1994).

General sales taxes and individual income taxes each produce roughly 30 per cent of total state tax revenues. Corporate income taxes produce about 6 per cent of state tax revenues, and excises 15 per cent (with taxes on motor fuels being by far the largest component, followed by those on tobacco products and alcoholic beverages). "Other taxes", including licence taxes and severance taxes (taxes on extracting or "severing" natural resources) amount to about 10 per cent of state receipts, roughly the same level as certain insurance trust taxes for unemployment compensation and worker's compensation and disability insurance. Property taxes and death and gift taxes produce marginal amounts of state tax revenue. About 20 per cent of total state revenues come in the form of grants-in-aid from the federal government. These are largely required to be used for particular purposes such as providing cash and medical assistance for low-income households or building and maintaining roads and bridges.

These percentages do, however, differ widely by state, as not all taxes are employed by all states and the economic characteristics of states differ widely, particularly the presence of economically important natural resources. Five states do not levy general sales taxes, nine have no broad-based individual income tax, and five do not levy a corporate income tax.[14] Tax bases and rates can differ widely, even among states that levy a given tax; see the next section. Among the "outlyers" in the percentage distribution of state tax collections are: Alaska, which receives the majority of its revenues from the taxation of natural resources (mostly oil), and Wyoming, which receives about 40 per cent from that source[15]; Florida and Washington, neither of which employs an individual income tax, and both of which obtain more than 60 per cent of revenues from the taxation of general sales;[16] New Hampshire, with its 45 per cent of revenues from selective sales

14. All references in this paper include the District of Columbia as one of 51 states, although it is not actually a state and it is not represented by a voting member in the US Congress. The count of states levying a corporate income tax includes Michigan, which levies a modified addition-method of value added tax, instead of a tax on corporate net income.
15. Alaska (and to a lesser extent Texas) also receive substantial amounts of revenue from oil produced on land that each state retained when it attained statehood.
16. Washington's "sales tax" revenues include a tax on business gross receipts as well as a general retail levy; Florida, by contrast, relies exclusively on a retail sales tax for its "sales tax" revenue.

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taxes; Delaware's receipt of roughly 20 per cent of tax revenues from franchise fees on corporations headquartered there; and Oregon, which levies no sales tax and receives 70 per cent of revenues from income taxes (followed by Massachusetts and New York with over 60 per cent from this source).

Local governments receive roughly 75 per cent of tax revenues from the property tax and about 10 per cent from general sales taxes. It should be noted, however, that tax revenues comprise only about 63 per cent of total revenues from own sources (and only 40 per cent of total revenues from all sources). The remainder of own-source revenues come from "charges and miscellaneous" (primarily "user fees" for selected services ranging from libraries to water and sewer charges and in some cases public utilities). The remainder of total revenues are derived from inter-governmental grants, primarily from the state level. Local governments in about 30 states employ general sales taxes, and local jurisdictions in 13 states levy local income taxes. (For the most part, local governments in a given state levy only one or the other of these general taxes, but there are important exceptions to this rule.)

Income taxes and property taxes levied by state and local governments are deductible in calculating taxable income under federal law, but sales taxes and excises are not, unless they are business expenses. Thus income tax rates and property tax rates are effectively reduced by a fraction equal to the federal marginal income tax rate of the taxpayer.[17] The federal government effectively pays for (subsidizes) this fraction of expenditures financed by revenues from these taxes.

There are no federal constitutional or statutory limitations on state issuance of debt for government purposes. Essentially, states have a free hand in this area, subject only to rules intended to insure a full disclosure of risk to all purchasers of securities, regardless of the nature of the issuer. The Federal Reserve Board (the central bank) and various agencies of the federal government monitor (but do not regulate) borrowing by state and local governments, as they would the activities of other large borrowers. Many state constitutions and statutes limit the issuance of debt by state governments. For example, nearly every state prohibits issuance of debt for current operating purposes. Most states also limit the purposes for which local governments may issue debt and the amount of debt that may be issued, relative to the tax base of the local government.

The federal government, in effect, subsidizes state borrowing costs by exempting interest payments of state and local governments from federal income tax.[18] While initially it was thought that this exemption was constitutionally required, more recently it is seen as a matter of public policy and interest group politics.

IV. DIVERSITY IN STATE PRACTICE

Because the Constitution grants the states wide latitude in tax policy, one finds substantial diversity in state tax systems; this diversity extends well beyond the choice of which taxes to levy.

A. General sales tax

1. Taxable sales

The United States is one of the few developed countries that does not have a national sales tax. Thus, there is no possibility of coordinating state taxes with a non-existent federal tax.[19] In essence, each state "goes its own way," defining its sales tax base as it wishes. State sales taxes are, however, generally similar in their basic structure.[20]

Nearly every state sales tax exempts prescription drugs. More than half of taxing states exempt food for home consumption and electric and gas utilities for residential use, and a few exempt clothing and telecommunications services. Eight states grant credits to low-income households in order to offset the burden of sales taxes; seven of these states do not exempt food.

The tax treatment of sales to manufacturers, producers, and processors is particularly diverse and contentious. There is a wide divergence between tax theory (under which all sales to business firms for business use would be exempt) and practice (where many such sales are taxed). As a general matter, states exempt wholesale sales (sales for resale) and sales of intermediate goods which become an ingredient and component part of a subsequent product sold at retail. However, only about one-half (24) of the taxing states exempt items consumed in the production process (e.g. fuel, lubricants, etc.), and a similar number exempt manufacturing machinery and equipment, as well as items consumed in the production process. Various economic studies have found that business purchases often account for 40 to 50 per cent of state sales tax bases.[21]

Interestingly, in the sales taxation of services sold to businesses, state practices more closely conform to theory. For example, nearly all states exempt custom computer software. This is attributable to the fact that sales taxes have traditionally been applied only to sales of tangible personal property and selected services, as well as to a growing concern that the taxation of business inputs will inhibit investment and job

17. Thus, for example, for a taxpayer subject to a marginal federal tax rate of 40 per cent, a state tax rate of 10 per cent would effectively be reduced to 6 per cent.
18. Over time eligibility for this exemption has been progressively limited, to prevent abuse, such as the use of proceeds from tax-exempt bonds to finance industrial development and other "private activities."
19. The fact that the states consider the sales tax their fiscal preserve is one reason the United States has not adopted a federal sales tax. In addition, it would be extremely difficult to coordinate a federal value added tax with state retail sales taxes. See Charles E. McLure, Jr., *The Value Added Tax: Key to Deficit Reduction?* (Washington: American Enterprise Institute, 1987). The state of Michigan levies a Single Business Tax, an addition-method value added tax.
20. John F. Due and John L. Mikesell, *Sales Taxation: State and Local Structure and Administration*, 2nd ed. (Washington, D.C.: The Urban Institute Press, 1995), at 61-64.
21. See Due and Mikesell, op. cit. A summary of these economic studies is found at page 73 of that volume. The figures in the text somewhat overstate the problem. In some industries (e.g. housing) tax is levied on business purchases (construction materials), instead of the final product (new houses). Such taxation is a surrogate for retail-level taxation, not an additional tax.

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creation.[22] Table 2 indicates the pattern of exemptions under state sales taxes in 1992.

Table 2

State Sales Taxes: Exemptions

Sales of:	Number exempting selected items	Total taxing selected items
Food	26	20
Prescription drugs	44	2
Residential utilities	31	15
Clothing	6	40
Telecommunications[1]	8	37
Custom computer programmes	31	15
Sales to contractors	3	43
Manufacturers, producers, processors	45	1
Repairers	13	33

Notes
All counts of states include District of Columbia.
1. The number of states taxing and exempting this item does not sum to 46 in the source document.
Source: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, Vol. 1: Budget Processes and Tax Systems* (Washington: ACIR, 1995), at 89-91.

Table 3

State Sales Taxes: Rates

Sales tax rate	Number of states
3% - 3.9%	2
4% - 4.5%	11
5%	15[1]
6% - 6.5%	16[2]
7%	2

Notes
1. Includes one state with a rate of 4.9 per cent.
Source: See note 1 (table 2), idem at 93-94
2. Includes one state with a rate of 5.75 per cent.

Cross-border shopping and mail-order sales pose a particular problem in the imposition of sales taxes. The Supreme Court has interpreted the Commerce Clause of the US Constitution to prohibit a state from requiring a seller without a physical presence in a state to collect sales and use tax on goods shipped into the state. Instead, states are required to collect such tax from the individual purchaser or user of the product, obviously something that cannot be done easily, except in the case of items that must be registered by the purchaser, such as cars and boats. The result defies common sense and violates basic principles of justice, since it gives out-of-state firms a competitive advantage over in-state retailers. The revenue loss from untaxed interstate sales is estimated at over USD 3.0 billion per year.

2. Tax rates

Although state tax rates range from 3 per cent to 7 per cent, they are clustered fairly narrowly in the range of 5 to 6.5 per cent; 30 state tax rates fall within this range. (See Table 3.) This is not, however, the end of the story. In about two thirds of the states that levy general sales taxes, local governments also levy sales taxes, commonly as surcharges on the state tax. While the most common practice is for municipalities or counties to levy local sales taxes, in some states special districts (commonly transit districts) also levy sales taxes. Combined state and local sales tax rates reach 8 per cent or higher in several states such as Alabama, California, Louisiana, New York, and Texas.

B. Individual income tax

1. Tax rates

Although a few states (six) levy a flat-rate individual income tax, most employ graduated rates.[23] For the most part, top marginal state tax rates are clustered in the range of 5-8 per cent; in fewer than ten states does the top marginal rate exceed 10 per cent. (See Table 4.)

Table 4

State Individual and Corporate Income Taxes: Top Marginal Rates

Top marginal rates	No. of states[1] *individual*	No. of states *corporate*
0% - < 5%	14[2]	8[3]
5% - < 6%	4	6
6% - < 7%	10	8
7% - < 8%	9	8
8% - < 9%	4	7
9% - <10%	3	8
10% or greater	7[4]	6

Notes
1. Five states do not levy either individual *or* corporate income tax: Nevada, South Dakota, Texas, Washington and Wyoming. Additionally, Arkansas, Florida, New Hampshire and Tennessee levy only limited or no *individual* income tax.
2. One state in this category bases its individual income tax rate on a percentage of the taxpayer's federal income tax liability. Nine states in this category do not levy broad-based individual income taxes.
3. Five states in this category do not levy corporate income taxes
4. Three states in this category base their individual income tax rates on a percentage of the taxpayer's federal income tax liability.
Source: See note 1 (table 2), idem at 66-69 and 74-77

Local jurisdictions (primarily cities) in 13 states also impose individual income taxes, and cities in three other states impose payroll taxes. Such payroll taxes are commonly intended to collect tax from individuals who work in the taxing city but reside in another. Some states allow resident individuals a credit for income and payroll taxes paid to localities in other states.

2. Tax base

Comparing tax rates tells only part of the story, and indeed, only a minor part. Working through the calculation of indi-

22. For a further discussion of state taxation of service transactions, see Federation of Tax Administrators, *Sales Taxation of Services: An Update* (Washington: FTA, April 1994).
23. Two states collect a flat percentage of federal income tax liability, and one imposes slightly graduated rates on federal tax liability; this, of course, produces a graduated rate schedule.

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vidual tax liability, beginning with a gross income figure and ending with taxable income, one encounters myriad ways in which state tax bases can (and do) differ from the federal base and from each other.

Most states base the state individual income tax on federal law to some extent. In about three fourths of the taxing states, state law conforms most closely to the concept of "adjusted gross income" (AGI) under federal law. (Adjusted gross income reflects various exclusions of income, such as alimony, pension contributions by employers (including the self-employed) and social security benefits as well as "adjustments" for moving expenses and contributions to individual retirement accounts.) States must also make adjustments to federal AGI for income which is taxable at the federal level, but not at the state (primarily interest on federal debt obligations) and for income exempted under the federal income tax, but not the state (primarily interest on the debt of state and local governments).

Eight states conform most closely with federal taxable income (derived by subtracting from AGI personal exemptions for the taxpayer, spouse and dependants, and a standard deduction or itemized deductions for personal expenditures). In three states, state tax liability is calculated simply as a percentage of federal liability.

Conformity is generally far from complete, however. For example, states show great variability in the extent to which they conform to the federal taxation of a portion of social security benefits and unemployment compensation. In addition, many have a more generous allowance for moving expenses and do not tax pensions paid by public employee retirement systems (and in some cases private retirement plans).[24]

In computing taxable income, states employ either personal exemptions or credits, in combination with standard deductions, to create a "tax threshold" below which no tax is due. The amounts of exemptions, credits and standard deductions, which commonly depend on the filing status of the taxpayer (single, married filing jointly, married filing separately, etc.) differ widely from state to state. There is also a fair amount of variation in the itemized deductions allowed taxpayers, particularly as it relates to the allowance of deductions for federal income taxes, federal social security taxes, state and local sales taxes, medical expenses, and casualty losses.

C. Corporate income tax

1. Tax rates

All but 12 of the 46 states levying a corporate income tax employ a single rate.[25] In those with a graduated rate, the top marginal rate is generally reached at a low level (less than USD 250,000 net income in all but one state). State corporate income tax rates are generally clustered in the 6 to 9 per cent range. (See Table 4.) Local corporate income taxes are permitted in six states – Kentucky, Michigan, Missouri, New York, Ohio and Oregon. Rates range from 0.5 per cent in Missouri to nearly 9 per cent in New York City.

2. Tax base

The calculation of the corporate income tax base exhibits every bit as much diversity across the states as the individual income tax base. Starting from the federal tax base, each state requires certain additions and allows certain subtractions in calculating income for state tax purposes. Among the most important additions are interest exempt under federal law (interest on the debt of state and local governments), income taxes of other states (allowed as a deduction in calculating federal tax), depreciation allowances (to the extent that federal law is more generous than state law), and net operating losses from prior years allowed as a deduction in calculating federal tax liability. "Subtractions" include depreciation allowances in excess of those under federal law and interest on obligations of the federal government. States allow a variety of credits (reductions in tax liability), notably for investment in pollution control and water conservation facilities. In addition, nearly all states allow some credits for increased investment and job creation in specified areas of the state called "enterprise zones."[26]

3. Apportionment formulas

Whereas the federal government taxes the worldwide income of corporations incorporated in the United States, as well as income attributed to US sources, state taxes are levied primarily on income deemed to have its source in the state.[27] Based on Supreme Court interpretations, the actual constitutional requirement is that the income be "rationally related" to the taxpayer's business activities in the state. All states use formulas to apportion the income of corporations among the states in which they do business. They do not, however, all use the same formula. Historically, states generally used a formula which accorded equal weight to three "factors" – payroll, property and sales. More recently, a considerable number have moved to give greater weight to the sales factor, presumably in order to reduce the implicit burden on payrolls and property and the potentially adverse effects on business location.[28] As of 1996, 22 states employed an equally weighted three-factor formula, 22 gave double weight to the sales

24. To some extent the discrepancy between state and federal laws reflects the failure of states to adopt recent changes in federal law. See Harley Duncan and Ronald Alt, "FTA Report: Impact of Federal Tax Changes on State Tax Systems," *State Tax Notes*, Vol. 7, No. 49 (3 December 1993), at 233-238.

25. The following discussion of corporation income taxes is generally applicable to Michigan's Single Business Tax (SBT), a modified addition-method value added tax imposed at a rate of 2.3 per cent on value added in excess of USD 45,000. Value added is apportioned to Michigan using an apportionment formula that accords "double weight" to the sales factor.

26. This discussion is also generally applicable to the calculation of business income of individuals not operating in corporate form.

27. Intangible income that is not derived from the taxpayer's business operations, however, is typically assigned to a state on a residence basis. See generally, Walter Hellerstein, "State Taxation of Corporate Income from Intangibles: Allied Signal and Beyond", *Tax Law Review*, Vol. 48, No. 4 (1993), at 739-879.

28. These are the formulas used in such areas as merchandising and manufacturing. Some states use specialized formulas for such activities as banking and finance, transportation, and communications. See Charles E. McLure, Jr., "The State Corporate Income Tax: Lambs in Wolves' Clothing", in Henry J. Aaron and Michael J. Boskin, eds., *The Economics of Taxation* (Washington: Brookings Institution, 1980), at 327-46, for the argument that income taxes apportioned on the basis of a formula implicitly tax the factors appearing in the formula.

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factor, 1 weighted the sales factor at 70 per cent and 2 used only a sales factor.

4. Unitary combination

One of the most controversial areas in state corporate income taxation is the definition of the entity whose income is to be subject to formula apportionment. Some states ("separate entity states") limit apportionment to the income and activities of a single corporation. Many, however, require some version of unitary combination. Under this system, formula apportionment is based on the income and factors of a group of affiliated firms deemed to be engaged in a "unitary business". Unitary combination is justified by these considerations: (a) corporations might otherwise manipulate transfer prices on transactions between affiliated entities (including interest income and expense and other financial transactions) to place taxable income in low-tax jurisdictions, and (b) the economic interdependence characteristic of modern corporations commonly makes it impossible, even conceptually, to isolate the source of income of a group of affiliated firms.[29]

Combination can be limited to the "water's edge," or it can be applied on a worldwide basis. The Working Group on Unitary Taxation mentioned earlier was convened to address the complaints of multinational business and foreign governments that worldwide combination is inconsistent with international practice (including that of the US federal government), which uses separate accounting to determine the nation of origin of income.[30] Many state corporate income tax cases decided by the US Supreme Court have involved the legitimacy of unitary combination, especially as applied to multinational corporations. In some cases the taxation of foreign-source dividends has also been involved. Over the years the definition of what constitutes a unitary business has also been subject to considerable contention and litigation.

The dozen years since the Working Group issued its report have seen substantially reduced use of worldwide combination, despite the method having repeatedly been condoned by the Supreme Court during that period. This reflects interstate competition for new investment, the threat of federal legislation, and the effects of anti-unitary lobbying in state capitals, as well as the recommendation of the Working Group that combination be limited to the water's edge. In exchange for agreeing to this recommendation, the federal government promised the states substantial additional administrative assistance, for example, on transfer pricing issues. In fact, this assistance has not materialized.

5. Dividends

Dividends pose a particularly important problem. To the extent dividends flow between corporations filing a combined report, they are eliminated from the calculation of taxable income. However, the proper treatment of other dividends is subject to controversy. Some states tax dividends received by corporations deemed to be engaged in a unitary business with the payor, but others exclude such dividends. This issue continues to be litigated.

D. Excises

The flavour of interstate diversity in excise taxation can be seen from the range of rates levied on three important products: gasoline, cigarettes, and alcoholic beverages. Gasoline taxes range from less than 10 cents per gallon in five states to 20 cents per gallon or more in 24 states. (These figures refer only to state gasoline taxes, per se. In some states there are also local taxes, and in some states sales of gasoline are subject to the general sales tax.)

Discrepancies are even greater in the excise taxes applied to cigarettes. Four southern tobacco-producing states levy taxes of 7 cents per pack (20 cigarettes) or less. By comparison, 27 states impose taxes of 30 cents or more per pack, including six states in which the rate is 50 cents or more.

Because of the differences in the major alcoholic beverages (beer, wine, and distilled spirits), it is difficult to summarize interstate differences in the taxation of these beverages. (The problem is further aggravated by the fact that 18 states operate wholesale or retail outlets, deriving revenues primarily from profits on these operations, rather than from explicit taxation.) Again, however, the differences are substantial. Tax rates on beer range from 6 to 10 cents per gallon in 11 states to 20 cents or more per gallon in 22 states. Tax rates on distilled spirits range from a low of USD 1.50 per gallon to a high of USD 6.50 per gallon in Florida.

State excise taxes on distilled spirits and tobacco products are generally administered through the use of indicia or tax stamps (denominated in amounts equal to the tax rate) which are affixed to the product before it reaches the retail distribution level. Wholesalers must purchase the tax stamps from the state tax authority and affix them to the product prior to sale to the retailer. For beer and wine, wholesalers or distributors are responsible for remitting tax to the state on all products they receive. Federal excise taxes on tobacco and alcoholic beverages are collected directly from manufacturers.

The situation is more complex for excise taxes on motor fuel. Traditionally, state taxes were collected by wholesalers and distributors at the point they delivered fuel to the retail level. Because of widespread evasion, however, both state and federal governments are attempting to move the point of taxation further up the distribution chain to the point at which the fuel first enters the system for ultimate delivery to retail outlets.

E. Areas of agreement

Two areas in which there is relatively little state diversity are payroll taxes that finance unemployment compensation and estate and gift taxes. This is true because the federal government allows tax credits for much of the state tax liability against federal liability. (In the case of the estate and gift

29. See the papers in Charles E. McLure, Jr., editor, *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Stanford, CA: Hoover Institution Press, 1984).

30. This inconsistency in federal and state approaches is not as great as opponents of unitary combination claim. The federal government sometimes uses formulas to allocate costs when arms-length prices do not exist.

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taxes, the credit is based on a federal law enacted in 1926.) Since such arrangements are probably better characterized as sharing of federal revenues with the states, than as taxes levied independently by the states, and because of their relative insignificance, they are not considered further here.

F. Appraisal

In short, the US constitutional system places a premium on the sovereignty of the individual states, allowing them wide latitude in designing their tax systems. This enables each state to design a system that is most in keeping with the desires of its citizens. This autonomy carries a price, however. Taxpayers, particularly those operating in multiple states, bear the substantial burden inherent in simply trying to comply with the multitude of state laws and tax authorities in discharging their obligations. States also pay a price for their autonomy and diversity in the form of reduced compliance. The differences between state and federal taxes and among state taxes make voluntary compliance through education and assistance difficult to accomplish. Further, enforcement efforts are complicated by differing rules which allow some income and transactions to avoid tax, while others are potentially subjected to multiple taxation.

V. MECHANISMS OF COOPERATION AND COLLABORATION

Despite the highly independent system of tax administration resulting from the sovereignty accorded the states by the US Constitution, there are a number of cooperative arrangements between state and federal tax authorities and among various groups of states. These arrangements are aimed primarily at improving tax compliance and enforcement; relatively few address the administrative and compliance burdens faced by multi-state taxpayers – a lacuna that has been the focus of recent criticism.

A. State tax agency organization

Each state has its own tax administration agency commonly known as the departments of revenue, which is responsible for the collection of taxes imposed by that state. State tax agencies are generally headed by individuals who are appointed by and serve at the pleasure of the governor, the elected chief executive of the state. In three states, the head of the tax agency is a statewide elected official, and several state revenue agencies are governed by a multi-member commission appointed by the state's governor.

State tax agencies are generally organized around the core functions of tax administration, rather than being organized by type of tax. A revenue department commonly has major organizational subunits devoted to identification and registration of taxpayers, processing of returns and remittances, taxpayer accounting, audit and enforcement, and taxpayer education and assistance, as well as various organizational support functions such as legal services, personnel, facilities, and information systems. For taxpayers desiring to adjudicate actions of the tax authority, there is commonly at least one level of administrative appeal within the revenue agency, with rights of subsequent appeal to other administrative tribunals and the state judicial system.

B. Federal–State cooperative activities

1. Federal–State exchanges of information

The cornerstone of cooperative tax administration in the United States is an active exchange of information between federal and state tax authorities to support enforcement of the personal and corporate income tax. Federal law authorizes the US Internal Revenue Service (IRS) to provide federal tax return information to state tax agencies, provided it is used solely for tax administration purposes and is properly safeguarded against unauthorized disclosure or release.[31] All states have entered into an exchange of information agreement with the IRS through which they routinely receive an abundance of tax information. Information exchanged includes copies of all federal audits or other adjustments to a taxpayer's return, identification of taxpayers filing a federal income tax return with an address in the receiving state, extracts of items of income and expense reported on the federal tax return, and information reports filed by third-party payers (e.g. banks, brokerage firms, and employers) with respect to taxpayers in a particular state.

Given the basic level of conformity between state and federal income tax bases (see earlier discussion), this information is often used to assess additional state tax directly. For example, one of the most effective information exchanges is an IRS programme that matches third-party reports of income to entries on taxpayer returns. The IRS assesses additional federal tax where income has been omitted and provides information on the adjustment to the state tax authority in which the taxpayer resides. The state customarily issues an automated assessment of additional state tax, unless the income is exempted by the state. States also compare the exchanged data with state files to insure consistency in amounts reported to federal and state tax authorities and to identify potentially non-filing taxpayers. With the massive amounts of information involved, nearly all information is exchanged on computer-readable or electronic media instead of paper.

Federal data and federal audit reports are the only, or at least the predominant, means of independently auditing state individual income tax returns in many states. The rates of state individual income taxes (generally 5-8 per cent of taxable income) are such that it is not cost-effective (particularly compared to the yield on audits of state corporate income taxes and retail sales taxes) to maintain a substantial cadre of state revenue agents to conduct on-site audits of individual income tax returns.

31. State tax statutes likewise authorize the exchange of return information with other states and with the federal government under appropriate safeguards.

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States also use the results of federal corporation tax audits for enforcement. Since the computation of state tax generally begins with federal taxable income, states rely extensively on federal examination activities for verification of the tax base and the proper treatment of various transactions, particularly those involving international operations. State agencies devote their audit activities primarily to verifying the apportionment of income across states, examining the taxpayer's treatment of certain types of transactions, and determining the membership of the unitary group if the state employs combined reporting.

States have recently gained access to data from other federal agencies to aid in tax enforcement activities. They receive regular reports from the US Customs Service on imported goods that they use to identify goods to which the retail sales and use tax may apply or to identify potential taxpayers that may not be registered.

Historically, the flow of information was largely from the federal government to the states. In recent years, however, states have begun providing more information to federal tax administrators. In particular, federal administrators use state lists of registered sales taxpayers to identify potential non-filers of federal employment and corporation taxes and to cross-check reported receipts. They also use files maintained by other state agencies that license individuals engaged in various trades and professions as a source of leads (e.g. on non-filers). Finally, state driver licence files provide a good source of address information and potential assets in a seizure situation. Here again, the data are exchanged under legal agreements regarding the use and safeguarding of the data, and most information is exchanged in computer-useable form.

There are relatively few instances in which the states and federal government conduct joint audits of individual taxpayers, except in the motor fuel excise tax area if earlier investigative work by either the federal or state tax authority has revealed evidence of criminal tax evasion.

There is little in the way of cooperative efforts between state and federal agencies in the administration of excise taxes on alcoholic beverages or tobacco products, except for occasional working arrangements between individual agencies at the local level.[32] Federal law, however, does require that manufacturers of tobacco products and alcoholic beverages provide reports to state tax authorities on all products shipped to wholesalers in the state. This is a great aid in insuring that tax is paid on all products entering the distribution chain in a particular state.

Likewise, there has been little cooperation in the collection of delinquent tax obligations, even though a delinquent taxpayer may often owe money to both state and federal authorities. In fact, this is often a source of friction between tax authorities, with one level attempting to assert priority over the other where there are insufficient resources to satisfy both obligations.[33]

2. Cooperative taxpayer assistance

Beyond the audit and enforcement efforts, state and federal tax authorities have undertaken a wide range of cooperative taxpayer service and education activities. Of particular note are cooperative or joint programmes for providing training and education to tax practitioners and preparers as well as providing cooperative registration and filing assistance to new businesses. It is also not uncommon for state and federal authorities to offer on-site taxpayer assistance at a single site.

The most ambitious effort builds upon a computerized or electronic filing programme begun by the IRS several years ago. States were, at the same time, beginning to enter the electronic filing arena. To avoid duplicative efforts and simplify matters for taxpayers, most states decided to enter into a cooperative filing effort with the IRS rather than develop their own individual filing programme. In 1996, 31 states participated in the joint FedState electronic filing programme. Under the programme, the federal and state individual income tax returns for persons using a participating tax preparer can be filed in a single electronic transmission with the IRS, which in turn provides the state return to the appropriate state tax authority.[34]

3. Collaborative training efforts

A final area of collaboration between state and federal tax authorities is in training personnel. This cooperation takes three forms:

- State tax agency personnel are able to take part in all IRS-sponsored training sessions if space is available. This includes access to a wide range of courses from short-term, specialized courses to more basic courses which might be several weeks in length (e.g. basic criminal investigation). This enables states to leverage the resources of the IRS to meet certain training needs for which it would be impractical to develop their own offerings.

32. In the past there was more cooperation between state and federal officials. More recently, the federal Bureau of Alcohol, Tobacco, and Firearms has been preoccupied with the activities of paramilitary militias.

33. Federal law regarding collection of delinquent taxes complicates efforts to share or jointly conduct collection activities. For example, federal statutes prohibit entities other than the IRS from collecting federal delinquencies. They also prevent the IRS from sharing any proceeds it might collect until all federal tax debts are satisfied. Legislation is under consideration which would ease this process. In one cooperative venture, about 30 states will withhold (i.e. levy and attach) a state income tax refund to satisfy a federal tax delinquency. Legislation to authorize the federal government to offer a reciprocal service to the states has been introduced in the US Congress. (See S. 1408, 104th Congress, 1st Session, 1995.)

34. Beyond the point at which the electronic return is received by the state tax agency, administration proceeds separately, with each level responsible for any further contact it might have with the taxpayer. A federal law enacted in 1976 authorized the federal government to administer state income taxes for states that agreed to adopt the federal income tax base (among other conditions). No state has availed itself of this opportunity, and the provision was repealed in 1992 as an unused and unnecessary piece of federal law. The proposed legislation cited in *supra* note 33 above would authorize cooperative and joint efforts in a number of areas without the conditions of the prior law, which states generally saw as too restrictive on their ability to define their own income tax (especially the base).

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- State and federal tax authorities have on occasion jointly developed specialized training programmes. Most recently, they cooperated in developing basic and advanced courses in motor fuel audit and investigation; over 1,200 state and federal agents attended the course over the last three years.
- IRS personnel regularly participate, both as instructors and students, in training sessions conducted by state agencies or their representatives. For example, the Federation of Tax Administrators (FTA)[35] regularly sponsors training workshops and conferences on current topics and techniques in tax administration for state agency personnel. IRS personnel regularly participate in such events.

4. Procedures for cooperation

The process by which these cooperative tax administration activities are initiated, developed, and implemented is diverse and somewhat dependent on the nature of the initiative. Outside the information and data exchange area, the cooperative efforts are generated largely by individual state tax authorities and their counterpart IRS district office. Representatives from the IRS and state tax agency regularly meet to examine ways to cooperate, and it is out of such liaisons that many individual initiatives grow. Once developed and tested, they are likely to be replicated in other states. But the implementation of many efforts may not occur in all areas of the country.

There is a similar coordinative mechanism at the national level for efforts affecting all states. The leadership of the FTA, as representatives of state tax authorities, holds regular liaison sessions with the executive leadership of the IRS to discuss and coordinate cooperative activities. The IRS maintains a small National Office staff (about 15 persons) dedicated to assisting states in working with the IRS and in providing information on the types of cooperative activities being conducted across the country. Numerous IRS staff throughout the country and in various functions devote at least part of their time to working with states. Leadership and staff of the IRS and FTA play a lead role in designing and implementing efforts that are nation-wide in implementation, e.g. the joint electronic filing programme and the information exchange programme. They are also active in facilitating the adoption of initiatives generated at the state-district level in other regions of the country.

C. Interstate coordination mechanisms

There are several multi-state organizations of state tax officials and authorities that contribute to coordination and collaboration in state tax administration. Generally speaking, these organizations are aimed at one or more of the following objectives: (a) improving state tax compliance through information sharing; (b) improving the uniformity of state tax laws and practices to increase compliance and reduce complexity for taxpayers; and (c) conducting administrative operations on a combined basis to reduce administrative costs and the complexity of operating in multiple states.

1. Multistate Tax Commission.

The Multistate Tax Commission (MTC) is an organization of 20 full-member states which serves as the administrative agency for the Uniform Division of Income for Tax Purposes Act (UDITPA) and the Multistate Tax Compact.[36] The MTC was formed in 1967 as a means of coordinating state activities in the taxation of businesses operating in multiple states and bringing greater uniformity to state taxation of such businesses. The Multistate Tax Compact and MTC were formed largely in response to a series of hearings and studies by the US Congress regarding the taxation of interstate commerce and purported complexities and inequities facing multistate businesses.[37] To forestall federal legislation preempting state taxation of interstate commerce, the states formed the Compact to bring greater uniformity and equity to state taxation of multistate businesses. In addition to the 20 full-member states, which are required to have adopted UDITPA and the Multistate Tax Compact, 15 states are Associate Members and an additional five states work with the MTC on various projects. Associate members do not participate directly in governance of the MTC and have not enacted the provisions of the Multistate Tax Compact.

The Multistate Tax Commission operates several programmes:

- A joint audit programme for member states wherein MTC staff (in conjunction with auditors from the individual states) conduct sales tax or corporate income tax audits on behalf of multiple states at the same time. Upon completion of the audit, individual states are responsible for dealing with the taxpayer on all matters and any appeals resulting from the assessment. The joint audit programme supplements, but does not replace, audit programmes of the individual states.
- An active process of working with states and taxpayer groups to develop uniform approaches to the taxation of multistate businesses.[38] Proposals for uniformity cover a

35. The Federation of Tax Administrators is an association of the principal tax administration agencies in each of the states, the District of Columbia and New York City. See discussion at Sec. V.C.2.

36. UDITPA is a model uniform law developed by the National Commissioners on Uniform State Laws as a means of coordinating the division of a corporation's income among states in which it does business. It has been adopted by 22 states and the laws of 12 other states are in substantial compliance with UDITPA. The National Commissioners on Uniform State Laws is an adjunct of the Council of State Governments and consists of leading state legislators and other state legal experts. Its mission is to review areas of state policy and governance which would benefit from a uniform state approach and to recommend legislation which would implement the preferred approach.

37. See generally the proceedings of the *Special Committee on State Taxation of Interstate Commerce, Committee on the Judiciary, US House of Representatives pursuant to Public Law 86-272*. The Subcommittee operated from 1962-1966. These hearings were generally known as the "Willis Committee" hearings after its chairman, Rep. Edwin E. Willis of Louisiana.

38. There are several organizations of business taxpayers with whom state tax administrators regularly interact and work in efforts to promote uniformity and consistency in state taxation. These include the Committee on State Taxation (COST), an adjunct of the Council of State Chambers of Commerce, which consists of roughly 400 multistate companies. The primary purpose of COST is to advocate for multistate taxpayers before state and federal legislative and judicial bodies and to provide training to member companies. Similarly, the Tax Executives Institute (TEI) is an organization of tax professionals from major multistate and international corporations domiciled in the United States and Canada. Its

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wide range of issues, but are commonly focused on developing consistent approaches to the apportionment and allocation of income of various industries and generally implementing the provisions of UDITPA, defining the jurisdictional reach of state authority to tax, and developing tax approaches to new and emerging technologies and industries. Examples of recent proposals are uniform apportionment formulae for multistate financial institutions, broadcasters, and publishers and a standard approach to the sales taxation of telecommunications services. All recommendations are advisory to state tax authorities and legislatures.

- A "nexus discovery" programme for about 40 states aimed at identifying taxpayers which should be, but are not, registered for tax purposes in one or more states.
- Coordination of state legislative initiatives at the federal level.
- Research and analysis of emerging tax administration issues.

2. Federation of Tax Administrators

The Federation of Tax Administrators is a non-profit association of the tax authorities in each of the 50 states, the District of Columbia and New York City.[39] In contrast to the MTC, the FTA is not an operating tax administration agency, but rather a mechanism for all states to cooperate in improving the techniques and standards of tax administration. The mission of the Federation is to improve state tax administration practices through research, writing, and information exchange on state tax policy and practices; training state tax agency personnel; and coordinating interstate and federal-state tax administration programmes.

The FTA regularly publishes newsletters and research reports on current issues in tax administration and conducts a wide range of training workshops and conferences on state tax administration issues and techniques. Training efforts generally cover new and emerging issues in tax policy and administration, advancements in the use of technology in tax administration, and specific developments in such areas as motor fuel and tobacco excises and tax research. As outlined above, the FTA is active in developing and coordinating various federal-state cooperative tax administration efforts and facilitating interstate cooperative efforts. FTA also works with states in pursuing federal legislative initiatives and examining emerging tax administration issues.

3. Regional cooperative agreements

In several areas of the country, state tax agencies have joined together to adopt regional agreements to encourage information sharing among the states as a means of improving tax compliance on interstate sales. States participating in the agreements agree to share information on goods being shipped into other participating states without the payment of tax.[40] Certain of the agreements also call for active encouragement of retailers to register in all states into which they ship goods. Such agreements are in place in the Great Lakes, Midwest and Southeast regions of the country. In addition, New York, New Jersey and Connecticut have extended this type of agreement to include a mechanism under which a retailer can file a single return with one state to satisfy its sales tax obligations in each of the three states.[41] The Southeast agreement also includes procedures for routinely sharing certain corporate income tax information.

4. Bilateral exchanges

In addition, each state has entered into agreements to exchange tax return information with nearly all other states. This exchange may be accomplished either through the Uniform Exchange of Information Agreement developed by the FTA and executed by about 45 states or through separate bilateral exchange agreements. Under these bilateral arrangements, states routinely share compliance information with other states on a taxpayer-by-taxpayer and a state-by-state basis. The exchanges may be more comprehensive. New York, New Jersey and Connecticut routinely exchange information on individual taxpayers in the New York City metropolitan area who work in one state, but reside in another, to insure consistent sourcing of the income and proper computation of credits for taxes paid in another state.

5. International Fuel Tax Agreement

In the last several years, states have been required by federal law to join the International Fuel Tax Agreement (IFTA), as a means of reducing the administrative burden on taxpayers through participation in a joint tax administration project. All states (and a number of Canadian provinces) are now members of IFTA, which provides a mechanism for apportioning the motor fuel excise tax liability of an interstate or multijurisdictional motor carrier among the states in which it operates.[42] Under the Agreement, the carrier files only a single tax return with the state in which it is domiciled or based, together with information on its operations (purchases, mileage, etc.) in all jurisdictions for the reporting period. The "base

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mission includes professional development and advocacy before state and federal policy makers. The Institute of Property Taxation (IPT) consists of tax professionals and representatives in the property and sales and use tax areas. Its mission is limited to professional development for its members and working with appropriate state and local tax authorities on matters of mutual interest.

39. Membership in FTA is open to all states, the District of Columbia, and certain large cities which administer their own sales or income taxes. New York is the only city that has elected to join.

40. The regional agreements provide that information gathered on transactions meeting specified criteria will be shared among the states. The information exchanges fall far short of providing information on all interstate sales. Such regional or other voluntary interstate agreements are inherently limited because they involve tax authorities in one state providing information to other states, which will lead to increased taxation of companies (or their products) operating in the state providing the information. Certain states are unlikely to join such endeavours because substantial portions of their economy may benefit from compliance difficulties currently faced by other states. Similarly, tax administrators considering participation in interstate sharing of information must be sensitive to the political interests in their state; otherwise they risk losing the support of elected officials.

41. For a more complete discussion, see Harley T. Duncan, "Interstate Cooperative Efforts to Enforce State Sales and Use Taxes," *Proceedings of the 81st Annual Conference on Taxation*, (Columbus, OH: National Tax Association-Tax Institute of America, 1989), at 93-98.

42. In the US, a carrier pays tax at the time fuel is purchased or "at the pump", but is then responsible for apportioning the tax paid on its entire fleet on the basis of miles travelled in each jurisdiction. Before the adoption of IFTA, a carrier was responsible for filing quarterly returns in each jurisdiction in which it operated, detailing its mileage, purchases and consumption and any tax or refund owed.

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state" provides information to other jurisdictions, reconciling the tax owed by the carrier in all jurisdictions, and otherwise provides for the administration of the tax with other jurisdictions on behalf of the carrier. The base state also audits carriers on behalf of all other jurisdictions. In short, the interstate carrier deals only with the tax authority in its base state, which is responsible for all contacts on behalf of the carrier with other jurisdictions.

New York State has taken the joint administration of IFTA one step further. It has developed a data processing facility which provides tax return and remittance processing services for 16 IFTA jurisdictions, including two Canadian provinces.[43] The processing centre captures all data from returns filed with it and handles all financial transactions among the states involved as well as with other IFTA jurisdictions. The states are individually responsible for registering and auditing carriers and dealing with delinquent carriers.

IFTA began as a voluntary cooperative effort among a relatively small number of states – three at the outset. However, because of the perceived benefits, the interstate trucking industry pushed hard for further participation and was eventually successful in securing enactment of a federal law requiring states to participate in IFTA if they wish to continue imposing the apportioned fuel use tax beyond 30 September 1996.[44] While some states initially resisted enactment of the requirement, all will have complied with its provisions by the deadline.

VI. CONCLUDING REMARKS

The sometimes chaotic "system" of tax assignment and tax administration in the United States reflects the unique historical development, in which a nation was created by states that retained substantial powers, including fiscal powers. The current system was not planned; like Topsy, in Alice in Wonderland, "it just growed". As a result, it is characterized by inconsistencies (e.g. in law and administration), gaps and overlaps (in tax bases), duplication (of administrative and compliance efforts), excessive litigation, inequities, and economic distortions.

While the system of essentially independent legislation and administration works fairly well for the United States – which shows no proclivity to change it in fundamental ways, it does not provide a useful blueprint to be followed by a nation attempting to construct a more rational and efficient system. However, the horizontal and vertical cooperative arrangements that have been worked out to deal with various problems are worth studying by a country that chooses to follow the path of independent legislation and administration.

43. As of April 1996, the centre is processing for 12 jurisdictions. The remainder will come on-line in July 1996.
44. See Public Law 102-240, the Internodal Surface Transportation and Efficiency Act of 1991.

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CENTRAL AND EASTERN EUROPE

AN OVERVIEW OF TRENDS IN TAX REFORMS IN SELECTED CENTRAL EUROPEAN COUNTRIES[1]

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I. INTRODUCTION

This paper provides an overview of the ongoing development of the direct taxation systems of certain Central and East European countries (hereafter: CEE countries), i.e. the Czech Republic, Hungary and the Slovak Republic.

These countries were selected on the grounds that they are all attempting to harmonize their tax systems, in line with those of EU Member States. Indeed all are associated members of the European Union.[2] However in spite of their common goals, the Czech Republic and Hungary represent diverging directions in the development of tax systems, they show two extremes: the Czech Republic's tax system is stable, while Hungary's tax system suffers from continuous contradictory changes, but nevertheless offers investors more incentives than the Czech system does.

The tax policy climate has altered considerably from the early 1990s to the present. After the political changes which occurred at the turn of the last decade these countries with emerging markets needed to develop new and appropriate tax systems.[3] They started almost from scratch as they had no real traditions in this field. They all therefore have had to search for new ways to improve their tax systems and to adapt their systems to new developments. The countries in transition have had considerable problems in establishing and developing adequate tax policies and regimes. These problems are particularly pronounced when it comes to fine tuning tax policy to satisfy the needs of specific industries.[4]

The countries in transition wish to develop tax systems, incentives and other methods similar to those of the EU Member States in order to achieve their economic goals, i.e. to encourage and promote the growth and competitiveness of their economies.

II. HISTORICAL OVERVIEW

A. The Czech and Slovak Republics

Czechoslovakia was, basically, the last of the socialist countries to undergo far-reaching political changes. After the "Velvet Revolution" in Czechoslovakia in 1989, an intensive preparatory work began to create reform legislation with the aim of restructuring the legal framework, removing restrictions on private economic activity and encouraging foreign investment and trade.

Formerly, Czechoslovakia had a central taxing authority which imposed all taxes in both republics.[5] The transformation of this system occurred in two stages. An entirely new, but transitional, system was introduced in 1989.[6] This was then replaced by the present system, which came into effect on 1 January 1993 and is closely based upon Western European models. The comprehensive tax system consists of corporate and personal income tax and a value added tax which closely follows the EU Directives. With the dissolution of Czechoslovakia on 31 December 1992, the new system was adopted by both the Czech and Slovak Republics, though subsequently both countries have adopted significant amendments and their tax systems are no longer identical.

In the period after this reform in the Czech Republic tax policy has been consistent and fairly tight. No reliefs, deductions and concessions are available, and the taxation system does not offer any form of incentive for foreign investors. Since the tax reform in 1993, no conceptual or structural changes have taken place in the tax legislation. Amendments to tax

* The author would like to acknowledge the valuable comments of Gabriella Erdös, Tax Partner of KPMG Hungária, Budapest.

1. This paper is a shortened updated version of the presentation made to the Scientific seminar: "The Importance of Institutions for the Transition in Central and Eastern Europe" held in Halle/Saale (Germany) on 18-19 March 1996. The seminar was mainly devoted to the developments in the agriculture and food industry, therefore special attention was paid to the taxation of the agricultural sector and the food industry. This paper does not separately cover these sectors, instead it is limited to examining the general trends of development in taxation in the region.
2. In addition, the Czech Republic and Hungary became members of the OECD.
3. Under the communist regimes, the tax systems reflected some of the irrationality of the applied economic systems. The years prior to the 1990s can be characterized by an unreasonably high state participation in the economy. The main purpose of the tax system, besides the collection of revenues for the state budget, was (as part of the central plan) to guide and influence the whole economy.
4. The European Union also has great concerns about its regime of incentives and subsidies for specific industries, mainly for agriculture and the food industry, and it is planning to restructure this within a 10-15 year period, using the financial devices available through the tax systems of Member States.
5. J. Prust: "The Czech and Slovak Federal Republic: Government Finances in a Period of Transition", (Ed. Vito Tanzi), *Transition to Market: Studies in Fiscal Reforms*, IMF 1993.
6. The system prior to the one introduced in 1989 had consisted of an enterprise profits tax and an turnover tax.

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laws were basically technical in nature, aimed at bringing increased clarity and closing unintended loopholes.

The Slovak Republic "inherited" the same tax system as the Czech Republic. As most foreign investment concentrated in the Czech territories, the Slovaks introduced incentives for specific industries and specific areas. However, these incentives were generally unsuccessful and were later withdrawn. In general, the Slovak Republic is somewhat behind the Czech Republic in amending its tax legislation and closing loopholes, nevertheless in most cases it follows in the same direction.

B. Hungary

The Hungarian tax system has been subject to constant, frequent and far-reaching changes. Among former centrally planned economies, Hungary pioneered the initiation of market-oriented reforms in general and the overhaul of fiscal institutions in particular. The reform effort began in 1968 with the introduction of a new "economic mechanism". In the course of continuous fiscal reforms the main purpose of the tax system changed from directing the economy to collecting budget revenue. The initial tax system represented a combination of different types of contributions to special funds and excess wage taxes, with a great number of preferences obtained on a highly discretionary basis.[7]

The milestone in taxation was the major reform of 1987 which introduced a comprehensive tax system with effect from 1 January 1988. The reform undertaken coincided with the entire rebuilding of the legal environment in Hungary. The characteristic features of this comprehensive tax system were the high effective tax rate and a wide range of tax preferences granted to selected activities or industries, mostly in the form of reduced tax rates. However, the most generous tax preferences were granted to foreign investors. The reform in 1990 replaced the entrepreneurial profits tax with a corporate income tax. With the entering into force of the Accounting Law in 1992, structural changes were introduced, the existing distortions[8] were corrected, the rates reduced and direct taxes harmonized. Since then, Hungary has followed the general trend of a further reduction in tax rates, of eliminating special preferences and of broadening the taxable base and has gradually adapted its tax system to European standards.

The 1994 amendments which came into force on 1 January 1995 represented a new reform which conceptually modified the Hungarian tax system, through the introduction of a two-stage corporate tax, and the repeal of a great number of tax incentives. The beginning of 1996 again witnessed changes in the legal framework, including changes in fiscal legislation caused by a need to secure economic stability, the deficit in the balance of payments, and the unconditional adoption of the aims of certain interest groups. Complex tax regulations of an anti-avoidance character were also introduced. Some of these regulations are unduly restrictive, ignore the economic reality and may hold back development.

The measures in the new corporate income tax and dividend tax law adopted for 1997 are designed to overcome the continuing budget deficit problem, while maintaining and encouraging economic growth and reducing inflation. Additional objectives of the new reforms are :

- to promote neutrality in competition;
- to facilitate harmonization with EU Member States; and
- to eliminate controversial and contentious elements of the current legislation.

Summarizing the trends it can be stated that the tax regimes of Central and Eastern Europe are developing from a common origin under the COMECON system towards systems more similar to those in the West. Among the countries referred to, the path, speed and scope of change is different. The tax system of Hungary from 1992 onwards underwent frequent, sometimes very contradictory, changes and developments, resulting in a reduction in taxpayer security. This continuous revision of the fiscal legislation endangers the main principles of neutrality, transparency and fairness. After the split the Czech and Slovak Republics introduced a completely new tax system on 1 January 1993, which, irrespective of certain fine tuning changes, still applies.

III. MAIN DEVELOPMENTS IN THE DIRECT TAXES BETWEEN 1988 AND 1997

A. Corporate income tax

The corporate income tax is levied on the worldwide income of legal persons, including limited partnerships. It also applies to the domestic income earned by branches of foreign companies. In Hungary partnerships are normally subject to corporate income tax, but the income of general partnerships in the Czech and Slovak Republics is taxed in the hands of the individual partners.

7. The taxes were not primarily used to collect state revenue but rather to direct the economy. Enterprises were subject to a complicated system of formal taxes and contributions to special funds, according to a specifically elaborated set of formulas. Profit allocated to these funds was taxed at progressive rates from 0 per cent to 70 per cent depending on the type of industry. This type of taxation was clearly neither transparent nor neutral, and gave rise to bargaining over the granting of tax preferences. During the 1970s, profit taxation was simplified with a regulatory tax rate of 40 per cent and a municipal tax rate of 6 per cent combined with a highly progressive excess wage tax rate of up to 400 per cent. Certain reliefs were still given on a discretionary basis.
The beginning of the 1980s again witnessed changes. Certain types of taxes were repealed, while the rate of profits tax and the municipal tax rate were increased to 45 per cent and 15 per cent respectively. In 1985 allocations to special funds were abolished, enterprises paid a 50 per cent profits tax and a municipal levy. Reduced rates were still available for certain activities and enterprises. [see Bácskai T.,(1971), "New developments in State Enterprise Taxation in Hungary", Vol. 6 *Acta Oeconomica* No 1-2, at 107-121; and Kopits G. (1993), "Hungary: A case of Gradual Fiscal Reform", *Transition to Market: Studies in Fiscal reforms*, IMF International Monetary Fund, at 387].

8. A great number of "distortions" were caused by the old-fashioned accounting system which did not give a true, complete or clear picture of the financial position of a business entity. The new Accounting Law introduced new norms and provisions for valuation and revaluation of assets, and for making accruals etc. The new tax law followed the new principles and accounting rules allowing the computation of the tax liability from the accounting profits.

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1. Tax rates

In 1988 the corporate tax rates were generally higher than those in Western countries, but a gradual reduction in the tax burden took place in the following years. Table 1 shows that the nominal rates have been reduced to a level which is now compatible (or even lower in the case of Hungary) with the corporation tax rates in EU and OECD countries.

Table 1
Standard Corporate Tax Rates

	1988	1989	1991	1993	1996	1997
Czech Republic	75	75	55*	45	39	39
Hungary	55**	50**	40	36	18+23***	18
Slovak Republic	75	75	55	45	40	40

* Except for the first CZK 200,000 which was taxed at 20 per cent.
** The first HUF 3 million was taxed at 35 per cent.
*** Basic corporate tax rate of 18 per cent and supplementary tax on profit distribution at a rate of 23 per cent.

In an attempt to encourage selected activities, a wide range of tax preferences were granted (mostly in the form of tax credits or reduced rates).

2. Taxation of distributed profits

The issue of how to tax distributed profits in relation to retained profits became an important issue during the fundamental reform and overhaul of the tax systems. The selected countries basically chose the classical tax system, whereby profits already taxed at company level are upon distribution subject to tax in the hands of the shareholders.

In the Czech Republic double taxation of dividends is relieved through the integration of corporate tax and income tax with respect to the taxation of distributed profits. This scheme allows shareholders a credit for the dividend withholding tax due to set off against the company's corporate tax which results in a reduced corporate income tax rate. This legislation which took effect on 1 January 1995, provides, in practice, different rates of corporate income tax on distributed and undistributed profits. On the other hand from 1994, the Czech Republic has put into place an imputation system through the exempting of dividend income for holding companies.

In the Slovak Republic no special provisions exist with respect to granting relief from double taxation. A purely classical system is applied.

The Czech and the Slovak Republics impose a withholding tax on dividends distributed to both domestic and foreign shareholders. In the Czech Republic the withholding tax is 25 per cent on dividends paid to domestic shareholders and 15 per cent if they are paid to foreign shareholders. In the Slovak Republic withholding tax on dividends is set at 15 per cent in all cases.

In Hungary from 1 January 1995 a reduced rate of 18 per cent applied to undistributed profits and a supplementary tax at a rate of 23 per cent applied to distributed profits. This tax was adopted in an effort to encourage companies to retain, rather than distribute, their profits. This two-tier regime was introduced within the framework of a general trend to reduce the availability of tax incentives and to restrict the application of tax incentives that had already been granted.[9] Moreover, the changes in the corporate tax system substantially altered the tax position of companies formerly benefiting from tax incentives. As a compensation for the losses suffered from the additional tax burden caused by the supplementary tax, Hungarian tax law offered treaty relief for double taxation to foreign shareholders (i.e. the relevant provision allowed foreign shareholders to apply the dividend articles of double tax treaties with respect to the rate of supplementary tax). All of this has resulted in a situation of uncertainty and has necessitated an extremely complex calculation procedure and administration.[10]

As from 1 January 1997 the problematic two-stage corporate tax structure has been abolished and replaced by a single corporate income tax rate of 18 per cent and a dividend withholding tax levied on the foreign recipient at a rate of 20 per cent.[11]

In Hungary profit distributions made by Hungarian companies to individuals were subject to tax at a flat rate of 10 per cent from 1995 (prior to 1995 it was 20 per cent). For 1997 the tax on dividends payable by individuals has been increased to 20 per cent or 27 per cent. The higher rate is applicable if the dividends exceed a certain percentage of the individual's share in the business.[12]

Although all these countries have classical systems, they apply offsetting measures to reduce the tax on dividends paid by resident companies to resident individuals as an incentive. Personal and corporate income tax remain completely separate.

3. Treatment of intercompany dividends

The treatment of intercompany dividends is not generally favourable; in the Czech and Slovak Republics dividends are subject to a local withholding tax that has always been treated as a final tax liability.

9. However, such fiscal incentives granted through the tax system have created difficulties (e.g. economic distortion).
10. The effective supplementary tax rate applicable to distributions was to be calculated as the weighted average rate applicable to the various shareholders. The effective supplementary tax rate, therefore, depended on the proportion of participation of treaty and non-treaty (including Hungarian) shareholders and the treaty rates applicable to each shareholder. Hungary did not apply withholding tax on dividends.
11. No dividend withholding tax will be levied on the profits distributed to resident persons (except natural persons and the permanent establishments of foreign persons) provided they are transferred to an account kept with domestic financial institutions. An exemption from dividend withholding tax is available to foreign persons for dividends which are used to increase the share capital of new or already existing Hungarian resident companies, or if the dividends are kept on a special purpose account with a domestic financial institution. The dividend tax will become payable at the moment when a non-resident makes the actual transfer of dividends or disposes of the relevant share capital.
12. The percentage is defined as double the prime rate of the National Bank of Hungary applying on the first day of the year in which the dividend was approved. The individual's share is the portion of the equity less the valuation reserve attributable to the shareholding. The 20 per cent or 27 per cent rates are calculated by the payor company and must be withheld from dividend payments.

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As mentioned above in the Czech Republic, from 1 January 1994 a partial imputation system was introduced for dividends paid through holding companies. If a company both receives dividends from a (minimum) 20 per cent owned subsidiary and pays such dividends to its parent company (minimum ownership requirement again 20 per cent), then the element of the dividend paid relating to the dividend received is not subject to withholding tax. With effect from 1 January 1995 a tax credit for distributed profits (i.e. a differential rate of corporate income tax on distributed and undistributed profits) was introduced. A company which pays dividends may deduct from its corporate tax liability an amount equal to one half of the withholding tax relating to the dividends) paid by the company in the year concerned.[13]

Prior to 1997, in Hungary dividends paid to corporate shareholders were not subject to withholding taxes (see above). Dividends received (except dividends subject to the controlled foreign companies rule[14]) are excluded from the computation of the taxable base for corporate income tax purposes.

4. Loss relief

Loss relief has been introduced in the countries concerned. The option to carry forward losses represents not so much an incentive but rather the removal of an important disincentive. In general, the countries concerned do not allow the carry back of losses.[15]

Table 2
The carry-forward of losses

	1988	1991	1993	1996
Czech Rep.	not available	not available	5	7
Hungary*	5	5	5	5**
Slovak Rep.	not available	not available	5	5***

* Hungary provides that losses incurred in the agricultural sector may be carried back for two years. Start-up losses can be carried forward for an indefinite period of time.
** The option to carry forward losses will be denied from the third year from commencement of entrepreneurial activity, if a taxpayer does not generate net sales revenue of at least 50 per cent of the total expenses incurred, unless permission is given by the tax authorities. Permission will be given only in the case of a natural disaster or if there is a justifiable failure in putting a new investment into operation.
*** No carry-back of losses is allowed. In addition, loss carry-forwards are restricted. Corporations can only use one fifth of the loss incurred in the current year to offset against the income from each of the next five years (i.e. 20 per cent each year). If the corporation incurs losses in the year to which a prior-year loss is carried over, the new loss is not available for the carry-over treatment.

5. Deductibility of bad debts

The treatment of bad debts was a critical issue in the countries under consideration. In the initial period tax legislation was silent concerning bad debts relief, and only in very specific situations permitted a tax deduction, e.g. the debtor had filed for insolvency or for bankruptcy or had gone into liquidation and the creditor registered a claim at court. Only recently have these countries introduced rules that allow tax deductions for specific bad debts.

In 1993 Hungary introduced a restrictive scale, which is still in force, for the creation of reserves for bad and doubtful debts. The amount deducted from the taxable base varies between 2 per cent and 25 per cent depending on how long overdue the debt is. Special, much more favourable rules apply to uncollectible debts as from 1996.[16] As of 1997 this favourable rule has been restricted by excluding foreign debts from the category of bad debts.

In the Czech Republic corporate taxpayers, other than banks, are entitled to write off bad debts incurred after 31 December 1995 on a phased basis.[17]

If proper action (e.g. legal proceedings against the debtor) is taken to collect long overdue bad debts such bad debts may be written off in proportion to the period of time they are overdue.[18]

The Slovak Republic has an even less generous regime for deducting bad debts, i.e. taxpayers, other than banks, can only deduct bad debts if the debtor becomes bankrupt.

B. Tax incentive policies in the context of different categories of taxpayers

For countries undergoing economic transition, foreign direct investment is of great significance. CEE countries considered – rightly or wrongly – corporate tax incentives to be a major tool in the transformation process, vital for creating a fiscal

13. The lower effective rate for distributed profits is in contrast to the Hungarian two-stage corporate income tax system, which from 1995 until 1997 applied a lower rate for undistributed profits.
14. As a new anti-avoidance measure, a controlled foreign company (CFC) rule has been introduced from 1997. A controlled foreign company is defined as a non-resident person:
- whose registered seat is located in a country that does not impose corporate tax on the income of non-residents or that has an applicable rate of tax under 10 per cent. (The CFC rule does not, however, extend to companies resident in OECD Member countries or in countries with which Hungary has a double taxation treaty); and
- in whose registered capital a resident person or corporation holds directly or indirectly an interest of at least 25 per cent for at least 30 days (aggregate) and also holds that interest on the last day of the tax year.

To prevent shifting taxable income outside of Hungary and receiving it as exempt income (dividends are normally excluded from the taxable base), dividends received from controlled foreign companies must be included in the taxable base.
15. Although Hungary permits a two year carry-back of losses for the agricultural sector.
16. The amount of uncollectible debts as specified in the law, (i.e. debts cancelled during bankruptcy or liquidation proceedings and loss of commercial credits,) provided the steps taken to collect them were unsuccessful are treated as tax deductible items. From 1996, the following are also recognized as uncollectible debts: (a) claims which have elapsed, i.e. which are older than five years; (b) claims which are forgiven by the creditors; (c) claims which are cancelled in a bankruptcy proceeding; (d) unrecoverable debts which are unrecoverable on the basis of a written declaration made by the liquidator in the case of liquidation; (e) existing claims against debtors who cannot be traced and the creditor has taken formal steps to locate the debtor; and (f) claims whose recovery costs would exceed the claim itself.
17. 20 per cent – for debts more than six months overdue; 33 per cent – for debts more than twelve months overdue.
18.

Period debt overdue (months)	*Write off (%)*
18	50
24	66
30	80
36	100

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environment conducive to attracting foreign direct investment.[19]

Basically, all the CEE countries widely used, (and some of them still use) a great range of incentives to make their economies competitive on the international market. The principal form of corporate tax incentives available in the initial phase of transformation in the CEE countries was tax holidays (which operate by exempting, or taxing at a preferential rate income earned during the first year of the founding of a company (initial incentive) or certain years depending on prescribed conditions. Most of the countries introduced generous tax incentives for joint ventures. However, because of the lack of experience in administering incentives and the lack of understanding of investors' motives, these measures were often introduced in an inappropriate way without examining interactions with other regulations. Consequently in many cases they could not fulfil their intended function of stimulating economic growth.[20]

Most commonly incentives were granted to newly established ventures: but they usually did not take into consideration possible start-up losses and they did not depend on the fulfilment of specified requirements and conditions. Therefore, the tax incentives granted have sometimes led to unexpected results: certain companies were unable to benefit from the tax holiday, others targeting quick returns made use of the incentives but did not play an important role in fuelling economic development. A tax holiday granted without pre-conditions primarily benefits short-term investments (this occurred in Hungary in 1988[21]). From a government's point of view tax holidays can lead to a large erosion of the tax base,[22] which affects neutrality and can have an unintended distorting effect on the economy.

These and similar experiences have changed the incentives policy: the emphasis is now on providing carefully targeted incentives i.e. offering incentives to companies investing in certain branches of the economy (e.g. in manufacturing, agriculture and the food industry) or in certain regions. Incentives are aimed at encouraging only large scale investments and have been granted on a case-by-case basis. Where the granting of tax incentives depended on officials exercising discretion (rather than the tax incentives being granted solely by reference to detailed conditions contained in the tax legislation), there was the danger of undue influence being exerted by the parties involved. Even though tax incentives were basically codified, it was possible in certain circumstances to negotiate incentives.

Table 3 provides information on tax holidays that were or are available to all corporate entities. The CEE countries granted a wide range of tax incentives in their early corporate income tax and foreign investment laws. However, from 1993-1994 the CEE countries have gradually reduced or completely eliminated tax holidays as a form of incentive for foreign investment. These investor specific incentives have been replaced with activity-specific allowances, credits for expenditure on new plant and machinery and temporary exemptions from tax for reinvested profits.

Table 3
Tax holidays available to all legal entities

	New businesses (years)			Special Activities			Reinvestment incentives			Others
	'88/'91	'93	'96	'88/'91	'93	'96	'88/'91	'93	'96	
Czech Rep.	2	no	no	yes	yes	yes	no	no	no	yes
Hungary	3	no	no	yes	yes	yes	yes	yes	no	yes
Slovak Rep.	2	1	no	no	yes	yes	no	yes	no	yes

There are significant differences in the practice of certain CEE countries towards granting incentives. This is due to considerations relating to the protection of the revenue base, and maintaining the principles of equity, simplicity and efficiency. *The Czech Republic* declared neutrality as a main principle in its new income tax code introduced in 1993.[23] *The Slovak Republic*, which suffered from insufficient foreign investment after the split, has decided to give up the principle of competitive neutrality and has introduced a number of tax incentives for foreign investors in 1993, although these incentives were again withdrawn for 1996.[24] *Hungary* has an extensive system of tax incentives. Prior to 1989, companies with foreign participation were subject to lower tax rates than domestic companies. The incentives have subsequently been modified and were mostly eliminated at the end of 1993, though existing enterprises continue to enjoy the incentives for which they have qualified.[25] For the 1995 tax year Hungary broke the trend by introducing the possibility of tax incentives for large-scale investors. At the beginning of 1996, Hungary again introduced new incentives in the form of a tax exemption or reduced tax rate depending on the size of investment and its result in terms of an increase of turnover or exports. The new incentives are very restrictive, designed for a group of companies having substantial capital

19. OECD, *Taxation of Foreign Direct Investment in Central and Eastern Europe*, (OECD Report released on 29 March 1995).
20. G. Erdös: "Tax incentives fall short", Vol. 5 *International Tax Review*, Nos. 3 and 4, March 1994.
21. A good example is Hungary, where many joint ventures have been established with the minimum amount of capital required by law (usually only a few hundred dollars for the foreign investor involved). The company was able to benefit from the tax incentives granted to joint ventures, achieving competitive advantages in this way over other domestic companies.
22. I.e. the government's revenues are reduced.
23. No tax holiday is available under Czech laws, except for a tax exemption for five years for small-scale energy producers. In 1994 an investment expenditure allowance was introduced to encourage companies to invest in new assets: 10 per cent of the acquisition price of machinery and equipment may be deducted from the taxable income of the first owner of the assets if they are not sold or leased within three years. Accelerated depreciation is also available.
24. In the period between 1993 and 1995 the Slovak Republic granted the following tax holidays (mainly to foreign investors):
- newly established joint ventures (one year); or
- joint ventures in underdeveloped areas funded through reinvestment of savings (two years).

For the following two years the tax rate is 20 per cent. For commercial companies with at least 30 per cent (minimum DEM 1 million) foreign capital a reduced tax rate of 30 per cent for two years applies.
Farmers and entities engaged in agriculture in the Slovak Republic can apply a standard deduction of 50 per cent against their income and avoid itemizing expenses. A rate of 20 per cent applies to the resulting taxable base.
25. Under the incentives granted to companies to attract foreign investment, particular attention must be paid to tax holidays given for ten years for industries of prime importance.

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and export market capacities. In order to develop special areas and regions the tax law provides for regional incentives as well. The incentives which were available in Hungary in 1996 are summarized in Table 4.[26] However, the biggest Hungarian corporate tax incentive is without any doubt the very low rate of corporate income tax (18 per cent).

Table 4
New or amended tax incentives in Hungary available to all taxpayers in 1996

Tax exemption or reduction	Industry/ region	Minimum investment	Period	Other conditions
30% of capitalized interest or 18% of interest expenses	economy development tenders	none	none	investment financed by Hungarian bank loan
19% of capitalized interest or 12% of interest expenses	manufacturing environmental protection, tourism	none	none	investment financed by Hungarian bank loan
50% reduction in the basic corporate tax (18%)	manufacturing	HUF 1 billion	5 years	25% but min. HUF 600 million annual increase in export
100% of basic tax on profits from the region, but max. 70% of CIT	manufacturing in special zone	none	5 years	1% export or agricultural income increase annually
100% of basic tax on profits from the region, but max. 70% of CIT	hotel and accom-modation in depressed area	none	5 years	none
100% of basic tax on profits from the region, but max. 70% of CIT	manufacturing in depressed area	none	5 years	export increase equal to 5% of the investment value

Both the Czech Republic and Hungary, at present, widely use such incentives as special or accelerated depreciation (granted for the acquisition of new machinery and equipment) investment expenditure allowances and investment tax credits.

C. Personal income taxes

In the countries under review, a decline in the top tax rates took place during the period between 1988 and 1996 (See Table 5). The reduction of the highly progressive rates has been combined with the widening of the tax base and increases in thresholds.[27]

Table 5
Personal Income Tax Rates

	Top rate on earned income			Lowest rate on income			Number of brackets		
	1988	1993	1996	1988	1993	1996	1988	1993	1996
Czech Rep.	60	47	40	15	15	15	12	6	5
Hungary	60	40	48	12	0	20	7	5	6
Slovak Rep.	60	47	42	15	15	15	12	6	6

1. Personal income taxation in the Czech and Slovak Republics

In Czechoslovakia, personal income taxation was introduced at the beginning of 1991. It was a schedular system under which different tax rates applied to different categories of income, and the income was not aggregated. Income was categorized as income from employment, agriculture or literary and artistic work, and "other income" such as business income or passive income. This other income was subject to citizen's income tax with rates ranging from 15 per cent to 55 per cent. The wage tax was designed for income from dependent services with progressive rates up to 60 per cent depending on the number of the taxpayer's dependents. The tax reform of 1993 abolished the former distinction between employment and other source income, and introduced a progressive tax scale with rates ranging from 15 per cent to 47 per cent for aggregated income. The top rates have been gradually reduced so that by 1996 they stood at 40 per cent in the Czech Republic and 42 per cent in the Slovak Republic.[28]

2. Personal income taxation in Hungary

Personal income taxation was in principle not in place in Hungary until the early 1980s and the emergence of a second economy. Since that time various taxes have been imposed on personal income from different sources with highly progressive rates of up to 75 per cent. In January 1988, a broader-based personal income tax with progressive rates which ranged from 12 per cent to 60 per cent was introduced. As of 1992, the personal income tax was further streamlined, the top marginal rate was reduced to 40 per cent, the structure of brackets was simplified and a personal allowance in the form of an exemption was granted. Since 1988 a separate 20 per cent final withholding tax was imposed on interest and dividend income, the latter was reduced to 10 per cent in 1995, while the tax on interest was set at 0 per cent in 1995. For 1995 credits and deductions against income were abolished and replaced by a system of credits against taxes. The year 1996 again witnessed a reform in personal income taxes that has caused a heated debate. The major changes include the

26. The incentives are available only in the years in which the conditions are met. The scope of incentives and the conditions for eligibility have tightened slightly for 1997. Tax allowances refer to the corporate income tax levied at 18 per cent on the taxable income (tax incentives displayed in the table refer to the first part ("basic tax") of corporate income tax).
27. Although, in certain instances thresholds have remained unchanged during periods of inflation. This leads to an effective reduction in the value of the relevant threshold.
28. In the case of the Czech Republic, for 1997 the brackets were extended (e.g. in the highest bracket from CZK 564,000 up to 756,000), but the rates remain unchanged.

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introduction of different tax rate schedules for income from dependent activities (employment) and for income from independent activities (e.g. business income) with a top marginal rate of 48 per cent and the abolition of the personal allowance. In the case of earning both types of income the tax is calculated proportionally using both tax tables. In addition, a new feature of personal income taxation is the extensive application of different flat rates, mainly to passive income and income from other sources. The 1997 modifications are not as significant as those of 1996; the dual tax rate schedule has been abolished and only one table applies, the top rate of tax has been reduced from 48 per cent to 42 per cent and the threshold triggering this rate has been substantially increased. The tax payable on dividends has again been increased to 20 per cent (the standard rate) or 27 per cent (the excess rate) – see above and note 12.

Undoubtedly, the introduction of the personal income tax regime was the most controversial fiscal reform measure in Hungary. The new tax was the subject of considerable criticism by politicians, tax experts and taxpayers at large. The criticism was based partly on historical sensitivities developed during the Habsburg episode and revived under the post-war regime, and partly on the reform's inflationary impact due to the inadequate one-time gross-up of wages for the personal income tax (to leave after-tax incomes unaltered).

IV. CONCLUSION

The main trend that can be discerned in each country is the movement away from communist style tax regimes and towards those adopted in advanced Western European countries.

The Czech and Slovak tax systems are rapidly reaching a relatively mature stage of development. Significant legislative changes that may have a great impact on business life are now occurring infrequently. The main structure of the system is clearly established and generally functions well.

In Hungary, the concept of the corporate tax system is fairly stable but the changes of 1996 and subsequently 1997 especially with respect to the withdrawal and subsequent introduction of new tax incentives – have led to a feeling of uncertainty among taxpayers. The frequent, and significant changes to the laws and regulations may create insecurity and instability, making business planning difficult. The changing nature of the Hungarian system lies not only in the effort by the government to tax what is possible and collect as much revenue as possible, but also in the efforts to close loopholes and develop a more sophisticated tax system capable of coping with the increasing complexity and variety of today's business transactions. Indeed, the increasing internationalization of doing business requires frequent changes to legislation and the adoption of more sophisticated taxation rules. This process of adaptation is part of the natural evolution of market-oriented systems.[29]

Finally, given the very short history of tax laws in Central Europe, a lot has been achieved in a very short period of time. If similar progress is made in the future, the tax regimes of these countries will undoubtedly reach their goal of achieving compatibility with the Western model.

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29. These changes not only serve the collection of revenues for the state budget, but also other, political goals. This aspect, however, can lead in the short run to distortions that must be eliminated later in the evolution process.

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INTERNATIONAL

A Comparison of Compliance Cost Estimates for the Tax Systems in the United States and New Zealand

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I. INTRODUCTION

Concern for whether income tax systems have become too complex has generated interest in the economic impact of complying with tax legislation. Many countries have undertaken programmes to estimate compliance costs as a way to measure the burden associated with complex income tax systems. The most recent estimates available indicate that the compliance costs associated with New Zealand's business taxes are approximately NZD 1.9 billion[1] (USD 1.3 billion, using a 0.70:1 exchange rate), while compliance costs for the United States are USD 75 billion.[2] These estimates, however, are not readily comparable.

The objectives of this article are to identify factors that are useful for comparing differing tax systems, and to highlight many of the differences underlying compliance cost estimates in the United States and New Zealand. Improving our understanding of how each country calculates and portrays these costs will help policy makers and tax administrators evaluate improved methods for measuring and interpreting compliance costs, in turn leading to improved efficiency in collecting tax revenues.

II. RELATIVE MEASURES OF COMPLIANCE COSTS

A. Compliance costs as a percentage of tax revenue

The federal budget for the United States is substantial; therefore, describing compliance costs as a percentage of tax revenue and/or GDP allows for a more appropriate, albeit imperfect, comparison to New Zealand data. In 1994-95, total federal receipts for the United States was USD 1.3 trillion dollars.[3] Of this amount, USD 543 billion was paid by individuals for income taxes, USD 140 billion was attributable to corporate income taxes, and USD 461 billion for social security-related contributions. Thus USD 1.1 trillion of revenue was related to an income tax system that corresponds to New Zealand's income tax system.[4] Since social security taxes, including self-employment taxes, are reported on the US income tax return, the associated revenue is included to provide more of a broad-based comparison with New Zealand's system.

Compliance costs for the predominantly income tax based system in the United States have been estimated at USD 75 billion or higher.[5] Using these data, the US tax compliance costs are 6.6 per cent (USD 75b/USD 1,144b) of the tax revenue. Slemrod, however, reported that the USD 75 billion costs were 10 per cent of federal and state income tax revenues. Slemrod's base is different from the one used in this study because he does not include receipts from social security taxes nor other state revenues. Furthermore Slemrod does not include all of the compliance costs associated with social security taxes and other state revenues, especially state income tax administration costs. A good comparison to Slemrod's 1995 estimate is the prior estimate based on 1982

1. C. Sandford and J. Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (Wellington, NZ: Institute of Policy Studies, 1992). The taxes included in this study were the Pay As You Earn (PAYE, covering employers' costs), the Fringe Benefit Tax (FBT), the Goods and Services Tax (GST) and the Business Income Tax. This study did not include the compliance costs from non-business related taxes, such as personal income tax, and various duties and excise taxes.
References to New Zealand figures are in New Zealand dollars, unless specified otherwise. Figures for the United States are in US dollars.
2. J. Slemrod, "The simplification potential of alternatives to the income tax", 66 *Tax Note* (27 February) (1995), at 1331-1340.
3. See 1995 IRS Form 1040 Instruction Booklet.
4. New Zealand funds its public retirement system through the collection of all types of revenue. It does not have a separate fund for social security type taxes.
5. Slemrod, *supra* note 2.

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data which reported compliance costs at 7 per cent of federal and state income tax revenues.[6]

If Slemrod's USD 75 billion estimate was calculated relative to only the 1995 federal income tax revenues, the compliance cost percentage would be 11 per cent (USD 75b/USD 683b).[7] Alternatively, if all federal revenues are included to match the available New Zealand data,[8] the compliance cost percentage would be 5.8 per cent (USD 75b/USD 1,300b). For New Zealand, the business compliance costs have been estimated at NZD 1,882 million (rounded to NZD 1.9 billion).[9] This is 8.1 per cent of the tax revenue generated by all the New Zealand taxes.[10]

Table 1
Estimates of compliance costs and related factors

Estimate	New Zealand NZD	New Zealand USD (0.70)	United States USD
Percentage of tax revenue	11.2%		5.8% (1995)
Percentage of GDP	3.1%		1.0% (1995)
1992 Nominal GDP	74 billion	52 billion	6.0 trillion
1995 Nominal GDP	87 billion	61 billion	7.3 trillion
Estimated compliance costs	1.9 billion	1.3 billion	75 billion
Tax administration costs	366 million	256 million	6.6 billion
Total national/ federal revenue collected by IRD/IRS	19.7 billion	13.8 billion	1.1 trillion
Number of income tax taxpayers	2.8 million		115 million
Number of IRD/IRS employees	5,890		113,000
Cost of paid preparers	604 million	423 million	7 billion
Per cent using paid preparers	36%		50%
Average number of taxpayer hours on tax affairs	11		27

One factor to be considered in a comparison between the two countries (aside from the inherent imprecision of estimating the compliance costs which will be discussed later), is the fact that New Zealand does not have state and local taxes that are comparable to those in the United States.[11] If these tax revenues are included in the US tax revenue base, the compliance cost percentage would be reduced as the denominator increases. In 1995, combined US state and local taxes were about half the size of federal revenues.[12] Thus, adding all of the state and local revenues would reduce the compliance cost ratio to about 3.9 per cent. However, if the revenue is included in the denominator, then the compliance costs associated with those taxes should be included in the numerator, but these compliance costs have not previously been estimated. One can only speculate on the size of the compliance costs for what are primarily income taxes that often "piggyback" on the US federal tax system, sales taxes, and property taxes.

In sum, to compare compliance costs as a percentage of tax revenue for New Zealand and the United States, the numerators and denominators should be closely aligned, but the divergent systems make this difficult. For the United States, compliance costs of state and local taxes are largely unknown, (income taxes may be included in the preparer fees and taxpayer time, but administration costs for sales and property taxes have not been estimated). If the compliance costs are not included, the associated revenue should also be excluded. Excluding the state and local tax revenue would result in a compliance cost ratio which is much higher than 2.9 per cent. Table 2 provides a summary of the data subjected to sensitivity analysis.

Table 2
Sensitivity analysis of compliance costs

	New Zealand	United States
Compliance costs as a per cent of tax revenue[1]	8.1%[2]	5.8%[3]
What if:		
Only include US income tax and social security receipts		6.1%
Only include US income tax receipts		11.0%
Add all federal, state and local receipts		2.9%
Only include federal and state income tax receipts		10.0%[4]
Add the 1995 IRD tax administration costs	9.4%	
Use 1995 tax receipts, assuming compliance costs (including IRD outlays) were constant	9.1%	

Notes
1. Compliance costs for New Zealand include in-house preparation time valued at NZD 28.50 per hour and at USD 10.00 per hour for the US compliance costs.
2. Source: McCulloch (1992).
3. This estimate is based on Slemrod's (1995) compliance cost estimate of USD 75 billion for the US. This numerator is then divided by total US tax receipts in 1994, USD 1.3 trillion.
4. Source: Slemrod (1995). He uses revenue from years prior to 1995. The estimate was 7% based on 1982 data (Slemrod and Sorum 1984).

Also problematic is the revenue and related compliance costs for administration of the US social security taxes. If the only issue was the compliance cost of the income tax system in the United States, then the social security receipts should be eliminated from the discussion. However, the New Zealand tax system applies receipts from income and goods and services taxes to the payment of its social security/retirement system, so including the US revenue from social security taxes facilitates a broader comparison between the two coun-

6. J. Slemrod and N. Sorum, "The compliance cost of the US individual income tax system", 37 *National Tax Journal* (1984), at 461-474.
7. See Table 1 for a summary of the data.
8. See Sandford and Hasseldine, *supra* note 1.
9. Id.
10. S. McCulloch, "Tax compliance costs: Heaviest burden on small firms." 72 *Accountants' Journal* (November) (1992), at 32 - 33. The total tax revenue includes personal income tax and various duties and excise taxes in addition to revenues considered by Sandford and Hasseldine, *supra* note 1.
11. New Zealand home owners are required to pay rates, a property tax charged by local authorities, which is similar to the local property taxes in the United States.
12. *USA Today*, "Heavy burden of taxes." (May 6) (1996), 13A.

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tries. If social security receipts are excluded, the compliance cost ratio would increase significantly. However, the resulting ratio would be misleading since many costs of complying with social security taxes are already intrinsically tied to the income tax system.

Similarly, other federal revenues such as gift and estate taxes are typically excluded from compliance cost analyses. Yet, the administration costs associated with these revenues are a part of the Internal Revenue Service's (IRS) budget. Thus, once the IRS expenditures are included as a compliance cost (or rather as an administrative cost), then total revenues (USD 1.3 trillion), could be justified as an appropriate denominator. The end result is a US compliance cost ratio of approximately 5.8 per cent (USD 75 billion/USD 1.3 trillion).

McCulloch[13] used the data collected by Sandford and Hasseldine and summarized the compliance costs for New Zealand. McCulloch reported compliance costs at 8.1 per cent of New Zealand's revenue, but this statistic did not include administration costs for the Inland Revenue Department (IRD). If NZD 366 million is added for the IRD's expenditures,[14] then total compliance costs are approximately NZD 2.2 billion. However, these are not recent figures since McCulloch reported 1992 compliance cost estimates. Total revenue received by the IRD in 1991-92 was NZD 19.7 billion.[15] Hence, the adjusted compliance cost ratio is 11.2 per cent (NZD 2.2b/NZD 19.7b).

Another difficulty with the New Zealand ratio is the fact that Sandford and Hasseldine valued in-house compliance time at NZD 25.83 per hour. In contrast, Slemrod valued individual and small business taxpayers at approximately USD 10 per hour. Even if a 1.42 currency conversion ratio is applied to the New Zealand hourly rate (yielding USD 18.08), the New Zealand in-house rate is much higher than the US rate.

Overall, the available data suggest a comparison of two comprehensive systems that are predominantly income tax based. Using the most current income estimates, the New Zealand ratio of total compliance costs to total receipts is 9.1 per cent, while the US ratio is 5.8 per cent.

B. Compliance costs as a percentage of GDP

Table 1 summarized the data used to calculate compliance costs in terms of both a percentage of tax revenue and a percentage of Gross Domestic Product (GDP). For New Zealand, the compliance costs of collecting all business related taxes (PAYE (only employer's costs), FBT, GST, and Business Income Tax) was NZD 1.9 billion for 1990-1991. This was 3 per cent of GDP for that year.[16] If the FBT and GST are excluded, then compliance costs were NZD 1.4 billion or 1.9 per cent of GDP. Alternatively, if the IRD expenditures are included as compliance costs, the ratio increases to 3.1 per cent when all taxes are included in the denominator. Lastly, if the 1995 New Zealand GDP figure is used with constant 1992 compliance costs (NZD 86.77 billion),[17] then the ratio is 2.5 per cent (NZD 2.2b/NZD 86.77b).

For the United States, if the USD 75 billion of compliance costs is divided by 1992 GDP of approximately USD 6 trillion, the compliance cost ratio would be about 1.2 per cent. However, if those costs are divided by 1995 GDP which amounted to USD 7.3 trillion,[18] then the compliance cost ratio is approximately 1.0 per cent for the United States.

Comparing compliance costs to GDP appears appreciably more reliable than comparing compliance costs to tax revenue because of the ambiguous nature of the revenues and their corresponding compliance costs; that is, which costs and revenues should be included in the calculations? One way to validate the appropriateness of the size of the revenues is to compare them to GDP figures. Pechman and Engelhardt[19] reported total tax revenues relative to GDP for 1987. New Zealand was not included in their study, but the United States had total tax revenues (from all types of taxes at federal, state and local levels) at 30 per cent of GDP. To place that number into an Asian-Pacific perspective, the ratio for Australia was 31 per cent.

These numbers are consistent with current US data. The Economic Report to the President[20] reported the 1994 ratio of total tax revenue to GDP for several countries. Specifically, the rates were 31.5 per cent for the United States, 32.9 per cent for Australia, 36.4 per cent for the United Kingdom, and 32.3 per cent for Japan. For New Zealand, the ratio appears to be between 31 per cent and 28 per cent, depending on the source of the data used. Using the compliance cost/GDP ratio, developed by Sandford and Hasseldine, of 2.5 per cent, and the 8.1 per cent compliance cost/tax revenue ratio reported by McCulloch, the ratio of total tax revenue to GDP would be 30.8 per cent. Using 1995 IRD revenues of NZD 24.3 billion, and NZ budget[21] data for GDP in 1995 of NZD 86.77 billion, the total tax revenue/GDP ratio for New Zealand is 28 per cent. If, however, a broader definition of total tax revenue is preferred (whereby taxes collected by sources other than the IRD, for example, the Customs Department and other collection agencies, are included), then total tax revenue increases to NZD 30.2 billion. This would raise the tax revenue/GDP ratio to 34.8 per cent.

The reason for looking at the tax revenue/GDP ratios is that the ratios for New Zealand and the United States are quite similar – both were in the vicinity of 30 per cent in 1992. This observation is consistent with reports on "Tax Freedom Day", the day of the year in which taxpayers cease working to pay their taxes and begin working for themselves. For the United States in 1996, this day was May 7th,[22] and for New

13. McCulloch, *supra* note 10.
14. Inland Revenue Department, *Report of the Inland Revenue Department: For the Year Ended 30 June 1995*, (Wellington, NZ: IRD National Office, 1995).
15. Id.
16. See Sandford and Hasseldine, *supra* note 1.
17. New Zealand Government, *Budget Economic and Fiscal Update 1996*, (Wellington: Government Printer, 23 May 1996).
18. Economic Report of the President, (Washington, DC: US Government Printing Office, 1996).
19. J. Pechman and G. Engelhardt, "The income tax treatment of the family: an international perspective" 43 *National Tax Journal* (1990), at 1-22.
20. *Economic Report to the President*, *supra* note 18.
21. New Zealand Government, *supra* note 17.
22. See Wall Street Journal, "Tax Report." (May 8), (1996), at 1.

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Zealand it was also May 7th.[23] This suggests that the total tax burdens are similar, and that it is the difference in actual and/or manner of computing the estimates for compliance costs that makes comparisons between the two countries difficult.

C. Tax administration costs

The 1994-95 outlays for IRD operating expenses were NZD 366 million,[24] and the 1995 IRS outlays were USD 6.6 billion.[25] The IRS federal budget appears to dwarf the IRD's expenditures on administration, but when the dollar costs are divided by the number of taxpayers, the picture changes significantly. New Zealand had 2.8 million income tax returns, (this includes partnership and corporate returns)[26] while the United States had 115 million individual income tax returns in the 1995 year.[27] Thus, the administration costs per income tax return are higher for New Zealand at NZD 131 each compared to USD 57 for the United States. If corporate and partnership income tax returns were included in the US figure, that would add about four million more returns,[28] which would lower the cost for each US return.

In contrast, if the compliance costs of each tax administration are divided by the number of IRD or IRS employees, then the cost per tax administration employee would be NZD 62,100 (USD 43,500) for New Zealand and USD 58,400 for the United States. This difference is caused by the fact that the IRD has about 5,890 full-time equivalent employees,[29] while the IRS has approximately 113,000 employees.[30] In other words, the IRS federal budget is 18 times larger than the IRD's, the number of IRS employees is 19 times higher than the IRD's, while the United States has at least 41 times as many income tax taxpayers as New Zealand. Table 3 provides a summary of these figures:

Table 3
Relative tax administration costs

	New Zealand (IRD)		United States (IRS)
	NZD	USD (0.70)	USD
Operating costs of IRD/IRS	366 million	256 million	6.6 billion
Cost per individual taxpayer	131	92	57
Cost per IRD/IRS employee	62,139	43,497	58,407
Ratio of IRD(IRS) employees to taxpayers	.002		.001
Administration costs relative to taxpayer compliance costs	19.4%		9.6%

Sandford and Hasseldine asserted that, when possible, the burden of compliance costs should be shifted to the tax administration and away from the taxpayer. If the relative size of tax administration costs is compared to taxpayers' compliance costs, the ratio is higher for New Zealand than for the United States; that is 19.4 per cent (NZD 366m/NZD 1,882m) as compared to 9.6 per cent (USD 6.6b/USD 69b), respectively. This suggests that either the New Zealand administration costs are too high in relation to taxpayers' compliance costs or that New Zealand is doing a far better job of shifting the compliance burden to the tax administration body, the IRD. The latter explanation is consistent with the fact that only 36 per cent of New Zealand taxpayers use a paid preparer,[31] while approximately 50 per cent of US taxpayers incur compliance costs by hiring a tax professional.[32] Furthermore, the IRD has twice as many employees per taxpayer as the IRS has, although both ratios are low with very few employees per taxpayer (.002 for New Zealand and .001 for the United States).

The above discussion on tax administration costs and the figures presented in Table 3 must be moderated by an understanding of what comprises tax administration costs in the two countries. The IRD is responsible for administering over 80 per cent of New Zealand's tax revenue, while in contrast, the IRS administration costs represent a smaller part of total US tax administration costs. There are state governments administering the collection of state and local income tax returns as well as other types of taxes, and these administration costs have never been accumulated and included in a model of compliance costs.[33] Thus, although the IRS budget is undoubtedly the major portion of tax administrative costs, total administration costs for the United States for all types of taxes or for even just income tax are not known.

D. Tax preparer assistance

A higher percentage of taxpayers use paid preparers in the United States (50 per cent) than in New Zealand (36 per cent), yet the compliance costs attributable to tax preparers are a much larger portion of the total estimates for compliance costs in New Zealand. For example, New Zealand preparer fees were NZD 604 million,[34] which is 32 per cent of NZD 1.9 billion total compliance costs. If the IRD expenditures are included in the compliance costs, then the percentage is 27 per cent (NZD 604m/NZD 2,248m). Either way, a significant portion of the New Zealand costs of compliance are going to the tax preparer community.

23. See C. Howie, "Free of tax after only four months" *The Dominion* (May 7) (1996), at 10.
24. Inland Revenue Department, (1995), *supra* note 14.
25. See Wall Street Journal, "Tax Report." (26 June) (1996)., at 1.
26. Inland Revenue Department, (1995), *supra* note 14.
27. Internal Revenue Service (1996), *Statistics of Income Bulletin* 15 (Spring).
28. Id.
29. Inland Revenue Department, (1995), *supra* note 14.
30. W. Hunter and M. Nelson, "An IRS production function." 49 *National Tax Journal* (March) (1996), at 105-115.
31. See Inland Revenue Department, "Electronic Filing of Tax Returns", 70 *Accountants' Journal*, (February) (1991), at 10-11, which reports that 870,000 returns were filed by tax agents in the 1989/90 year in New Zealand. The IRD reported that there were 2.433 million income tax related returns filed in the 1989/90 year; see Inland Revenue Department, *Annual Report* (1991), at 19. This equates to a paid preparer ratio to total income tax related returns of 0.3576 or 36 per cent.
32. Internal Revenue Service, (1996), *supra* note 27.
33. Neither have the compliance costs of property rate taxes been considered in a similar manner in New Zealand.
34. McCulloch, *supra* note 10.

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In the United States, USD 7 billion of the USD 69 billion compliance costs are attributable to tax preparer fees, which is about 10 per cent. If the IRS expenditures are included in the total costs, then the percentage is 9 per cent (USD 7b/USD 75b). Thus, while more taxpayers use paid preparers in the United States than in New Zealand, these costs are a smaller percentage of the total costs. The major portion of the US costs is the value of the time required by the taxpayers themselves. With one-half of 115 million taxpayers not using tax preparers, the value of such a large number of people's time rapidly adds up, even at only 10 per hour this equates to a figure of USD 1.15 billion.

Sandford and Hasseldine estimate that 46.5 million in-house hours were spent on tax compliance. Out of the 46.5 million, 30.9 million were attributable to income taxes. The average time per income tax return is, therefore, 11 hours (30.9m/2.8m). Slemrod reported that the individual taxpayer averaged 27 hours per year dealing with tax affairs. That estimate is based on three billion hours per year and does not include another 3.6 billion hours that is spent annually by small business. Clearly, taxpayers in the United States must devote appreciably more of their leisure time (and/or productive time) to tax matters than their counterparts in New Zealand. This observation is also reflected in the relative levels of complexity in tax legislation and tax returns between the US and New Zealand.

III. LIMITATIONS AND CONCLUSIONS

Drawing conclusions about which country is more efficient in terms of its compliance costs is difficult, because both the revenues and the manner of calculating the compliance costs differ. To the extent that taxpayers ultimately bear the burden of tax administration costs, a broad-based comparison could be the average cost of compliance per taxpayer (or per return filed). For New Zealand, this would be NZD 786 (determined as NZD 2.2 billion/2.8 million, or in US dollars, USD 550), and for the United States it would be USD 652 (USD 75 billion/115 million).

The implications of this comparison should be cautiously interpreted. For example, the US data include only a USD 10 per hour estimate for in-house tax preparation, while the New Zealand estimate is NZD 25.83 (USD 18.08), which makes the US taxpayers' hourly rate low relative to the New Zealand rate. This is surprising considering the relatively higher cost of living in the United States compared to New Zealand. Also, the US estimate does not include compliance costs for social security administration nor for the administration and compliance costs of state and local taxes.[35]

Moreover, the New Zealand data collected by Sandford and Hasseldine emphasized business taxpayers more than the average individual taxpayer, while the US data emphasize individual taxpayer data. For example, the data presented in this paper generally combine all sources of New Zealand revenue and all compliance costs.[36] If the compliance costs for only PAYE (employers' costs) and business income taxes are considered, the costs would be NZD 1,421 million (USD 995 million), excluding the IRD's expenditures which are difficult to allocate to each type of tax. Dividing NZD 1.4 billion by 4.8 million tax returns (2.8 million income tax returns and 2.0 million PAYE returns[37]), the average compliance cost per income tax-related return would be NZD 292 (USD 204). In the United States if corporate, partnership, and payroll tax returns were added to the analysis, the cost per return would be significantly reduced as well.

Although the limitations within this study are numerous, which makes inter-country comparisons difficult, some facts still provide useful overviews for evaluating the appropriate size of compliance costs for each country. First, the average US taxpayer is spending 27 hours per year while the average New Zealand taxpayer is spending 11 hours on his (income) tax affairs each year. Second, the compliance costs for New Zealand are approximately 9.1 per cent of the tax revenue while the compliance costs are estimated at 5.8 per cent of the US tax revenue. Based on GDP figures, New Zealand's compliance costs are 2.9 per cent of its GDP, while they are as low as 1.0 per cent for the United States. This difference could be partially explained by the economies of scale that a larger nation such as the United States can draw upon compared to a small nation such as New Zealand, a country whose population size is just over 1 per cent of that of the United States.

Given the difficulty of identifying comparable data for any two countries, tax administration agencies must not only keep themselves informed about other countries' systems, but they should also focus on internal comparisons over time. Tracking the performance of one's own system allows for more comparable data and, therefore, more valid conclusions. Studying the way in which other countries calculate such costs will add insights on how to measure one's own country's compliance costs.

35. State and local tax revenues also are excluded from the denominator.
36. This does not include personal income tax and various excise taxes and duties.
37. These figures include personal and other non-business income tax related returns.

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CANADA

CANADA'S NEW DEPARTURE TAX PROPOSALS

Jack Bernstein, Aird & Berlis

I. INTRODUCTION

Many Canadians have emigrated from Canada as a result of employment or business opportunities or by choice on retirement. The increasingly global nature of business has seen Canadians expanding their businesses around the world. Lower tax rates and better business opportunities have led to migration of Canadian entrepreneurs and executives.

Canadians of retirement age may find the allure of a move to a milder climate coupled with a reduction or elimination of Canadian taxes to be an irresistible combination. Many Canadians have retired to the Bahamas, Bermuda, Cayman Islands and other Caribbean tax havens. Others have opted to maintain their Canadian domicile and become resident in the United Kingdom, Ireland, France and Greece in order to avoid paying tax on income not earned in or remitted to the foreign jurisdiction.

Proposed amendments to Canada's departure tax will have an impact on individuals, corporations and trusts considering giving up Canadian residency. Many Canadians may have no alternative but to maintain Canadian residency or to become dual residents in order to avoid the departure tax. It will also impact on non-residents of Canada who dispose of certain assets and on executives and entrepreneurs outside of Canada who are considering a move to Canada. New reporting requirements are also proposed for emigrants for the year of departure.

II. THE REASON FOR THE PROPOSALS

In response to the publicity last summer over an advance tax ruling given to the Bronfman family with respect to shares of Seagram's held by a Canadian trust, Finance Minister, Paul Martin announced major changes on 2 October 1996 to the income tax rules for individuals, corporations and trusts who leave Canada and for non-residents who dispose of certain property. The ruling obtained by the Bronfman family in 1991 came under scrutiny by the Auditor General earlier this year and resulted in the controversy over the apparent leakage from the Canadian tax system. Canada taxes non-residents on the disposition of "taxable Canadian property" (a defined term). A Canadian trust owned shares which were taxable Canadian property. A series of transactions permitted the transfer of the shares to the United States without Canadian income tax. A House of Commons Finance Committee was charged with reviewing this matter and made several recommendations for improving Canada's tax system.

It is proposed that all emigrants, including trusts, will be subject to Canadian departure tax on any gains that have accrued up to the time of departure, other than on Canadian real estate, inventory used in a Canadian business and certain pension rights. Non-residents who dispose of an interest in a non-resident corporation, partnership or trust the value of whose assets over the prior five years consisted primarily of Canadian real property, resource property or timber rights, will be taxable in Canada.

III. CURRENT DEPARTURE TAX RULES

Canada levies a departure tax in respect of certain property owned by a taxpayer who terminates Canadian residence. An individual (not a corporation) may elect to pay the departure tax over six years.

Under Section 128.1(4), immediately before becoming a non-resident, a taxpayer is deemed for income tax purposes to have disposed of each property, subject to certain exceptions, for proceeds equal to the fair market value at that time. The taxpayer is deemed to have reacquired each property at a cost equal to fair market value. In the case of a corporation which emigrates there is a deemed year end and the corporation is deemed to have disposed of all properties at fair market value. A trust would be subject to departure tax on assets, other than taxable Canadian property. A trust could distribute taxable Canadian property (defined below) to a non-resident beneficiary on a tax deferred basis.

Where the taxpayer is an individual, the following types of property have been exempted from this rule:

(a) taxable Canadian property (a defined term);
(b) capital property that is the subject of an election (such election may not be made by a trust) to be treated as taxable Canadian property;
(c) inventory used in a business carried on by the taxpayer in Canada at the particular time; and
(d) the right to receive specified income amounts (generally pension entitlement).

Taxable Canadian property is defined in Paragraph 115(1)(b) to include the following:

(a) real property situated in Canada;
(b) capital property used by the taxpayer in carrying on a business in Canada (other than an insurance business);
(c) a share of a corporation resident in Canada, other than a public corporation (generally a public corporation is a Canadian corporation, the shares of which are listed on a stock exchange in Canada);

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(d) a share in a public corporation if at any time in the five-year period immediately preceding departure not less than 25 per cent of the issued shares of any class were owned by the taxpayer or persons with whom he did not deal with at arm's length;
(e) an interest in a partnership, provided that in the twelve months immediately preceding the disposition not less than 50 per cent of the fair market value of the partnership property was taxable Canadian property, certain resource property or an income interest in a Canadian resident trust;
(f) a capital interest in a trust resident in Canada;
(g) a unit of a unit trust resident in Canada;
(h) a unit of a Canadian mutual fund trust if at any time during the five-year period immediately preceding departure not less than 25 per cent of the issued units were owned by the taxpayer or persons with whom it did not deal at arm's length;
(i) any of the property deemed by the Act to be taxable Canadian property; and
(j) an interest or an option in the above property.

Section 248(1) provides an extended meaning of taxable Canadian property which is to apply for the purposes of departure tax. Taxable Canadian property also includes a Canadian resource property, a timber resource property, an income interest in a resident trust, a retiring partner's income rights under a partnership, and a life insurance policy in Canada.

As a result of the departure tax, the departing taxpayer could realize either a capital gain or a capital loss depending upon the adjusted cost base of his capital property or an income gain or loss in respect of any inventory owned outside of Canada.

Taxpayers have been limited in using the election to have taxable Canadian property subject to departure tax in a manner that triggers net losses. The intention is to preclude the deferral of a disposition of property with inherent gains and to treat properties with inherent losses as having been disposed of.

In the past, it was not necessary to provide Revenue Canada with a list of all of the assets of a taxpayer who was emigrating from Canada. When the personal tax return was filed for the individual in respect of the year of departure, the taxpayer would indicate that he ceased to be resident in Canada during the year and the date of departure. Only assets subject to departure tax or actually sold in the year up to the date of departure were required to be reported in the return.

Until recently it has been possible for an individual (other than a trust) who otherwise would be subject to departure tax to elect to have his property treated as taxable Canadian property and thereby defer liability for tax on inherent capital gains until the actual disposition of the property or until a deemed disposition. The election was required by the 30th April of the year following the year of departure.

When security was provided, the payment of the departure tax would be deferred until the actual sale. This was important as double taxation could otherwise arise. This would occur because on a actual disposition of the property by the former Canadian resident tax may arise in the new jurisdiction of the taxpayer based on the historic cost of the property without any step up in cost base being available for the fair market value of the property at the time that the taxpayer moved to the new jurisdiction. In that case, no foreign tax credit may be available in respect of the tax arising in Canada on departure.

Revenue Canada was prepared to permit a foreign tax credit to be claimed at the time of actual sale of the property subject to the election where foreign tax arose on that sale. In order to make the election, security had to be furnished to the minister, sufficient to satisfy the tax liability that would have arisen had no election been made. Revenue Canada requires a security charge on the property of the taxpayer (or any other person) which charge is enforceable within Canada, a guarantee from any other person, or a declaration of trust of a financial institution.

Taxable Canadian property has been excluded from departure tax as the Canadian fiscal authorities would be able to collect tax on those assets at the time of an actual sale. Section 116 of the Income Tax Act requires that a vendor of taxable Canadian property obtain a certificate either ten days before or after a sale which would either confirm that the tax of 33 1/3 per cent of the gain has been paid or that a treaty exemption applied. Failure to provide the certificate imposes on the purchaser the tax liability of the vendor without the benefit of any treaty exemption which may have applied.

Generally, Canada's tax treaties do not exempt capital gains arising on either a disposition of Canadian real property or on capital property used in carrying on a business in Canada. Similarly, if the value of the shares of a Canadian company is derived principally from Canadian real estate, Canada's tax treaties do not provide an exemption from tax on the capital gain.

Assume a non-resident, living in a jurisdiction with which Canada has a bilateral income tax convention, owns Canadian real estate through a Canadian company. The shares would be taxable Canadian property in accordance with the provisions of the *Income Tax Act*. The transfer of non-real estate assets to the company by the non-resident could dilute the value of the Canadian real estate assets of the company to less than 50 per cent of the value of the company. Although the shares would still be taxable Canadian property, the relevant treaty exemption would then be available.

Although gains from the alienation of property, other than real property, are generally taxable only in the contracting state of which an alienator is resident under the terms of Canada's income tax conventions, a special provision is made in most of the treaties for former Canadian residents. Depending on the treaty, Canada retains the right to tax all gains from the alienation of property derived by a resident of another country if such person was previously resident in Canada at any time during a specified period prior to the alienation of property and was resident for an aggregate period of time. In the Canada–US treaty, the rule applies if the person was resident in Canada at any time in the past ten

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years during any period of twenty consecutive years. The Canada–UK treaty refers to five years during any aggregate period of 15 years and the other treaties generally have a five or six year limitation.

IV. NEW PROPOSALS

The new definition of taxable Canadian property will apply to both Canadian residents and non-residents. An earlier technical interpretation of the old definition had confirmed that taxable Canadian property was not relevant for Canadian residents.

Taxable Canadian property will be defined to include a share in the capital stock of a non-resident corporation, an interest in a partnership or an interest in a non-resident trust where at any time during the last five years more than half of the fair market value of the underlying assets of the entity comprised Canadian real property or Canadian resource properties or timber rights. Although property used in carrying on business in Canada (other than an insurance business) will continue to be taxable Canadian property, this treatment will cease once the property is no longer used in the business. The non-resident will be deemed to have disposed of such property at its fair market value at the time it ceases to be used in carrying on a business in Canada. A non-resident of Canada who disposes of shares of a foreign corporation whose value is or has been derived from primarily Canadian real property, Canadian resource properties or timber rights would be subject to the requirement to obtain a Section 116 Certificate. The plan to dilute the Canadian assets of the non-resident corporation or Trust may be unrealistic in light of the five year test. This provision will be very difficult to enforce and will undoubtedly lead to instances where non-residents will not be aware of the requirements. Generally, these rules apply after 1 October 1996.

It is proposed that the ambit of the departure tax be extended for individuals who emigrate after 1 October 1996, to apply to all property, other than:

(a) real property situated in Canada;
(b) capital property used in, or property described in an inventory of, a business carried on by the individual through a permanent establishment in Canada immediately before that time (a partnership interest in a partnership carrying on business in Canada would not be excluded and could be subject to departure tax);
(c) Canadian resource properties;
(d) certain pensions;
(e) assets owned by an individual who has lived in Canada for less than five years;
(f) employee stock options;
(g) a life insurance policy (possibly?)

Departure tax, will now apply to:

(a) shares of Canadian or foreign private or public corporations;
(b) an interest in a partnership;
(c) a capital or income interest in a Canadian or foreign trust;
(d) a unit trust;
(e) a unit in a mutual fund trust;
(f) a timber resource property;
(g) a retiring partner's income rights;
(h) portfolio investments (e.g. government or corporate bonds or debentures or shares of public corporations within prescribed limits);
(i) foreign real estate;
(j) foreign inventory;
(k) non-depreciable or depreciable capital property not used by the taxpayer in carrying on a business in Canada;
(l) personal-use property;
(m) listed personal property defined by the Act as works of art, jewellery, rare manuscripts and books, stamps and coins.

To the extent that a deemed disposition occurs, the taxpayer will be deemed to have acquired the property at fair market value.

A trust will be subject to the departure tax with respect to the fair market value of all property (other than Canadian real estate) distributed to a non-resident beneficiary. The trust and the beneficiary will have the right to provide the security for the taxes otherwise payable. The taxable Canadian property distributed by a trust to a beneficiary would remain taxable Canadian property to the beneficiary. This will ensure that the liability for Canadian tax on a subsequent sale be assumed by the beneficiary.

An individual will be permitted to provide security acceptable to the Minister of National Revenue for the payment of any tax liability arising as a result of the deemed disposition described above. No interest will arise on the tax and the tax will be exigible at the time of the actual sale of the asset. The tax is based on the value at the time of departure and not on any subsequent appreciation.

If a capital loss arises within three years of departure on taxable Canadian property only, it may be carried back to offset the gain on departure. Assume that the shares of a Canadian private corporation owned by the emigrant are redeemed or purchased for cancellation within the three years after emigration. For Canadian tax purposes a deemed dividend will arise equal to the difference between the adjusted cost base (increased on departure) and the paid up capital. The deemed dividend will be subject to Canadian withholding tax.[1] Revenue Canada is considering whether this type of planning would be abusive as it effectively eliminates the departure tax and replaces it with the lower withholding tax on dividends.

If security is provided, the payment of the tax arising on the deemed disposition will be postponed until the actual sale of the property in respect of which security has been given. Otherwise, emigrants would be required to pay the tax without having the benefit of third party proceeds. Double taxation is possible even if payment of the tax is deferred since the other

1. If the emigrant resides in a treaty jurisdiction the rate of withholding tax may be 15 per cent.

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country may not allow a step up in cost base of the assets subject to departure tax. For example, the US taxes dispositions based on historic cost. A foreign tax credit may not always be available in the other jurisdiction for Canada's departure tax whether paid before or after departure. By postponing the tax until the actual sale, if the actual sale triggers tax in the other jurisdiction the foreign tax credit should be available either in Canada for the foreign tax or in the foreign jurisdiction in respect of the Canadian tax. The foreign jurisdiction may not allow a foreign tax credit for Canadian tax relating to the pre-departure gain and not to a sale. Steps may be taken before departure to step up the cost of the assets for the purposes of the foreign jurisdiction. Depending upon the jurisdiction, a sale to a family member may accomplish this objective.

There is a concern that a subsequent disposition, which would otherwise qualify as a roll-over (e.g. transfer to a Canadian holding company or share for share exchange), may accelerate the departure tax as the posting of security defers the payment until there is a disposition.

Under the existing system, an election was available to treat property as taxable Canadian property and thereby defer liability for tax on inherent capital gains until the actual disposition of the property or until a deemed disposition. Under the new rules, the definition of taxable Canadian property will be significantly narrowed. To the extent that the deemed disposition applies with respect to other assets, they will be deemed to be disposed of for proceeds equal to the fair market value at the time of departure. In other words, should the assets appreciate in value subsequent to departure, only the gain up to the date of departure would be subject to Canadian tax on the sale. This is different under the existing law where the election to treat property as taxable Canadian property entitled Canada to tax the full gain on the property at the time of sale. The future gain (on the appreciation after departure) will also be subject to Canadian tax if the property is taxable Canadian property unless a treaty exemption applies. As indicated in the case of a former Canadian resident, relief may not be available under an income tax convention for the first five, six or ten years, depending on the relevant treaty or if the asset is Canadian real estate. In that case Canada will also tax the gain after departure.

In the past, it was possible to avoid departure tax by converting non-taxable Canadian property to taxable Canadian property. For example, foreign assets or Canadian portfolio investments could be rolled into a Canadian private corporation pursuant to Section 85(1) prior to emigration. The shares of the Canadian corporation would have been taxable Canadian property exempt from departure tax. A subsequent sale of the shares of the Canadian private corporation would not have been subject to tax in Canada provided the person emigrated to a jurisdiction which has a tax treaty with Canada, the person resided outside of Canada for at least five years and the value of the private company was not attributable primarily to real estate in Canada. This type of planning will no longer be available as the shares of the private company would be subject to departure tax.

To the extent that the departure tax arises in connection with shares of a qualified farm corporation or of a small business corporation, the USD 500,000 capital gains exemption would be available in order to reduce the tax otherwise arising.

It is significant that all individual emigrants who own property with a total value of more than USD 25,000 will be required to report all their property holdings to Revenue Canada. An exemption will exist for personal-use property (including clothing, household goods, cars, etc.) with a value of less than USD 10,000. The reporting requirements will apply to all individuals who have left Canada after 1995 and will take the form of a schedule or similar document to be included with the person's income tax return for the year they left Canada. This may give rise to some difficult valuation issues and disputes with Revenue Canada as to the value of interests in private corporations.

The proposed changes appear to be a case of overkill. The objective of the Section 116 certificate was to ensure that the Canadian fiscal authority could collect the tax on the ultimate sale of taxable Canadian property. This provision and the restriction in Canada's tax treaties requiring that the individual reside outside of Canada for at least five years should have been a sufficient deterrent for Canadians trying to avoid their tax liability on taxable Canadian property by emigrating from Canada. A quick flip was not possible. The perceived abuse in the Bronfman Ruling could have been addressed by subjecting Trusts to departure tax in the same manner as corporations and by taxing the distribution of taxable Canadian property to a non-resident beneficiary.

Based on my extensive experience in advising taxpayers emigrating from Canada, it was rare that the person departed from Canada in order to rely on a treaty capital gains exemption with respect to the subsequent sale of taxable Canadian property.

The rule which now requires that a departing person pay departure tax or post security may be too onerous. For example, assume that a father owns the shares of a business. He has decided to implement an estate freeze and to issue common shares to his children who are to continue the business. The father exchanges the common shares for non-voting retractable preferred shares and then retires to Florida. Assuming that the parent is still required to guarantee the bank's obligations, the posting of security in connection with the departure on the preferred shares may adversely affect the father's ability to provide financial assistance to the business or interest in other ventures. This result appears to be unduly punitive. The father in this example should consider becoming a dual resident. This may be accomplished by not selling his Canadian residence. Revenue Canada will assume Canadian residency has not been terminated where an individual retains a residence available to him. The tie breaker rules in the Canada–US treaty would apply to determine where the father is resident for purposes of the treaty. As Canadian residency would not have been terminated, the departure tax would not apply. If the centre of personal and economic interests has shifted to the United States and the father now spends more time in the United States than in Canada, the father could be deemed to be a resident of the United States for purposes of the Canada–US treaty without having been subject to Canada's departure tax. After ten years, the Cana-

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da–US treaty protection in Article XIII would be available to shelter from Canadian tax gains arising on the sale of the shares of the Canadian company.

Canada's proposed legislation may be a disincentive for international entrepreneurs considering a move to Canada. It may also deter senior executives wishing to take on a long term assignment in Canada and then return to their home country. The emigration rules coupled with the new foreign reporting requirements requiring an annual disclosure by residents of Canada of offshore assets having a value in excess of USD 100,000 (other than a residence) may deter individuals from becoming Canadian residents. There are substantial penalties for failure to disclose non-Canadian assets including interests in foreign corporations and funds advanced to foreign trusts.

Conference diary

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

MARCH 1997

Trusts and "Stiftungen", Amsterdam, 6-7 March 1997 (English):

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

Tax Planning Conference, the Corrib Great Southern Hotel Galway, Dublin, Ireland, 6-7 March 1997 (English):

The Institute of Taxation in Ireland, 19 Sandymount Avenue, Dublin 4, Tel.: 353-668 8222, Fax: 353-668 8088.

APRIL 1997

International Tax Planning Techniques, Amsterdam, 10-11 April 1997 (English):

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

Offshore Tax Planning Before It Is Too Late, Marriott Hotel, London, 18 April 1997 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

International Partnerships & Joint Ventures, Vienna, 18 April 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

International Real Estate Investment, Vienna, 18 April 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

MAY 1997

Investment Funds, Luxembourg, 16 May 1997 (English):

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

Application of Tax treaties (advanced course), Amsterdam, The Netherlands, 21-23 May 1997 (English):

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

JUNE 1997

International Tax Aspects of Permanent Establishments, Amsterdam, The Netherlands, 16-17 June 1997 (English):

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

International Licensing, Amsterdam, The Netherlands, 20 June 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

Executive Transfers in Europe, Amsterdam, The Netherlands, 20 June 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

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UNITED STATES

CHANGES TO TAXATION OF "INBOUND" FOREIGN TRUSTS

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I. INTRODUCTION

The Small Business Job Protection Act of 1996 ("the Act"), which became law on 20 August 1996, contains the foreign trust legislation first introduced in 1995 and makes a number of important tax and reporting changes to the treatment of "inbound" foreign trusts (i.e. trusts established by foreign persons for the benefit of US persons). The Act generally limits the availability of "grantor trust" treatment with respect to trusts which do not have a US person as grantor. As a result, US taxes will be imposed on trust distributions to US beneficiaries which were formerly tax-free under prior law, and the tax efficacy of such trusts will be dramatically affected in most cases. These changes are generally effective as of the date of enactment, 20 August 1996.

II. LOSS OF GRANTOR TRUST STATUS WHEN TRUST ESTABLISHED BY FOREIGN GRANTOR

Under the prior law, many foreign trusts established by foreign grantors, or with respect to which a person other than the grantor has sole power to advance income or capital to himself (i.e. a Section 678 trust) were considered foreign "grantor trusts." As a result of being so classified, the grantor or other person holding grantor powers was deemed to own the trust assets, and thus the grantor (or such other person), was subject to tax on the trust's income and/or gains. Thus, the trust had no current or accumulated income, and trust distributions to US beneficiaries were generally received free of US income and gift tax.

Under the Act, "grantor trust" status generally applies only if the grantor (or other person with grantor powers) is a US citizen or resident, or a domestic corporation. For this purpose, a controlled foreign corporation is treated as a domestic corporation. Excepted from this "no foreign grantor" rule are (1) trusts which are revocable by a foreign grantor, either alone or with the consent of certain related or subordinate persons, and (2) trusts from which, during a foreign grantor's lifetime, distributions (whether of income or assets) may be made only to the grantor and/or his spouse. Also excepted are *Rabbi* trusts and other trusts the distributions for which are treated as compensation for services rendered. In addition, the Treasury Department ("the Treasury") is authorized to except other appropriate cases (e.g. certain investment trusts) by regulation.

In addition to the foregoing exceptions to the "no foreign grantor" rule, the Act grandfathers certain existing trusts established by foreign grantors which are grantor trusts under Section 676 (revocable trusts) or under Section 677 (income for the benefit of the grantor and/or his spouse). This grandfathering applies only to trusts in existence on 19 September 1995, and only in respect of assets transferred in trust prior to that date and income thereon.

Finally, the "no foreign grantor" rule does not apply for purposes of determining whether a foreign corporation is a passive foreign investment company (PFIC). This means that a foreign corporation cannot avoid PFIC status by transferring assets to a foreign trust.

In the case of all trusts which are not excepted from the "no foreign grantor" rule or grandfathered, trust income and gains will become taxable either on the trust (if a domestic trust) or when distributed to US beneficiaries. Subject to regulations, such beneficiaries will receive a foreign tax credit for any foreign taxes actually incurred by a foreign grantor with respect to income of a foreign trust that would be a grantor trust but for the "no foreign grantor" rule.

The Treasury is also authorized to issue regulations which would recharacterize purported "gifts" from foreign corporations or partnerships to prevent avoidance of the "no foreign grantor" rule. In addition, amounts derived directly or indirectly from a non-grantor foreign trust and received by US persons from a person other than the foreign grantor will be treated as received directly from the foreign trust.

The Act expands the reach of the existing "give and go" rule (whereby certain prior gifts of property by a US beneficiary to a purported foreign "grantor" will, to the extent of such transfers, cause the US beneficiary to be treated as trust grantor) to include other direct and indirect transfers (excluding sales for full consideration). However, the legislative history indicates that this provision will not apply to transfers by a member of the beneficiary's family.

III. PRE-IMMIGRATION ("DROP OFF") TRUSTS

Under prior law, a foreign non-grantor trust (e.g. an irrevocable trust for the benefit of the grantor's children) established by a foreign person prior to assuming US residence was not considered a grantor trust under Section 679 following the grantor's move to the United States, notwithstanding that the beneficiaries also became US persons. In other words, the

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foreign trust's income remained outside the US tax net unless distributed to US beneficiaries.

Under the Act, if a foreign person transfers property to an irrevocable foreign trust and becomes a US resident within five years of such transfer, the trust will become a Section 679 grantor trust if it has a US beneficiary at the transferor's residency starting date. However, for this purpose, a beneficiary who becomes a US citizen or resident more than five years after the transfer of property into a trust will not be considered a US beneficiary. The changes made by the Act to Section 679 apply to transfers of property occurring after 6 February 1995.

IV. INFORMATION REPORTING BY US BENEFICIARIES

Under prior law, US persons receiving distributions from foreign trusts were required to report such receipts only to the extent that they represented taxable income. There was no special form; the information was merely included in a taxpayer's normal income tax return. If insufficient information was provided to determine the proper application of the rules relating to an accumulation distribution, the accumulated income was deemed to have arisen in the trust's earliest year. Further, there was no requirement under prior law for the donee of a gift to report its receipt.

Under the Act, each US beneficiary who receives a distribution from a foreign trust (whether or not the distribution is considered taxable to another person as grantor) is required to make an annual return identifying the trust, distributions received from the trust, and other information prescribed by the Treasury. If adequate records are not provided by the beneficiary to determine the proper treatment of any distribution, the IRS may treat the distribution as an accumulation distribution with the Section 668 interest charge deemed to apply from the midpoint of the trust's existence. The Treasury is also authorized to issue regulations to relieve a beneficiary of this result if the foreign trust designates a US agent for service of process.

For failure to file a required information return, a US beneficiary will be subject to a penalty equal to 35 per cent of the gross trust distributions received. For failure to comply within 90 days after mailing of an IRS notice, the beneficiary will be subject to an additional USD 10,000 penalty per month until compliance. The penalties are subject to a "reasonable cause" defence. However, this defence will not be considered to be met by foreign civil or criminal laws prohibiting disclosure by a trustee or any other person.

Under the Act, US persons are required to report the receipt of gifts from foreign persons the aggregate value of which exceeds USD 10,000 annually (indexed for post-1996 years), excluding gifts for tuition or medical care. This is intended to allow the IRS to verify that such gifts are not, in fact, disguised income distributions. For failure to report such gifts, the IRS may recharacterize a gift as income, in which case the donee will be subject to a penalty equal to five per cent of the value of the gift per month, up to 25 per cent. No duplication of reporting is required if the "gift" can also be characterized as a trust distribution.

V. RESIDENCE OF TRUSTS

Under prior law, the principal factors used to determine the residence of a trust were the residence of the principal trustee and the place of trust administration. However, other factors could also be applied, including the nationality or residence of the grantor or beneficiaries, the proper law of the trust, and situs of assets.

Under the Act, a trust is considered domestic if (1) a US court is able to exercise primary supervision over administration of the trust and (2) one or more US fiduciaries have authority to control all major decisions of the trust. All other trusts are foreign. The first test will normally be met if, for example, the trust instrument is governed by the trust laws of a US state (or is registered under a provision similar to Article VII of the Uniform Probate Code). The second test will normally be met if a majority of the fiduciaries are US persons, and no foreign fiduciary (including, for this purpose, a protector or other trust advisor) can veto important decisions of the US fiduciaries. The changes made by the Act with respect to the residence of trusts are applicable to taxable years of trusts beginning after 31 December 1996 or, on an elective basis, to taxable years ending after the date of enactment.

VI. ANTI-ABUSE REGULATORY AUTHORITY

The Treasury is authorized under the Act to issue anti-abuse regulations to prevent avoidance of the income tax rules applicable to trusts and beneficiaries, as well as to estates. In particular, the Treasury is expected to issue anti-abuse regulations to prevent avoidance of the rules relating to accumulation distributions, including the Section 668 interest charge.

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UNITED STATES

TAX COURT DECISION RADICALLY CHANGES US TAXATION OF ROYALTIES PAID TO OVERSEAS LICENSORS

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I. INTRODUCTION

On 2 October 1996, the United States Tax Court (Tax Court) issued its decision in *SDI Netherlands BV v. Commissioner of Internal Revenue*.[1] In that case, the Tax Court reversed an Internal Revenue Service (IRS) administrative precedent of over 15 years' standing relating to the taxation of royalties paid for the use of intangible property within the United States and opened the door to a new range of international tax planning opportunities for multinational groups seeking to exploit such property in the United States.

II. CONTEXT AND BACKGROUND

Section 861 of the US Internal Revenue Code of 1986, as amended (IRC or 1986 Code), sets forth a number of statutory rules governing the source of income for US federal income tax purposes. These rules are important in a number of operative contexts under the 1986 Code, most notably (1) in determining the appropriate level of tax credit that the United States will allow for foreign income taxes[2] and (2) in ascertaining the types of income derived by a non-US person[3] that the United States may tax. In general, non-US-source income that is not effectively connected with the recipient's conduct of a US trade or business is exempt from US tax, whereas US-source income not so connected is subject to withholding tax at a flat statutory rate of 30 per cent gross (or a lower treaty rate, if applicable).[4]

Unlike most of the other source-of-income rules in the Code, which are driven by the residence of either the payor (interest and dividends, with some exceptions) or of the payee (gains from the sale of many types of property), payments made in consideration of the right to use the property of another have long been sourced according to the location of the property. This principle can be found as far back as 1870, when a revenue statute first provided explicitly that rents paid for the use of real property located within the United States would be taxable to a non-resident alien owner of the leased property.[5] The rule was recast in terms of source, and extended to other types of property, in 1921,[6] and was carried through in essentially the same form through the first two codifications of the US tax law in 1939 and 1954 and to the current provision of the 1986 Code.

III. EARLIER PRECEDENTS

Although the statutory formulation of the "place-of-use" source rule is easy to state, and is in fact generally not difficult to apply in the case of *tangible* personal property, significant complications are introduced where the property in question is *intangible* (i.e. patents, trademarks, copyrights, technical know-how, scientific processes, trade secrets, etc.). In that context the place of use is the territory in which (1) the licensee is legally entitled to use the property (i.e. pursuant to the terms of an express or implied licence) and legally protected for so doing (under local intellectual property law, contract law, or otherwise), or (2) the property is actually (but lawfully) used. Thus, if the owner of intangible property validly grants a licence to a licensee for only a single jurisdiction (e.g. the United States), actual use within the United States will be sufficient to source the corresponding royalty income of the licensor within the United States; and, conversely, unauthorized use of the property outside the United States will not result in any of the royalty income being allocated away from the United States for tax purposes (although, presumably, compensatory money damages ultimately obtained by the lessor as redress for the unauthorized use of the property in the other jurisdiction would produce foreign-source income for US tax purposes.)[7]

1. Docket No. 23747-94, 107 TC __, No. 10 (1996).
2. Only income taxes levied by a foreign taxing jurisdiction on income that is not deemed to be from sources within the United States under US tax law principles may qualify for the credit. See IRC § 901 et seq.
3. A non-US person is a non-resident alien individual or a foreign corporation, partnership, estate or trust. See IRC § 7701(a)(30) (definition of "US person").
4. See IRC §§ 871-872, 881.
5. Pub. L. No. 164, 41st Cong., 2d Sess., 16 Stat. 256 (14 July, 1870), § 6. The statute does not speak in terms of source, but the principle appears to be implicit in the distinction drawn between US-situs and non-US-situs real property.
6. Pub. L. No. 98, 67th Cong., 1st Sess., ch. 136, 42 Stat. 227 (23 November, 1921), § 217(a)(4). The rule was restated without substantive change by Pub. L. No. 562, 70th Cong., 1st Sess., ch. 852, 45 Stat. 791 (29 May, 1928), § 119(a)(4); that citation was preserved when the preceding series of revenue acts was first codified in 1939 (53 Stat., Part I, at 53-54, 76th Cong., 1st Sess., 10 February, 1939).
7. Under the "origin of the claim" test established for amounts paid in litigation; see, e.g. *United States v. Hilton Hotels Corp.*, 397 US 580 (1970). See also Rev. Rul. 72-232, 1972-2 CB 276 (copyright royalties were from sources outside the United States where the licensor sold the copyrighted material exclusively in a country other than the United States under the copyright protections of that country; the fact that the materials were printed in the United States was deemed irrelevant).

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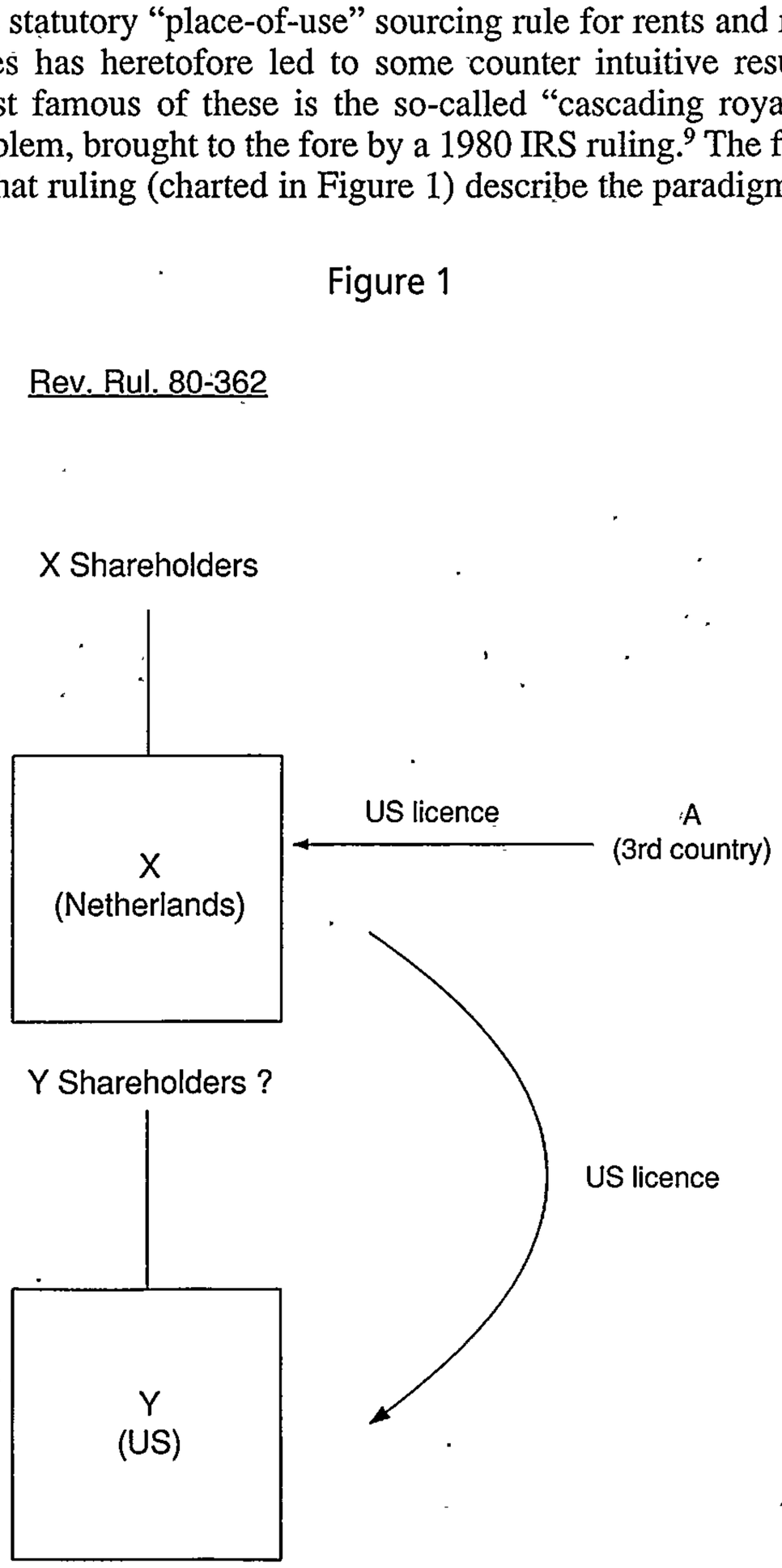
For this purpose, the concept of "use" appears to relate to the ultimate use of the intangible property, as opposed to any intermediate uses to which it might be put. For instance, where a non-US owner of trademark rights licensed those rights to a US manufacturer which affixed the trademark to products within the United States and then shipped the products to non-US customers (presumably for an enhanced sales price reflecting an increase in the products' market value due to the presence of the trademark), the IRS held nearly 30 years ago that the use took place where the products were used and consumed by the end customers (outside the United States), and not where the trademark itself was affixed to the goods (within the United States).[8]

The statutory "place-of-use" sourcing rule for rents and royalties has heretofore led to some counter intuitive results. Most famous of these is the so-called "cascading royalty" problem, brought to the fore by a 1980 IRS ruling.[9] The facts of that ruling (charted in Figure 1) describe the paradigm: A

Figure 1



non-resident alien not engaged in the conduct of a US trade or business licensed intangible property to a Netherlands corporation, which relicensed the same property rights to a US corporation for exploitation in the United States. The non-resident alien resided in a country with which the United States did not have an income tax treaty; under the US–Netherlands income tax treaty as then in effect, US-source royalties derived by a Dutch resident (such as the corporation in the ruling) were exempt from US taxation. The IRS held that the property licensed to the Netherlands company was in fact used in the United States (after being relicensed to the US company), so that, although the royalties paid by the US company to its Dutch licensor were exempt from tax in the United States under the US–Netherlands treaty, the royalty income derived by the non-resident alien from the Dutch company was US-source royalty income that was fully taxable to the non-resident alien recipient under Section 871 of the 1986 Code (no treaty between the United States and the non-resident alien's country of residence being available).

Although the rule enunciated in Revenue Ruling 80-362 has often been criticized, no contrary authority had been issued by the IRS or any court until the *SDI* decision.

IV. THE *SDI* SITUATION

The SDI Group is an affiliated group of multinational companies involved in the design, manufacture, marketing and servicing of commercial systems software for use by third-party customers on mainframe computers throughout the world. The group is headed by a Bermuda company (SDI Bermuda), and also includes a Dutch company ultimately known as SDI Netherlands BV (SDIN). In 1986, SDIN licensed on a non-exclusive basis the worldwide rights to certain software from its indirect Bermuda parent; although clearly included in the worldwide scope of the licence, the United States was not mentioned by name. Royalties were to be payable at a rate equal to 93 per cent of the aggregate net royalties received by SDIN from all sub-licences of the subject rights; from 1987 through 1990 the royalties paid under that licence amounted to over USD 19 million.

During the four years at issue SDIN sub-licensed the US portion of the rights on an exclusive basis to SDI USA, a US affiliate of SDIN, in exchange for a royalty equal to 50 per cent of the licensee's gross revenues; the aggregate royalties paid on that sub-licence over the period amounted to over USD 11 million. On a global basis, SDIN retained almost USD 1 million in net royalty income (the excess of royalties received over royalties paid) during the 1987-1990 period. A simplified chart of the structure is set out in Figure 2.

8. Rev. Rul. 68-443, 1968-2 CB 304.
9. Rev. Rul. 80-362, 1980-2 CB 208.

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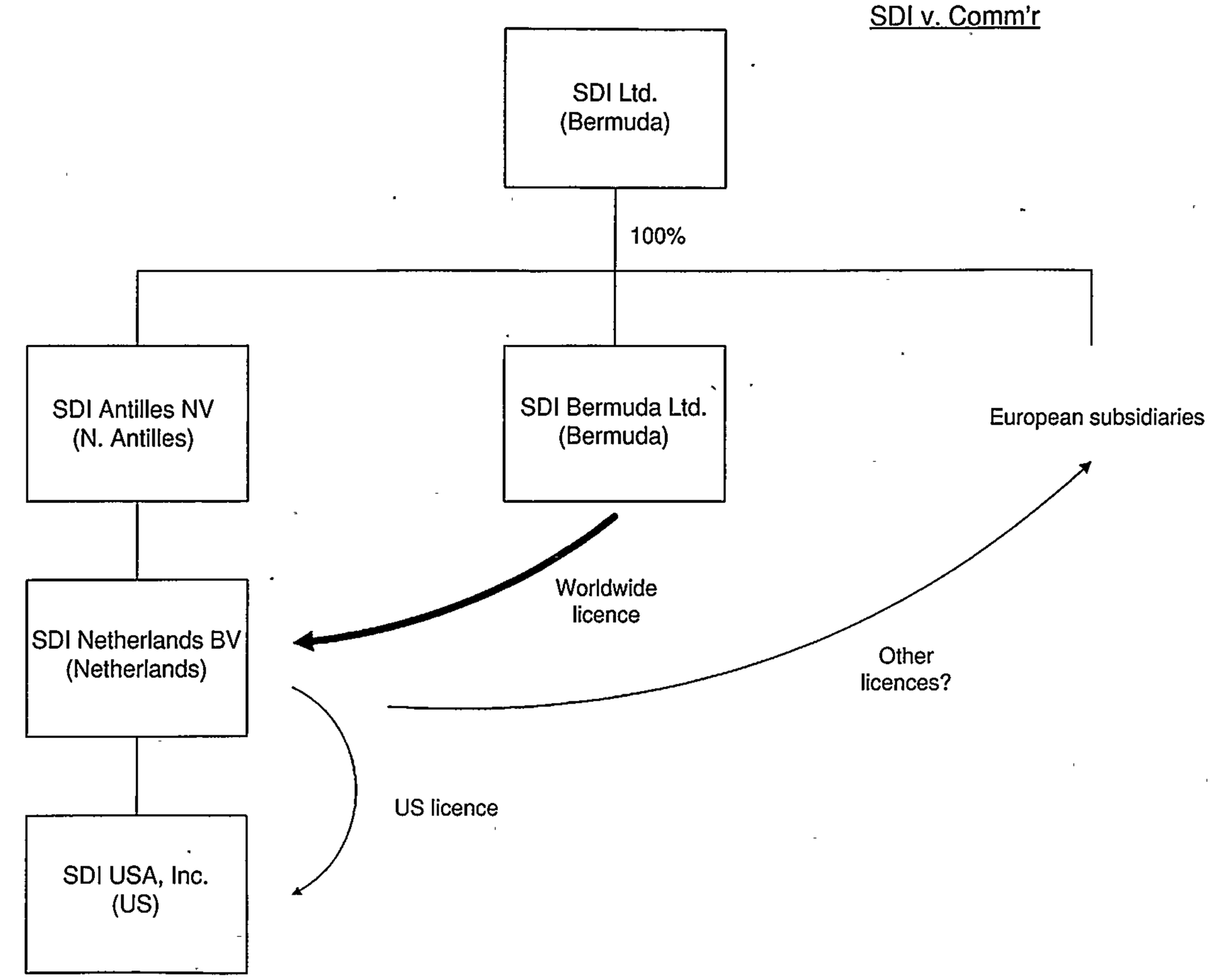
Figure 2



Royalty payments on the sub-licence were made free of US withholding tax under the authority of Article IX of the income tax treaty between the United States and the Netherlands as then in effect. However, SDIN also made its royalty payments to SDI Bermuda free of US withholding tax. The IRS assessed deficiencies against SDIN, claiming that a portion of SDIN's royalties paid to SDI Bermuda constituted US-source income of SDI Bermuda that was subject to withholding, and further that SDIN was a withholding agent with respect to those payments and should therefore be held to account for its failure to withhold the statutory 30 per cent tax on the royalty payments to SDI Bermuda. SDIN thereupon petitioned the Tax Court to overturn the IRS assessment.

V. THE COURT'S ANALYSIS

The Tax Court first disposed of an evidentiary issue in favour of the IRS, and then went on to the first (and, as it turned out, the only) substantive issue discussed: whether royalties paid by SDIN to SDI Bermuda constituted US-source income of a type subject to the 30 per cent statutory tax under Section 881 of the 1986 Code and the corresponding withholding obligation imposed by Sections 1441 and 1442 of the 1986 Code.[10] The crux of the IRS argument was that the SDIN royalties paid to SDI Bermuda should be viewed as retaining their character as US-source income to the extent attributable to the undeniably US-source royalties paid to SDIN by SDI USA, under authority of Rev. Rul. 80-362, *supra*. The IRS also relied on several cases that it claimed should be read to support a proportional allocation approach to tracing the source of royalties through multiple payors;[11] however, the Tax Court noted that, in each of those cases, the payments that were ultimately held subject to withholding were made by a US payor.

The Tax Court was unpersuaded by the IRS position. Beginning its analysis with Rev. Rul. 80-362, *supra*, it began by noting that IRS rulings are not entitled to any special weight as precedent for unresolved tax questions, and criticized the ruling for its lack of reasoning or legal precedent to support

10. If the royalties had been found to be from sources within the United States, SDI Bermuda would not have been subject to net basis taxation under Sec. 882(a) of the 1986 Code, since it was not engaged in the conduct of a US trade or business during the years at issue.

11. See, e.g. *Wodehouse v. Commissioner of Internal Revenue*, 15 TC 799 (1950); *Molnar v. Commissioner of Internal Revenue*, 156 F2d 924 (2d Cir. 1946).

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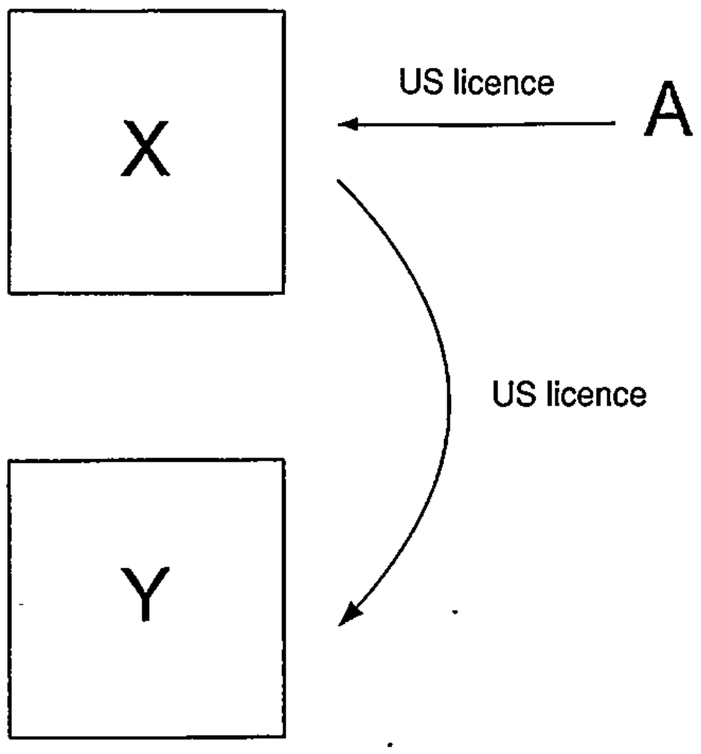
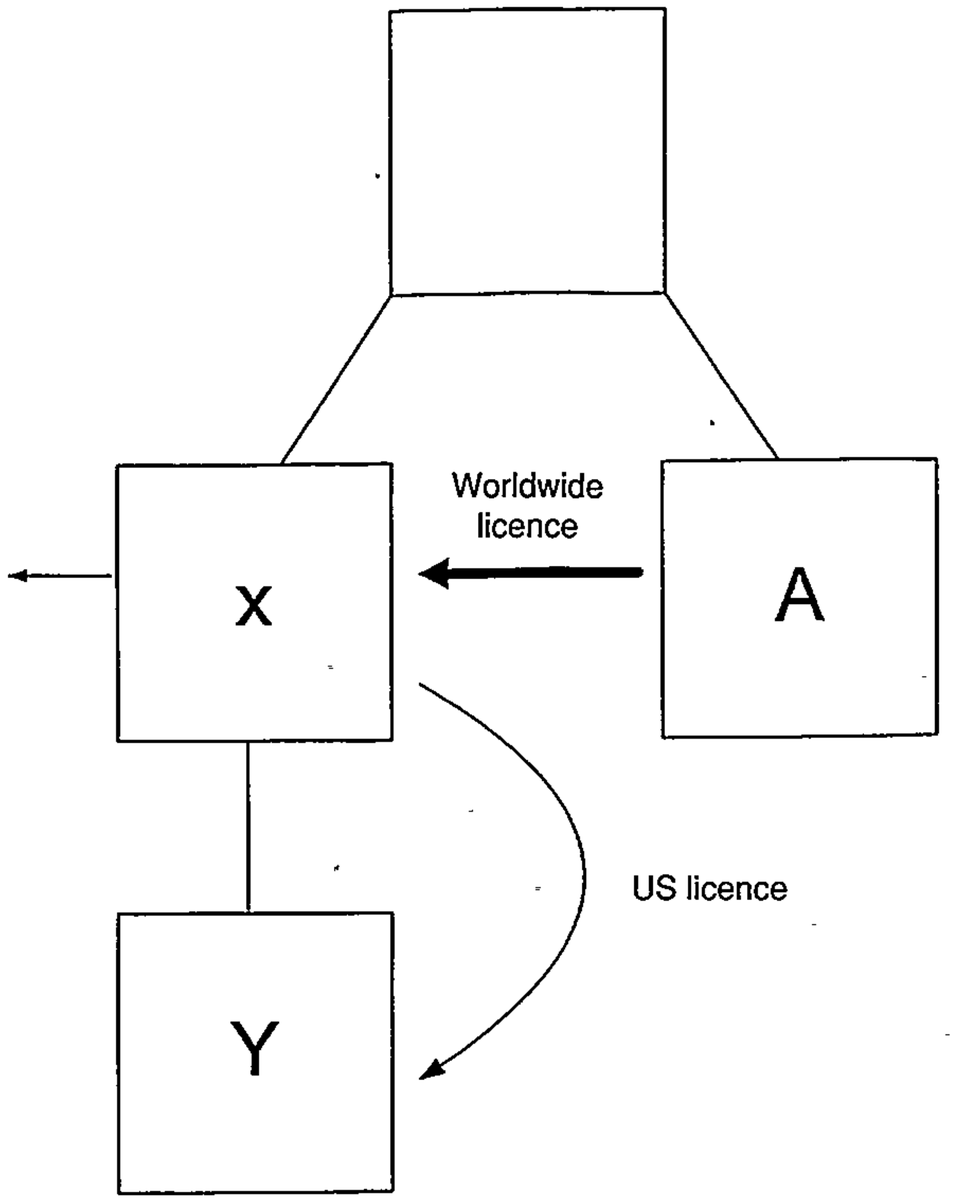
(note 12)
Figure 3

Rev. Rul. 80-362



SDI v. Comm'r



its conclusion.[12] The opinion then goes on to note that the IRS had not pressed the argument that SDIN was a mere conduit between SDI USA and SDI Bermuda, which might (if the fact of such status had been proven) have supported the IRS position.[13] Instead, the Tax Court analogized the situation before it to the one it addressed the previous year in *Northern Indiana Public Service Co. v. Commissioner of Internal Revenue*,[14] in which an intermediary offshore finance subsidiary was not ignored for US withholding tax purposes because it engaged in substantial business activity that resulted in significant earnings (because of an interest rate spread captured by the finance subsidiary.[15]

In the *SDI* case, according to the Tax Court, the parties entered into two separate licence agreements with separate and distinct terms, under which SDIN had independent roles as main licensee and sub-licensor. SDIN retained a spread on the royalty stream that yielded a substantial amount of net income (between 5 and 6 per cent, according to the opinion). Therefore, the Tax Court ruled that it would be inappropriate to treat any portion of the SDIN royalty to SDI Bermuda as attributable to royalty income received by SDIN from SDI USA.

The Tax Court seemed particularly troubled by the possible consequences of a different holding. Ever since the issuance of Rev. Rul. 80-362, *supra*, commentators have noted the major theoretical difficulty with the "cascading royalty" approach: i.e. it carries the risk of multiple instances of US withholding taxation on the same income stream, where a royalty is paid through several tiers of taxable entities.[16] Although the IRS disavowed any intent to impose multiple levels of withholding tax on the royalty paid by SDI, the Tax Court was unwilling to countenance a holding that would require an exercise of administrative discretion by the IRS in order to avoid that result. The weight accorded to this issue by the Tax Court suggests the possibility that the judge was more troubled by the inequity that might result from a contrary holding than by the relative lack of direct precedential underpinnings for the decision that was ultimately rendered.

VI. RAMIFICATIONS AND OPPORTUNITIES

It is difficult to predict how much of an impact the *SDI* case will have on future international licensing transactions and structures. For one thing, the case appears to have been poorly argued by the government: as an example, the Tax Court went out of its way in the opinion to note that, although there was an affiliation between SDIN and SDI USA, the IRS did not press this point at trial and did not argue the corresponding position that SDIN should be viewed as merely a conduit for royalties that should have been deemed paid by SDI USA to its ultimate Bermuda parent (which would have supported the imposition of a withholding obligation, there being no comprehensive income tax treaty in effect between the

12. This was an important step in the court's reasoning: as can be seen by the side-by-side comparison of the fact patterns in Rev. Rul. 80-362 and the *SDI* case set out in Figure 3, it is difficult to see how the Tax Court could have sustained the precedential value of the ruling and not upheld the IRS position in the case before it.
13. See *Aiken Industries, Inc. v. Commissioner of Internal Revenue*, 56 TC 925 (1971) (back-to-back loans with no interest spread captured by the intermediary).
14. 105 TC 341 (1995) (on appeal to Seventh Circuit Court of Appeal).
15. The choice of the *Northern Indiana Public Service Co.* case as the guiding precedent, although appealing at first blush because of the similarity of the corporate structures involved, is somewhat surprising given that the interest sourcing rule depends on the status of the payor (making the substantiality of the payor a critical analytical factor), whereas the royalty sourcing rule is independent of that status.
16. See (1) Isenbergh, *International Taxation: US Taxation of Foreign Persons and Foreign Income* (2d ed. 1996), at 7:20-21; (2) Kuntz & Peroni, *US International Taxation* (1992), at C1:45-46; Dale, "Withholding Tax on Payments to Foreign Persons", 36 *Tax. L. Rev.* 49, 66-67 (1980).

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United States and Bermuda).[17] There were also other issues raised by the petitioner that were never addressed by the Tax Court, such as whether SDIN could, as a non-US corporation not engaged in a trade or business within the United States, be required to act as a withholding agent by the US government; because of the Tax Court's pro-taxpayer resolution of the source issue, these remaining questions were deemed moot and therefore were not addressed in the opinion. Furthermore, as noted above, the holding may have been result-oriented (i.e. driven by a desire to foreclose inequitable consequences that might flow from a contrary holding), so the extent to which the decision's reasoning is properly applicable to other contexts is open to question. In addition, the royalty and limitation-on-benefits articles (Articles 13 and 26) of the current US–Netherlands treaty, which replaces the version in force during the years at issue in the *SDI* case, would significantly complicate the analysis of the case's facts if they were presented today. Finally, the decision was handed down very recently, so the IRS has not yet indicated whether it will file a judicial appeal, accept the decision, or publish its official non-acquiescence (by which the IRS would accept the Tax Court's decision with respect to the taxpayer and years at issue, but would not follow the decision in other contexts).

Bearing the foregoing in mind, it is nevertheless interesting to speculate on how the principles of the *SDI* decision could prove useful in various international tax planning contexts.

A. Multinational intellectual property holding structures

The most obvious method of applying the *SDI* decision is in similar factual situations, namely the establishment and operation of international licensing structures. If the case remains good law, it provides a road map for multinational groups seeking to maximize the intra-group use of owned intangibles without attracting excessive withholding tax liabilities. In particular, the "mixing bowl" approach of the SDI Group, in which the US sub-licence royalties were commingled with royalties from other worldwide sub-licensees within SDIN before being paid on to SDI Bermuda. However, the Tax Court's broad hint in the opinion that a conduit argument might have achieved for the IRS what its other positions did not, suggests that taxpayers seeking to establish or reorganize their multinational licensing operations to fall within the protections of the *SDI* case will have to exercise caution that their arrangements do not fall foul of the various conduit precedents available to the IRS.

B. Dispositions of intangible property

A related area in which the *SDI* decision may be relevant is at an alternative point in the useful life cycle of an item of intangible property, i.e. upon its sale. Although the rules of the 1986 Code for sourcing gains from the sale of property are generally tied to the seller's tax residence,[18] there are numerous important exceptions to this principle. One of these is the source rule for the gain from the sale of intangible property where the consideration to be paid is tied to the use or productivity of the intangible: such gain is sourced in the same manner as a royalty.[19] Presumably whatever comfort taxpayers may take from the *SDI* decision as to multi-tier royalty flows applies to contingent sales of intangible assets as well.

C. US foreign tax credit planning

Since the source rules generally apply equally to US and non-US taxpayers, a natural question arises as to the circumstances in which a US multinational's licensing arrangements might be affected by the *SDI* decision. It appears that the most likely such context is the area of foreign tax credit planning, since the US foreign tax credit is only available for foreign taxes paid on foreign-source income (as determined under US tax principles).[20] For example, query whether a US multinational's overseas licensing subsidiary can now sublicense the US rights to the US parent's intangibles to a sublicensee for use in the United States without having the corresponding portion of the main royalty it pays to the parent recharacterized as US-source income:[21] if that technique were successful, foreign taxes on other income that might not otherwise be creditable because of the Section 904 limitations could become available.

D. Application to tangible property

The statutory sourcing rule for royalty income applies equally to rentals paid for the use of tangible property. Thus, for example, income from "true" leases (as opposed to financings or sales documented in leasing terms) of transportation hardware and other tangible personal property is sourced according to place of use.[22] It will be interesting to see whether the *SDI* case can provide support for lessors of tangible property, where the property's physical location at a given moment can be readily ascertained.

E. Other types of income

The unusual feature of the statutory sourcing rule for rents and royalties that gives rise to the issues raised by Rev. Rul. 80-362 and the *SDI* case is that the rule is not tied to the status of either the payor (e.g. for dividends or interest) or the payee (e.g. for most non-inventory sales gains). That characteristic is present in the case of a select number of other types

17. In this context, mention should be made of IRC § 7701(l), enacted after the years at issue in the *SDI* case, which authorizes the IRS to issue regulations designed to combat "back-to-back" arrangements in certain situations where the result is avoidance of US tax. Those "anti-conduit" regulations have since been issued by the IRS (see Treas. Reg. § 1.881-3), but there are real questions as to their applicability to cascading royalty arrangements.
18. See IRC § 865.
19. IRC § 865(d)(1)(B).
20. See IRC § 904(a).
21. IRC § 904(g) contains an "anti-black-box" rule that resources certain income of "United States-owned foreign corporations"; however, by its terms that provision would not appear to apply to the situation described in the text.
22. Real estate leases are a special subset of this rule: leased real estate is by its nature used where the real estate is physically situated.

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of income to which the principles of the *SDI* decision may be relevant. For example, compensation income is sourced by reference to the place in which the services are performed,[23] and insurance underwriting income is sourced by reference to the location of the risk covered.[24] In addition, certain types of income are subject to an arbitrary sourcing rule (e.g. the 50/50 rules for international transportation[25] and communication[26] income). It may be that the *SDI* case will give some scope to imaginative planning designed to control the source of these and other types of income that share the sourcing characteristic of payor-payee independence.

VII. CONCLUSION

The scope and precedential value of the *SDI* case are somewhat unclear at this stage, and additional judicial and administrative determinations will be required in order to resolve that uncertainty. However, it is clear that the decision represents a major shift in this part of the US tax law and provides an opportunity to consider significant potential international tax planning opportunities for US and other multinationals and their advisers.

23. IRC § 861(a)(3).
24. IRC § 861(a)(7).
25. IRC § 863(c)(2).
26. IRC § 863(e)(1).

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BOOK CHOICE

GLOBAL TAX PLANNING AND OFFSHORE OPPORTUNITIES

Federico Scarlata
Comtax Publishing AB, 1995

INTERNATIONAL TAX PLANNING

Dennis Campbell (Ed.)
Kluwer Law International, 1995

BARRY LARKING*

Head of IBFD Library and Source Information

It takes a brave man to edit a book on international tax planning and a still braver man to write one. *International Tax Planning* (edited by Dennis Campbell and authored by many) and *Global Tax Planning and Offshore Opportunities* (written by Federico Scarlata) do little to dispel this view, but they do still produce some very worthwhile reading.

Global Tax Planning is the statement of someone with a cause: "multinational-man's" battle against "government's voracious daily need for funds", or, "the great challenge of freedom". The book is divided into two parts. The first addresses a number of principles of international taxation in a way which makes them accessible for newcomers to the area or to non-professionals seeking their way to freedom. The second focuses on tax havens and contains a good practical guide to the most popular locations – I certainly will not be taking my millions to Andorra! Despite its title, the book should not be seen as an encyclopedia of international tax – indeed there are a number of notable omissions – but as a highly personalized critique of the subject. Although the structure is at times a little hard to follow and the message probably comes over better in its original Italian, it is nevertheless a good read with plenty of illuminating insights and inspired comments.

International Tax Planning is really a *pot-pourri* of tax issues and countries. Admittedly, it does not pretend to be more nor less than this, although whether it should have been is another matter. Whatever the quality of the individual contributions, the book comes together awkwardly as a whole, and as a result is less of the handy reference tool it might have been. Nevertheless, many of the individual contributions contain valuable practical information and will repay careful reading. The difficulty of bringing structure into the book is also indicative of the breadth of its coverage. My own four-part classification hardly does justice to this but I found it a handy *aide memoire*: "vehicles", covering non-profit organizations, trusts, investment funds and asset securitization; "anti-avoidance", including treaty shopping and US penalties for getting it wrong; "country specialities", such as Swiss bank secrecy, Dutch tax rulings, and Liechtenstein tax (or rather lack of it); and, finally (where would a book on international tax planning be without it), "EU Harmonization".

The test of a book about tax planning is probably the extent to which it contains principles or techniques which will save you tax. Both books satisfy this test. *Global Tax Planning* starts with some fundamental issues like double taxation and transfer pricing and goes on to discuss planning structures such as finance branches, holding companies, and coordination centres, as well as a special structure for Italian joint ventures. The Italian "usufruct" structures, now largely of historical interest only, could probably have been passed over. The terminology explanations will be appreciated by those new to the area, although it is a pity that the reader is left guessing as to the meaning of some of the more exotic sounding concepts such as "secondary sheltering opportunities", "stapled stock" or "drop-off (!) trusts". However, this is more than compensated for by the many insightful observations sprinkled throughout the book, such as the too often forgotten fact in international tax planning that "at the end of the path....there will always be PEOPLE". Along this path will normally be companies, and here the global tax planner has a marvellous electronic tool, Comtax, to help him. A "still life" at the end of the book illustrates the point by taking 20 different ways to route dividends from A to B in order to determine the "optimal" solution.

Turning to the tax-treasures in *International Tax Planning*, we find out why charitable donations in Austria are so unpopular, discover ways of minimizing exposure to US transfer pricing penalties and how to get a Dutch tax ruling (and what types are available), we pick up VAT planning tips using Irish non-resident companies, and can apply on the spot for Gibraltarian residence. We also learn why not to die in Italy!

Inevitably the two books have overlaps, and perhaps the only surprise is that there are not more. A disappointing example is that of trusts. Both books give a good account of the historical background and terminology relating to trusts, but in neither case is their relevance for international (or global) tax planning actually explained. Both books also pay due regard to anti-avoidance, emphasizing the two way nature of the tax planning game, the object of which Mr Scarlata neatly sums up on behalf of the tax planner as being "to avoid the anti-avoidance rule".

* The views expressed herein are those of the author in his personal capacity and do not necessarily reflect those of the IBFD.

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South Africa

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Editors E. Danziger and E.M. Stack.
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This handbook is a compilation of major tax legislation currently in force. The first part of the book is devoted to an examination of the 1996 amendments to the Income Tax Act. This is followed by the Income Tax Act, regulations and practice notes and extracts from the Tax on Retirement Funds Act, the VAT Act, the Estate Duty Act and the Transfer Duty Act. This bound volume is published annually.
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THE TAXATION OF GLOBAL TRADING OF FINANCIAL INSTRUMENTS:

AN EXECUTIVE SUMMARY OF THE DISCUSSION DRAFT

Organisation for Economic Co-operation and Development, Paris 1997

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Technological change, the communications revolution, and the spread of financial deregulation and liberalisation have had a dramatic effect in globalising financial markets. Financial firms have developed innovative financial instruments, such as derivatives, to meet the global demand to finance trade and investment and to reconcile the often different demands of borrowers and investors.

Such innovation challenges traditional tax systems both as regards the taxation of the end users of innovative products and the providers of such instruments. A second challenge arises because financial firms have increasingly organised their activities on a global basis so as to be able to meet the demands of investors for global financial products, 24 hours a day. It is this phenomenon of global trading that the paper addresses.

The paper looks in some detail at the factual background to global trading. This covers the general business background, trends in the financial industry, the type of financial institutions involved and the products that they trade.

There is a detailed description of the various ways global trading businesses can organise themselves and the various functions which they must perform. These include sales, marketing, trading, risk management, systems control, accounting, settlement and other support functions.

The paper outlines the challenges posed to the traditional way of taxing such enterprises. A description of trading models is given and the application of traditional transaction methods to such trading patterns is reviewed, using the views set out in the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter referred to as the "TP Guidelines").

Global trading is often carried on in branch form (or through agents) for reasons of capital adequacy and so the paper also reviews the difficulties of applying the existing rules to such situations. Particular problems arise as to the question of whether certain kind of activities carried on in a particular jurisdiction amount to the carrying on of business there through a permanent establishment. This question can be difficult to answer, given the integrated nature of much global trading. There are also many problems concerning the attribution of income and expenses to a permanent establishment of a global trading business. For example, to what extent should tax administrations recognise transactions within a single legal entity, such as mirror swaps between a permanent establishment and head office?

The core of the paper concerns the examination of the most difficult cases, where the different functions necessary to perform the global trading business are so integrated that it is difficult to evaluate them on a separate basis. The case for applying transactional profit split methods, as methods of last resort, is reviewed. The discussion draws on the existing guidance given in the TP Guidelines and examines how this can be applied in the special factual circumstances of global trading. The paper concludes that the special circumstances can be adequately dealt with by the application of existing tax rules and transfer pricing methodologies. However, it is felt that further guidance on the practical application of the rules would be very useful for both taxpayers and tax administrations.

The paper looks at current practices for actually applying the profit split method (in cases where it has had to be used as a method of last resort) and especially the use of factor formulae to arrive at an arm's length profit split. There is a detailed discussion of the factors that could be used when performing either a contribution or a residual profit analysis. These include compensation of marketers, risk managers and traders, measurement of capital/risk exposure, risk management and compensation of support staff.

There is also a brief consideration of other factors that could be used in such a formula and of how to best measure the different factors. The vital issue of how to weight the factors to produce an arm's length result is also explored.

The paper does not generally reach recommendations but that was not its intention. It aims to provide a basis for discussion of the issues raised by global trading. The description of the issues and the setting out of the options open to Governments to deal with them provided in the paper, is seen as a first step in forming a multilateral consensus on how to tax such activities. The Special Sessions is particularly aware of the need for input from the business community before taking the project further.

NOTE
The Discussion Draft will be published in full in a forthcoming issue of the IBFD's International Transfer Pricing Journal.

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BELGIUM

THE 1997 BUDGET: IMPLICATIONS FOR INTERNATIONAL FINANCING STRUCTURES

Herwig Joosten

Ernst & Young LLP, New York

I. INTRODUCTION

Over the last few years, budgetary pressures in Belgium, as well as impending deadlines for monetary integration called for by the Maastricht Treaty, have resulted in the emergence of new tax legislation. At the end of July 1996, parliament provided the Belgian Government with special powers to introduce the new legislation needed to reduce Belgium's budget deficit to the EU limit and to restore the country's competitiveness. Consequently last December was characterized by a long series of new measures in the areas of social security and direct as well as indirect taxes.

The 1997 Budget Law, which was promulgated by the Royal Decree of 20 December 1996, is designed to further reduce Belgium's budget deficit as a percentage of gross national product. It also contains several corporate tax, individual income tax, indirect tax and social security measures.

The following provides an overview of the most important new measures.

II. CARRY-FORWARD OF LOSSES/CHANGE IN CONTROL

Losses can in general be carried forward indefinitely for tax purposes. However, under the new budget law losses can no longer be carried forward if control of a company changes, unless the change of control can be justified by legitimate financial and economic needs. The concept of control (50 per cent of voting rights or factual control) is defined under Belgian accounting law. The aim of this measure is to discourage the practice of selling loss-making companies.

The acquisition of a loss-making company is economically justified if some or all of the company's activities continue to be carried out and its personnel is (even partially) retained. The change in control of a Belgian company resulting from the transfer of shares or management to a company that is part of the same consolidated group apparently does not prevent the carry-forward of losses. It will be possible to apply for an advance ruling in this respect. This measure also applies with regard to the carrying over of the Belgian investment deduction.

III. THIN CAPITALIZATION/BASE EROSION RULE

As of 1 January 1997, the interest on non-publicly issued loans paid or accrued by a Belgian company to another company that enjoys a favourable tax regime[1] is no longer tax deductible if the total amount of the tainted loans outstanding (on which the interest is calculated) exceeds a certain threshold. The threshold is seven times the amount of the sum of the borrower's reserves at the beginning of the relevant accounting year and the paid-in share capital at the end of the relevant accounting year. Any capital increase taking place during the course or at the end of the fiscal year may thus increase the corporate tax deductibility of interest on these tainted loans.

Initially, the rule was designed to deal with the funding of Belgian companies by foreign companies subject to a favourable tax regime. The limitation on the deductibility of interest was introduced to stop tax motivated structures, such as the case where a Belgian company with a highly capitalized foreign subsidiary[2] grants loans to its parent or the parent's group in Belgium.

The law, however, has been written in such a general way that the thin capitalization rule will also apply in the case of a Belgian coordination centre financing to a Belgian company. Thinly capitalized Belgian companies that fund themselves through their Belgian coordination centre or through a foreign company benefiting from a favourable tax regime may therefore have to rethink their financing structure.

IV. PARTICIPATION EXEMPTION

Belgium's very favourable holding company regime can be briefly summarized as follows:

- a complete tax exemption for capital gains realized on qualifying shares;
- a 95 per cent exemption from the taxable basis for dividends received from qualifying shares;

1. An abnormal or special tax regime or a regime that is considerably more advantageous than the ordinary Belgian tax regime.
2. E.g. an Irish IFSC, a Swiss finance company or a Dutch company with a Netherlands Antilles subsidiary or branch.

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- in principle, unlimited deductibility of interest and other charges even though the expenses relate to investments generating tax-free income;
- a 0.5 per cent stamp duty on capital increases;
- the possibility to invoke the EU Parent-Subsidiary Directive and, thus, receive dividends from EU subsidiaries free of withholding taxes;
- an exemption from Belgian withholding tax for dividends paid to 25 per cent EU parent companies;
- a favourable tax treaty network (5 per cent withholding tax with most non-EU countries, including the United States);
- deductibility of capital losses suffered at the time of liquidation of a subsidiary to the extent of its paid-in capital; and
- no withholding taxes upon liquidation.

Belgian holding companies do not enjoy a particular tax regime. The Belgian dividend exemption applies to all Belgian companies and, therefore, may be used to efficiently manage the tax situation of a Belgian operating company (a mixed holding company) or may be combined with the use of a Belgian coordination centre.

Under the new US check-the-box rules, a Belgian company can easily be hybridized (treated as a corporation in Belgium but as a partnership or branch for US tax purposes). These rules may render the use of a Belgian holding company (eventually combined with the use of a Belgian coordination centre) a very effective international tax planning tool for US multinationals.

The 95 per cent exclusion of dividends[3] from the taxable base is subject to a minimum participation requirement (except if the dividends are received by banks, investment companies or insurance companies). The minimum share capital investment in the distributing company must at least equal 5 per cent of the investment value of the shares *or* should amount to not less than BEF 50 million (about USD 1.6 million). This minimum threshold does not need to be fulfilled to enjoy the capital gains tax exemption.

Prior to the 1997 Budget Law, the participation exemption and capital gains tax exemption were only granted if the distributing company had been subject to Belgian tax or a foreign tax similar to the Belgian corporate tax. The *subject to tax* requirements that need to be fulfilled in order to obtain the 95 per cent participation exemption or the capital gains exemption on shares have been substantially modified by the law of 20 December 1996, and have become extremely complex.

A taxpayer may seek an advance ruling from the Belgian tax authorities that a dividend meets the subject to tax requirements in order to benefit from the participation exemption.

Prior to the introduction of the new subject to tax tests, certain dividends from foreign finance companies which were either subject to a special tax regime (such as an Irish IFSC) or acted as a conduit company (such as a Dutch holding company holding shares of a Netherlands Antilles company) would, under Belgium's domestic law, be excluded from the Belgian participation exemption.

Most Belgian tax treaties, however, contain non-discrimination clauses with regard to dividend payments. Since the participation exemption was available to Belgian holding and finance companies (such as the Belgian coordination centre), the participation exemption also had to be applied to dividends from an Irish IFSC or a Dutch holding company, based on the non-discrimination clauses in the respective treaties.

Under the recently enacted measures, dividends from Belgian finance and holding companies are also excluded from the participation exemption. Consequently, the non-discrimination clauses in Belgian treaties should no longer provide relief.

Obviously, the government had to change the definition of "finance company" in order to prevent Belgian coordination centre dividends from being taxed. The new finance company status only applies to companies that are in the business of external borrowing outside their group.[4] Since a Belgian coordination centre can only lend on an intercompany basis or perform intercompany financial services, it does not fall under the new definition of finance company and, therefore, its dividends qualify for the 95 per cent exemption.

The change in the definition of finance company also implies that dividends from foreign companies that are intercompany lenders or provide intercompany financial services and are subject to a favourable corporate tax regime, but not established in a tax haven, still qualify for the dividend exemption.[5]

A dividend distributed by a company which is:
- not subject to corporate income tax or not subject to a foreign tax similar to the Belgian corporate tax; or
- established in a tax haven country (a country where the ordinary tax regime is considerably more favourable than the Belgian regime);

never qualifies for the participation exemption. Consequently, dividends distributed by Luxembourg 1929 companies (since not subject to tax) or distributed by companies established in tax havens (such as the Dutch Antilles, Aruba, Barbados, Jersey, Bermuda, the Caymans and Liechtenstein) do not qualify for the dividend exemption, regardless of the nature of their activity. The tax authorities have established several official non-exhaustive indicative lists of tax haven countries and tax haven companies which serve as general rulings.

A foreign company that benefits from a favourable tax regime and is in the business of external financing may still benefit from the Belgian dividend exemption provided it is established in the EU. An Irish IFSC of a Belgian bank that provides financing for the bank's clients could qualify for this exception. In these circumstances the participation exemp-

3. Dividends distributed by investment companies are excluded from this rule.
4. A group is composed of a parent company and its subsidiaries (i.e. companies in which it holds, directly or indirectly, a participation of at least 20 per cent).
5. Dividends from an Irish IFSC, a Dutch company qualifying for the new Dutch financing regime, or a Swiss company (with favourable tax status) that is in the business of intercompany lending should, therefore, under normal circumstances qualify for the Belgian participation exemption.

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tion may be obtained provided the Belgian shareholder can evidence a legitimate financial and economic motivation for using a foreign finance company and provided the foreign finance company is sufficiently leveraged.

The foreign finance company's equity should not exceed a predefined percentage of its liabilities (this percentage will be reduced from 50 per cent in 1997 to 33.33 per cent in 1999). The leverage test seems easy to comply with but the need for economic justification seems more burdensome.

Dividends received from treasury companies benefiting from a special tax regime are not tax exempt. Companies that are mainly involved in cash pooling and act as treasury centres for their group members (such as Belgian coordination centres) are not viewed as treasury companies from a tax point of view.

Dividends distributed by a foreign investment company subject to normal taxation will under normal circumstances qualify for the participation exemption. Dividends from investment companies benefiting from a special tax status should not qualify for exemption. However, if such an investment company distributes at least 90 per cent of its income, full transparency may apply.

The new subject to tax tests no longer exclusively refer to the tax regime of the company distributing the dividend. The new tests also refer to the tax regime to which the profits (which constitute the basis for the dividend distribution) have been subjected.

Dividends that originate from profits realized in a country other than the country in which the distributing company is a resident and that have been subject to a favourable tax regime, in principle, do not qualify for the participation exemption. In certain countries, it may be possible to obtain an exemption on foreign source income. Dividends that are paid out of such exempt profits from offshore activities no longer qualify for the Belgian participation exemption.

In addition, dividends paid by a company out of the profits of its foreign establishment (if subject to a favourable tax regime) do not qualify for the participation exemption. Dividends from a Dutch company with a Netherlands Antilles branch or a Luxembourg company with a Swiss finance branch will only be eligible for the participation exemption if the total effective foreign tax paid amounts to at least 15 per cent of the branch profits. However, a dividend distributed by a Belgian company that originates from its foreign establishment established in a country that has concluded a double tax treaty with Belgium qualifies for the participation exemption.

Following from the above, dividends from a Belgian company distributed out of profits realized in its Swiss finance branch would qualify for the dividend exemption, whereas dividends distributed by a foreign company out of its Swiss finance branch would not qualify. Taking into account the non-discrimination provisions in most Belgian treaties, it is doubtful whether the tax authorities will always be able to successfully apply this new legislation.

Dividends paid by an intermediate company (such as a holding company) will normally not qualify for the participation exemption. Under the previous subject to tax tests, dividends received from holding companies could enjoy proportional look-through treatment. Under the new regime, dividends of a company that receives and redistributes dividends will only qualify for the exemption if at least 90 per cent of the redistributed dividends would have been exempt in Belgium had they been distributed directly.

Where a dividend received from a foreign holding company is comprised of more than 10 per cent of non-qualifying dividends, it is fully taxed.[6] A Luxembourg company that distributes a dividend to its Belgian parent that is 80 per cent attributable to dividends received from fully taxed subsidiaries and 20 per cent to dividends received from a foreign low-taxed finance company will no longer qualify for the Belgian participation exemption. Based on the above, Belgian companies may have to revise some of their foreign holding structures.

The 90 per cent rule does not apply if the distributing company is a Belgian company listed on a recognized stock exchange or a listed foreign company established in a tax treaty country and subject to a normal tax regime. The 90 per cent rule also does not apply if the intermediary company is itself subject to full taxation on the redistributed dividends. A Belgian or Dutch holding company receiving dividends from a Luxembourg 1929 company will be fully taxed thereon; if these companies redistribute the dividends, the redistributed dividends should qualify for the Belgian participation exemption.

V. MANAGERS/DIRECTORS/PARTNERS

The provision that recharacterizes interest into dividends if the amount of the loans granted by individual partners, shareholders, or directors to their companies exceed a certain threshold (1/1 ratio in principle) has been harmonized. The difference in tax treatment between active partners and managing directors has been removed. Loans made by non-resident companies to Belgian resident companies in which the foreign lender company is a director are also subject to the requalification.

Initially, the government wanted to introduce: (i) recharacterization of profit-sharing bonuses paid to company directors as dividends; and (ii) the non-deductibility of management fees exceeding certain limits. These measures, however, were not accepted by the Belgian Council of State. The Belgian Government has indicated that the corporate tax deductibility of such compensations will be further scrutinized in the future.

6. Where less than 10 per cent of the dividend is comprised of non-qualifying dividends, the dividend is 95 per cent exempt.

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VI. CAPITAL GAINS REALIZED ON INTANGIBLE ASSETS

The capital gains tax that relates to the sale of fixed assets held for at least five years can, under certain conditions, be deferred by investing in other depreciable fixed assets. This deferral possibility can result in substantial tax savings if the reinvestment asset is a fixed asset with a long useful life. In the past, this deferral possibility could be applied in the case of intangible assets (such as client lists, patents, trademarks and licences) even if they had never been depreciated. As of 27 September 1996 the deferral possibility for intangible fixed assets only applies if these assets have been previously depreciated for tax purposes.

VII. BANKING CONFIDENTIALITY

Previously, the Belgian treasury was, under normal circumstances, not entitled to open an investigation with regard to a bank unless it could prove that there was evidence of tax evasion and complicity by the financial institution.

From 1 January 1997, it is sufficient that there be evidence that tax evasion is either in existence or being prepared, without the need of evidencing complicity by the bank. The investigations may now be carried out by the tax inspector who initially started up the investigation, without the involvement of the Belgian special tax brigade. These changes further reduce Belgium's bank secrecy.

Belgian resident individuals are for the first time obliged to voluntarily declare any foreign bank accounts held on their annual tax return starting this year. Based on this information, tax officials may ask for foreign bank account extracts.

VIII. OTHER BUDGET MEASURES

1. The introduction of a 16.5 per cent tax (increased by municipal and crisis tax) levied on capital gains realized by individuals from the sale within five years of its acquisition of developed real estate.

2. The indirect real estate property tax (*Revenu Cadastral*), which is levied on owners of dwellings that are not let, or which are let but not used for business, is substantially increased.

3. A solidarity contribution of 33 per cent will apply on the benefit-in-kind resulting from the personal use of a company car.

4. Excise duties on fuel, cigarettes and certain alcoholic beverages will increase.

5. A special annual tax of 0.06 per cent will be levied on certain tax-exempt saving deposits.

6. A 0.2 per cent tax, applicable as of 1 January 1997, is levied on each delivery of bearer securities.

7. Non-indexation of standard deductions, tax brackets, scales and thresholds until 1999.

8. Taxation of certain non-tax deductible costs made by organizations (not being ordinary non-profit associations) which are not subject to the normal tax regime for corporations.

9. The tax exemption for new staff hired in the field of scientific research should be increased from BEF 440.000 to BEF 880.000 in the very near future.

10. A stock exchange tax applying to government bonds was introduced on 6 December 1996.

11. The abolition of the 0.42 per cent stock exchange tax.

12. Many other unpopular measures in the domain of social security.

Conference diary

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

APRIL 1997

International Tax Planning Techniques, Amsterdam, 10-11 April 1997 (English):

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

Offshore Tax Planning Before It Is Too Late, Marriott Hotel, London, 18 April 1997 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

International Partnerships & Joint Ventures, Vienna, 18 April 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

International Real Estate Investment, Vienna, 18 April 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

MAY 1997

Investment Funds, Luxembourg, 16 May 1997 (English):

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

Application of Tax treaties (advanced course), Amsterdam, The Netherlands, 21-23 May 1997 (English):

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

JUNE 1997

International Tax Aspects of Permanent Establishments, Amsterdam, The Netherlands, 16-17 June 1997 (English):

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

International Licensing, Amsterdam, The Netherlands, 20 June 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

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EUROPEAN UNION

WITHHOLDING TAXES AND THE MOST FAVOURED NATION CLAUSE*

David Hughes**

I. INTRODUCTION

This article examines whether EU Member States are obliged to offer "Most Favoured Nation" (hereinafter MFN) treatment to residents of fellow Member States. This question was considered in written question 647/92 to the Commission of the European Communities and is a key argument that may be raised in the *Hoechst/Pirelli* litigation currently in progress.

In view of the uncertainty created by the European Court of Justice's (ECJ) focus on non-discrimination issues, it is not surprising that doubts have been raised over whether offering more favourable terms to residents of one EU Member State compared to residents of other Member States is permissable. Framed in terms of the written question "when the tax treaty which the taxpayer's home country Member State A has concluded with Member State B is less favourable than a tax treaty that Member State B has concluded with a Member State C (or a third country D) then [will] the taxpayer of Member State A be entitled to the benefits of the more favourable position of the third party treaty"?

In order to attempt to answer this question, it is necessary firstly to consider the nature of bilateral tax treaties and secondly to determine the impact that the Treaty of Rome has on the content of these treaties.

II. THE NATURE OF TAX TREATIES

When states enter into bilateral tax treaties with each other they do so primarily to:

- facilitate international trade through providing certainty[1] and removing the impediment of double taxation;[2]
- fight tax evasion through providing a basis for cooperation between tax administrations; and
- provide a basis for the sharing[3] of tax revenues.[4]

The actual process of achieving these objectives is through negotiations, conducted via skilled negotiators. In most instances the OECD and/or UN Model Treaties provide a standard reference point. Given the conflicting interests between states[5] the treaty actually signed is essentially a compromise reflecting both the relative bargaining positions of the parties and the skills of their respective negotiators.[6] I.e. no state actually gets all it wants from a treaty. Given the complex issues involved it is not surprising that in practice it may take many years to agree on the specific provisions to be incorporated into a treaty.[7]

To provide an example of the practical implications of the above consider the following. Country A is a technologically advanced nation, it concludes treaties with country B, a developing nation and country C, a net capital exporter to country A.

In its negotiations with country B, country A had originally pressed for a 5 per cent withholding rate on royalties and interest, this it argued would free up cross-border capital flows. On the other hand, country B took the position that the rates should be 15 per cent in both cases (since this figure would give it a larger share of the relevant tax revenues). After much hard negotiation B proposed the following two alternative solutions:

Alternative A	
Royalties	15%
Interest	7.5%
Alternative B	
Royalties	10%
Interest	10%

Country A accepted alternative B as a good compromise solution.

Turning to its negotiations with country C, both countries quickly agreed on a 5 per cent rate for royalties. The ease that agreement was reached on this point was no doubt facilitated by the fact that royalty income flows between the two coun-

* The views expressed in this article do not necessarily reflect the views of either the IBFD or IFA.

** The author wishes to acknowledge the insightful comments made on an earlier draft of this article by Prof. Wim Wijnen, IBFD and Prof. Dr Klaus Vogel.

1. Once the treaty is signed the source country's ability to change the tax environment is restricted. For instance while it may in its own domestic legislation increase withholding rates, these increased rates would not apply to the income subject to withholding taxes derived by enterprises of its treaty partners.
2. Although states often offer unilateral measures to relieve double taxation these measures do not provide the relatively comprehensive protection and benefits afforded by a tax treaty. Thus states have an incentive to protect their enterprises by concluding treaties even where they have domestic legislation which provides for unilateral relief.
3. Of course ideally each state would like to obtain the maximum tax base and revenues.
4. Baker, Philip, *Double Taxation Conventions and International Tax Law* (second edition) Sweet & Maxwell at 12.
5. See *supra* note 3.
6. See Hinnekens, Luc "Compatibility of Bilateral Tax Treaties with European Law Applications of the Rules", *EC Tax Review* (1995) at 213.
7. See for example the US–Netherlands treaty.

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tries were of roughly similar amounts.[8] The withholding rate for interest was much more controversial. Country A argued for a 5 per cent rate, while country C believed a nil rate would be beneficial to both states. In the end country A accepted country C's arguments and settled on the nil rate.

Withholding Rates

	Country B	Country C
Royalties	10%	5%
Interest	10%	0%

From the above it is clear that differentiation occurs vis-à-vis taxpayers resident in different treaty countries. Additionally differentiation also occurs within a single tax treaty between taxpayers with different revenue and expense profiles.

Both types of differentiation are acceptable under international law, notwithstanding the inclusion of an OECD type non-discrimination article[9] in the relevant tax treaty.[10] In this regard it is important to remember that without the tax treaty each state would be entitled to apply the withholding rates etc. provided for under its domestic legislation. These rates are normally higher than the corresponding treaty rates. Treaties therefore represent a package of measures designed to benefit taxpayers by eliminating double taxation. Taxpayers may rely on their provisions[11] but not rewrite them.[12]

III. EU ISSUES

A formal basis for bilateral tax treaties between Member States is contained in Article 220 of the Treaty of Rome. This provides that:

> Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals the abolition of double taxation within the community.

While recognizing the usefulness of such treaties, Article 220 in no way reduces the requirement that any treaty negotiated comply with the Treaty of Rome.

The Treaty of Rome does not contain any provisions designed to ensure the harmonization of direct taxes within the EU.[13] This together with arguments over the impact of the principle of subsidiarity, raises questions about the extent of the legitimate involvement of the EU in direct tax matters.[14] However, regardless of these doubts the ECJ has since 1986 regularly reviewed direct tax matters where discrimination has been alleged.

Article 6 of the Treaty of Rome contains a general prohibition against discrimination by Member States on the grounds of nationality. Detailed provisions governing the application of this principle are contained in Articles 48 (freedom of movement of workers), 52 (freedom of establishment), 59 (freedom of provision of services) and 73b (freedom of capital movements).

It is important to underline that certain freedoms are more fettered than others. For instance the freedom of capital movements (Article 73b) is subject to a restriction set out in Article 73d which states:

> 1. The provisions of Article 73b shall be without prejudice to the right of Member States:
> (a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where the capital is invested . . .
> 2. The provisions of this Chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.
> 3. The measures and procedures referred to in paras. 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 73b.

Therefore a Member State may discriminate against non-residents and still comply with Article 73b provided that the discrimination is neither arbitrary nor (intended) simply as a restriction on the free movement of capital.

The ECJ has held that discrimination occurs where different rules are applied to comparable situations or where the same rule is applied to different situations.[15] Furthermore although strictly the prohibition is against discrimination on the grounds of nationality, the provision has been construed widely and applies to protect non-residents, since non-nationals are in general non-residents.

First in *Schumacker* and again in *Wielockx* the ECJ recognized that the position of resident and non-resident is normally not comparable since sources of income, and the taxation of that income by the states concerned may be different.[16] For that reason they determined that for a taxpayer to be in a comparable position all or almost all that person's income[17] must be earned in the state where the alleged discrimination occurred.

Applying this to the question of the MFN, a major practical obstacle presents itself since it is unlikely that the parent

8. This of course is a simplification. In practice treaty negotiators adopt a reasonably standardized approach, which they maintain regardless of the amounts involved, (which in many cases they may not even be able to quantify). Taking a consistent approach facilitates the treaty negotiation process. Nevertheless I would argue that this standardized approach has as its basis, the objective of obtaining the "overall" maximum benefit for their state.
9. Art. 24 OECD Model Convention.
10. Indeed para. 57 of the OECD Commentary states that Art. 24(5)'s "object 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". See Hughes David, "Non-discrimination: A Consideration of Article 24(5) OECD Model Convention" 50 *Bulletin for International Fiscal Documentation*, 9 (1996), at 390.
11. Although a taxpayer may normally rely on the provisions of a tax treaty in certain jurisdictions domestic law provisions may override treaty provisions.
12. I.e. a Japanese taxpayer investing in the US could not argue that the Germany–US treaty applied to a specific transaction, solely on the grounds that that treaty contained a more favourable provision than did the US–Japan treaty.
13. Art. 100 which does not explicitly refer to direct taxes forms the basis for the directives on direct taxes. See Gammie M. and Brannan G., "EC law strikes at the UK corporation tax – The death knell of UK imputation?" 8-9 *Intertax* (1995) at 392.
14. Vermeend, Willem, Editorial Vol. 5 *EC Tax Review* 2, at 54.
15. See para. 17, C-80/94 (Wielockx) C-279/93 (Schumacker). See also Kamphuis H.J. and Pötgens F.P.G. "Goodbye Mr Bachmann, Welcome Mr Wielockx", 50 *Bulletin for International Fiscal Documentation* 1 (1996), at 3.
16. I.e. different tax rates, allowances and deductions are likely to apply.
17. Although the matter is not without some doubt, it is generally believed that *almost all* implies at least 90 per cent of the taxpayer's income.

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company will earn substantially all of its income from the state in which the subsidiary is resident.

Indeed this problem reiterates the fundamental problem of establishing the principle of the MFN. Existing case law i.e. *Schumacker*, *Wielockx* etc. merely deal with the relatively straightforward issue of establishing discrimination by comparing a Member State's treatment of its own residents with its treatment of non-residents. If the MFN principle were recognized the relevant comparison would not be with the source country's own residents but rather with the *best case* resident of a third country with which the source state has a treaty.

Notwithstanding this initial objection against comparability based on an income rule, the case for an MFN is a strong one. Surely a Member State cannot treat a resident of Member State X more favourably than a resident of Member State Y? I.e. a Member State would not be able, for instance, to offer a French plumber a higher wage than a German plumber for doing precisely the same work since this would be a clear and unjustifiable breach of the fundamental freedoms, being discrimination purely on the grounds of nationality.[18] Unfortunately the position regarding the offering of different rates of withholding tax to residents of different Member States is far more complex, involving issues not only of EC Law e.g. subsidiarity, but also of national sovereignty, the allocation of taxing rights among Member States and the future of bilateral tax treaties within the EU.

The argument in favour of MFN treatment is that offering for instance different rates of withholding tax to taxpayers resident in one EU Member State as opposed to residents of other Member States or indeed residents of third countries is discriminatory (infringing Article 6) since it provides a bias in favour of inward investment from the country with the lowest withholding rate.

This argument however fails to recognize both the nature and underlying rationale of tax treaties. I.e. that tax treaties represent a trade-off of measures reflecting the specific circumstances of the two states. (See section II above.) The argument also ignores the true nature of withholding tax, which is that it is a tax imposed by the source state which should be offsetable in the residence state. Finally the argument ignores the adverse practical implications of a finding in favour of the MFN. These issues are discussed below.

IV. TREATY TRADE-OFFS

As set out in Section II tax treaties are the result of complex negotiations in which various trade-offs are accepted in order to achieve a package of measures, that it is believed will benefit taxpayers of both contracting states, subject to the revenue constraints of the countries involved. In this context this section examines possible motives for lowering withholding tax rates.

The main reason for offering lower withholding rates is usually not to attract inward investment but instead to:

(1) help the state's own enterprises (since those operating within the treaty partners borders will be subject to lower withholding rates);
(2) protect the state's tax base (since it will be able to obtain a greater slice of the tax payable by it's own enterprises on their foreign earnings.[19]

The reason why attracting inward investment is normally only a secondary motive, is that states have to deal with the "here and now" i.e. it is a concrete fact that they have enterprises who are taxpayers and that they have a revenue base, attracting inward investment is only a theoretical possibility. I.e. there are no guarantees that adopting a certain withholding rate strategy will achieve the desired effect of attracting inward investment.[20]

Nevertheless, the offering of a lower withholding rate may be seen as a method of offsetting a perceived disadvantage (for instance a high domestic income tax, social security tax or corporate tax rate), vis-à-vis investors of a particular state.

Example
Country A, is currently negotiating treaties with countries B and C. The following corporate and personal tax rates apply.

	Country A	Country B	Country C
Corporation tax	50%	50%	35%
Income tax	60%	60%	40%

Country A wishes to attract as much inward investment from countries B and C as possible, subject to obtaining a "fair share of tax revenue" on any profits arising from the investments made.

In its tax treaty with country B, country A offers a withholding rate of 15 per cent on royalties. However, to attract investment from C it may have to offer a reduced rate of say 5 per cent in order to offset the disadvantage of its relatively high corporate and income tax rates.

The fact that taxpayers resident in country C are offered a lower rate of withholding tax does not reflect the fact that investors from country C are being treated any more favourably than investors from country B, it merely reflects the fact that they require a greater inducement to invest in country A, since country A has rather high domestic tax rates.[21] The withholding tax payable by country C's investors is being lowered, to reflect the lower domestic burden C's

18. See *supra* note 6.
19. I.e. the residence state will have to give less credit since the foreign tax withheld will be smaller.
20. This analysis applies to developed countries (in this instance EU countries). Developing nations may rank attracting inward investment as the primary objective of their treaty policy.
21. I.e. country A's high corporate and personal tax rates impose a significant impediment to inward investment. Offering lower withholding rates is one way of mitigating this impediment.

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investors would face, if they chose to reinvest in their own country.[22]

Indeed with the ever increasing globalization of trade and investment, it cannot make sense to favour investors from specific countries. I.e. an investment of USD 100 million made by a French corporation is surely as welcome as an equivalent investment made by a United States or Japanese investor.

Even if through a historical accident i.e. that the disadvantages that led to a lower withholding rate being negotiated ceased to apply, for instance because country C became a high tax country, the fact that no revision to the relevant treaty is made[23] to reflect this, does not necessarily imply its investors are being favoured vis-à-vis country B's. Indeed, to successfully allege discrimination, comparability must be established.

As mentioned above, comparability as measured by an income rule may be difficult to achieve. This however may not prove too much of a stumbling block if the ECJ is determined to extend the scope of the non-discrimination principle. In this case, perhaps a weak form version of the comparability requirement will be stated as a condition.

However, regardless of the ECJ's ingenuity in this matter, the author is of the opinion that from an economic perspective it is currently impossible to envisage a situation where an investor resident in one country is in an identical or at least "comparable" situation to an investor resident in another country.

Comparability problems include:

The impact of the domestic tax regime. Tax rates normally differ. Even where corporate and income tax rates coincide, the effective tax burden facing investors in each country is likely to vary significantly. Timing issues, the deductibility of expenses, the carry forward and carry-back of losses, capital duties and VAT are among the main tax issues that make a comparison impossible.

Tax treaties. Investors in both countries will have access to their respective treaty networks. These networks will impact upon tax rates, timing issues etc.

In addition, the fact that a tax treaty reflects a bundle of measures also affects comparability. If for instance the relevant third party treaty has a lower rate of withholding tax on interest than the actual treaty, but a higher rate for royalties should taxpayers be allowed to "cherry pick" i.e. to demand the lower withholding rate on interest, whilst retaining the original (beneficial) rate on royalties?

Non-tax factors. The general investment climate in the countries concerned will have a fundamental impact. I.e. interest rates, investment opportunities, etc.

Comparability ignoring these factors is, it is argued, a rather abstract concept, without much relevance to the real world, where economic decisions must be made.

V. WITHHOLDING TAXES

It is possible to argue that withholding taxes should not be seen as discriminatory since they effectively wash out in computing a multinational enterprise's final liability to corporation tax.

Consider the following: country X has concluded tax treaties with countries A and B. The following information is relevant.

	Country X	Country A	Country B
Corporation tax rate	30%	50%	35%
Withholding tax rate (Royalties)	-	10%	5%

Corp X resident in country X has two subsidiaries, Sub A and Sub B, resident in countries A and B respectively. The results of the group for 1996 were as follows.

	Corp X	Sub A	Sub B
Gross Income	200	100	100
Royalties (Gross)	–	(100)*	(100)**
	200	–	–
Tax	(60)***	–	–
Profit after tax	140	Nil	Nil

* Withholding tax 100 X 10% = 10
** Withholding tax 100 X 5% = 5
*** Tax computation

		Corp X
200 @30% =		60
less withholding tax:	Sub A	(10)
	Sub B	(5)
Payable by Corp X		45

As can be seen in this example, the actual difference in withholding tax rates does not affect the group's final corporation tax burden. I.e. the amount distributable to Corp X's shareholders is not reduced by the withholding tax, payable by Subs A and B, since the withholding taxes are fully offsetable against Corp X's corporation tax liability.

The ground for alleging discrimination would be that Sub A has to pay withholding tax at a much higher rate than Sub B. However, as pointed out above provided that the withholding tax is offsetable, no economic discrimination has taken place,

22. Since high withholding rates coupled with a low tax rate in the residence country increase the likelihood that the withholding tax will only be partially offsetable against the main corporation tax liability, it may well be necessary to lower withholding tax rates to ensure that the tax withheld does not become an additional tax and hence a deterrent to investment.
23. In practice, because of the very limited resources states generally make available to facilitate treaty negotiations together with the effects of the standardized approach treaty negotiators take, many treaties are revised only very occasionally. Perhaps in recognition of this certain treaties contain explicit provision for the alteration of withholding tax rates, in the event of a change in domestic tax rates. See for instance, Art. VI Germany–United Kingdom treaty.

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the issue is solely one of allocation of revenues between the countries concerned.[24]

Even if the withholding tax is not immediately offsetable,[25] it is possible to put up a strong argument that the residence country should allow the carry-forward of relief for the withholding tax,[26] and that therefore again the issue is one of allocation not discrimination.

VI. PRACTICAL IMPLICATIONS

On the assumption that Member States treaties with each other reflect the intentional allocation of taxing rights between Member States, a finding by the ECJ that withholding rates different to those contained in the treaties apply is likely to have a significant and perverse impact on state treasuries. Put simply, a finding in favour of the MFN is a large step forward in the direction of residence taxation.[27] I.e. since the highest rate of withholding tax applied by a Member State, may not exceed the lowest rate agreed by that Member State the taxation of income shifts decidedly in favour of the residence state, which may now retain a larger slice of the tax cake for itself.[28] Some Member States would undoubtedly benefit,[29] but only to the extent that other partners lose.

The above is argued on the perhaps overly optimistic assumption that Member States' treaty networks survive the initial aftermath of the introduction of an MFN principle. Consider the following: if state A which has conceded a zero withholding rate to one EU state would be forced to apply this rate to residents of state B with which it has agreed on a withholding rate of 15 per cent, state B would still be entitled to withhold 15 per cent from state A's residents so that the essential symmetry of the treaty would be destroyed. State A would have no choice other than to terminate the treaty with state B. In a very short space of time no treaties between EU Member States would exist.[30]

A finding in favour of the MFN would therefore have profound political implications which could damage the cohesion of the EU.[31] The author argues that the introduction of an MFN requires careful consideration and agreement by all Member States, so that compensatory measures for states adversely affected can be agreed. In addition, states should be given time to renegotiate and coordinate tax treaties to mitigate the downside of the MFN.

VII. CONCLUSION

Given the strong arguments against the applicability of the MFN, and lack of EC law, with which to underwrite a determination in its favour, it is perhaps not surprising that the European Commission, when considering written question 647/92,[32] found against the application of MFN treatment.

In the present climate, where much criticism has been focused on the ECJ for making technical errors,[33] and ignoring economic reality,[34] prudence may dictate that erring on the size of caution is preferable to being accused of adopting an "Alice in Wonderland" attitude.[35]

Whatever approach the ECJ eventually adopts, J.F. Avery Jones' call for the Court to refer to an independent body for expert advice[36] is particularly relevant in the current context. After all, the interests of the European Union will not be best served by replacing *haphazard differentiation* with *rationalized discrimination*. Consideration of the "big picture" is called for.

24. This is a fundamental point. The author argues that provided the withholding tax is offsetable, variations in withholding rates do not per se act adversely against the taxpayer.
The party "adversely" affected might, on the assumption that its enterprises earned little foreign income, be the state who charges the lowest withholding since its revenues would be lower than the state charging the higher rate. However, of course this difference may be more than offset by revenues raised through attracting a greater share of inward investment due to it's lower withholding rates. The equation is an extremely complex one.
25. For example because of start-up losses.
26. The question is therefore one of taxing rights. Withholding taxes are no more discriminatory than corporation tax charged by the resident state.
27. Residence based taxation is unlikely to be the answer if the goal is to eliminate competitive obstacles and disadvantages. In this regard Prof. Klaus Vogel argues that source taxation combined with exemption in the residence state would better achieve this objective. See Prof. Klaus Vogel, "Problems of a Most-Favoured-Nation Clause in Intra-EU Treaty Law" *EC Tax Review* 1995/4 at 264.
28. I.e. it need now only provide relief for a smaller amount of withholding tax.
29. It is possible that there will be an overall shrinkage in the size of the EU tax cake as tax mitigation strategies are developed to direct income flows through the new structure of lower withholding rates.
30. This paragraph draws on the views of Prof. Dr Klaus Vogel.
31. The author argues that the imposition of a principle of taxation which may dramatically affect EU States' taxation rights (and revenues) not only vis-à-vis each other but also with third party states, may put substantial strain on the cohesion of the EU. Indeed, the fact that there is likely to be clear winners and losers under an MFN is likely to aggravate the situation.
This analysis ignores the potential for substantial erosion of the EU tax base that the adoption of an MFN principle might bring.
32. Referred to in the introduction.
33. See Kamphuis H.J. and Pötgens F.P.G. "Goodbye Mr Bachmann, Welcome Mr Wielockx" 50 *Bulletin for International Fiscal Documentation* 1 (1996), at 7.
34. See Avery Jones J.F., "Carry on Discriminating" 36 *European Taxation* 2, (1996) at 46.
35. See *supra* note 14 at 54.
36. See *supra* note 34 at 49. Avery Jones J.F. suggests that the OECD would be well placed to provide an expert opinion for the Court.

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MALAYSIA

A REVIEW OF RECENT TAX DEVELOPMENTS IN MALAYSIA

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I. INTRODUCTION

The National Budget presented by the Minister of Finance on 25 October 1996 was the most significant tax event in 1996. The 1997 Budget has been described as a reasonable and relatively painless budget. It is aimed at strengthening the foundations of the economy and ensuring the well-being of Malaysians.

The economy is expected to grow by 8.2 per cent in 1996 and by 8.0 per cent in 1997 compared to 9.5 per cent in 1995. The current account deficit in the balance of payments is also expected to be reduced from 9.0 per cent of Gross National Product (GNP) in 1995 to 6.3 per cent of GNP in 1996 and to 4.4 per cent of GNP in 1997. Some of the economic indicators for the years 1995 to 1997 are shown in the appendix to this article.

Against this backdrop, the 1997 Budget focuses on the following areas:

- achieving sustainable growth through enhanced productivity;
- strengthening the balance of payments position with improvements in the services sector and higher domestic production; and
- strengthening the agenda for social development.

Due attention has been given to the need for Malaysia to shift towards productivity-driven growth which involves encouraging high-technology industries, multimedia application, automation, research and development and human resource development.

To improve the balance of payments, exports of services are encouraged, tourism activities are promoted, incentives are offered to the financial sector and domestic production capacity is to be increased.

A range of incentives and increased allocations have been granted to the social sector which includes rural development, poverty reduction programmes, housing, health, youth, women, theatre and the arts, and environmental conservation.

This article examines the various measures introduced in the Budget and the Finance Act 1997 with regard to direct and indirect taxation as well as other recent developments in the Malaysian tax system.

II. THE 1997 BUDGET CHANGES

A. Business taxation

1. Purchase of proprietary rights

The purchase of proprietary rights such as patents, designs, models, plans, trade marks and brands is viewed as a purchase of capital assets which does not qualify for a tax deduction. Further, these rights, being intangible assets, do not qualify for capital allowances. However, royalties for the use of these intangibles are tax deductible.

To encourage the acquisition of the latest technology by Malaysian companies, expenditure incurred to purchase such rights is allowed as a tax deduction with effect from year of assessment (Y/A) 1997.[1]

2. Approved loans

By virtue of Paragraph 27 of Schedule 6 to the Income Tax Act (ITA), interest income derived from Malaysia on an approved loan by a person not resident in Malaysia has been exempt from withholding tax.

Such loans must be specifically approved by the Ministry of Finance as an approved loan under Section 2 of the ITA. Currently, subject to certain conditions, the following loans by non-residents are eligible to qualify as approved loans:

- a loan or credit made to the Government, State Government, local authority or statutory body;
- a loan or credit made to any person where the loan or credit is guaranteed by the Government or State Government; or
- a loan or credit exceeding MYR 250 million.

In an effort to encourage more borrowers to obtain loans from the international offshore financial centre of Labuan, the definition of "approved loan" has been amended so as to restrict the third category stated above to applications received prior to 25 October 1996.[2] Thus, after 25 October 1996, approved loan status is restricted to the first two categories.

Thus, loans or credits exceeding MYR 250 million are no longer subject to the withholding tax exemption. However, withholding tax exemption on interest is available on borrowings from institutions in Labuan.

1. The relevant amendment to the legislation has not been introduced.
2. Amendment to Sec. 2(1) of the ITA 1967.

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3. Accelerated depreciation allowances

To further encourage the use of natural gas for vehicles, it is proposed that from Y/A 1997 accelerated depreciation through a 40 per cent initial allowance and 20 per cent annual allowance (i.e. a three-year write off) be granted in respect of the following assets:

- monogas buses operated by transport companies;
- equipment for the provision of natural gas at petrol stations such as gas compressor units, ground storage cascades, dispenser units, control panels, compressor bays, electric cables and high pressure pipes.

It is expected that the relevant statutory order will soon be issued to give effect to this proposal.

4. Withholding tax

Currently, failure to comply with the withholding tax provisions in the ITA with respect to interest, royalties, contract payments and special classes of income would render the payer liable to the following:

- the payment made would not be tax deductible in arriving at the adjusted business income of the payer;
- the imposition of late payment penalties of 10 per cent and 5 per cent on the tax due if it is not paid to the Inland Revenue Board within the stipulated time periods; and
- the payer is liable to pay the tax plus the penalty as a debt due to the Government.

With effect from Y/A 1997, the expense would be allowed as a deduction even though the withholding tax is not paid within one month of the due date, provided such withholding tax and a penalty equal to 10 per cent of the gross amount of the expense is subsequently paid[3]. This total amount constitutes a debt due from the payer to the Government. The amendment regarding imposition of the penalty is effective from 25 October 1996.

The financial impact of the amendment to the penalty provisions is illustrated below:

	Previous MYR	*Current* MYR
Gross royalty	1000	1000
Less: withholding tax (10%)	(100)	(100)
Net royalty payable	900	900

Penalty for late payment of withholding tax:

	MYR	MYR
After 30 days		
10% x MYR 100	10.0	-
After 90 days		
5% x (MYR 100 + MYR 10)	5.5	-
Increase in debt due		
10% x MYR 1000	-	100
	15.5	100
Disallowance of gross royalty (income tax effect 30% x MYR 1000)	300.0	-
Total tax impact	315.5	100

5. Living accommodation

Currently, a manufacturer who incurs expenditure on the construction or purchase of a building for the provision of living accommodation for his employees, is entitled to capital allowances in respect of the expenditure incurred at the rate of 10 per cent annually.

With effect from Y/A 1997, the capital allowance has been extended to include employers undertaking a hotel, tourism business or an approved service project (in relation to transportation, communications, utilities or any other approved sub-sector).[4]

However, for the purposes of this provision, an "employee" must not be a director, an individual having control of the business or a member of the management, administration or clerical staff engaged in that business.

6. Child care facilities

Currently, capital expenditure incurred by an employer in constructing or purchasing a building to establish child care facilities for its employees will qualify for an allowance of 10 per cent annually.

In line with the foregoing, with effect from Y/A 1997, expenses incurred by employers on the provision and maintenance of child care centres for the benefit of persons employed by them in their businesses is deductible from gross income.[5] The deduction does not include capital expenditure incurred on land, premises, buildings, structures or works of a permanent nature or on alterations, additions or extensions thereof in setting up such facilities.

7. Approved musical or cultural group expenses

To encourage the private sector's involvement in the promotion of national culture, a deduction from gross income is to be given with effect from Y/A 1997 to companies establishing and managing a musical or cultural group approved by the Minister.[6] The qualifying expenditure may include expenditure on equipment, instruments, costumes and other related expenses.

8. Approved charity and community projects

With effect from Y/A 1997, expenditure incurred on the provision of services, public amenities and contributions to any approved charity or community project pertaining to education, health, housing and infrastructure is deductible from

3. Amendment to Secs. 39(1)(f)(i) and (j) as well as to Secs. 107A, 109 and 109B of the ITA 1967.
4. Amendment to para. 42A(1) of Sch. 3 of the ITA 1967.
5. Amendment to Sec. 34(6)(i) of the ITA 1967.
6. Amendment to Sec. 34(6)(j) of the ITA 1967.

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gross income.[7] However, the said amount will not qualify for further deduction under Section 44(6) of the ITA as approved donations.

9. Promotion of culture, arts and heritage

Under current legislation, cash donations for the promotion of culture, arts and heritage made to the Government, State Government, local authority or an approved institution or organization under Section 44(6) of the ITA, will qualify for deduction.

In order to encourage greater private sector participation in such activities, the following cash contributions would be deductible as donations from Y/A 1998:

- contribution to a trust account under the Ministry of Culture, Arts and Tourism to sponsor cultural performances including orchestra, theatre and other local cultural performances recognized by the Ministry as national culture;
- contribution to a trust account under the Ministry of National Unity and Community Development to fund research and activities to overcome social problems; and
- contribution to a trust account under the Department of Museum and Antiquities and the Department of National Archives to fund research and activities related to the preservation of national heritage.

With effect from Y/A 1997, a deduction in respect of artefacts and manuscripts donated to the Government or State Government would be allowed based on the valuation determined by the Department of Museums and Antiquities or the National Archives[8]. This will also apply to such donations made by individuals.

10. Donations to technical and vocational institutions

From Y/A 1997, cash donations to technical or vocational training institutions not operated primarily for profit and approved by the Director General of Inland Revenue for the purposes of Section 44(6), will qualify for deduction.[9]

11. Freight charges

Freight charges paid to Malaysian shipping companies for transportation on board Malaysian registered ships currently qualify for double deduction in arriving at adjusted income. However, it has been found that this incentive is not effective in helping to promote the development of the shipping industry in Malaysia and it is therefore to be withdrawn effective from Y/A 1998.

12. Local fund management company

Effective from Y/A 1996, the chargeable income of a foreign fund management company derived from services rendered to foreign investors is subject to a concessionary income tax rate of 10 per cent. Income arising from the provision of fund management services to local investors is taxed at the normal corporate tax rate of 30 per cent.

To further develop the fund management industry in Malaysia and to allow equal treatment to local fund management companies, income derived by local fund management companies from the provision of fund management services to both foreign and local investors will be taxed in the same manner as in the case of foreign fund management companies.[10] This is effective from Y/A 1997.

This is achieved through the redefinition of "foreign fund management company" to mean a company incorporated in Malaysia and licensed under the Securities Industry Act, 1983. This definition would thus include Malaysian-owned fund management companies.

13. Closed-end funds

In seeking to promote Malaysia as a regional financial centre, the Government through the Securities Commission, has been promoting numerous financial products and vehicles. The guidelines on closed-end funds (CEF) were introduced in October 1995. Apart from the exemption on interest earned by CEFs on certain bonds and securities, which was introduced in the 1996 Budget, specific legislation has not been previously introduced on the treatment of CEFs for tax purposes.

With effect from Y/A 1997, CEFs will be treated in the same manner as unit trusts.[11] The principal features of this basis of treatment are as follows:

(i) CEF is defined to mean a public limited company incorporated in Malaysia and approved by the Securities Commission to engage wholly in the investment of funds in securities.

(ii) Gains from the realization of investments by CEFs will be exempted from income tax. Such exempt income arising from gains on realization of investments as well as interest on certain bonds and securities, can be declared as tax exempt dividends to shareholders. The normal two-tier exemption mechanism applies.

(iii) Only a fraction of the following permitted expenses, as in the case of unit trusts, is allowed for deduction in arriving at the total income of a CEF:
- manager's remuneration;
- maintenance of register of shareholders;
- share registration expenses; and
- secretarial, audit and accounting fees, telephone charges, printing and stationery costs and postage.

The fraction of permitted expenses is determined based on the following prescribed formula:

$$A \times \frac{B}{4C}$$

where

A = the total permitted expenses incurred for that basis period;

B = the gross income consisting of dividends and interest chargeable to tax for that basis period; and

7. Amendment to Sec. 34(6)(h) of the ITA 1967.
8. Via introduction of Sec. 44(6)(A) of the ITA 1967.
9. Amendment to Sec. 44(7) of the ITA 1967.
10. Amendment to Sec. 60G(6) of the ITA 1967.
11. Via introduction of Sec. 60H to the ITA 1967.

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C = the aggregate of the gross income consisting of dividends and interest (whether exempt or not) and gains made from the realization of investments (whether chargeable to tax or not) for that basis period.

The deduction shall be at least 10 per cent of the total permitted expenses. However, where a CEF is unable to utilize the deduction in a year of assessment, the excess cannot be carried forward.

14. Exemption on interest earned from bonds

Under current legislation, interest received by an individual, unit trust and listed closed-end fund from bonds (other than convertible loan stock) issued by companies rated by Rating Agency Malaysia Berhad is exempted from tax.

With effect from Y/A 1997, tax exemption is given if the companies issuing the bonds are rated by Malaysian Rating Corporation Berhad which is the second rating agency.[12]

15. Exemption on income of non-resident company for providing lecturers

In line with the objective of overcoming the shortage of expertise in certain fields and to introduce new ideas and techniques to Malaysians, an income tax exemption of 50 per cent is to be given to income derived by any non-resident organization or company from services rendered by their lecturers or speakers in approved organizations and educational institutions in the fields of science, engineering and technical skills, high technology, information technology, and other critical disciplines.

It appears that where the non-resident organization or company has a taxable presence (i.e. a permanent establishment) in Malaysia, the income tax exemption of 50 per cent would be given on the income derived from the selected fields upon submission of its Malaysian tax return. Non-resident organizations or companies that are regarded as having a taxable presence in Malaysia could include those involved in twinning programmes with local colleges or universities.

Where the non-resident organization or company does not have a taxable presence in Malaysia, it appears that the income tax exemption of 50 per cent represents an abatement of the 10 per cent withholding tax (final tax on the non-resident) on the gross income derived from the selected fields. The income tax exemption is effective for five years of assessment from Y/A 1997 to Y/A 2001. The relevant statutory order is expected to be gazetted soon.

16. Cooperative societies

Currently, a registered cooperative society continues to enjoy tax exemption for five years from the date of registration if its members' funds as at the first day of the basis period for a year of assessment are less than MYR 500,000. Members' funds mean the aggregate of the paid-up capital, statutory reserve fund, reserves, balance of share premium account and balance of profit and loss appropriation account.

To encourage the growth of cooperative societies and to allow the members (who are generally from the lower income group) to continue enjoying the benefits of tax exempt dividends, registered cooperative societies with members' funds of less than MYR 750,000 will be exempt from tax with effect from Y/A 1997.[13]

17. Film hire duty and royalties

Prior to 1 January 1997, the Cinematograph Film Hire Duty Act, 1965 required any person desiring to rent any film for exhibition to be registered as a registered renter. Such registered renters were subject to a film hire duty at the effective rate of 15 per cent of gross rental receipts. In view of the film hire duty levied, film rentals paid to non-residents were accordingly not subject to withholding tax.

Effective from 1 January 1997, the Cinematograph Film Hire Duty Act, 1965 has been repealed. Accordingly, film rentals paid to non-residents will now be subject to withholding tax.[14] Rentals derived from motion picture films, films or video tapes or other means of reproduction, where such films or tapes have been or are to be used or reproduced in Malaysia, will now constitute royalties under the ITA 1967. Where such payments are made to non-residents, tax will have to be withheld at the rate applicable to royalties i.e. at 10 per cent of the gross payments.

B. Personal taxation

1. Relief for life insurance premiums

Currently, relief of up to MYR 5,000 is given to an individual on the combined total of contributions to the Employees Provident Fund (EPF) and premium payments made to life insurance companies. However, for life insurance premiums, the payer is only allowed relief of up to 7 per cent of the capital sum assured. With effect from Y/A 1997, the 7 per cent restriction has been removed.[15] This is a move designed to enable a taxpayer to enjoy greater relief in respect of contributions to EPF and premium payments for life insurance policies. Unfortunately, the maximum relief remains at MYR 5,000.

2. Relief for medical expenses

Currently, an individual is entitled to a deduction of up to MYR 5,000 for medical expenses incurred on his parents. However, medical expenses incurred by the individual on himself, his wife or children are not allowed as a deduction.

To reduce the financial burden of those afflicted by serious diseases, a deduction of up to MYR 5,000 (from Y/A 1997) will be given to an individual in respect of medical expenses incurred on himself, his wife or child, provided the individual, his wife or child is suffering from a serious disease.[16] If his wife is earning income and is separately assessed, she will

12. Amendment to para. 35(c) of Sch. 6 of the ITA 1967.
13. Amendment to para. 12(1)(b) of Sch. 6 of the ITA 1967.
14. Amendment to Secs. 2(1), 4A(iii), 15A(c) and Part V of Sch. I of the ITA 1967.
15. Amendment to Sec. 49(2) of the ITA 1967.
16. Amendment to Sec. 46(1) of the ITA 1967.

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also be allowed a separate deduction of up to MYR 5,000 for such expenses she incurs.

"Serious disease" has been defined to include acquired immunity deficiency syndrome, Parkinson's disease, cancer, renal failure, leukaemia and other similar diseases. The claim must be evidenced by a receipt and certification issued by a medical practitioner.

3. Child care facilities

In the 1994 Budget, the Government introduced an incentive in the form of industrial building allowance to encourage employers to provide child care facilities for their employees. Although many employers have responded by establishing such facilities, it is unclear whether these facilities will constitute a taxable benefit to the employees.

To clarify the situation, an amendment has been made (with effect from Y/A 1997) whereby child care benefits provided by employers are excluded from being treated as a benefit in kind to the employees.[17] Thus, holiday travel, medical, dental and child care benefits would constitute non-taxable benefits.

4. Exemption on income from cultural performances

To encourage the appreciation and promotion of national culture and the preservation and conservation of national heritage, resident individuals participating in cultural performances which have been approved by the Ministry of Culture, Arts and Tourism, will be exempt from income tax on the income derived from such performances.[18]

This exemption, however, is only applicable to non-professional performances or individuals who are not performing in their official capacity and is effective from Y/A 1997.

5. Tax treatment of income earned by non-resident lecturers

Currently, non-resident lecturers and speakers at local universities and educational/ training institutions are assessed to tax on income earned in Malaysia at a flat rate of 30 per cent, as in the case of other non-residents.

Under most Double Taxation Agreements (DTA) between Malaysia and other countries, foreign lecturers and researchers who are invited by any university or public institution to teach or conduct research are exempt from Malaysian tax provided that the period of their visit does not exceed two years and that they are taxable in their home country.

In a move designed to help overcome the shortage of teaching expertise in certain specialized areas by securing the services of foreign lecturers/academicians (who are not entitled to treaty exemption) it is proposed that 50 per cent of gross income received by non-resident lecturers and speakers who lecture in approved educational and training institutions/ organizations, be exempted from income tax. This exemption, however, is only granted to lecturers and speakers in specialized fields such as science, engineering and technical skills, high technology, information technology and other critical disciplines.

The above incentive is effective from Y/A 1997 to Y/A 2001 and a statutory order is expected to be gazetted soon.

6. Notification of cessation of employment

Currently, where an employer is about to cease employing an individual, he is required to notify the Director General in writing one month prior to the date of cessation. In addition, an employer is required to withhold monies from the employee's salary until a tax clearance is issued to ensure that the employee's taxes are settled.

The introduction of the Schedular Tax Deduction (STD) scheme in 1995 resulted in the collection of monies on a monthly basis by way of deduction from the employee's salary. The notification of cessation of employment and withholding of monies is inconsistent with the STD scheme since the objective, which is to collect the employee's tax liabilities, would have been achieved under the STD scheme.

Therefore, from 1 January 1997, notification of cessation is not required[19] to be given to the Director General when the following circumstances arise:

- where the income from the employment of the employee is subject to the STD scheme; or
- where the employee's total monthly remuneration from employment is below the minimum amount of income that is subject to monthly STD; and
- the employee is not retiring from employment.

However, it appears that the requirement for employers to withhold monies due to employees will continue to apply, thus requiring a "tax clearance" to be obtained. This appears to be an anomaly which is expected to be clarified by way of guidelines.

C. Tax incentives

1. Incentives for high technology industries

In line with the Government's strategy to shift from labour intensive to knowledge-based technology and capital-intensive industries, the development of selected wafer fabrication products fundamental to the semiconductor industry will be encouraged. It is anticipated that this will strengthen linkages between industries in addition to increasing skills. Wafer fabrication was already granted incentives in the 1996 Budget. No new tax incentive was announced in the 1997 Budget.

2. Incentives for companies located in the Multimedia Super Corridor

Introduced as a catalyst for the development of state-of-the-art information-based industries, the Multimedia Super Corridor (MSC) is a region carefully crafted to enable mutual enrichment of companies and countries using leading technologies in a border less world. A total of eight special areas

17. Amendment to Sec. 13(1)(b) of the ITA 1967.
18. Via introduction of para. 32C to Sch. 6 of the ITA 1967.
19. Amendment to Sec. 83(3) of the ITA 1967.

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will be promoted, including telemedicine, smart-schools, research and development clusters, multipurpose cards and electronic government.

The Multimedia Development Corporation, established by the Government to ensure that MSC companies have the world's best environment for harnessing multimedia services, has a mandate to manage and market the MSC. It is proposed that companies approved by the Multimedia Development Corporation be eligible for the following incentives subject to certain conditions:

- pioneer status for ten years or an investment tax allowance of 100 per cent on qualifying capital expenditure is to be given to new or existing companies;
- exemption from all taxes on multimedia equipment;
- special incentives for companies whose presence will attract other companies to establish their operations in the IT City;
- special guidelines to regulate foreign currency transactions and loans;
- small and medium-scale industries (SMIs) undertaking research and development activities in the MSC are to be given funding under the allocation for Intensification of Research in Priority Areas (IRPA); and
- recruitment of expatriates is to be freely permitted based on necessity.

In addition, the Prime Minister announced the following incentives when launching the MSC on 1 August, 1996:

- MSC companies will be allowed unrestricted recruitment of overseas knowledge workers for the next ten years; and
- there will be no restrictions on foreign ownership within the MSC.

The effective date of the incentives has not been announced. Further, no amendments to the legislation have been introduced as yet.

3. Tourism industry

To encourage the tourism sector, it is proposed that either investment tax allowance or pioneer status be given for the following tourism projects:

- the construction of medium and budget hotels (limited to a three star category hotel as certified by the Ministry of Culture, Arts and Tourism);
- the construction of holiday camps and recreational projects including summer camps;
- the expansion and modernization of existing hotels; and
- the construction of convention centres with a hall capable of accommodating at least 3,000 participants.

It should be noted that the incentives for expansion and modernization of existing hotels were previously withdrawn on 1 January, 1996. Therefore, the above incentives have been reinstated and will be given only once for each existing hotel.

The details of the tax incentives are summarized in the table below:

Types of incentive	Promoted area*	Outside promoted area
Pioneer status		
Tax holiday period	5 years	5 years
% of statutory income exempt from tax	85%	70%
Investment tax allowance (ITA)		
Qualifying period	5 years	5 years
Rate of ITA	60%	60%
% of statutory income against which ITA is deducted	85%	70%

* Promoted area refers to Sabah and Sarawak and the Eastern corridor of Peninsular Malaysia comprising the states of Kelantan, Terengganu, designated areas in Pahang and the district of Mersing in Johor.

The effective dates for the proposed tax incentives are as follows:-

Proposed tourism project	Incentive effective from:-
Construction and expansion of hotels	• 1 January, 1996. • Hotel construction or hotel expansion activity must not have commenced as at 25 October, 1996
Construction of holiday camps and recreational camps	• Applications must be received after 25 October, 1996.
Construction of conference centres	• Year of assessment 1997

In addition to the above incentives, local companies organizing or promoting conferences held in Malaysia will be granted tax exemption on income earned from bringing in at least 500 foreign participants. This proposal is effective from Y/A 1997 to Y/A 2000.

It is expected that the exempt income may be transferred to an exempt income account out of which exempt dividends may be paid to shareholders similar to the income tax exemption given to operators of inbound tours. It is also expected that the above-stated proposals will be enacted by way of statutory orders.

4. Tax incentives for strengthening the industrial linkages schemes

The Government aims to reduce the overdependence on imports of intermediate goods and increase domestic production capacity. One of the special programmes implemented to curb this overdependence on imports is the programme to strengthen industrial linkages, particularly between large firms and SMIs as suppliers of components. The tax incentives introduced to enhance industrial linkages are as follows:

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(i) *Tax incentives for large companies*

It is proposed that the following expenditure incurred by large companies, including multinational companies, for the benefit of SMIs be allowed as a deduction:
- technical assistance;
- training of employees;
- product development and testing; and
- factory auditing to ensure the quality of the suppliers' products.

The above proposal (as no amendments have been made to the relevant legislation) is aimed at encouraging large companies to participate in the industrial linkages programme, thereby encouraging the growth of the SMIs. This incentive is effective from Y/A 1997.

(ii) *Tax incentives for supplier companies*

At present, SMIs which are suppliers of components to large companies are granted pioneer status for a period of five years if their products are in the promoted list. The exemption is limited to 85 per cent of statutory income if the factories are located in a promoted area and 70 per cent if they are located outside the promoted area.

In order to further strengthen the industrial linkages scheme, the following tax incentive is proposed for supplier companies, including SMIs: pioneer status is to be given for a period of ten years to supplier companies which produce intermediate goods under an approved scheme and are capable of achieving a world class standard in terms of price, quality and capacity. The exemption will be given on 100 per cent of statutory income.

The incentives will be effective for applications received after 25 October 1996. However, no legislative changes have yet been introduced.

Type of incentive	
Pioneer status	
% of statutory income exempt from tax	100%
Investment tax allowance (ITA)	
Rate of ITA	60%
% of statutory income against which ITA is deducted	100%

5. Reinvestment allowance

Currently, the reinvestment allowance incentive is given to resident companies carrying out manufacturing and agricultural projects which undergo expansion or diversification of their existing business into any related product, or undertake modernization of their existing business in respect of a product or any related product within the same industry. With effect from Y/A 1997, the incentive has been extended to include the following cooperative societies and associations:
- agro-based cooperative societies (within the meaning assigned under the Farmers' Organisation Act, 1973);
- area, national or state farmers' associations (within the meanings assigned under the Farmers' Organisation Act, 1973); and
- area, national or state fishermen's associations (within the meanings assigned under the Fishermen's Associations Act, 1971).[20]

To encourage reinvestment in equipment which significantly increases productivity levels, it is proposed, with effect from Y/A 1998, that an approved reinvestment be given reinvestment allowance of 60 per cent of capital expenditure incurred as a deduction against 100 per cent of statutory income. The incentive will be similar to that granted to the eastern corridor of Peninsular Malaysia, Sabah and Sarawak. However, it is unclear as to how one would determine whether the reinvestment increases productivity levels. It is hoped that some guidelines will be issued on this in due course.

D. Labuan – International Offshore Financial Centre

The Government's efforts to promote Labuan as an International Offshore Financial Centre (IOFC) since its establishment in 1990 have been facilitated by Labuan's conducive legal framework and environment. Further efforts are now required to enhance Labuan's competitiveness as an IOFC.

(i) *Introduction of securities legislation*

The Minister has announced the formulation of a securities legislation regime specifically to encourage stock market activities in Labuan. Financial services activities based on *Syariah* principles, such as fund management, *Takaful*, loan market, interest-free banking and private debt securities, are also encouraged in Labuan.

(ii) *Offshore Banking Act 1990*

Currently, only commercial banks are granted offshore banking licences in Labuan. The 1997 Budget proposes that the Offshore Banking Act 1990 be amended to allow merchant banks and Islamic banks to operate in Labuan. It is envisaged that banks in niche specialist areas such as corporate advisory services, may be provided with an investment banking licence to operate in Labuan. This is in line with the Government's efforts to promote new offshore banking activities in Labuan.

(iii) *Offshore Companies Act 1990*

Currently, the Offshore Companies Act, 1990 prohibits Malaysian residents other than a trust company, from holding shares in a Labuan offshore company. The 1997 Budget proposes to relax this prohibition whereby Malaysians will be allowed to own offshore companies. Whilst the proposal will encourage Malaysians to own offshore companies, it is expected that the permitted activities of such offshore companies will be restricted to investment overseas.

It has also been proposed to allow non-Malaysian owned offshore companies to undertake portfolio investment in Malaysia. The income from such portfolio investment in Malaysia will qualify for preferential tax treatment under the

20. Via introduction of para. 10 to Sch. 7A of the ITA 1967.

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Labuan Offshore Business Activity Tax Act, 1990 (LOBATA).

(iv) *Labuan Offshore Business Activity Tax Act 1990*

Currently, an offshore trust is defined in the LOBATA as a trust created in Labuan where the settlor and beneficiaries are non-residents. This means that where any beneficiary subsequently becomes a Malaysian resident, the trust's status as an offshore trust will be tainted and the trust would be precluded from enjoying the preferential tax treatment under LOBATA.

With effect from Y/A 1997, the definition of an offshore trust in LOBATA has been amended to be in line with the recently enacted Labuan Offshore Trusts Act, 1996 (LOTA). Although the definition of an offshore trust under LOTA still requires the settlor and beneficiaries to be non-resident at the time of the creation of the offshore trust, the new definition allows the trust to remain as an offshore trust even if any beneficiary subsequently becomes a Malaysian resident. The new definition will thus have the effect of enabling an offshore trust to enjoy preferential tax treatment even if one of the beneficiaries subsequently becomes a Malaysian resident.

(v) *Other tax incentives*

In addition, the following incentives have been proposed which are aimed at promoting the development of Labuan:

- Companies deriving income from providing qualifying professional services such as financial, accounting, secretarial and legal services to offshore companies will be granted an exemption of 65 per cent of statutory income (i.e. profits after deduction of capital allowances). This exemption will take effect Y/A 1997 to Y/A 2000. It appears that this proposal when gazetted will replace the current position which provides for 50 per cent exemption of adjusted income derived by a person from the provision of qualifying professional services to offshore companies.
- The tax exemption of 50 per cent of the employment income of a non-citizen individual serving in offshore companies in a managerial capacity, will be extended up to the Y/A 2000.
- The required period of stay in Labuan for individuals to be eligible to purchase duty free goods has been reduced from 72 hours to 24 hours with effect from 25 October 1996.
- Reduction of road tax by 50 per cent in Labuan effective from 1 January 1997.

E. Petroleum income tax

1. Contributions to approved projects

In line with the Government's aspiration to create a caring and artistic society, deductions against gross income are given for the following:

- expenditure incurred on the provision of services, public amenities and contributions to approved charities or approved community projects pertaining to education, health, housing and infrastructure;
- expenditure incurred in establishing and managing a musical or cultural group approved by the Minister;
- expenditure incurred (not being capital expenditure on land, premises, buildings, structures or works of a permanent nature or on alterations, additions or extensions thereof or in the acquisition of any rights in or over any property) on the provision and maintenance of a child care centre for the benefit of employees.[21]

The above is effective from Y/A 1997 and is similar to the changes made to the ITA 1967.

2. Contribution to Abandonment Cess Fund

Currently, contributions made by a contractor under a production sharing contract to the Abandonment Cess Fund do not qualify for tax deduction. The reason is that the tax authorities view such contributions as not being incurred in the production of income. Since the purpose of the Fund is to ensure funds exist to conserve the environment after the site has been abandoned by the contractor and to be consistent with the tax deduction accorded to contributions to the Petroleum Research Fund, contributions made to the Abandonment Cess Fund will be allowed as a tax deduction retrospectively from the Y/A 1989. The amendment is expected to be legislated by way of a gazette order.

3. Gift of artefacts or manuscripts

In arriving at the chargeable income of a person, a deduction (from assessable income) equal to the value of any gift of an artefact or manuscript made by the person to the Government or State Government will be given with effect from Y/A 1997. The value for the deduction is to be determined by the Department of Museums and Antiquities or the National Archives.[22]

F. Real property gains tax

1. Transactions between connected persons

For real property gains tax purposes, a transaction between connected persons is not treated as an arm's length transaction. In connection with the above, a "relative" is treated as a connected person.

With effect from 25 October 1996, the word "relative" is to be redefined to exclude an uncle, aunt, nephew, niece and cousin.[23] With the proposed exclusion, a transaction with a person's uncle, aunt, nephew, niece and cousin will no longer be treated as one between connected persons.

21. Via introduction of Secs. 16(7B), (7C) and (7D) of the Petroleum Income Tax Act (PITA) 1967.
22. Via introduction of Sec. 22(1A) of the PITA 1967.
23. Amendment to para. 1(1) of Sch. 2 of the Real Property Gains Tax Act (RPGTA) 1976.

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2. Date of disposal and acquisition

Under current law, the date of an agreement is deemed to be the date of disposal (and acquisition) of an asset for real property gains tax purposes. In the absence of such an agreement, the date of disposal is deemed to be the date of completion of the disposal of the asset.

From 25 October 1996, the first reference to an agreement in the above paragraph refers only to a *written* agreement; whilst the second circumstance described would apply where there is *no written* agreement.[24]

G. Indirect taxation

1. Import duties

(i) *Reduction and abolition of import duties*

Unlike previous years, where import duties on thousands of items were reduced or removed, this year's Budget affected only a few items. These include dental alloys, deodorants, cosmetics and soap products, instant print film, duplicating paper, carpets, razor blades, modems, uninterrupted power supplies, and transmission apparatus like transceivers. The changes took effect from 25 October 1996.

(ii) *Reimposition of import duties*

The Minister has gone against the trend of past years' Budgets by increasing import duties (with effect from 25 October 1996) from 5 per cent to 20 per cent, on heavy machinery like track laying bulldozers and angledozers, graders, levellers and scrapers, pile drivers and pile extractors.

The repair and reconditioning of heavy machinery was classified as a promoted activity so as to encourage SMIs in the machinery and engineering industry to participate in this activity. Apparently, the Government is not satisfied with the progress in this sector as a large amount of such machinery remains abandoned and unused. In order to help develop this promoted activity further, import duties on such heavy machinery have been increased.

(iii) *New exemption policy*

In order to strengthen the country's balance of payments, the Government has revamped its policy on ad hoc exemption of import duties on spares and consumables such as replacement parts for machinery/equipment used directly or indirectly in production, and organic or inorganic consumables used directly or indirectly in the manufacturing process. These include items such as screws and bolts, filters, valves, gaskets, refractory bricks and other manufacturing aids.

The hotel industry has not been spared from this revamp. The Government has curtailed the items eligible for exemption in this industry. Items include crockery, cutlery, linen and covers.

The assembly industry (especially electrical and electronic products) is also subject to this new policy. The minimum import duty that has to be paid now on components used in the manufacture of products for the local market is 5 per cent. However, for the export market, the existing policy on exemption remains.

These changes are effective for applications received after 25 October 1996.

2. Export duty

With effect from 25 October 1996, export duty on oils obtained from bituminous minerals (crude) has been reduced to 20 per cent from 25 per cent.

3. Sales tax

The 1997 Budget abolished sales tax on 54 items including canned anchovies, mackerel and tuna, dental materials, uninterruptible power systems, transmission apparatus, paper products, and all types of printing paper. This measure is in line with the Government's policy to reduce inflation.

As a measure to reduce the cost of production of selected non-taxable products such as computers and peripherals, packaging materials made of paper, products of the printing industry, agricultural or horticultural sprayers, plywood, retreaded tyres, uninterruptible power systems and modems, the 1997 Budget exempted all goods used in the manufacture of these products from sales tax.

Special incentives are introduced to promote industries related to the Multimedia Super Corridor by granting tax exemption on multimedia equipment such as uninterruptible power systems, apparatus for carrier-current line systems or for digital line systems.

Sales tax exemption on spares and consumables used in manufacturing is withdrawn to curb imports of these intermediate goods and to improve the country's balance of payment position. Similarly, tax exemption on certain hotel equipment such as crockery, cutlery and linens has been withdrawn. However, those manufactured locally will be exempted. Spares and consumables used for research and development and for approved training will continue to be given tax exemption.

With effect from 25 October 1996, the Sales Tax Act, 1972 has been amended by inserting a new Section 2B which deems a licensed warehouse and a licensed manufacturing warehouse to be both situated outside Malaysia. Consequently, goods sold in the local market will be treated as imports and a higher sales tax will have to be paid.

4. Free zones

The Free Zones Act 1990 has been amended (with effect from 25 October 1996) to allow retail trade and any other activity to be carried out in a free zone, subject to such conditions as the Minister may deem fit to impose.

This would facilitate multinational companies to establish International Procurement Centres in the Free Zones.

24. Amendment to para. 15 of Sch. 2 of the RPGTA 1976.

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5. Service tax

(i) *Export of services*

At present, the Service Tax Act 1975 (STA) requires service tax of 5 per cent to be charged in respect of any prescribed service provided in any prescribed professional establishment or prescribed establishment whether the service is provided to a person overseas or within Malaysia.

In order to avoid diminishing the international competitiveness of Malaysia's professional services, with effect from 25 October 1996, services supplied for and to a person in a country other than Malaysia (excluding Langkawi, Labuan and Free Zones) will not be liable to service tax provided the following conditions are satisfied:

- the service is not supplied in connection with goods or land situated in Malaysia; and
- the person is not in Malaysia at the time the service is performed.[25]

Previously, such exemption was allowed administratively but more recently the authorities had required service tax to be charged where prescribed services were provided in Malaysia to a person overseas.

(ii) *Payment of service tax*

Based on the amendment to Section 14 of the STA, 1975, which was gazetted on 20 July 1995, service tax is due at the time when payment is received for the taxable service provided or when the taxable goods are sold or provided to the customer or purchaser. Where the payment is not received within a period of six months from the date of issue of the invoice, the service tax is due on the day following that period and the service provider is required to pay the tax to the customs authorities.

The six month-period is to be lengthened to twelve months[26] with effect from 25 October 1996. Thus, in cases where the payment for any taxable service provided is not received within twelve months from the date of issue of the invoice, the service tax becomes due on the day following that period.

In the intervening period from 20 July 1995 to 25 October 1996, following several representations by the private sector and professional bodies to the Minister of Finance, the following was decided:

- service tax in respect of invoices issued prior to 20 July 1995 is to be settled only after payment thereof has been received;
- for invoices issued from 20 July 1995 onwards, service tax is to be settled according to the amendment to Section 14 of the STA. However, the due date for payment of service tax on outstanding invoices has been extended to twelve months from the date of issue of the said invoices, instead of six months. Once again, the issue was dealt with administratively.

(iii) *Exemption from service tax*

Currently, service tax is chargeable in respect of medical, health care, consultancy and other services provided by private hospitals with an annual sales turnover of MYR 300,000 or more of prescribed services. To promote Malaysia as an international medical centre and reduce costs borne by patients, the Service Tax (Amendment) Regulations, 1996 provides that from 1 January 1997, service tax in the case of private hospitals will be restricted to the provision of food, rooms for lodging and sleeping accommodation in such hospitals.

Service tax is also chargeable at present in respect of consultancy services where the provider has an annual sales turnover of MYR 300,000 or more of prescribed services. To enhance and promote research and development activities in Malaysia from 1 January 1997, consultancy services relating to research and development companies approved by the Minister of Finance will be excluded from service tax.

(iv) *Widening of scope of service tax*

As a measure to encourage prudence, with effect from 1 January 1997, service tax will be imposed on charge or credit cards provided and issued by a charge or credit card company, including a bank and a financial institution. The rates of service tax for providing and issuing such cards are as follows:

Validity period of card issued	Rate of tax MYR
a. One year or any part thereof	50
b. Exceeding one year but not exceeding two years	100
c. Exceeding two years but not exceeding three years	150
d. Exceeding three years but not exceeding four years	200
e. Exceeding four years	250

This measure, although intended to curb spending, is more a revenue generation measure.

H. Other changes

1. International Procurement Centre (IPC)

IPCs are regional organizations established by manufacturing companies to reap economies on the cost of the provision of services and purchase of raw materials, components and finished products.

To attract multinational companies (MNCs) to use Malaysia as their centre of marketing and distribution, the Minister proposed the following incentives for approved IPCs:

- approval for expatriate posts based on requirements of IPCs;
- the unlimited ability to retain their export proceeds in one or more foreign currency accounts maintained with any licensed commercial bank;

25. Amendment to Sec. 2 of the Service Tax Act (STA) 1975.
26. Amendment to Sec. 14(2) of the STA 1975.

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- the ability to participate in foreign exchange forward contracts with any licensed commercial bank to sell forward export proceeds based on projected sales;
- exemption from the requirements of the Ministry of Domestic Trade and Consumer Affairs Guidelines on foreign equity ownership of the wholesale and retail trade; and
- importation of raw materials, components or finished products without payment of custom duties into Free Zones or Licensed Manufacturing Warehouses for repacking, cargo consolidation and integration before distribution to the final consumers.

The Ministry of International Trade and Industry (which is directly responsible for the promotion of investment in the country) will act as a one-stop centre to process and approve all applications for IPC status.

Local as well as foreign companies may apply for IPC status. They must undertake procurement of raw materials, components and finished products for sale to related and unrelated companies in Malaysia or abroad. This would include procurement from local sources or from third countries.

In order to qualify for the incentives offered, IPCs must satisfy the following criteria:

- a minimum paid-up capital of MYR 0.5 million for locally incorporated companies;
- a minimum total business spending of MYR 1.5 million per year;
- a minimum annual business turnover of MYR 100 million; and
- goods to be handled directly through Malaysian ports and airports.

2. Initiatives for financial and banking sectors

To further develop Malaysia as a premier capital market and services centre in Asia, the Minister announced a package of initiatives to promote the financial and banking services sector. Some highlights of these initiatives include:

(i) *Security broking services*

As a measure to enable local security broking firms to compete with foreign brokers, they are permitted to establish unit trusts, undertake fund management and underwriting activities, and issue call warrants. Subject to certain conditions, they are also permitted to manage listings of companies and undertake electronic share transactions.

In order to facilitate the transfer of technology and expertise from foreign broking firms, foreign equity of up to 49 per cent in domestic brokerage firms will be allowed. The Government will also ensure active Bumiputera participation in this sector.

(ii) *Benchmark bonds*

To promote the expansion of the domestic bond market, the Government will introduce a series of bonds aimed at providing a benchmark yield curve in the private debt securities (PDS) market. These series of bonds will be issued on a regular basis in the form of zero coupon bonds which fulfil Islamic principles.

The investment rules of the EPF, National Savings Bank and the Social Security Organisation will be liberalized to increase their investments in PDS instruments. The level of mandatory investment in Malaysian Government securities by these institutions will also be lowered to encourage the development of the PDS market.

(iii) *Paper less trading of securities*

As a measure to increase the liquidity of the bond market, a system for electronic transfers of funds and securities (SPEEDS) has been enlarged to include unlisted corporate bonds.

(iv) *Islamic share index*

In line with the Government's vision of promoting Kuala Lumpur as a regional Islamic financial centre, an Islamic share index will be introduced on the KLSE.

(v) *Over-The-Counter (OTC) market*

The introduction of an OTC market will allow the trading of shares of high technology companies which are too recently established to have a sufficiently long earnings history.

3. Exchange control – foreign currency accounts

Currently, Malaysian resident exporters are allowed to maintain only one foreign currency account. The amount of proceeds which an exporter can retain in the account is restricted to an overnight balance ranging from USD 1 million to USD 5 million depending on the level of export earnings of the exporters.

It is proposed to allow exporters to maintain more than one foreign currency account and qualified exporters will be allowed to retain up to a maximum of USD 10 million.

4. Road tax

To encourage the wider use of natural gas for vehicles (NGV), the road tax for the following types of vehicles will be reduced from 1 January 1997:

Type of vehicle	Reduction
Monogas vehicles (solely powered by NGV)	50%
Bi-fuel/dual vehicles (petrol or diesel vehicles converted to use NGV)	25%

III. OTHER DEVELOPMENTS

A. The Inland Revenue Board of Malaysia

The Inland Revenue Board (IRB) of Malaysia was established on 1 March 1996 under the *Inland Revenue Board of Malaysia Act 1995*. The new body corporate replaces the Inland Revenue Department.

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B. Tax exempt dividends payable out of offshore income

Foreign sourced income received in Malaysia by a resident company (other than a company carrying on the business of banking, insurance, shipping and air transport) is exempt from tax with effect from Y/A 1995.

By virtue of the Income Tax (Exemption) (No. 31) Order 1995 which came into effect from Y/A 1995, dividends distributed out of the aforementioned exempt income are also exempted from tax. Such dividends would thus not be subject to the Section 108 franking requirements. If the recipient is a company, it may redistribute a second tier of tax exempt dividends.

The effect of the above exemption combined with Malaysia's tax treaty provisions may provide planning opportunities for Malaysian resident companies.

C. Approved Service Projects (ASP)

Under the guidelines issued on tax incentives for the services sector, the following service projects may qualify for ASP status:

Transportation	airline (international sector)/airport operations, seaport operations and rail transport.
Communications	computer/information technology development and satellite-based telecommunication projects.
Utilities	gas pipeline, electricity generation and water/sewerage/toxic waste treatment plants.

D. Partial exemption for trade associations

With effect from Y/A 1996, trade associations resident in Malaysia enjoy the following tax exemptions:

(i) For trade associations established before 1 January 1996 – an exemption of up to 50 per cent of the statutory income for each year of assessment from Y/A 1996 to Y/A 2000.

(ii) For trade associations established on or after 1 January 1996 – an exemption of up to 50 per cent of the statutory income for a period of five years commencing from the year of assessment in which it was established.

E. Exemption on securities borrowing and lending

The Income Tax (Exemption) (No. 30) Order 1995 provides that effective from Y/A 1996, a borrower and a lender are exempt from tax on income arising from:

(i) a loan of securities listed on the Kuala Lumpur Stock Exchange;

(ii) the return of the same or equivalent securities; and

(iii) the corresponding exchange of collateral, in respect of a securities borrowing and lending transaction made under a *securities borrowing and lending agreement*.

To qualify for the exemption, the "borrower" and "lender" must be persons authorized by the Securities Commission to engage as a borrower or lender in securities borrowing and lending transactions under a securities borrowing and lending agreement approved by the Commission.

F. Income from rental of real property

In 1995, the IRB issued a guideline setting out the various situations under which income derived from the rental of property would be treated as income derived from a business source. In February 1996, the IRB amended Paragraph 1.4 of the guideline which deals with rental income from a mixture of residential houses, retail-residential property and commercial buildings. Consequent to the amendment, rental income will be treated as business income under Section 4(a) of the ITA if it is derived from at least four units of residential houses, retail-residential property or commercial buildings.

Further, in October 1996, the IRB issued the following clarification:

1. For the purpose of Paragraph 1.2 of the guideline which deals with rental income from retail-residential property, one unit means a normal double-storey property with the shop area on the ground floor and the residence on the first floor.

   However, every floor of such a property that has a separate legal title is treated as one unit, irrespective of whether the property is owned by a single taxpayer or every floor of the property is owned by different taxpayers.

2. Rental income received from the letting of factories, warehouses and office/shopping complexes qualifies to be taxed as business income under Section 4(a) of the ITA.

G. Double Tax Agreements

To date, Malaysia has signed 46 double tax agreements with the following countries:-

Australia	Jordan	Russia
Austria	Malta	Saudi Arabia
Bangladesh	Mauritius	Singapore
Belgium	Mongolia	Sri Lanka
Canada	Netherlands	Sudan
Czech Republic	New Zealand	Sweden
Denmark	Norway	Switzerland
Finland	Pakistan	Thailand
France	Papua New Guinea	Turkey
Germany	People's Republic of China	United Arab Emirates
Hungary	Philippines	United Kingdom

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India	Poland	United States of America
Indonesia	Republic of Albania	Vietnam
Iran	Republic of Fiji	Zimbabwe
Italy	Republic of Korea	
Japan	Romania	

Notes:
1) The agreements with Saudi Arabia and the United States of America are limited in scope.
2) On 10 December 1996, a new agreement was signed with the United Kingdom to replace the existing agreement.

H. Real Property Gains Tax (RPGT)

Pursuant to the Finance Act 1996, capital gains accruing to an individual who is not a citizen and not a permanent resident on *disposals* of real property or shares in real property companies *after 27 October, 1995* are chargeable to RPGT at the rate of 30 per cent. In the 1995 Finance Bill, it was proposed that the 30 per cent rate of tax was to have been applicable to disposals by the said individuals on chargeable assets acquired after 27 October 1995. Some representations have been made to amend the legislation so as to revert to the position originally proposed in the Finance Bill. It is understood that the Ministry of Finance is looking into this matter.

I. Human Resources Development Fund

The Human Resources Development (Amendment) Act, 1996 provides that with effect from 1 August 1996, employers in the manufacturing industry with at least ten but not more than forty-nine employees and with a paid-up capital of less than MYR 2.5 million are given the option to register with the Human Resources Development Council and contribute the human resources development levy at the rate of 0.5 per cent of the wages of the employees in any month. The coverage of the Human Resources Development Fund has also been extended to the services sector.

Further, Section 6(1) of the Human Resources Development Act was amended to enable an employer who has paid the levy upon registration to immediately qualify for financial assistance under the said Act without having to wait for a further period of five months.

J. Labuan

1. Establishment of Labuan Offshore Financial Services Authority (LOFSA)

LOFSA was established on 15 February 1996 to further develop and promote Labuan as an international offshore financial centre (IOFC). As a one-stop agency, LOFSA will be responsible for licensing, supervising and regulating offshore financial services and activities in Labuan. Its functions include administering and enforcing the offshore financial services legislation and cooperating with offshore financial institutions in Labuan to promote offshore financial services.

2. Labuan Offshore Trust Act, 1996

The Labuan Offshore Trust Act was recently passed by Parliament to provide for the creation and recognition of offshore trusts to further expand the offshore financial services available in Labuan. The Act deals with the creation and recognition of offshore trusts, the role and responsibilities of trustees, secrecy provisions and other legal implications.

IV. CONCLUSION

Overall, the 1997 Budget has adopted the appropriate strategies given the state of the economy and the need to prepare for the various economic challenges that lie ahead. In essence it is all about consolidation, stabilization and facing up to the economic realities.

Although there were no reductions in the income tax rates, Malaysia remains fairly competitive with its neighbours. It is unlikely that income tax rates will be lowered in the next few years as the Malaysian economy undergoes rationalization. Once again, the Sales and Service Tax was not announced. Indeed it is understood that in the short term it is unlikely to be introduced. Theoretically, a comprehensive tax on goods and services is needed. Until then, there is little expectation of any further lowering of income tax rates. We should, nevertheless, still see incentives being introduced selectively as Malaysia moves further along the path towards full industrialization.

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APPENDIX

MAJOR ECONOMIC INDICATORS

	1995	1996[S]	1997[SS]
Gross Domestic Product (growth %)	9.5	8.2	8.0
Per Capita Income (at current prices, MYR)	10,058	11,118	12,171
Consumer Price Index (growth %)	3.4	3.6	3.5
Unemployment rate (%)	2.8	2.6	2.5
Gross National Savings (as % of GNP)	36.5	38.8	41.3
Balance of Payments			
– Merchandise (MYR billion)	0.2	4.6	10.0
– Services (MYR billion)	(19.0)	(19.4)	(21.5)
– Deficit as % of GNP	9.0	6.3	4.4
Total exports (growth rate %)	20.2	4.1	9.4
Total imports (growth rate %)	24.6	1.8	6.7
Manufacturing (growth rate %)	14.5	12.8	12.5
Mining and quarrying (growth rate %)	9.0	3.1	0.9
Construction (growth rate %)	17.3	9.0	8.8
Services (growth rate %)	9.4	8.9	8.7
Agriculture, livestock, forestry and fishing (growth rate %)	1.1	1.6	1.4
International reserves (months of imports)	3.3	4.0	NA
Revenue (MYR billion)	51.0	56.5	60.8
– Direct taxes (% of revenue)	44.5	44.0	44.3
– Indirect taxes (% of revenue)	37.2	37.3	37.7

Source: Economic Report 1996/97, Ministry of Finance, Malaysia.
S Estimate
SS Forecast
NA Not Available

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CANADA

INTERPRETATION OF CANADIAN TREATIES: RECENT DEVELOPMENTS

Jack Bernstein

Aird & Berlis

I. INTRODUCTION

This article examines the impact of the *Kubicek Estate v. Canada*[1] decision on the interpretation of terms contained in Canadian treaties.

II. FACTS

Mr Kubicek Jr. and his wife, both American residents, jointly purchased a cottage in Ontario in 1967 for CAD 17,500. Upon his wife's death in 1981 Mr Kubicek Jr. became sole owner of the cottage. For tax purposes he was deemed to have acquired her half share in the property for its market value at the date of her death i.e. CAD 28,700. The fair market value of the cottage immediately prior to his death on 16 September 1992 was CAD 350,000. At issue was the manner in which the capital gain was to be calculated.

Paragraph 9 of Article XIII of the Canada–US Income Tax Convention (1980) provides relief from Canadian taxation for certain gains accrued before 1 January 1985, (the date the provision came into force) on property owned on 26 September 1980. Basically, the amount of the gain which is liable for tax in Canada in accordance with Article XIII shall be reduced by the proportion of the gain attributable on a monthly basis to the period ending on 31 December of the year in which the US Convention entered into force.[2]

The taxpayer computed the amount of the exempt portion of the gain on the deemed disposition of the one half interest in the property he acquired in 1967 to be CAD 115,045. This amount was arrived at using the following formula:

$$\text{Gain}^{*} \text{ of CAD } 166{,}250 \times \frac{207 \text{ (months } 19/9/67 \text{ to } 31/12/84)}{299 \text{ (months owned } 19/9/67 \text{ to } 16/9/92)}$$

* The gain is derived as follows: (CAD 350,000 – CAD 17,500) x 50% = CAD 166,250.

The total gain on the deemed disposition on death was computed to be CAD 197,505 (the gain on the one half interest acquired in 1981 i.e. CAD 146,300 (CAD 175,000 – CAD 28,700) plus the gain on the one half interest acquired in 1967 less the exempt portion (CAD 166,250 – CAD 115,045). Therefore a total taxable capital gain of CAD 148,128 (75 per cent[3] of CAD 197,505) was reported.

Revenue Canada calculated the exempt portion of the capital gain of CAD 166,250 on the deemed disposition of the one half interest in the property acquired in 1967 to be the lesser amount of CAD 104,156 by applying the following formula:

$$\text{Gain of CAD } 166{,}250 \times \frac{156 \text{ (months } 31/12/71 \text{ to } 31/12/84)}{249 \text{ (months owned } 31/12/71 \text{ to } 16/9/92)}$$

The total taxable capital gain of CAD 234,414 (75% x (166,250 + CAD 146,300)) was reduced by CAD 78,117 (¾ of the exempt portion of CAD 104,156). The Minister therefore reassessed the total taxable capital gain in respect of the deemed disposition on 16 September 1992 to be CAD 156,297.

III. THE ISSUES

The issue was whether in computing the gain reference was to be made to the income tax provisions which generally provided that capital gains would only be taxable after December, 1971 based on the Income Tax Application Rules or whether the Treaty provides additional relief.

In the Income Tax Act (ITA) the term "gain" is not specifically defined. Paragraph 40(1)(a) defines capital gain as the difference between proceeds of disposition and the adjusted cost base. Under the Income Tax Application Rules, the adjusted cost base is the value of the property on valuation day (31 December 1971).

A similar issue had been considered in *Kaplan Estate v. The Queen* 94 DTC 1816 (TCC). The Court indicated that the word "gain" was not defined in the ITA. The Act only defined "capital gain". The "gain" under the Canada–US Tax Convention should not be construed as a capital gain for the purposes of the Act. It is necessary to calculate the "gain" in doing the computation under paragraph 9 of Article XIII. It was held in *Kaplan* that the Minister erred in deducting the adjusted cost base of the property in arriving at the capital gain to which the formula was applied. The appropriate

1. *Kubicek Estate v. Canada* [1996] T.C.J. 841.
2. Alternatively such greater portion of the gain may be relieved as is shown to the satisfaction of the competent authority of Canada to be reasonably attributable to that period.
3. The taxable portion of the chargeable gain.

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method of calculating the formula was to calculate the number of months between the date on which the property was purchased and 1 January 1985 rather than the number of months between 31 December 1971 and 1 January 1985 which was the basis for the Minister's calculation. The Court in *Kubicek* refused to see any distinction between the *Kaplan* case and the case at bar.

Interpretation Bulletin IT-173R2 outlined the tax treatment by Canada of gains derived by residents of the United States arising from the alienation (i.e. dispositions and deemed dispositions) of property in Canada. The method used by the taxpayer in *Kaplan Estate* was specifically delineated in Interpretation Bulletin IT-173R2. Following the *Kaplan* case, Interpretation Bulletin IT-173R2 was revised in February, 1996 to clarify Revenue Canada's position that the Income Tax Application Rules must be taken into account in calculating a capital gain on property owned since 1972 and that these rules would be relevant for the formula in paragraph 9 of Article XIII of the Canada–US Tax Convention. This revision was announced in the Income Tax Technical News No. 4 dated 20 February 1995.

IV. THE VERDICT

The Minister's argument in *Kaplan* was based on Section 3 of the *Income Tax Conventions Interpretation Act* which provides that where a term is not defined in a tax convention, reference may be made to the ITA to obtain its meaning. However, although the term "gain" is not defined in the Income Tax Act Convention, neither is it specifically defined in the ITA. In *Kaplan*, the Judge did not rely on the Interpretation Bulletin but indicated that the Minister was taking a different position from the Interpretation Bulletin (which as indicated above, was subsequently revised). Mr Justice McArthur indicated that he did not agree with the opinions expressed in the amended Bulletin. He therefore held that the time period to be used in calculating the deduction is from the date of purchase of the property and not from 31 December 1971.

V. CONCLUSION

Although the case dealt with a narrow issue, it is interesting as it confirms that Revenue Canada may not always be correct in its published interpretations. Where the Income Tax Convention contains a reference to a term which is not specifically defined in the ITA, then the ITA will not be relevant in its interpretation.

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MEXICO

MEXICO'S NEW TRANSFER PRICING RULES

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I. BACKGROUND

Most OECD[1] Member countries[2] have established transfer pricing guidelines in their domestic legislation which take into account the recommendations issued by the organization's Committee on Fiscal Affairs. Accordingly and in line with the increasingly open nature of Mexico's economy[3], Mexico has decided to incorporate into its internal laws new comprehensive legislation on transfer pricing. The new regime goes beyond the practices and policies adopted by the tax authorities during the *Maquiladora*[4] compliance campaign that began in January 1995.

The reforms recently enacted include provisions governing:

- transfer pricing documentation requirements;
- approved transfer pricing methods;
- multi-year rulings;
- penalty provisions;
- filing fees; and
- the time limit before the *negativa ficta*[5] applies in the case of transfer pricing ruling requests.

Although not expressly stated in the new legislation, the legislators have emphasized in the foreword to the reform the fact that their intent when drafting the provisions was to ensure that the authorities observed the pre-eminence of traditional methods as much as possible[6].

In the case of disagreement between the taxpayer and the authorities, the alternative of competent authority intervention based on the tax treaties entered into by Mexico (which was not legislated under internal laws), is now included as an option. This reform brings the Federal Fiscal Code in line with the terms negotiated under Mexico's various treaties.

One of the most notable changes in the law is that taxpayers now have to document their foreign related party transactions. Notwithstanding this in the case of domestic transactions, Article 64-A still applies so that the *Hacienda*[7] may continue to determine the taxpayer's income which arises on non-arm's length transactions irrespective of the residency for tax purposes of the parties.

II. MAIN POINTS

The main points which arise from the new legislation may be summarized as follows:

- Transfer pricing compliance is highly stressed and its observance is connected to the criteria used to determine whether or not a permanent establishment exists.
- Transactions with low tax jurisdictions (tax havens) are discouraged.
- Endorsement of the arm's length principle following the OECD's Guidelines. (However certain global formulary apportionment procedures are retained.)[8]
- The burden of proof is shifted to the taxpayer, if this burden is not discharged the Hacienda may determine the price or amount of consideration.
- Definitions of *related party*, *comparable transactions* and *comparable companies* are given. In addition the legislation provides for certain adjustments to be made to the comparables.
- The adoption in principle of OECD transfer pricing methods without imposing a specific hierarchy.
- Recognition of an arm's length range and principle. Thus a price, amount of consideration or operating profit margin within the specified range is deemed arm's length. If the taxpayer is outside the range, the median is deemed to be the arm's length point.
- Documentation is required to evidence arm's length transactions and to be eligible for the reduced penalties set out in the legislation.
- The Federal Fiscal Code adopts specific provisions to govern transfer pricing rulings and bilateral APAs and to allow multi-year rulings, it also includes guidelines on corresponding adjustments.

Additional provisions are set out which give the Hacienda the power to determine the prices of importations and exportations and other cross-border charges, as well as to construct dividends under certain circumstances. These provisions give the Hacienda greater powers than are normally associated with traditional transfer pricing regimes.

1. The Organisation for Economic Cooperation and Development.
2. Mexico became a member of the Organisation on 18 May 1994.
3. Mexico has recently introduced trade liberalization, reduced its withholding rates and removed exchange controls.
4. Maquiladoras are in-bond industries that manufacture, process, assemble, and/or repair raw materials and components. The finished or semi-finished products are then typically exported back to the country of origin.
5. Generally, under Mexican law when a tax authority does not respond to a taxpayer's consultation within a period of three months subsequent to the formal request, it is understood the petition has been rejected.
6. Following the guidelines as set forth in para. 2.49 of the OECD Guidelines
7. Mexican Ministry of Finance and Public Credit
8. Art. 4 of the Income Tax Law for permanent establishments and fixed bases and Art. 23 for companies engaged in international air and land transportation.

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Relevant transfer pricing provisions included in the Federal Fiscal Code, Income Tax Law and Federal Law of Dues, which went into effect as of 1 January 1997, state the following.

III. ARTICLE 64 GENERAL ARM'S LENGTH PRINCIPLE

This article sets out the criteria and methods the Hacienda may adopt when assessing income to unrelated parties engaged in non-arm's length transactions.

The article also gives powers to the Hacienda to make adjustments that go beyond the arm's length principle as proposed in Chapter I of the OECD Guidelines. For example it permits an adjustment to be made under the arm's length principle in cases involving tax fraud or tax avoidance.[9]

Further, the legislation seems to conveniently refer to the "arm's length principle" and "market value" as synonymous for transfer pricing purposes.

Finally, it provides that the Hacienda will take into account when determining the price or amount of consideration, arising in connection with import or export transactions or any payment made abroad, the following criteria:

The current national or foreign market prices. Where these are not available, the appraisal that the tax authorities make or have demanded;

The cost of the goods or services derived by subtracting from the market value the percentage of the gross profit using the provisions of the Federal Fiscal Code or the Income Tax Law. The cost will be determined according to Mexican GAAP; and

The price at which a taxpayer sells goods acquired from another entity multiplied by the result of subtracting from the unit the coefficient that could be used to determine the taxable income of the referred to taxpayer according to the Income Tax Law.

IV. ARTICLE 64-A, ARM'S LENGTH PRINCIPLE FOR RELATED PARTY TRANSACTIONS

A. General

Until 1996, Article 64-A granted powers to the Hacienda to determine the prices of related party transactions when such transactions were not carried-out under the arm's length principle.

Under the new article:

(a) The arm's length principle as set forth in the OECD Guidelines is adopted.

(b) Formerly, the burden of proof was on the authorities. From 1st January the amendment shifts the burden of proof on to the taxpayers by stating that corporate taxpayers that carry out transactions with related parties are obligated under the Income Tax Law, when determining their taxable income and authorized deductions, to apply to their transactions the prices and amounts of consideration that would otherwise have been used with or between independent parties in comparable transactions.

B. Definition of related parties

Under the old regime, the Hacienda had powers to determine prices on related party transactions when a party possessed an interest in the business of another party, when the parties had common interests or when a third party had interests in the businesses or goods of both parties. The term interest was not defined. This omission made it difficult to determine the scope of the transfer pricing authority of the Hacienda.

The new article takes the definition of a related party firstly from the OECD Guidelines, and secondly from Article 9 of the Model Tax Convention which clarifies the term and extends the scope of transfer pricing compliance.

The new definition states that two or more parties are related when one directly or indirectly participates in the administration,[10] control or capital of the other, or when a person or group of persons directly or indirectly participate in the administration, control or capital of the said parties.

Unfortunately no definition has been given of what is meant by *direct* or *indirect participation* neither are the terms *administration*, *control* and *capital* defined.

Likewise, no threshold of participation or other parameters to facilitate the application of the law have been given.[11]

C. Comparable transactions and companies

Transactions and companies are comparable for transfer pricing purposes "when no differences exist among themselves that significantly affect the price, consideration or profit margin referred to in Article 65, or where such differences exist, they are eliminated by means of reasonable adjustments".

It seems that the legislator intended to state that the comparison is between the controlled transactions and the comparable ones. The usage of "inexact" comparables is currently an international trend. Indeed in countries like Mexico which have limited access to information on companies and which also lack reliable databases from which to derive transfer pricing information it has become established practice.

In order to identify differences between the controlled transactions and the comparables, guidelines are established that correspond to the five OECD factors determining comparability:

9. Para. 1.2 of the OECD Guidelines
10. "Direction" under the OECD model.
11. Both taxpayers and tax authorities would benefit if the threshold of participation was explicitly stated.

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1. *Characteristics of the transactions*
   Specific guidelines are given for financing, provision of services, sale or use of goods and finally for transactions involving intangible property.
2. *Functional analysis*
   Taking into account the functions or activities, including the risks and assets of each party.
3. *Contractual terms*
4. *Economic circumstances*
5. *Business strategies*
   Including market penetration, permanence and expansion.

D. Methods

There are six methods set out in the new Article 65 of the Income Tax Law. Unlike the OECD Guidelines that discourage the use of transactional profit methods and consider them as last resort methods, Article 65 allows the application of any of the methods. It does not impose a hierarchy or a best method approach.

The methods are as follows:
- Comparable Uncontrolled Price (CUP)
- Resale Price Method (RPM)
- Cost-Plus
- Contribution Profit-Split
- Residual Profit-Split
- Transactional Operating Margin Method (TOMM)

Although sufficient provisions are given to get a basic understanding of the methods, regulations will be needed to provide guidance on their potential application. Furthermore, no safe harbour provisions are extended to the taxpayer in this transition period, apart from the maquiladoras per the 1996 miscellaneous tax provisions.

Legislators stated in the foreword to the tax reform that the methods were drafted following OECD Guidelines. Thus the OECD Guidelines could be taken as a source of interpretation. However, further legislation may be required before the guidelines can be used as an authoritative interpretation in Mexican courts.

The new methods although based on the OECD Guidelines, have certain peculiarities.

1. CUP

CUP takes into consideration the same principle as the OECD version, however the exclusion of the wording "in comparable circumstances" will create conflicts when establishing the criteria for applicability (and thus its reliability,) and when determining the adjustments that must be made to the transactions.

2. RPM and Cost-Plus

RPM and Cost-Plus require the use of the gross margins of comparable transactions and do not give the flexibility allowed by the OECD of applying net margins and projected costs (Article 65 requires actual costs determined under Mexican GAAP). For instance, in the case of the cost-plus method, the OECD allows the costs and expenses of an enterprise to be grouped into three different segments: direct costs, indirect costs of production and operating expenses.

A gross margin method would build a cost base including direct and indirect costs while a net margin approach would also include operating expenses.

Under the OECD Guidelines net margins may show more tolerance than gross profits margins to certain functional differences between controlled and uncontrolled transactions.

The Mexican cost-plus method expressly states that the "plus" shall be computed by dividing gross profit by the cost of goods sold, of the comparable operation or company.

3. Contribution Profit-Split Method

Under the description of the application of the Contribution Profit-Split Method, it is stated that for the division of profits, consideration should be given to elements such as assets, costs and expenses. If these are the only examples that correspond to a functional analysis, the approach is consistent with the OECD Guidelines, otherwise, this could be viewed as a sort of formulary apportionment. We believe though, that these items were expressly mentioned simply to provide examples of elements that have to be taken into account when applying the profit split method.

4. The Transactional Operating Margin Method

The Transactional Operating Margin Method is defined as the method that "consists in determining in related party transactions, the operating profit that would have been obtained by comparable companies or independent parties (sic) in comparable transactions, based on profitability factors which take into account variables such as assets, sales, costs, expenses or cash flows".

This definition which conceptually corresponds to the one set out in the OECD Guidelines, puts an emphasis on the operating profit obtained from comparable transactions. This raises the question as to whether such method based on comparable transactions equates to the comparable profits method (CPM) under US methodology. The CPM evaluates whether the amount charged in a controlled transaction is arm's length, based on indicators from uncontrolled taxpayers, in other words, companies rather than transactions.

It seems that the Mexican TOMM would be equivalent to CPM to the extent that the tested company carries out one transaction or a group of segmented transactions only, otherwise it could be argued that the method is not in accordance with the OECD Guidelines since it compares the consolidated global profits of multinational enterprises.

An example illustrating a situation where both methods approximate to each other would be in the case of maquiladoras. The individual transaction between a conventional maquiladora and its parent is the provision of a service. Meaning that, all endeavours, functions and activities of the maquiladora are synthesized in the provision of a service. Therefore, from a US transfer pricing standpoint, CPM using

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for instance US service providers to establish the transfer price of the services from maquiladora to parent would yield a reasonable result. Likewise, from a Mexican standpoint the use of US service providers to establish a transfer price under the transactional approach under Mexican TOMM would be acceptable as well. Nevertheless, this does not mean that CPM and TOMM are equivalent, an analysis on a case by case basis is required.

Based on the above we would like to reiterate that this CPM-style method should be applied with caution especially with non-US multinationals since in practice it may not be strictly as similar to the OECD's Transactional Net Margin Method as it appears to be at first glance.

E. Accounting principles

For the purposes of determining revenues, costs, gross margins, net sales, expenses, operating profit, assets and liabilities, accounting principles generally accepted in Mexico should be followed.

This principle is stated in Article 65 which addresses transfer pricing methods. In this respect, it is understood that the items of the tested company referred to in the previous paragraph should be determined based on Mexican GAAP. Where non-Mexican comparables are used to determine the transfer price, the observance of this provision will require careful analysis.

Generally, the use of non-Mexican comparables will require adjustments to the financial statements of the comparables in respect of the accounting/valuation method applied to certain transactions. These adjustments are necessary to bring the financial statements of the comparables in line with the Mexican GAAP. Where such adjustments are made, the taxpayer should be prepared to explain and justify the adjustments.

F. Application of methods

Taxpayers are allowed to obtain ranges of prices, considerations or profit margins through the adoption of any of the methods authorized under Article 65 when determining their transfer prices.

Article 65 states that the range may be adjusted by means of statistical methods. No reason is given why this may be necessary, although it is understood that it is in order to obtain a statistically representative sample.

This means that the Hacienda will accept methods which use interquartile ranges, Berry ratios, etc.

Further, in conformity with OECD and IRS Guidelines, the Mexican rules provide that the taxpayer will be found to have determined its transfer price on an arm's length basis, if the amounts are within the arm's length range. Otherwise, the median will be deemed to be the arm's length price. A notable deviation however, from the IRS regulations is that the taxpayer need only apply one method.

Following the spirit of the OECD and since no written provision is contained in the new legislation, taxpayers retain the freedom to apply methods to establish prices not contained in the legislation provided those prices satisfy the arm's length principle in accordance with the Guidelines and provided that the corresponding documentation is prepared and maintained. Therefore the application of a hybrid method is in principle a possibility.

V. DOCUMENTATION

Specific transfer pricing documentation requirements are established which require taxpayers to obtain and retain documentation to evidence that non-resident related party transactions were carried out on an arm's length basis. This obligation is effective for transactions that take place on or after 1 January 1997.

Article 64-A empowers the Hacienda to determine the income arising on related party transactions regardless of the country of residence of the taxpayers. It would seem that in principle Mexican resident companies which do not enter into any non-resident related party transactions are not obliged to document their related party transactions. It is however not clear whether these companies would be eligible to benefit from the reduced penalties if the Hacienda raised an assessment under Article 76 of the Federal Fiscal Code.

The fact that documentation should be contemporaneous is not expressly stated in item XIV of Article 58 of the Income Tax Law which sets out the transfer pricing documentation requirements. Nevertheless, a comprehensive interpretation of this and other transfer pricing provisions implies that documentation should be contemporaneous.

The Hacienda may only request documentation for completed fiscal years, in other words requests for a review of supporting information may only be issued to taxpayers after 31 March 1998.

Item XIV of Article 58 sets out the following documentation requirements;

(a) Name, address and residence for tax purposes of related parties with which transactions are carried out, as well as documentation that discloses the direct or indirect participation.
(b) Information related to the functions or activities, assets used and risks assumed by the taxpayer.
(c) Information and documentation on the principal related party transactions and corresponding amounts.
(d) Details of the method applied under Article 65 including information and documentation on comparable transactions or companies.

A question arises as to the additional burden that this new requirement will impose on taxpayers, however, echoing the views of the OECD, taxpayers should recognize that the production of such documentation will facilitate the resolution of potential transfer pricing disputes with the Hacienda.

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VI. TRANSACTIONS WITH LOW TAX JURISDICTIONS

A salient aspect of the 1997 Mexican tax reform is the attempt to discourage transactions with low tax jurisdictions.

In this respect, it is established that, unless proved otherwise, transactions with corporations or entities located or resident in a low tax jurisdiction, will be deemed to be:

- transactions between related parties; and
- not carried out on an arm's length basis.

This will automatically give the authorities the power to determine the price, consideration or profit margin unless the taxpayer can prove through documentation properly prepared[12] that either arm's length prices were used or that the transactions were between independent parties.

This provision goes beyond the scope of the Guidelines issued by the OECD which state that "Tax administrators should not automatically assume that associated enterprises have sought to manipulate their profits". Clearly there is a risk that taxpayers may incur double taxation where they deal with related parties resident in countries included in the "red list" that are not tax havens from a tax and economic standpoint.

VII. TRANSFER PRICING RULINGS AND DISPUTE RESOLUTIONS

Mexico commenced the enforcement of transfer pricing provisions in 1995 with a transfer pricing ruling campaign for maquiladoras.

A significant addition to the Federal Fiscal Code under new Article 34-A, allows the Hacienda to issue transfer pricing rulings covering up to nine years. The year of issuance, and the next and/or past four years.

This new article gives the Hacienda the authority to reach extended Advance Pricing Agreements (APAs) with taxpayers. Under the old legislation the Hacienda was precluded from issuing rulings dealing with more than one fiscal year.

A period of eight months is established for the Hacienda to resolve APAs. It is understood that, unless this is achieved the terms solicited by the taxpayer will be rejected.

An important aspect is the fact that to this date the written private rulings include wording that confirm the usage of a mark-up rather than the new methodology stated in the amendment to the Federal Fiscal Code. This together with the introduction of multi-year rulings implies that it will be necessary to substantially modify the content of private rulings.

Taxpayers are encouraged under the OECD guidelines to reach extended APAs especially when the application of traditional methods is not straightforward or is difficult to apply,[13] accordingly the Hacienda should facilitate this process.

Further, legal precedence is established for bilateral APAs by providing that transfer pricing rulings may arise from bilateral agreements with countries with which Mexico has a tax treaty. In these cases, the Hacienda may totally or partially waive surcharges provided that the tax authorities of the other country have not accrued interest in favour of the taxpayer or refunded the corresponding tax.

Hence, the Mexican authorities through the mutual agreement procedure negotiated in tax treaties, may be able to resolve disputes over juridical double taxation arising from transfer pricing adjustments.

The above paragraph is inconsistent with some of the new provisions of the Income Tax law due to the fact that the rulings issued under the terms of Article 34 of the Federal Fiscal Code enables a determination of the profitability level of a taxpayer whereas the new Article 34-A states that APAs will authorize the adoption of a methodology for determining the profitability level of a taxpayer.

A 4,000 Mexican peso (MXN) filing fee is established for the processing of a transfer pricing ruling, and a MXN 800 fee for the review of each annual report on the application of a transfer pricing ruling.

In principle under the new regime taxpayers, primarily maquiladoras, which have not yet received their ruling, may be eligible for a multi-year ruling. Further confirmation of this point is advised before filing with the Hacienda.

Generally, taxpayers (subject to certain exceptions) may only file two amended returns. Taxpayers will be allowed to file amended returns based on an adjustment resulting from a mutual agreement procedure irrespective of such limitation. Based on current experience the Hacienda may also waive surcharges for the unpaid taxes if the corresponding payment is made within the mandated time frame after the ruling is notified.

VIII. CONSTRUCTIVE DIVIDENDS

The changes to the law affecting constructive dividends conflict with the OECD Guidelines since paragraph 1.36 of the Guidelines states that an examination by the tax authorities should be based on the transaction actually undertaken by the associated enterprise and only in exceptional cases should that transaction be disregarded or reconstructed. Furthermore the OECD believes that restructuring legitimate business transactions is arbitrary and could result in double taxation.

The constructive dividend provisions of the Income Tax Law were amended to incorporate the definition of related party and to add two new situations that trigger a constructive dividend:

(a) interest not deductible in accordance with item XV of Article 24 of the Income Tax Law (non-arm's length interest)

12. I.e. prepared under the guidelines given in Sec. XIV of Art. 58 of the Income Tax Law.
13. Para. 4.124 of the OECD Guidelines

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(b) interest arising from back-to-back loans, even when granted through financial institutions resident in Mexico or abroad.

In this respect the arm's length principle is invoked in order to avoid the recharacterization of interest payments as profit distributions, interestingly there are no "thin capitalization" rules and thus there may be difficulty in applying the arm's length provisions.

IX. PENALTIES

The provisions of the Federal Fiscal Code include the possibility of reduced penalties where the taxpayer has complied with the transfer pricing documentation requirements.

Penalties may be reduced as follows:
(a) By 25 per cent of the tax omitted when the payment of the tax on the adjustment is made before the Hacienda gives notification of the resolution of the assessment.
(b) For overstated losses, 15 per cent to 20 per cent of the overstatement.
(c) In other cases, 35 per cent to 50 per cent of tax.

X. PERSONAL INCOME TAX SUBJECTS

Transfer pricing provisions are traditionally addressed to corporate entities and individuals that carry out business activities. Under OECD Guidelines reference is generally made to MNE (Multinational enterprise) groups or associated enterprises, suggesting that transfer pricing guidelines apply precisely to commercial transactions. On the other hand, the same guidelines state that transfer pricing should not be confused with problems of tax fraud or tax avoidance.

Under the new wording of Article 74 of the Income Tax Law which governs general taxation aspects for individuals, the definition of related party is extended to cases where "linkage exists among them (the parties) in accordance with customs legislation".

Article 78 of the Customs Law, establishes that linkage exists, among other instances, when there is an employee-employer relationship or when the parties are members of the same family.

No distinction is made between business and non-business transactions. Thus these provisions go beyond the traditional scope of transfer pricing provisions.

XI. MAQUILADORAS

It is expected that the 1997 transfer pricing provisions for Maquiladoras will be issued later in 1997. It is also expected that the safe harbour and APA provisions effective in 1996 will be extended to 1997.

Under previous law, the maquiladora expressly did not constitute a permanent establishment for the foreign related entity, irrespective of the fact that certain transactions may have indeed otherwise constituted a permanent establishment such as the provision of dependent personal services. It seems from the reform that the Hacienda considers that a maquiladora will always constitute a permanent establishment of the foreign related party.

Nevertheless, under a Transitory Article of the 1997 tax reform, it is stated that non-residents that act in Mexico through a Maquiladora will not be deemed to have a permanent establishment in Mexico if their documentation proves that the transactions carried out with the Maquiladora are established on an arm's length basis, and that such documentation is delivered to the tax authorities when so requested.

Maquiladoras that have received rulings from the Hacienda enjoy the following benefits:
- observance of the agreed mark-up;[14]
- no permanent establishment is deemed for the non-resident related party; and
- asset tax waiver on foreign owned assets.

14. Thus the Hacienda may not attribute greater income to the taxpayer merely by raising the mark-up.

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A guide to VAT in the EU. The Single Market changes. 1995 update. Edited by Coopers & Lybrand.
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ISBN: 90 411 0900 5.
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(B. 115.875)

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Funding Europe's solidarity. Resourcing foundations, associations, voluntary organisations and NGOs in the member states of the European Union. A report. Edited by Liam P. Doyle.
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ISBN: 2 930170 00 X.
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(B. 115.746)

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(B. 115.871)

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Mens, Harrie L. van.
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The Hague, Kluwer Law International, P.O. Box 85889, 2508 CN The Hague, The Netherlands. 1995, pp. 86.
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This publication deals with the most important aspects of the relevant legislation in the Netherlands, Germany, Spain and the United Kingdom. In particular, the question of liability of members of the Management Board or the Supervisory Board and the various aspects of the taxation of employees in these countries, tax planning techniques, advantages/disadvantages of the granting of stock options and share-participations to employees are discussed.
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Reference source book for tax advisers, professionals and management involved in international structures, tax planning and advice, both in Germany and the United Kingdom and throughout the world. Explains the provisions in the UK–German double taxation convention and deals with the tax treatment of sources of income and capital gains arising within the United Kingdom which are owned by German residents.
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Privatization and restructuring. An incomplete-contract approach.
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This paper deals with restructuring and privatizing industrial enterprises in a transition economy. As was the case in East Germany, a government privatization agency sells the firms to private investors on the basis of bilateral negotiations. Since the government wants to privatize quickly, the contract between agency and investor was signed before the net value of the firm is known.
(B. 115.852)

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Conyn, G.A.A.; Emmerig, B.; Ettema, C.M.; Koele, I.A.; Mens, K.L.H. van.
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Deventer, Kluwer. 1996.
Fiscaal Actueel, pp. 83. NLG 40.
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(B. 115.771)

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ISBN: 90 200 1851 5.
An overview of the proposal to change the law on substantial shareholdings presented to the Parliament in June 1996, with special references to the individual income tax, corporate income tax, net wealth tax and wage tax. The text of the proposal is appended.
(B. 115.773)

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Amsterdam, Price Waterhouse. 1996, pp. 263.
Guide to assist those interested in doing business in the Netherlands, based on material assembled on 1 January 1996. Information is given on foreign investment and trade opportunities, investment incentives, banking and finance, labour relations and social security, auditing and accounting, taxation of corporations and individuals, shareholders, foreign companies, VAT and other indirect taxes.
(B. 115.803)

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Olffen, M. van; Turkenburg, M.A.Th.; Wagensveld, T.C. van; Wouters, J.C.J.; Mens, K.L.H. van.
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ISBN: 90 200 1847 7.
The authors deal with foreign companies having their business activities in the Netherlands. Description is given of the Dutch legal framework relating to the recognition of a foreign company. A comparative article is devoted to foreign vs. local company structures and activities. Special attention is paid to the residency, non-discrimination and emigration/immigration aspects. Some examples of foreign entities structures such as Delaware Inc., Liechtenstein Stiftung and Anstalt, etc. are given. The texts of the proposals presented to the Parliament on "Wet formeel buitenlandse vennootschap" (No. 24.139) and "Wet conflict recht corporaties" (No. 24.141) are appended.
(B. 115.770)

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Obluda, S.
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Leeuwen, C.H.J. van; Koedooder, M.T.M.; Mens, N.F.M.
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Deventer, Kluwer. 1996, pp. 323. NLG 49.50.
ISBN: 90 312 1381 0.
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Cheastry, Adrienne; Davis, Jeffrey M.
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Schnieder, Ernst-August.
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Comparative study of the corporate tax systems of Germany and Spain. Covers double taxation and its relief both in a national context (shareholder integration) as well as in an international context (foreign tax credit and exemption). Choice of business form, foreign base companies and worldwide versus source-based taxation are also dealt with.
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A comprehensive guide to the taxation provisions relating to land transactions up to and including the 1996 Finance Act. This edition takes into account the implications of the changes to the treatment of interest following the introduction of the "loan relationship" rules in the Finance Act 1996. It includes a comprehensive chapter on the landfill tax, VAT tribunal decisions and commentary, cases relevant to property taxes, tax planning aspects, council tax, inheritance tax and stamp duties.
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Reference source book for tax advisers, professionals and management involved in international structures, tax planning and advice, both in Germany and the United Kingdom and throughout the world. Explains the provisions in the UK–German double taxation convention and deals with the tax treatment of sources of income and capital gains arising within the UK which are owned by German residents.
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Editors Kees van Raad and Rijkele Betten.
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Dolzer, Rudolf; Stevens, Margrete.
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This study reviews modern bilateral investment treaty (BIT) practice as it relates to all the provisions found in a typical BIT. After offering some general considerations, the book examines the scope of application of BITs, with respect to both investments and investors, and to the application in time of investment treaties. The study then reviews provisions relating to the admission of investments, and the treatment standard offered by host countries, including a review of transfer clauses. Finally it discusses the expropriation provisions, and concludes the study with an analysis of BIT provisions on dispute settlements and subrogation.
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The paper considers the various procedures and practices relating to budgeting and accounting for foreign aid, and points out that as a result of the high degree of ringfencing associated with the aid, a kind of functional diarchy has emerged with serious implications for expenditure management in the recipient countries. It concludes that more structured negotiations, improved information systems as well as performance agreements have the potential of avoiding the problems now encountered.
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Washington, IMF International Monetary Fund. 1996.
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This paper discusses how different procedures may lead to different fiscal outcomes, particularly to different degrees of fiscal discipline. It examines theoretical arguments that link procedural rules to fiscal outcomes, it also emphasizes the limits of the literature, and suggests several issues open for further research. By reviewing the empirical evidence drawn from OECD countries, Latin American countries, and the USA, the paper concludes that budget procedures are important determinants of fiscal outcomes.
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(B. 115.580)

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This paper reviews conceptual linkages between taxation and unemployment, available empirical evidence and country policies that may have a bearing on these linkages in the OECD and in a sample of developing and transitional economies. It concludes that the emphasis in policy should be placed on minimizing tax distortions, rather than on formulating activist tax policies to reduce unemployment.
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LUXEMBOURG

HIGHLIGHTS OF THE NEW UNITED STATES–LUXEMBOURG DOUBLE TAX TREATY

Jean Schaffner
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I. INTRODUCTION

On 3 April 1996, Luxembourg and the United States signed a new comprehensive double tax treaty (DTA) which is intended to replace the old treaty of 18 December 1962 (the 1962 treaty). The DTA has not yet been ratified by the contracting states, mainly because 1996 was an election year in the United States. It is likely that ratification will occur in 1997 and that the DTA will then come into effect on 1 January 1998.

The purpose of the DTA is to adapt the framework of Luxembourg–US relations to the current US tax treaty policy, reflected by other recent US double tax treaties (e.g. the treaties signed with France on 31 August 1994 and with the Netherlands[1] on 18 December 1992.[2])

One of the objectives of the United States when renegotiating the 1962 treaty was to include restrictions in the new tax treaty which prevent the use of Luxembourg for the creation of intermediate companies investing in the United States. For this reason, Article 24 of the DTA, containing the limitation on benefits ("LOB") provision, is to be viewed with great care.

This article undertakes an examination of key provisions of the DTA. It also analyses differences with other US treaties with Western European countries which contain an LOB provision. Certain tax planning opportunities which arise from these differences are highlighted.[3]

II. SAVING CLAUSE

The DTA contains a saving clause, which has been introduced at the request of the United States. Article 1 of the DTA, which defines the general scope of the treaty, enables the United States to tax its residents and its citizens as if the DTA had not come into effect. The saving clause extends this taxation right to former US citizens, who surrendered citizenship within the previous 10 years, to save taxes. Although a similar saving clause can be found in various other US tax treaties and already existed in the 1962 treaty, it is interesting to briefly address this provision which reflects the US approach to double tax issues.[4]

From a US perspective, the purpose of the saving clause is that the DTA should limit the taxation rights in respect of non-resident foreigners only. Residents and citizens should always be subject to US taxes on their worldwide income. A tax treaty should not decrease resources of the US revenue and should not facilitate tax avoidance.

The scope and the impact of the saving clause are, however, reduced by the methods for the elimination of double taxation and by Article 1 of the DTA itself. Indeed, Luxembourg is nevertheless allowed to fully tax the persons falling under the saving clause provided the treaty confers the right to tax to Luxembourg (Article 25(3)). The United States will allow Luxembourg tax as a credit against US tax due by their residents and citizens, who fall under the scope of the saving clause. In other words, the saving clause does not have an impact on Luxembourg tax revenue, but may negate Luxembourg tax advantages that would otherwise have been available to US residents and citizens.

Article 1(4) of the DTA further provides (i) that the saving clause shall not affect certain treaty provisions (in particular Article 19 on pensions, Article 26 on non-discrimination and Article 27 addressing the mutual agreement procedure), and (ii) that the saving clause is not directed at non-US citizens, who are not green card holders, for certain kinds of income (e.g. income earned by students or diplomatic agents).

III. DEFINITION OF BENEFICIAL OWNERSHIP AND TRANSPARENT ENTITIES

The DTA gives an interesting definition of the term "beneficial owner" (Article 3(1)), which is important for the articles on dividends, royalties and interest payments. In the presence of a partnership or another entity transparent for treaty purposes, treaty benefits will be available to the members of this entity, in as far as they are subject to tax on the relevant income in their contracting state of residence. For example, if

1. Hereafter referred to as the "Dutch treaty" and the "French treaty".
2. For a very detailed analysis of the tax treaty between the United States and the Netherlands, see "A Commentary to the United States–Netherlands Tax Convention", *Intertax* Special Issue, May 1993.
3. The purpose of this article is not, however, to give a complete outline of the whole DTA. Certain aspects are therefore presented in a simplified way only, to facilitate the analysis.
4. For detailed developments on the saving clauses imposed by the United States, see Klaus Vogel, *DBA Doppelbesteuerungsabkommen Kommentar* (Beck, 1990), at 89.

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a Luxembourg general partnership (*société en nom collectif*) derives US-source interest payments, Luxembourg resident members of that partnership may enjoy the withholding tax exemption of Article 12 of the DTA. Similarly, US resident partners of a transparent US limited liability company may also be deemed beneficial owners of Luxembourg interest payments and are thus entitled to treaty benefits.

Difficulties may arise where the transparent entity originates from a third country (e.g. a French general partnership – *société en nom collectif*). In the author's view, the setting-up of a transparent entity under a jurisdiction of a third country should not prevent members of this transparent entity, who are residents of one contracting state, to be granted treaty benefits for income derived through that transparent entity from the other contracting state. This analysis is consistent with Luxembourg tax law.[5] Further, a situation involving a French general partnership has also to be analysed under the French treaty. In an exchange of letters annexed to this treaty, the United States has declared that it is prepared to apply the tax treaty it has entered into with the country of residence of the member of the partnership. Thus, in the above example, the United States would apply the DTA signed with Luxembourg if US-source income is derived through a transparent French general partnership by a taxpayer resident in Luxembourg.[6]

Another difficulty lies in the definition of a "transparent entity". It can easily be imagined that an entity transparent for Luxembourg tax purposes would be recognized as a taxable company in the United States. The Treasury Department Technical Explanations indicate that the qualification of the contracting state where the members of the entity reside is relevant.[7]

In a way similar to Article 3(1), Article 4(1)(b) of the DTA indicates that a partnership qualifies as a resident of a contracting state to the extent that the income derived by it is taxable in that state either in its hands or in the hands of its partners. For example, from a Luxembourg perspective, capital gains on the sale of a substantial participation in a Luxembourg company by a US partnership having two members, one being a US resident, the other one being a resident of a third (non-treaty) country, will be taxable in Luxembourg to the extent that the gain corresponds to the share of the third country resident in the US partnership's profits. The fraction of the capital gain realized by the transparent US partnership which is subject to tax in the United States at the level of the US resident member is deemed to be derived by a US resident for DTA purposes.

To benefit from the super-reduced withholding tax rate on dividends (Article 10(2)) the beneficial owner has to hold a *direct* participation in the voting stock of the distributing company. This test does not bar a company member of a transparent entity from benefiting from this super-reduced withholding tax rate as this member is deemed the beneficial owner of the dividends, by virtue of Article 3(1) of the DTA. He is therefore considered to be the direct owner of the participation in the distributing company.

IV. TAX RESIDENCE, DUAL RESIDENT COMPANIES

The residence of taxpayers is defined by Article 4 of the DTA which refers to the domestic law of both contracting states, and only includes a tiebreaker clause for individuals. For companies, the United States basically looks at the place of incorporation of the company, while Luxembourg considers its place of effective management. Thus, a company incorporated in the United States and managed in Luxembourg is deemed a resident of both contracting states for treaty purposes.[8]

In respect of dual resident companies, the DTA requires that the competent authorities of both contracting states (i.e. the US Secretary of the Treasury and the Luxembourg Minister of Finance) determine the company's residence for treaty purposes by mutual agreement with regard to its place of effective management, its place of incorporation and other relevant factors. In the absence of an agreement, the company will be deemed a resident of neither contracting state under the DTA. The purpose of this rule is to encourage taxpayers to organize their affairs so as to minimize the possibility of dual residence.[9]

The shareholders of a dual resident company will nevertheless not be excluded from treaty protection.[10] Accordingly, shareholders of one contracting state of a dual resident company would be entitled to treaty benefits on royalties paid by this company which are deemed originating from the other contracting state. Indeed, royalties are deemed to arise in a given contracting state if they are paid for the use of property or know-how in that state (Article 13(4) of the DTA). This source rule means that the residence of the payer is not directly relevant. For interest payments, the relevant criterion is the location of the permanent establishment (in Luxembourg or in the United States) of the dual resident company in connection with which the indebtedness was incurred, provided the interest being paid was borne by that permanent establishment (Article 12(4) of the DTA).

No solution apparently exists for dividend distributions. Each contracting state may consider that the dual resident distributing company is a resident of its jurisdiction for the application of the withholding tax on dividends.[11]

Another interesting feature is that pension funds and other not-for-profit organizations qualify as residents under the DTA. Hence, Luxembourg-source passive income (e.g. divi-

5. See Alex Sulkowsky, "International tax problems of partnerships", Luxembourg report, *Cahiers de droit fiscal international* 80a (Kluwer, 1995), at 371.
6. See Bruno Gouthière, "France: New tax treaty with the United States, 35 *European Taxation*, 3 (1995), at 95.
7. Treasury Department Technical Explanations of the convention between the government of the United States of America and the government of the Grand Duchy of Luxembourg for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital signed at Luxembourg on 3 April 1996, released on 18 September 1996.
8. The same difficulty may arise under Art. 4(4) of the Dutch treaty and under Art. 4(4) of the French treaty.
9. See Treasury Department Technical Explanations, Art. 4.
10. See Jean-Pierre Winandy, *The 1996 US – Luxembourg Income Tax Convention*, edited by Fiduciaire Générale de Luxembourg (1996), at 7.
11. See *supra* note 2, at 178.

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dends and interest payments) derived by a US pension fund may benefit from the reduced withholding tax rates of the DTA.

V. DIVIDEND WITHHOLDING TAX

Article 10 on dividends is, on the one hand, more favourable than the former US–Luxembourg tax treaty and, on the other hand, less generous. Under the 1962 treaty, the Luxembourg withholding tax was reduced to 5 per cent in the presence of a substantial shareholding and to 7.5 per cent for portfolio dividends and dividends earned by individuals. The DTA provides that the withholding tax on Luxembourg and US-source dividends may not exceed 5 per cent of the gross amount of the dividends if the beneficial owner is a company that owns directly at least 10 per cent of the voting stock of the distributing company. Otherwise, the withholding tax rate may not exceed 15 per cent. Consequently, US individuals, or companies not holding a substantial participation in the Luxembourg company paying the dividends, will bear a 15 per cent Luxembourg withholding tax, instead of only a 7.5 per cent tax.

However, according to Article 25(1), the United States will allow the Luxembourg withholding tax as a credit against the US income tax. The impact of this increase of the tax rate on the overall tax burden of the US resident beneficiary will therefore in most cases be reduced. The increase would, however, affect exempt US entities entitled to treaty benefits.

In this respect, it is also interesting to note that the DTA contains in its Article 30(3) a grandfathering provision, whereby a taxpayer may elect to benefit for one year after the entry into force of the DTA from more favourable provisions of the previous treaty of 1962. Accordingly, dividends distributed during the first year of application of the new treaty may, on option, still be subject to a 7.5 per cent withholding tax in Luxembourg. This option implies that the old treaty will be applicable to this taxpayer in its entirety, which means that no cherry-picking is possible.

Where a US parent company has held for at least two years at the date of distribution a direct holding of at least 25 per cent of the voting stock of the Luxembourg distributing subsidiary, Luxembourg will exempt from withholding tax dividends distributed by this Luxembourg subsidiary to its US parent. Only dividends attributable to shares individually complying with this two-year holding period may be exempt. A similar provision, based on the EC Parent-Subsidiary Directive of 23 July 1990 (90/435), can also be found in the Luxembourg–Switzerland double tax treaty dated 21 December 1993. This withholding tax exemption shall only apply to dividends paid out of profits originating from the active conduct of a trade or business (including banking and insurance undertakings) in Luxembourg.[12] It is not necessary that the distributing company itself carries on an active trade or business in Luxembourg, it may in fact merely redistribute dividends received from an operating subsidiary in Luxembourg.

Foreign-source profits do not qualify for this exemption, which is also not available for the redistribution of passive investment income generated by a Luxembourg industrial or commercial company. It may therefore be important to trace the (active, passive or foreign) origin of profits distributed by a Luxembourg company.

In view of the provisions for the relief of double taxation, this restriction, which does not exist in the above-mentioned Luxembourg–Switzerland treaty, is perfectly justified. Indeed, the United States applies the credit method for eliminating double taxation. If a US company owns at least 10 per cent of the voting power of a Luxembourg company distributing dividends, the tax credit available in the United States will include the Luxembourg withholding tax and the underlying corporate income tax paid by the distributing company on the profits out of which the dividends are paid (Article 25(1)(b) of the DTA).

If the Luxembourg distributing company is a mere holding company benefiting from the Luxembourg participation exemption (Soparfi regime), it may be exempt on its income consisting of dividends and of capital gains on the sale of substantial participations. There is no reason for Luxembourg to grant incentives, i.e. a withholding tax exemption, that will vanish in the United States, as the beneficiary will be fully taxed on the dividends received from a Luxembourg Soparfi. However, a US parent company having an active subsidiary in Luxembourg may, depending on its own income tax burden, take advantage of the absence of withholding tax in Luxembourg.

The provisions of Article 10 are also applicable where a beneficial owner of dividends holds depositary receipts evidencing the ownership of the shares in respect of which the dividends were paid. Under the Dutch treaty, the holder of depositary receipts may benefit from the super-reduced rate of 5 per cent available to a company owning a substantial participation in the distributing subsidiary. He may, however, not avail himself of the reduced rate of 15 per cent if he merely receives portfolio dividends.[13]

Article 10(3) includes participatory bonds in the list of securities the income of which qualifies as dividends. The state of residence of the distributing company may further include in the term "dividend" all income distributed by a domestic company which is treated as a distribution under its own tax law. Thus, from a Luxembourg perspective, silent partnership interest payments should be treated as distributions and be subject to the withholding tax on dividends if derived by a US resident.[14]

12. The wording initially inserted in Art. 10(2)(b) was more ambiguous, as it merely required that "the Luxembourg company that distributed the dividends is engaged in the active conduct of a trade or business in Luxembourg".
13. See *supra* note 2, at 177.
14. In general, a silent partner (*bailleur de fonds typique*) participates, under domestic law, in the profits of the undertaking in which he made an investment, and thus earns income subject to the withholding tax on dividends. He is, however, not entitled to a share of the liquidation surplus and does not have to contribute to the undertaking's losses. Unlike a *bailleur de fonds atypique*, deriving business profits from its participation, he may therefore not be deemed co-owner of the undertaking. See for example Art. 5 and protocol of the Luxembourg–Germany tax treaty dated 23 August 1958; see further Klaus Vogel, *DBA Doppelbesteuerungsabkommen Kommentar* (Beck, 1990), at 634 and 675.

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VI. BRANCH TAX

Article 11 of the DTA enables the United States to apply a branch tax of 5 per cent to the business profits of a US permanent establishment of a Luxembourg resident and to income and capital gains derived by this resident from its US real property. In substance, the branch tax is levied on the dividend equivalent amount[15] that is transferred to the home office, instead of being reinvested in the US branch. Under the Dutch treaty (Article 11), the branch tax is limited to the profits accumulated by the branch after the treaty entered into effect. No such restriction exists in Article 11 of the DTA. It is therefore advisable to repatriate accumulated branch profits prior to the date of the first application of the new Luxembourg–US tax treaty. Under the current treaty neither of the contracting states could withhold a branch tax.

The branch profit tax is, to some extent, in conflict with Article 26(2) of the DTA, which prohibits the taxation of permanent establishments that an enterprise of a contracting state has in the other contracting state in a less favourable way than the taxation of domestic enterprises of that contracting state. Article 26(5) therefore expressly indicates that the non-discrimination provision does not prevent the levy of the branch tax.

VII. INTEREST PAYMENTS AND ROYALTIES

Article 12 exempts interest payments from withholding at source in the country of the payer. Article 12 reflects Luxembourg domestic tax law, as well as Luxembourg treaty policy. Like Article 10 (dividend payments) and Article 13 (royalties), the exemption is available conditional upon the fact that the recipient of the payments is the beneficial owner thereof.

By application of Article 13 of the DTA, royalties may benefit from a withholding tax exemption, which should favour cross-border streams of income between both contracting states. Under Luxembourg domestic law, royalties are, in general, exempt from withholding tax, except if they are paid for literary or artistic work or on inventions used, or patents registered, in Luxembourg. However, no internal provision allows a withholding tax at source on other industrial property rights, know-how or trade marks.

The treaty definition of the term "royalties" is extensive and encompasses income from literary, artistic (including audio and cinematographic rights, video tapes, disks and other means of reproduction) and scientific work, patents, trade marks and other industrial property rights, as well as information concerning industrial, commercial or scientific know-how. It also includes gains arising on the alienation of such property, if the gain is related to the productivity of the property. This list is similar to the one contained in the old 1962 tax treaty, which granted a withholding tax exemption for royalties and interest payments.

In comparison to, for example, the US–Netherlands tax treaty, this enumeration also includes cinematographic rights. Despite this very comprehensive list, the incorporation of royalty companies in Luxembourg should nonetheless be contemplated only after a complete examination of the LOB provision of Article 24 of the DTA.

VIII. CAPITAL GAINS

Article 14 of the DTA addresses capital gains and offers welcome clarification in comparison to the 1962 treaty, which merely contained a source rule for capital gains, but no direct allocation of the right to tax (except on real estate). The new DTA follows the principles of the OECD, save for real property companies. In essence, a contracting state may tax capital gains on the sale of shares of a company of the other state investing predominantly in real estate situated in its jurisdiction.

Another beneficial change is the inclusion of a residual article focusing on income not dealt with under any other article of the DTA (Article 22).

IX. LIMITATION ON BENEFITS

Even if a person is a resident of a contracting state, he is nevertheless not automatically granted the benefit of treaty protection. The LOB provision should prevent treaty shopping, where an intermediate company is set up in a jurisdiction which offers a favourable tax environment and further has a comprehensive double tax treaty with the United States. In the absence of an LOB provision, the United States will have to grant treaty protection to this intermediate company, even though it might not be keen on granting similar advantages to the country of residence of the final investors. In that situation, the benefits of the structure will belong to the intermediate country and to the country of origin of the investors. These two countries may derive additional income and tax revenue from this structure, while the United States will lose tax revenue because of it. From a US perspective, every foreign investor should pay an appropriate portion of US taxes. The United States does not want its tax treaties to "turn into open-ended contracts with the entire world".[16]

Provisions similar to Article 24 of the DTA can be found in other recent US tax treaties (entered into e.g. with Switzerland, Portugal, France, the Netherlands, Spain and Sweden). Older treaties signed by the US had already tended to exclude certain residents from the benefit of the articles addressing withholding taxes on dividends, interest payments and royalties.[17]

The LOB provision distinguishes between qualified residents, non-qualified residents enjoying limited protection and excluded persons (i.e. non-residents within the meaning of Article 4 and residents who fail the LOB test). The test is

15. As defined by US domestic tax law, see Treasury Department Technical Explanations, Art. 11.
16. See H. David Rosenbloom, "Derivate Benefits: Emerging US Treaty Policy", *Intertax* February (1994), at 83.
17. See for example, the US–Belgium treaty dated 9 July 1970, as amended in 1987.

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applied on an annual basis. A person who qualifies for treaty protection during a given year may indeed be excluded therefrom in the following year. The LOB test has to be met in both directions, i.e. Luxembourg may also refuse to apply provisions of the treaty to US residents who do not comply with the LOB test. Below, we will examine the LOB provisions from the more sensitive perspective of a Luxembourg resident investing in, or deriving income from, the United States.

A. Qualified residents

A resident of a contracting state is a qualified resident for a taxable year if he meets *one* of the following *alternative* conditions:

- Article 24(2)(a): an *individual* is always a qualified resident.
- Article 24(2)(b): a *public entity* of one of the contracting states is always a qualified resident.
- Article 24(2)(c): Shareholder/base erosion test *(see below)*
- Article 24(2)(d): *Stock quotation test (see below)*
- Article 24(2)(e): *Public ownership/base erosion test (see below)*
- Article 24(2)(f): a *not-for-profit organization* qualifies as a resident under the LOB provision if more than half of its members are qualified residents.

1. Article 24(2)(c): Shareholder/base erosion test

The shareholder/base erosion test is met if, at the same time, 50 per cent of the principal class of shares of a company is ultimately owned by qualified residents or by US citizens and that company does not fail a base erosion test.

The ultimate ownership test does not mean that direct ownership is required. Intermediate owners are disregarded. A Luxembourg public limited company (*société anonyme*) may have registered or bearer shares. Bearer shares may qualify under the shareholders test although it may be difficult to establish the ownership of these shares.

The ownership test merely requires the holding of 50 per cent of the principal class of shares of the relevant company, which means that it is not necessary that 50 per cent of the total share capital of the company is held by qualified residents.[18] The DTA is, in this respect, more advantageous than, for instance, Article 30(1)(d) of the French DTA and Article 26(1)(d) of the Dutch DTA. The term "principal class of shares" generally refers to the ordinary or common shares of the company, provided that such class represents the majority of the voting power and value of the company.[19]

Under the base erosion test payments to beneficiaries other than qualified residents of either contracting state (or to non-US citizens) that are deductible for tax purposes, other than arm's length payments in the ordinary course of business, must not exceed 50 per cent of the gross income of the company for that year. Under the Dutch treaty, there is an alternative to pass the base erosion test. A Dutch company also meets the base erosion test if less than 70 per cent of its gross income is used to make deductible payments to non-qualified persons under the Dutch treaty and less than 30 per cent is used for deductible payments to persons that are neither qualified residents nor European Union residents. A similar possibility is given under the French treaty.

Non-tainted arm's length payments in the ordinary course of business are those payments made "for services or purchases or rentals of tangible property including immovable property". The purpose of the negotiators was to disqualify from treaty benefits companies that deduct excessive amounts of royalties and interest payments from their taxable profits. From a broad perspective, however, payments for services may, *inter alia*, include financial services. A distinction has therefore to be drawn between mere "passive" interest payments and consideration for services rendered. The base erosion test should, for instance, be met by a Luxembourg company paying finance charges to a non-qualifying contracting party in relation to the acquisition of business assets.

Obviously, under domestic tax law, payments effected in the ordinary course of business by a Luxembourg company must always be in accordance with the arm's length principle. Otherwise, these payments would be deemed abnormal transactions and, as such, would not be tax-deductible expenses. Quite often, the Luxembourg tax authorities are prepared to grant a ruling with a view to certify that a transaction is acceptable to them. A ruling may ascertain an appropriate profit margin taxable in Luxembourg, for instance if a Luxembourg company acts as a group finance company and onlends to group members funds borrowed intra-group or from third parties.[20] A group finance company deducts a significant amount of interest payments and finance costs from its taxable profit. If the beneficiaries of these interest payments are not qualified residents, the group finance company may fail the base erosion test. Because of the size of the Luxembourg economy, the base erosion test of the DTA unfortunately offers little flexibility.

2. Article 24(2)(d): Stock quotation test

A listed company, the shares of which are substantially traded either on any stock exchange registered with the SEC, or on the NASDAQ, the Luxembourg stock exchange or the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, London, Madrid, Milan, Paris, Sidney, Tokyo and Toronto has access to treaty benefits. The list of recognized stock exchanges does not include either the EASDAQ, created in 1996, or the Zurich stock exchange. This last exclusion may adversely affect Luxembourg subsidiaries of Swiss banks.[21]

The list of recognized stock exchanges is reduced if the company, desirous to qualify for treaty benefits, is a closely held

18. See Harrison J. Cohen, Lawrence A. Pollack and Roger Molitor, "Analysis of the New US–Luxembourg Income Tax Treaty", *Tax Management International Journal*, July (1996), at 412.
19. See Treasury Department Technical Explanations, Art. 24.
20. Similar rulings may be negotiated in other countries, including the Netherlands.
21. See Frank Muntendam, "Luxembourg: New Tax Treaty with the United States", 36 *European Taxation*, 12 (1996), at 386.

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company, meaning that, despite the quotation, 50 per cent or more of the principal class of its shares is owned by persons who are neither qualified residents under the DTA, nor residents of a Member State of the European Union or of a state that is a party to NAFTA, each of these persons owning more than 5 per cent of the shares for more than 30 days during a taxable year. In that case, the Luxembourg stock exchange and the NASDAQ are not recognized stock exchanges. In substance, the negotiators of the DTA considered that the obtaining of a listing in Luxembourg or on the NASDAQ was relatively easy, and could have led a company to seek a listing although it did not have a broad shareholding.

The shares are substantially traded if at least 6 per cent of the principal class of shares is traded during the previous year. As opposed to the Dutch treaty, the DTA does not require that significant trades are effected every month.

At the end of 1996, 43 Luxembourg companies[22] were listed on the Luxembourg stock exchange. Of these companies 24 had a share capital denominated in Luxembourg francs. We have investigated if the principal class of shares of these 24 companies is substantially traded on the Luxembourg stock exchange.[23] In fact only four companies – Luxempart, Selangor Holding, Banque Internationale à Luxembourg and CEGEDEL – meet this test. Large Luxembourg companies such as Arbed, Audiofina, Kredietbank or Banque Générale de Luxembourg fail it. Further, most of these companies are not traded on any other recognized stock exchange, save for instance for Arbed, Ares-MMRA, Audiofina and CEGEDEL which are all also listed in Brussels. It is therefore quite likely that insufficient attention was paid to the size of the Luxembourg economy when including these stock quotation criteria.

3. Article 24(2)(e): Public ownership/base erosion test

A company directly or indirectly controlled by listed companies, within the meaning of Article 24(2)(d), satisfying the base erosion test of Article 24(2)(c), is a qualified resident under the DTA. The term "control" refers to the ability to influence the actions of the company, but does not necessarily require a majority ownership.

There is no requirement as to the number of ultimate listed shareholders of this Luxembourg subsidiary, and the wording of the DTA does not require that the listed shareholders of this subsidiary should be resident in Luxembourg, the United States or the European Union. According to Frank Muntendam,[24] the Luxembourg authorities concur with this prognosis.[25] This represents an advantage of the DTA over the French and Dutch treaties. Unfortunately, the Treasury Department Technical Explanations have indicated that the test of Article 24(2)(e) is open exclusively to subsidiaries of listed Luxembourg and US companies.

B. Non-qualified residents benefiting from limited treaty protection

1. Article 24(3): Active business test

A non-qualified resident of Luxembourg may nevertheless benefit from treaty protection with respect to income derived from the United States if it satisfies a quite complex active business test. To that effect, four criteria have to be considered:

(i) The company must be engaged in the *active conduct of a trade or business* in Luxembourg (other than a mere investment business). The Luxembourg company may either be directly engaged in this trade or business, or indirectly, via an associated enterprise. Consequently, a Luxembourg holding company may be able to meet this test if the income is generated by one of its operating subsidiaries.

(ii) The US income is only *incidental* to the Luxembourg activity. The incidental character of the US income is taken as given where the US income merely facilitates the conduct of the Luxembourg business. As an example the contracting states indicated that the investment of working capital by a Luxembourg undertaking in the United States may have an incidental character to its Luxembourg business.

(iii) If the above "incidental" condition is not complied with, the United States item of income has to be derived *in connection with* the Luxembourg business, which is the case if it accrues in the ordinary course of such business, provided the Luxembourg beneficiary of the income owns, directly or indirectly, less than 5 per cent of the US payer, or if the US activity is a line of business forming a part of, or being complementary to, the Luxembourg business.

(iv) Once the connection between the US-source of income and the Luxembourg business has been established, it has to be evidenced that the Luxembourg business is *substantial in relation* to the Luxembourg company's interest in the US activity that generated the income.[26]

The "substantial in relation" test will be appraised according to the facts and circumstances of every particular situation. Basically, this provision purports to prevent a Luxembourg business undertaking from being used to extract US-source profits although this Luxembourg business has no real economic substance in comparison to the US business from which payments – deductible for US tax purposes and/or qualifying for reduced withholding tax rates – are made.

A safe harbour exists for this "substantial in relation test", consisting in a comparison between three different factors. The Luxembourg asset value has to equal at least 7.5 per cent of the US asset value related to the activity that generated the

22. Other than undertakings for collective investment.
23. Statistical information kindly provided by the Luxembourg stock exchange indicates the number of shares traded for each company in 1996. It was further possible to determine with kind assistance from the Luxembourg company registry how many shares have been issued by each listed company.
24. See *supra* note 21, at 390.
25. See *supra* note 18, at 413.
26. This "substantial in relation" condition is not relevant if the US item of income is merely incidental to the Luxembourg business.

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income. Similarly, the Luxembourg gross income and payroll expenses have both to reach at least 7.5 per cent of the US gross income and payroll expenses. Finally, the average of these three factors has to be at least 10 per cent. These percentages should possibly reflect the difference in sizes between the economies of Luxembourg and of the United States.[27] Strangely the same factors are included in the French and Dutch treaties, although the Luxembourg economy is not yet as large as those of France or the Netherlands.

All the above factors reflect data pertaining to the Luxembourg undertaking in respect of its activity carried out within the borders of Luxembourg. Under the Dutch treaty, the activity conducted in other EU Member States may also be taken into consideration, except that the 7.5 per cent factor is replaced by a factor of 50 per cent and the 10 per cent factor is increased to 60 per cent.

If the Luxembourg resident holds less than a 100 per cent participation in the US income-generating activity, the above factors have to be reduced in due proportion. Thus, if the Luxembourg resident owns no interest at all in the US activity, this "substantial in relation" test will automatically be met.

2. Article 24(4): Derivative benefits test

Article 24(4) provides for a derivate benefits test that may enable a Luxembourg non-qualified resident to enjoy treaty protection if 95 per cent of its shares are ultimately held by seven or fewer residents of a Member State of the EU or of a party to NAFTA, with which the United States has concluded a comprehensive double tax treaty. At present all EU Member States and all countries that are a party to NAFTA have a tax treaty with the United States.

To qualify as a resident of a Member State of the EU or of a state party to NAFTA, either the ultimate shareholder must pass the comprehensive LOB test existing in the tax treaty his country has signed with the United States or, in the absence of a comprehensive limitation on benefits provision therein,[28] he should be deemed a qualified resident under the LOB provision of the Luxembourg–US DTA.

There is no condition according to which the ownership test has to be satisfied by residents of a single EU Member State or country that is a party to NAFTA.

Furthermore:

(i) a base erosion test, similar to that included in Article 24(2)(c), must be passed: payments by a Luxembourg company to non-qualified residents or to non-residents of the EU or of NAFTA,[29] that are deductible for tax purposes, other than arm's length payments in the ordinary course of business, should not exceed 50 per cent of the gross income of the company for that year. Hence, a Luxembourg joint-venture involving EU companies may not be used for routing royalties from the United States to a non-EU country, although it may be used for channelling royalties to another EU Member State.

(ii) in respect of royalties, interest payments and dividends paid to a Luxembourg intermediate company, no US withholding tax reduction will be available under the DTA if the tax treaty existing between the United States and the residence country of the relevant shareholder provides for a less favourable withholding tax reduction than the DTA. The rates that are compared are those applicable in a situation where the shareholder would have directly received the US-source income, and in view of the holding period requirements and holding thresholds prescribed by both treaties. For example, in the presence of dividends distributed by a US company, the rates for individual shareholders or for portfolio dividends of the DTA should not be more favourable than the respective rates applicable under the tax treaty the United States has signed with the residence country of the shareholder of the Luxembourg intermediate holding company. There is no direct comparison between the rate applicable under the DTA to dividends distributed by a US company to its Luxembourg parent (i.e. the superreduced rate of 5 per cent) and the rates available under the treaty existing between the United States and the residence country of the investor for individual shareholders or for portfolio dividends (in general, a reduced rate of 15 per cent only).

If the treaty the United States entered into with the residence country of the investor provides some benefit, but without being as generous as the DTA, it is not possible to obtain a partial benefit under the DTA, which would merely correspond to the withholding tax reduction granted by the relevant treaty.[30]

(iii) where the shareholder of the Luxembourg company exclusively meets an active business condition (such as the test of Article 24(3) of the DTA),[31] Article 24(4) is only available if the item of US income derived by this shareholder via the intermediate Luxembourg company is connected with an active trade or business conducted by the shareholder in his country of residence.

The DTA is more flexible than other US tax treaties which include a derivative benefit test. The advantage of the DTA in comparison to the French, Swiss or Dutch treaties is that it allows EU companies, having no Luxembourg shareholders, to set up a joint-venture in Luxembourg for investing in the United States, while the derivative benefits tests of the three other treaties all require a minimum of 30 per cent domestic shareholding. Joint-ventures having exclusively EU ownership are therefore excluded from the scope of the French, Swiss and Dutch treaties, except if they comply with another LOB test. Bearing in mind that a holding company is, in general, not able to fulfil the active business test, the role of Luxembourg as a location for intermediate holding companies[32] may remain significant in the future.

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27. See para. 7(b) of the protocol to the United States–Switzerland treaty of 2 October 1996 (not yet effective, hereafter the "Swiss treaty").
28. See the United Kingdom–US treaty of 31 December 1975.
29. The base erosion test of Art. 24(2)(c) does however not accept payments to residents of a Member State of the EU or of a party to NAFTA.
30. See *supra* note 18, at 419.
31. I.e. where he fails a shareholder/base erosion test, a stock quotation test and a public ownership/base erosion test, and is not an individual, a public entity or a not-for-profit organization.
32. Of non-listed groups, because otherwise a public ownership test may be available.

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The absence of a domestic shareholding requirement in the derivative benefit test is also important because most Luxembourg companies, regardless of their activity, are held by foreign investors. For example, in November 1996 of the 224 banks registered in Luxembourg only four were controlled by Luxembourg residents.[33]

3. Article 24(5): Triangular cases test

The triangular cases test of Article 24(5) addresses the situation where a Luxembourg company derives US-source income that is attributable to a permanent establishment of the Luxembourg company in a third country. Except where an active trade or business is carried out by this foreign permanent establishment, treaty benefits are not available if the tax rate in this third jurisdiction is less than 50 per cent of the Luxembourg tax that would have been imposed if the US income were not attributable to the foreign permanent establishment.

This provision may in particular prevent a Luxembourg company from making investments in the United States via a Swiss finance branch, which would be subject to a tax burden significantly lower than the Luxembourg corporate income taxes. In that situation, the United States may levy a withholding tax of 15 per cent on US-source dividends, interest payments and royalties.

C. Particular provisions

1. Article 24(6): Disproportionate part of income/ Preferred shares

Article 24(6) partially excludes treaty benefits if a Luxembourg company, controlled by persons which are not qualifying residents of one of the contracting states, of the EU or of NAFTA, is entitled, because of a particular arrangement, to a portion of US income which exceeds the portion it would have received in the absence of such agreement.

For instance, a Luxembourg company controlled by a Swiss resident, holding preferred shares of a US company, may not benefit from the reduced withholding tax of the DTA for preferred US dividends. Treaty benefits may, however, be available for that part of US income that corresponds to an ordinary dividend.[34]

2. Article 24(7): Safety net provision

A resident of a contracting state who fails the LOB test may nevertheless be entitled to treaty benefits if the other contracting state so determines (Article 24(7)). The motivations of this taxpayer have to be analysed. It is required that the implementation of the structure did not have as one of its principal purposes the obtaining of benefits under the treaty. It is not sufficient that the taxpayer pursued, among others, non-tax related objectives.

Consideration may, according to the Treasury Department Technical Explanations, *inter alia* be given to the existence of a clear business purpose, the conduct of an active trade or business, a valid business nexus between the entity and the activity giving rise to the income, and, if it is a corporation, the extent to which it would be entitled to treaty benefits comparable to those afforded by the DTA, if it had been incorporated in the country of residence of its majority shareholders. Under the Dutch treaty, additional criteria are the date of incorporation of the relevant company (i.e. if it existed before the treaty entered into force) and the continuity of its historical business and ownership (in order to avoid corporate takeovers). Obviously the criteria listed by the Dutch treaty, reflecting the rationale of the safety net provision, may also be relied upon under the DTA.

3. Particular exclusions

Particular exclusions from the scope of the DTA exist for pure holding companies governed by the law of 31 July 1929[35] and for investment companies governed by the law of 30 March 1988 relating to undertakings of collective investment (UCIs). While the first exclusion is included in almost all Luxembourg tax treaties (except in the treaties with China and Romania), there is little justification for the second restriction. French undertakings for collective investment qualify for instance as residents under the French treaty (see Articles 4(2) and 30(1) of the French treaty).

Luxembourg UCIs may be divided into two categories, namely investment companies with variable share capital and investment funds.[36] While investment companies are in general organized as public limited companies (*sociétés anonymes*) with legal personality, investment funds have no separate legal personality and are characterized by the joint ownership of securities. Investment funds may, however, be deemed a "body of persons" within the meaning of Article 3(1)(a) of the DTA. Further, although not being subject to corporate income taxes, Luxembourg UCIs are subject to an annual registration duty (*taxe d'abonnement*), calculated on their total net assets. Luxembourg legal authors therefore express the opinion that they are fully liable to tax in Luxembourg.[37] Thus, Luxembourg UCIs are protected by the tax treaties signed by Luxembourg, subject to specific exclusions. As the DTA only excludes investment companies, it might reasonably be argued that an investment fund may avail itself of the benefit of the DTA. As a consequence, a reduced withholding tax of 15 per cent might be available on US-source dividends and an exemption might be secured on US interest payments. Capital gains realized by the invest-

33. The breakdown of the country of origin of the majority shareholders was the following: Belgium (23), Germany (72), France (18), Italy (20), Switzerland (17), Scandinavian countries (14), United States (9), Japan (9), the Netherlands (6), United Kingdom (5), Israel (5), Brazil (5), South Korea (5), etc.

34. Provided the Luxembourg company qualifies for treaty protection under one of the LOB tests.

35. Luxembourg ordinary commercial companies benefiting from the participation exemption are not targeted by this exclusion.

36. I.e. *sociétés d'investissement à capital variable* (SICAV) and *fonds commun de placement* (FCP).

37. See Philippe Hoss and Patrick Kinsch, "Conventions fiscales internationales et OPCVM", *IFA Joint Seminar of the French, Belgium and Luxembourg branches*, Luxembourg, May 1992; see further Philippe Hoss, "Dans quel cadre s'inscrit la fiscalité des actionnaires des OPCVM établis à Luxembourg: Le point de vue des actionnaires luxembourgeois et étrangers", ALFI Yearbook 1994, at 45.

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ment fund on US securities might in principle not be subject to taxation in the United States.

Unlike the Dutch and the French treaties, the DTA does not include a test for headquarters companies. Consequently, it may prove difficult to set up a *société de coordination* in Luxembourg for multinational groups having interests in the United States. However, the headquarters company tests in the French and Dutch treaties are rather stringent, which implies that for instance not many French *quartiers généraux* will qualify as a headquarters company under the French treaty.

4. Compatibility of the LOB provision with EC law

One important issue, analysed by various authors, is the compatibility of the LOB provision with EC law. Indeed, the LOB provision is likely to infringe the fundamental freedoms granted by the EC treaty and thus may violate EC law. Exclusion from treaty benefits exists under the LOB provisions for non-home country EU investors in a Luxembourg (Dutch, French etc.) company. Similar exclusions apply to the beneficiary of payments under the base erosion test, although these exclusions can not be directly understood as fighting situations of treaty abuse.

Why apply in the DTA a base erosion test where only payments to qualifying residents of both contracting states or to US citizens are "good" payments, when the Dutch treaty also accepts, to a certain extent, payments made to residents of the European Union? One might also ask why is the derivative benefits test in the Dutch treaty only available if there is a minimum of 30 per cent Dutch holding in the Dutch intermediate company, while, under the DTA, a Luxembourg intermediate company fully owned by EU residents could pass the derivate benefits test of Article 24(4)?

In fact, the existence of unjustified discrimination between domestic and EU nationals (and residents) depends on the application of the safety net provision (Article 24(7) of the DTA or Article 26(7) of the Dutch treaty). As indicated above, the safety net provision enables a resident of a contracting state having failed all tests under the LOB provision to be granted treaty benefits if it has not as one of its principal purposes the obtaining of benefits under the treaty. Paragraph XXI of the Memorandum of Understanding of the Dutch treaty expressly refers to the free flow of capital and persons within the European Union. Treaty benefits might therefore be granted if a given structure does not appear abusive in a Union context, although not complying with the LOB provision. For instance, the Memorandum of Understanding of the Dutch treaty gives as an example a company which ceases to qualify for treaty protection because of a change in its shareholding. If this change in shareholding is not attributable to tax avoidance motives, the company should still benefit from the treaty. No similar provision is included in the DTA. Hopefully, a similar approach, considering the EU membership of Luxembourg, should govern the safety net provision and the LOB provision generally under the DTA.

D. Conclusion

The LOB provision suffers from several difficulties. For instance it is not clear what evidence is required to satisfy the tests contained in the provision nor is it clear which contracting state is entitled to appraise compliance with the tests. Under the Dutch treaty, the certification for Dutch residents seeking treaty protection generally lies with the Dutch tax administration.[38] Under this procedure, the Dutch taxpayer has to provide sufficient documentation (in particular, it has to submit an estimate of its US-source passive income for which treaty benefits are claimed) to the Dutch tax inspector, who in return may issue a certificate confirming that the LOB test is passed. This documentation requirement constitutes a way for the US authorities to obtain documentation that would not be available under the exchange of information clause. Nevertheless the taxpayer has also to file in the US for the application of the relevant treaty provision (e.g. form 1001 for a withholding tax reduction on US-source dividends). The Dutch certification has to be obtained every year and no prospective *ex ante* certification is available. On the basis of a declaration by the taxpayer that his situation has not changed and that therefore there is no need to supply updated documentation, the validity of the certificate may be extended for two subsequent one-year periods. The Treasury Department Technical Explanation does not contain a similar procedure, but merely provides that once the competent authorities of both the United States and Luxembourg have gained more experience, guidelines may be developed and made public. In the meantime, a certain level of insecurity will persist.

Another problem arises from the complexity of the LOB provision in the DTA.[39] The LOB provision purports to be comprehensive, with a view to close treaty shopping opportunities and to cover a priori all possible scenarios. Nevertheless, the DTA is, in the author's view, easier to access than the Dutch treaty. The provision is also more comprehensive than the corresponding Article 22 of the Swiss treaty,[40] which offers more room for interpretation and consequently leaves a lot of grey areas, detrimental to fiscal certainty. From these perspectives, the DTA offers advantages over both the Swiss and Dutch treaties.

X. ELIMINATION OF DOUBLE TAXATION

The 1962 treaty was the only treaty signed by Luxembourg where the credit method was used as a general method for the elimination of double taxation. In introducing the exemption method for the elimination of situations of double taxation in Luxembourg, the DTA adheres to traditional Luxembourg tax treaty policy. This exemption is granted where the DTA confers the right to tax to the United States, even if the rele-

38. Regulation of the Dutch Ministry of Finance dated 10 May 1994 and Notice 94-85 issued by the US Internal Revenue Service on 4 August 1994.
39. A brief chart at page 172 is intended to facilitate the analysis of Art. 24.
40. For example, there is no safe harbour rule in the Swiss treaty for the activity test (see Art. 22(1)(c) and para. 4 of the Memorandum of Understanding).

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vant item of income is, under US domestic law, not deemed US-source income and therefore not subject to US taxation.[41]

XI. NON-DISCRIMINATION CLAUSE

Concerning taxes covered by the DTA it is worth mentioning that by virtue of US treaty policy only federal taxes are covered by the treaty. The federal authorities are in fact not allowed to restrict the different member states' right to tax by means of international agreements. The non-discrimination clause (Article 26 of the DTA) is an exception to this principle; as it includes all taxes imposed by the contracting states and by political subdivisions or local authorities thereof.

An interesting opportunity might result from the broad scope of the non-discrimination clause as regards the Luxembourg capital duty (*droit d'apport*). A 1 per cent capital duty is levied on the incorporation of a Luxembourg company and on subsequent capital increases. No capital duty is due if at least 75 per cent of the shares of an EU company are contributed to a Luxembourg company, in exchange for shares of the beneficiary company, or if an EU company contributes either all its assets and liabilities, or a branch of activity, to a Luxembourg company. As a prerequisite for these exemptions the company involved should be incorporated or have its place of effective management in the European Union.

The contribution by a US company of all its assets and liabilities, as well as the contribution of more than 75 per cent of the shares of a US company to a Luxembourg company might, by virtue of Article 26, also benefit from this capital duty exemption. In the author's view, the extension of the scope of this exemption to US companies by the Luxembourg tax authorities would have a positive impact on the Luxembourg economy as it may favour the reorganization of multinational groups of companies which include US entities.[42]

XII. EXCHANGE OF INFORMATION

Article 28 of the DTA provides that the competent authorities of both contracting states shall exchange the information which is necessary to correctly apply the provisions of both the DTA and their domestic law. In accordance with the OECD Model Convention and with Luxembourg treaty policy, a contracting state is not obliged (i) to carry out measures at variance with its domestic law, (ii) to collect information which can not be obtained under its domestic law, or (iii) to furnish information which would result in the disclosure of professional secrets, or would be contrary to public policy.

During the treaty negotiations, the United States indicated its regret that information covered by the Luxembourg banking secrecy could not be made available to them. Banking secrecy is based on the constitutional principle of protection of private life. It has been embodied in Luxembourg tax and criminal law, as well as in the regulations dealing with the banking and the insurance sectors. Banking secrecy may, however, not be opposed to (i) Luxembourg and, to a certain extent, foreign regulatory authorities, for purposes of prudential supervision of financial or insurance undertakings, (ii) criminal investigations, of money laundering and of tax fraud, and (iii) inheritance tax purposes if the deceased was a resident of Luxembourg. The Luxembourg authorities make about 250 information requests per year to Luxembourg banks in an effort to reply to *commission rogatoire* from foreign jurisdictions.[43]

Paragraph IV of the Memorandum of Understanding indicates, on the one hand, that the provision of information protected by the Luxembourg banking secrecy will be addressed by the Treaty on Mutual Legal Assistance in Criminal Matters to be entered into between the United States and Luxembourg[44] and, on the other hand, that the United States should be able to benefit from assistance identical to that granted to Member States of the European Union. Indeed, it would, under this most favoured nation principle, be logical to exchange tax information with the United States on a similar basis to that applying under the 1978 protocol on tax matters, to the European Convention on Mutual Judicial Assistance in Criminal Affairs, signed in Strasbourg on 20 April 1959. Basically, under this protocol, which has not yet been ratified, Luxembourg will grant assistance if a taxpayer has used fraudulent means, with a view to elude significant amounts of taxes in the requesting state. These two conditions are also those of the offence of tax fraud (*escroquerie fiscale*), which was introduced into Luxembourg law in 1993.

41. See *supra* note 2, at 193.
42. Id. at 206.
43. See Marc Elvinger, "Fraude Fiscale et Secret Bancaire", Discussion paper presented at a conference held on 23 October 1996, organized in Brussels by Skyroom Events.
44. As of the date of writing (February 1997), no draft of this treaty was available.

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LIMITATION ON BENEFITS PROVISION
(Article 24 of the DTA)

1. Qualified residents

Individual:
Art. 24(2)(a)

or

Public entity:
Art. 24(2)(b)

or

Company 50% of the shares of which are owned by qualified residents and not failing a base erosion test: Art. 24(2)(c)

or

Listed company:
Art. 24(2)(d)

or

Company controlled by a listed company that does not fail a base erosion test: Art. 24(2)(e)

or

Not-for-profit organization:
Art. 24(2)(f)

⇓

Qualified residents:
⇒ treaty benefits available

2. Non-qualified residents

Company which meets a substantial activity test:
Art. 24(3)

or

Company which is held by not more than 7 EU or NAFTA residents:
Art. 24(4)

or

Safety net provision:
Art. 24(7)

⇓

Non-qualified residents:
⇒ treaty benefits available in respect of the relevant income only

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AUSTRIA

HOLDING COMPANY TAXATION IN AUSTRIA

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I. INTRODUCTION

The EC Court of Justice's (ECJ) recent decision in the *Denkavit* case necessitated amendments to the holding period set out in the Austrian international holding privilege. This article explains these amendments and also outlines the new developments affecting holding company taxation in Austria.

II. DOMESTIC AND INTERNATIONAL HOLDING PRIVILEGE

A. Domestic holding privilege

By virtue of Section 10 paragraph 1 Corporate Income Tax Act (hereafter referred to as "KStG") dividends received by an Austrian corporation are exempt from tax if certain conditions are met (holding privilege). Qualified dividends are:

1. Profit shares of any kind derived from a participation of shares in domestic corporations or commercial cooperatives.
2. Refunds granted by commercial cooperatives pursuant to Section 8 paragraph 3 No. 2 KStG.
3. Profit shares of any kind derived from the participation in domestic corporations in the form of participation rights (Section 8 paragraph 3 No. 1 KStG).
4. Profit shares of any kind derived from participation capital within the meaning of the Austrian Banking Act and the Insurance Supervision Act.

The holding privilege avoids economic double taxation of distributed profits from domestic corporations. Basically profits should be subject to taxation at the level of the corporation which realizes the profits. Profit distributions to individuals are subject to personal income taxation at a rate of 25 per cent (or half of the average income tax rate).

Where profits which are passed through an intermediate corporation are subject to corporate income tax at the level of the intermediate corporation, a cumulative double taxation would result if these same profits are subsequently taxed in the hands of the parent company. In order to avoid double taxation, the KStG of 1966 provided for an exemption of qualified participation dividends if the interest of the parent company in the subsidiary exceeded 25 per cent. In the KStG of 1988 the required minimum interest was abolished. Therefore the domestic holding privilege applies regardless of the percentage participation or the length of the period of ownership of the participation.[1] "Profit shares of any kind" are exempt which implies that for instance disguised profit distributions are exempt from corporate income tax (as are dividends, received after the shares have been sold, or dividends paid by a controlling parent corporation to minority shareholders of a controlled subsidiary corporation, (the so-called "dividend guarantee").[2] The domestic holding privilege does not apply to capital gains which result from the sale of domestic shares.

B. International holding privilege

According to Section 10 paragraph 2 KStG dividends received from international holding participations are exempt from corporate income tax. An international holding participation is defined as the ownership of at least 25 per cent of the share capital of a foreign corporation. The legal form of the foreign corporation must be comparable to Austrian corporations. The comparability test is deemed to be satisfied by EU corporations listed in annex 2 to the Austrian Income Tax Act (hereafter referred to as "EStG").

The regulation regarding the international holding privilege also stipulates that the foreign shares be owned for a minimum period of two years. Dividends received prior to the expiry of the two-year term are initially taxable. The two-year minimum holding requirement has been introduced by the Tax Amendment Act 1996. According to the previous regulation the holding privilege applied only, if the participation had existed continuously for at least 12 months preceding the balance sheet date determining the computation of income (therefore under the new regime it is not possible to shorten the minimum participation period by means of a change of the balance sheet date). In contrast to the domestic holding privilege the international holding privilege also applies to capital gains arising from the sale of foreign shares, provided that the interest disposed of in the foreign corporation constitutes at least 25 per cent of its share capital. Where the shares prior to the sale are subject to a special write-off caused by a reduced going concern value, the capital gain is taxable to the extent of the previous write-off.

C. Holding privilege and cost of financing

Both the Austrian tax authorities and the Austrian courts take the position that interest payable in connection with the

1. Compare this to the international holding privilege regime.
2. See Doralt/Ruppe, *Grundriß des österreichischen Steuerrechts*, I, at 277.

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acquisition of shares subject to the holding privilege, can not be deducted for tax purposes. In case of an international holding participation the exclusion from deductibility applies only if all prerequisites for the application of the holding privilege are fulfilled (for instance expiry of the minimum participation term).

This position is based on Section 12 paragraph 2 KStG which states, that expenses, economically directly connected to non-taxable income, shall not be deducted.

The authorities argue that there is a direct economic connection between privileged dividends which are exempt from tax and interest payable in connection with the acquisition of the underlying shares. However, the tax profession in Austria strongly opposes this view. They instead argue that there is no direct economic connection between the dividends received and the interest payable on a loan used to acquire the shares. Since the capital gain resulting from the disposal of shares is subject to corporate income tax (this is fully true for domestic holding participations and under certain conditions also true for international holding participations), the interest payable on the acquisition price is connected to taxable income.

The literature suggests that recent decisions from the Austrian administrative court and the Austrian constitutional court have been based on the assumption of an economic connection between financing costs and taxable capital gains. Thus financing costs should also be deductible for tax purposes. This applies equally to interest paid in connection with international holding participations, since the international holding privilege is only applicable if certain conditions are fulfilled.[3]

Normal overhead costs (for instance wages) which could be theoretically linked to non-taxable dividends are deductible according to the current practice of the Austrian tax authorities. On the other hand, the exclusion from the deduction of financing costs shall – according to the authorities – also apply if debt-financed assets are contributed to a foreign corporation which qualifies for the international holding privilege.[4]

D. Holding privilege and special write-offs

It is the opinion of the Austrian administrative court that special write-offs caused by a fall in the going concern value of the shares are directly connected with the asset (substance) of the shares. Therefore, according to general principles special write-offs are deductible for tax purposes. However, the special rule of Section 12 paragraph 3 KStG excludes special write-offs from qualifying as a deduction, if the reduction of the going concern value is caused by a profit distribution from the subsidiary to the parent (holding) company. Nevertheless, the reduced going concern value is relevant for tax purposes.[5] The prohibition against deducting special write-offs in connection with profit distributions of the subsidiary has been criticized heavily in the literature. For practical and constitutional reasons a general non-taxability of changes in the value of participations has been suggested (this principle was incorporated into a draft version of the Tax Reform Act 1993). Deductible special write-offs and losses on disposals which are not caused by profit distributions from the subsidiary to the parent company shall be prorated over a period of seven years.

III. GROUP TAXATION

A. Consolidated group taxation

If a controlled subsidiary and a controlling parent corporation have entered into a non-profit agreement, the profit (loss) of the controlled subsidiary corporation as computed for purposes of corporate income tax shall be attributed to the controlling parent corporation.

Controlled subsidiary corporations are corporations or commercial cooperatives which are subject to an unlimited (corporate income) tax liability. Controlled parent corporations are corporations, commercial cooperatives, mutual insurance associations and banks within the meaning of the Banking Act (if they are corporate entities) which are subject to an unlimited (corporate income) tax liability.[6]

Prerequisites of consolidated group taxation are the conclusion of a non-profit agreement and the financial, economic and organizational domination of the controlled subsidiary corporation by the controlling parent corporation. Currently there is a discussion regarding the overhaul of the concept of consolidated group taxation in Austria. It is possible that the prerequisites of economic and organizational domination may be abolished in the course of the next tax reform.

The tax advantage offered by consolidated group taxation does not consist in the attribution of profits from the subsidiary to the parent company (since the domestic holding privilege achieves the same result). Instead the principle advantage of consolidated group taxation is that profits and losses may be offset between controlled subsidiary corporation and controlling parent corporation.[7]

Another advantage of consolidated group taxation is that financing costs incurred in connection with the acquisition of the interest in the controlled subsidiary corporation can be deducted for tax purposes. This is based on the fact that profits of the controlled subsidiary corporation are attributed directly (no tax-exempt dividend distribution) to the controlling parent corporation where the profits are subject to corporate income tax.[8]

3. See for instance Lang, "Fremdkapitalzinsen zur Finanzierung der Anschaffung von Beteiligungen abzugsfähig ?", *Ecolex* 1995, at 507; Wundsam/Spitzer, "Fremdfinanzierung der Beteiligung in der (Nicht-) Organschaft", *Recht der Wirtschaft* (RdW) 1995, at 75.
4. See Littich/Schellmann/Schwarzinger/Trentini, Holding, at 43.
5. See Wiesner, "Beteiligungen und ausschüttungsbedingte Teilwertabschreibungen", *Ecolex* 1994, at 123.
6. This should be contrasted with the German consolidated group taxation which also allows individuals to qualify for the "controlling parent entity status".
7. A set-off between losses and profits of companies could also be achieved by means of a group of (limited) partnerships where the principle company of the group is a corporation.
8. See Austrian Ministry of Finance, 8 August 1994, *RdW* 1994, at 299.

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B. Thin capitalization rules

The draft version of the Structural Adjustment Act 1996 prepared by the Austrian Ministry of Finance provided among other things for the introduction of thin capitalization rules in Austria. The draft provision contained fixed debt/equity ratios and did not distinguish between resident and non-resident shareholders. In contrast thereto Austrian entrepreneurs suggested the thin capitalization rules should be restricted to applying to loans granted by non-resident shareholders. However, this may lead to constitutional doubts.[9] The draft provision was heavily criticized in the literature and was eventually abandoned.[10]

In an international context the stipulation of fixed debt/equity ratios seems to be of doubtful validity, since they may not be in accordance with arm's length principles.[11] Furthermore, the International Fiscal Association recommends that a taxpayer should have the right to prove that its debt/equity ratio is appropriate even if it exceeds a specified fixed ratio.[12]

It is worth mentioning that the current draft version of the Tax Amendment Act 1996 does not contain thin capitalization rules. However, it is very likely that in the course of the next Austrian tax reform thin capitalization rules will be introduced into the domestic income tax law.

IV. ANTI-ABUSE PROVISIONS ACCORDING TO THE PARENT-SUBSIDIARY DIRECTIVE

A. Holding period requirements

The Parent-Subsidiary Directive also takes measures against "directive-shopping" (Article 1 paragraph 2). EU Member States have the right to exclude corporations from the benefits of the Parent-Subsidiary Directive, if such corporations can not prove that they will hold shares in foreign subsidiaries for at least two years (holding privilege) or that an EU parent corporation will hold shares of the domestic subsidiary for at least two years (exemption from withholding tax).

In Austria the anti-abuse provisions of the Parent-Subsidiary Directive have been implemented in Section 94 a EStG and Section 10 paragraph 3 KStG. Under certain conditions Section 94 a EStG grants an exemption from withholding tax on dividends paid to EU corporations.[13] Pursuant to Section 94a EStG in connection with regulation 56/1995 the exemption from withholding tax is subject to the following conditions:

- the EU parent company is listed in annex 2 to the EStG and holds at least 25 per cent of the share capital of the Austrian subsidiary;
- the participation must be held by the parent company for at least two years.

The exemption will not in any event apply if:

- the parent company has not met the continuous ownership and holding period requirements set forth above; or
- application of the withholding tax exemption conflicts with Ministry of Finance regulations disallowing the exemption (prevention of tax evasion or abuse); or
- the distribution constitutes a hidden profit distribution.

The grounds for suspected abuse are specified in more detail in regulation 56/1995 issued by the Austrian Ministry of Finance. According to this regulation the Austrian subsidiary is not responsible for an abuse if the subsidiary possesses a declaration from the dividend recipient which states that:

- the main activity of the foreign parent corporation is not the administration of assets;
- the foreign parent corporation has its own staff; and
- the foreign parent corporation has an office at its disposal.

In addition to the above declaration by the foreign parent corporation, there must be no evidence which casts doubt on the accuracy of the declaration.

If the declaration can not be produced, the subsidiary must deduct the withholding tax and the foreign EU parent corporation has to request reimbursement from the Austrian tax authorities. The foreign parent corporation must prove its qualification for the exemption method when applying for reimbursement (prior to the Tax Amendment Act 1996 the domestic subsidiary was also entitled to apply for reimbursement).

As mentioned above the two-year minimum participation period is also required if the international holding privilege is to be applied (Section 10 paragraph 2 No. 2 KStG). In this context the recent judgement of the ECJ, with respect to the *Denkavit* case is of importance. Pursuant to Section 10 paragraph 2 KStG (old version) the international holding privilege can not be applied, if the minimum holding period has not been fulfilled at the time of receipt of the foreign dividend. Dividends received prior to the expiry of the holding period are taxable. This provision is in clear breach of the Parent-Subsidiary Directive (comparable and therefore doubtful regulations have been implemented in Denmark, Netherlands, Portugal and Germany.[14] According to the decision mentioned above Article 3 paragraph 2 in connection with Article 4 paragraph 1 of the Parent-Subsidiary Directive states that the international holding privilege is applicable even where the two-year minimum holding period has not yet been fulfilled.

According to the ECJ the exemption from the withholding tax should be granted, even if the justification of the tax exemption can only be checked after all prerequisites have been fulfilled. On the other hand the Member States are not

9. See Lang, "Unterkapitalisierung", in Gassner/Lang/Lechner (Eds.), *Aktuelle Entwicklungen im internationalen Steuerrecht*, at 156.
10. See for instance Rödler, "Besteht Bedarf für eine gesetzliche Beschränkung der Gesellschafterfremdfinanzierung?", *FJ* 1996, at 151.
11. See Gahleitner, "Die tschechischen Unterkapitalisierungsregelungen aus Sicht österreichsicher Investoren", *Stener und Wirtschaft International* (SWI), (1996), at 495.
12. IFA, "Internationale Aspekte der Unterkapitalisierung", *SWI* 1996, at 494.
13. See Leitner, Mißbrauch im internationalen Steuerrecht aus österreichischer Sicht, *IWB* 1996, Fach 5, Gruppe 2, at 357.
14. *Steuer-Telex*, (1996), at 359.

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obliged to grant the tax exemption if it can not be proven whether the required participation period can be met. In such cases a reimbursement procedure may be justified. I.e. if all the conditions are subsequently met the exemption from the withholding tax has to be applied as from the beginning of the participation period. The opinion of the ECJ with respect to the exemption from the withholding tax can also be applied to national provisions regarding the international holding privilege.[15]

The Tax Amendment Act 1996 reflects the recent ECJ decision. Dividends received from a foreign subsidiary which although basically satisfying the international holding privilege requirements, has not yet fulfilled the minimum participation period at the time of distribution, are initially taxable according to the new version of Section 10 paragraph 2 No. 3 KStG (applicable to dividends received after 1 January 1996 and for capital gains realized after 1 January 1997). After the required participation period has elapsed, the authorities have to decide whether the holding privilege is applicable.

The ECJ decided that Article 5 paragraph 1 and paragraph 3 of the Parent-Subsidiary Directive are directly applicable so that taxpayers may claim the tax exemption on the basis of that directive. For dividends, which have been received by Austrian corporations after Austria joined the European Union and where the application of the international holding privilege has been declined because of the fact that the required holding period has not yet been fulfilled, any corporate income tax levied on the foreign dividend may be reclaimed after the minimum holding period has been fulfilled.

On the other hand the recent decision of the ECJ implies that the Austrian provision of Section 94 a EStG and the requirements contained therein regarding the minimum participation duration are in accordance with the Parent-Subsidiary Directive. Pursuant to Section 94 a EStG previously deducted withholding tax may be reclaimed by an EU parent corporation if the minimum holding period requirements are met.

B. Method change in cases of suspected tax abuse

Austrian regulations regarding the international holding privilege contain another provision which may be doubtful under both the EC Directive and the Austrian constitutional law.

Section 10 paragraph 3 KStG specifies three grounds for suspected abuse which also form the basis of the Ministry of Finance regulations:

- the company's main source of income is passive income; and
- there is no comparable taxation with respect to the taxable base and the tax rate applied in the jurisdiction of the country of residence; and
- it is not proven that non-resident individuals directly or indirectly hold the majority interest in the Austrian parent company.

In such a case, the tax exemption granted under the international holding privilege will be replaced by an indirect foreign tax credit (method change). This means that the foreign corporate income tax burden may be deducted from the Austrian corporate income tax burden which is levied on the foreign dividends. The deductible foreign corporate income tax will be added to the foreign dividends in assessing the Austrian tax base. The provision mentioned above has been criticized since it obviously exceeds the legal content of the anti-abuse provisions set forth in the Parent-Subsidiary Directive. Moreover, the Austrian authorities take the presence of grounds for suspected abuse as an absolute legal presumption for the presence of actual tax abuse. This is in clear contrast to the corresponding EC provision referring to the exemption from withholding tax on dividends paid to EU corporations.[16]

15. See for instance Hügel, "Internationales Schachtelprivileg: Mindestbeteiligungszeit richtlinienwidrig", *RdW* (1996), at 545.
16. See *supra* note 13.

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INTERNATIONAL

TRIANGULAR SITUATIONS: A CASE OF DOUBLE SOURCE TAXATION OF INTEREST AND ROYALTIES[1]

Marco Lombardi

Marco Lombardi is a Research Associate with the IBFD. This article evolved out of research done by the author in his role as 1996 IFA Research Associate. Triangular cases are the subject of one of the seminars to be held during the 1998 IFA Congress in London.

I. INTRODUCTION

Triangular situations are commonly defined as situations involving three states. The 1992 OECD Report "Triangular Cases"[2] defines the "typical" triangular cases as those in which income from dividends, interest or royalties derived from a source within a certain state is received by a permanent establishment in another state which belongs to a head office resident in a third state.[3]

These and other triangular cases are dealt with in the Commentary to the OECD Model,[4] but are not specifically covered by the Model itself.[5] Generally, this is held to be due to the fact that, by definition, tax treaties are normally[6] bilateral in nature and therefore cannot effectively deal with multilateral situations. As is argued below, and as the OECD Commentary would seem indirectly to confirm, this conclusion is not necessarily correct.

A. Double source taxation of interest

This article intends to discuss the triangular situation which may arise where payments of interest are made which are connected with a permanent establishment that the payer has in a "third state". In particular, the question as to whether double tax treaties, either following the OECD Model or partially departing from it, may help to settle potential conflicts between the source rules of two different states will be examined.[7] Other interest and royalties situations that may cause double or even triple source taxation are not dealt with in this article.[8] For sake of simplicity, hereafter the term "source rule" is used broadly to cover rules that allow a certain state to tax income which is derived by a non-resident of that state.

The situation considered in this article, which is discussed in paragraphs 28 to 30 of the Commentary on Article 11 of the

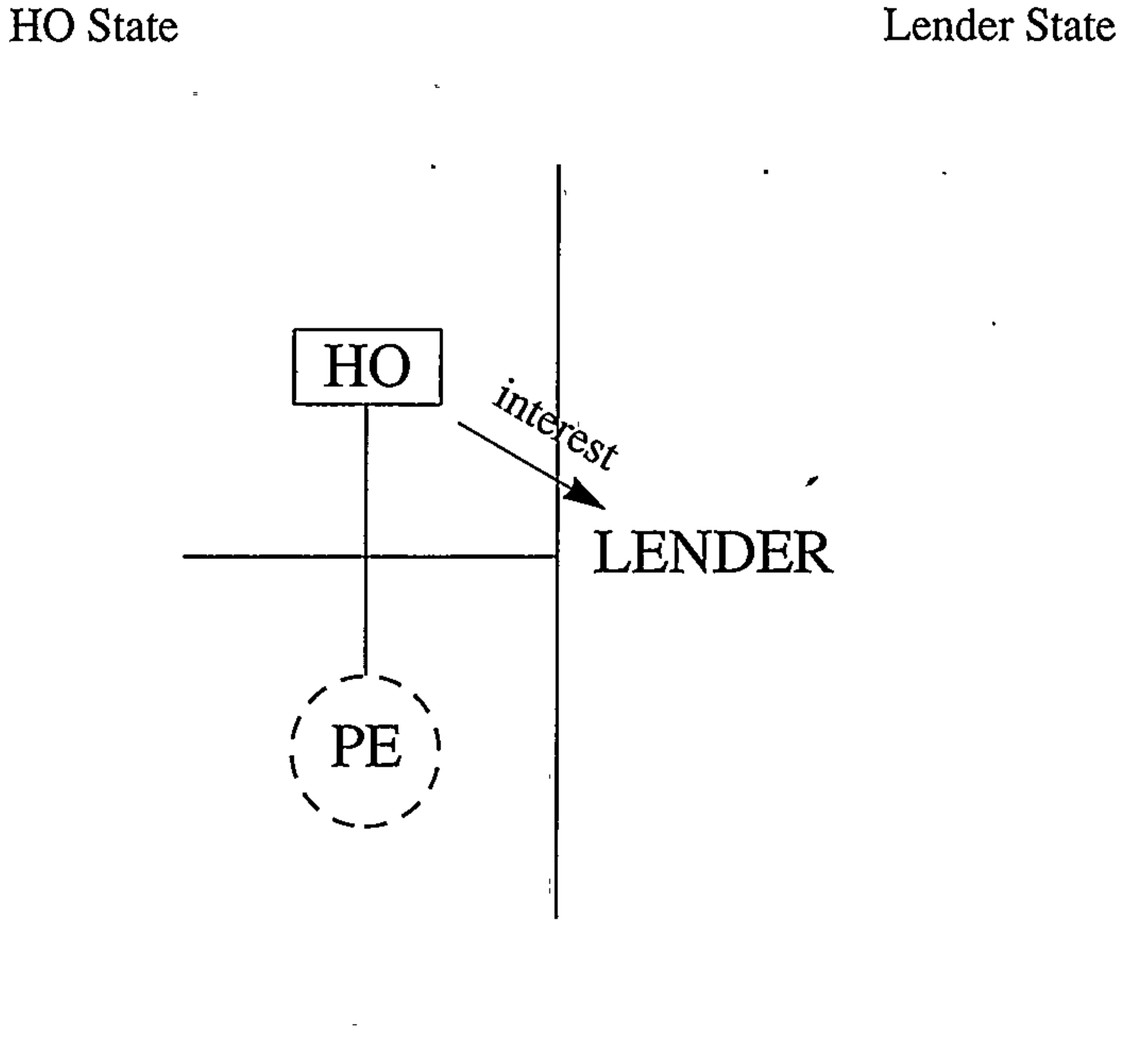

Exhibit 1

1. The author wishes to thank Rijkele Betten and Prof. Kees van Raad for their valuable comments on the draft of this article.
2. The Report was published by the OECD as the second chapter of the *Model Tax Convention: Four Related Studies*, No. 4 of the series "Issues in International Taxation".
3. In para. 2 at 28.
4. In this article "OECD Model" stands for the 1992 OECD Model Double Tax Convention on Income and on Capital, as amended in 1994 and 1995.
5. For example, the case discussed in this article (dealt with in paras. 28 to 30 of the OECD Commentary on Art. 11), the "typical" triangular case dealt with in the Commentary on Art. 24; the case dealt with in paras. 3(c) and 11 of the Commentary on Art. 23; the case referred to in para 37 of the Commentary on Art. 25; etc. Other cases, for instance the case of a dual resident company paying or receiving dividends to or from a resident of a third state, are not touched upon by the Commentary. For a discussion of some of these triangular cases see K. van Raad, "The 1992 OECD Model Treaty: Triangular cases", 33 *European Taxation* 9 (1993), at 298.
6. Examples of multilateral tax treaties are the 1922 Convention of Rome and the Nordic Convention.
7. For a discussion of source rules and jurisdiction to tax see K. Vogel, "Worldwide vs. source taxation of income – A review and re-evaluation of arguments", *Intertax* (1988) at 224. On the issue of source see also J.S. Phillips and M.H. Collins, General Reporters, in Cahiers de droit fiscal international *The assessment and collection of tax from non-residents* Vol. LXXa, Deventer: Kluwer (1985); J.A. Jones, "Does the UK give credit for tax on a permanent establishment abroad? In *Essays in Honour of Sidney I Roberts*, Eds. H.H. Alpert and K. van Raad (Deventer: Kluwer 1995).
8. The UN Commentary on Art. 11(5) largely refers to the OECD Commentary. However, it adds that a different source rule may be adopted, i.e. based on the "place of use" of the loan. With regard to royalties the UN Commentary on Art. 12(5) also refers to a "place of use" rule. This may lead to further triangular and even quadrangular situations.

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OECD Model, is the following. A person ("Head Office")[9] resident in a certain state ("HO State") pays interest to a person ("Lender") resident in another state ("Lender State") in connection with a loan entered into for the benefit of a permanent establishment ("PE") in a third state ("PE State") and borne by the latter[10], for instance for the purchase of machinery and equipment used by the PE (exhibit 1).

In this situation interest payments may be subject to taxation in three states, namely in the HO State, in the PE State and in the Lender State. In particular, triple taxation may arise if the HO State levies taxes (normally by withholding) on interest paid by residents of that state and, at the same time, the PE State also levies taxes[11] on interest which is either borne or economically connected to the PE. However, there is relief from double source taxation only if the Lender State grants to the Lender a tax credit in respect of the taxes levied in both the HO State and the PE State (unfortunately this will not often be the case).[12]

This article does not deal with the situation of internal loans between Head Office and PE, which, with the exception of the case of banks, are rare in practice.[13]

B. Double source taxation of royalties

Triangular situations may also arise where royalty payments are made by the Head Office under e.g. a licence agreement entered into by the Head Office for the benefit of the PE. However, since the OECD Model, unlike the UN Model, does not provide for any source taxation of royalties, this article concentrates first on interest payments and deals separately with royalties at Section V below.

II. THE OECD MODEL

The triangular interest situation described above is discussed below in the light of the interest article of the OECD Model. Article 11 of the OECD Model provides that interest may be taxed both in the state of the recipient and in the source state. In the latter case taxation is limited to a maximum of 10 per cent of the gross amount of the interest. Article 11(5) first sentence sets forth the basic source rule with respect to interest and provides that interest is deemed to arise in the contracting state where the payer is a resident of that state. However, Article 11(5) second sentence adds that:

> where the person paying the interest, whether he is a resident of a contracting state or not, has in a contracting state a permanent establishment or a 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 arise in the state in which the permanent establishment or fixed base is situated.

Paragraph 27 of the OECD Commentary on Article 11 clarifies that interest is deemed to be borne by a permanent establishment when there is an economic link between the loan on which the interest accrues and the permanent establishment. Paragraph 27 also gives some examples of situations in which such an economic link is normally deemed to exist.[14] In practical terms, interest borne is synonymous with interest deductible by the PE.

Paragraphs 28 to 30 of the OECD Commentary on Article 11 suggest, *inter alia*, that a solution may be found at a multilateral level. The following discussion, however, does not take into account theoretical multilateral solutions and concentrates instead on possible solutions at the bilateral level.

A. No treaty between the HO and the PE States

Let us imagine that there are two treaties, both following the OECD Model: one between the Lender State and the HO State and one between the Lender State and the PE State. However, there is no treaty between the HO State and the PE State. Under Article 11(5), first sentence of the HO State–Lender State treaty the HO State may levy taxes on the interest paid to the Lender. Article 11 says nothing about the right to tax of the PE State in the event that the loan was obtained by the Head Office for the requirements of the PE and the interest is borne by the PE in the PE State. However the PE State, under its domestic law (and under Article 11(5), second sentence of its treaty with the Lender State) may also tax the interest. It would seem that under these circumstances the two existing treaties do not provide any solution to the situation of double source taxation. On the other hand no problem of double source taxation arises if the PE State does not generally levy taxes on outbound interest or in any event on interest borne by permanent establishments situated in that state.

Assume the Head Office is in Italy, the PE in Nigeria and the Lender is resident in the Netherlands (see exhibit 2). Currently there is no treaty between Italy and Nigeria. Under the Italy–Netherlands treaty the interest paid by the Italian Head

9. Using the term "Head Office" in this article in no way implies that the PE is in any legal sense an entity distinct from the Head Office.
10. For the PE the money borrowed therefore represents a liability and not "owned capital".
11. How technically this tax is levied (i.e. by withholding?; by assessment?) is a matter for the PE State's domestic law.
12. The full creditability of the foreign taxes shall generally be prevented if in the Lender State the foreign tax credit rules provide for a "per country" limitation of the foreign tax credit. In addition, even in the absence of such a limitation, since the Lender is only taxed on his profit margin as opposed to his gross income, he will often be unable to credit the entire amount of the source taxes against his income tax due on the margin.
13. Loans for the benefit of the PE are often negotiated and entered into directly by the head office. In general, (with the exception of banks), the funds raised by the head office from third parties cannot be in legal terms on-lent to the PE since the PE is not a separate legal person. In fact, many domestic tax rules disallow internal debt-claims, i.e. they disregard internal loans between Head Office and PE. This reflects the position of the OECD, expressed in the 1994 Report on the "Attribution of Income to Permanent Establishments" and confirmed in para. 18.3 of the Commentary on Art. 7 of the OECD Model. The Report (but not the Commentary) recognizes the possibility of interest deductions in case of overcapitalized PEs. This exception, however, is not reproduced in the new (i.e. including 1995 amendments) OECD Commentary to Art. 7.
14. Namely, (a) when the loan has been contracted directly by the management of the PE; (b) when the loan contracted by the head office is used solely for the purposes of the PE and ultimately borne by it. The Commentary (point c)) leaves to the contracting states the choice of whether to extend the same principle in case of a loan entered into by the head office for the benefit of more than one PE located in different states.

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Office is deemed to arise in Italy and may be subject to tax there.[15] Under Article 11 of the Nigeria–Netherlands treaty the interest is also deemed to arise in Nigeria and may also be subject to tax there.[16] The Lender may thus be confronted with two source taxes based on the gross amount of the interest.

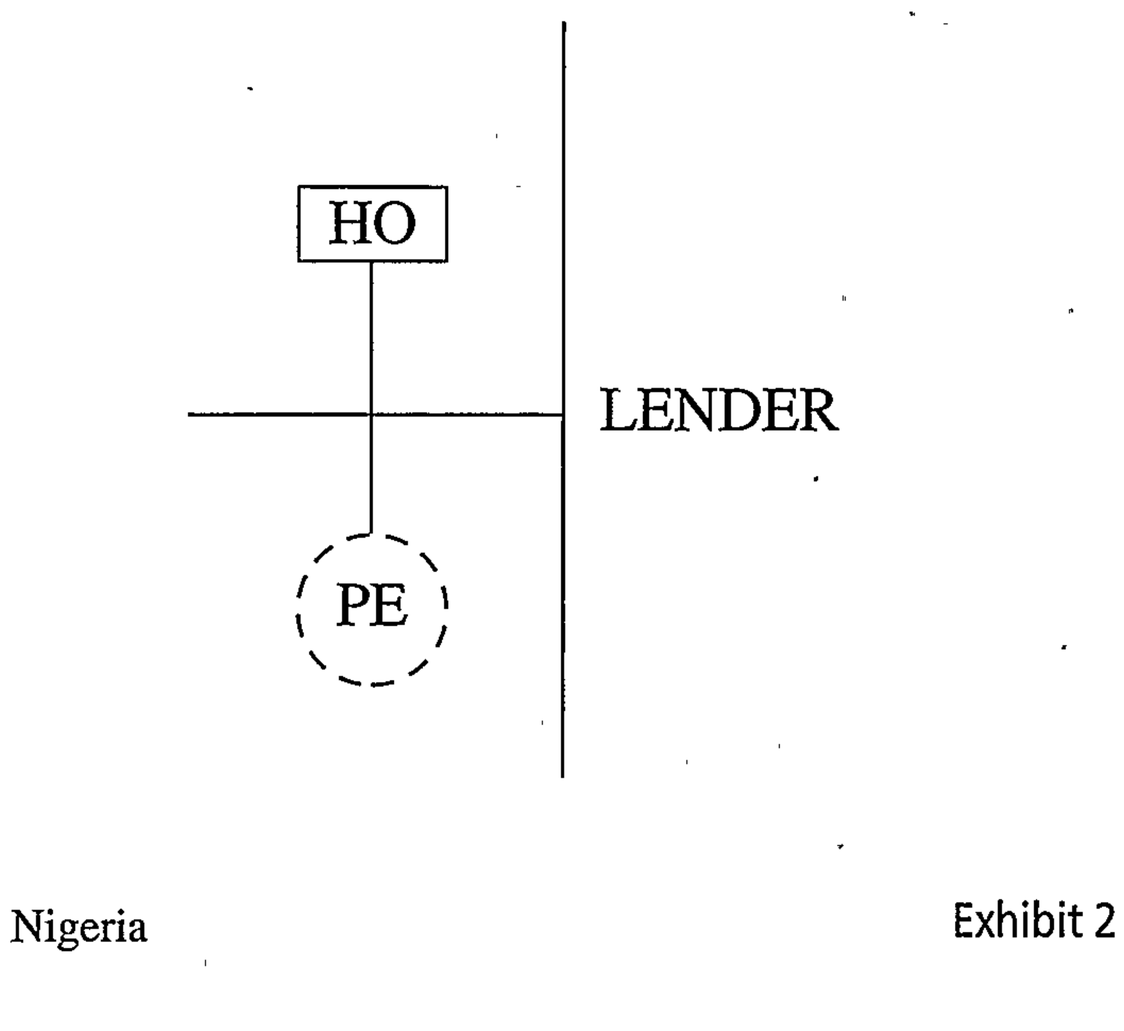

Exhibit 2

B. Article 11(5) as a source tie-breaker clause

Let us now imagine that there is a treaty between the HO State and the PE State with an interest article following Article 11 of the OECD Model. In this case it does not matter whether or not the PE State has an OECD type treaty with the Lender State, nor whether the Lender State has such a treaty with the HO State since these treaties, as discussed above, would not in any event provide a solution to double source taxation.

The OECD Commentary on Article 11(5) suggests, at paragraph 29, that Article 11(5) of the PE State–HO State treaty could eliminate double taxation at source. Although the Commentary does not expressly so state, it may be inferred that the solution envisaged is that Article 11(5) second sentence of the treaty between PE State and HO State is to be interpreted as setting forth a general rule for the determination of the source of the interest which applies beyond those cases where the interest is derived by a resident of either PE State or HO State.[17] In other words, under this interpretation, Article 11(5) second sentence would contain a general tie-breaker rule on the settling of two conflicting source rules (hereinafter referred to as the "Tie-breaker Rule"). This would extend its effects to interest derived by a person resident in a third state, thus superseding the (explicit or implicit) domestic source rules of the HO State.

Certainly Article 11(5) second sentence of the HO State–PE State treaty, if so interpreted, would in principle offer a solution to the problem of double source taxation. But whether in practice the Lender could avoid double source taxation depends on whether such an interpretation is compatible with the principle contained in Article 1 of the OECD Model which generally restricts the application of the treaty to residents of the two contracting states.[18] The OECD Commentary stops short of dealing expressly with the issue of whether residents of third states may enjoy benefits under a treaty between two other states. However, since Article 11(5) second sentence would not eliminate double source taxation if it could not benefit residents of third states, it may be inferred that the OECD's view is that, in spite of Article 1 of the HO State–PE State treaty,[19] the Tie-breaker Rule of Article 11(5) of this treaty, after the ratification of the same, becomes part of HO State domestic law and as such may be relied upon by the Lender.[20] The Lender's entitlement to HO State domestic law, rather than his entitlement to the HO State–PE State treaty, would therefore seem to be the real issue at stake.

In practice, however, the question remains unresolved as to whether the solution of double source can apply to persons other than HO State–PE State treaty residents i.e. to the Lender. Furthermore, the issue arises as to what extent the Lender may *effectively* enjoy protection against double source taxation. Especially since the Lender, not being a resident of either HO State or PE State, cannot in principle invoke the mutual agreement procedure provided for in the HO State–PE State treaty and therefore could only rely on the remedies offered by HO State domestic law. In short, the interpretation of Article 11(5) second sentence suggested by the OECD does not always allow the Lender to predict in advance the amount (and the place) of the source taxes that will be levied on the interest he will receive. By the same token, it may not always reassure the Head Office, in its capacity as withholding agent, about the correctness of its choice not to withhold taxes on interest payments made to the Lender.

C. Single source taxation

How the Tie-breaker Rule of Article 11(5) may eliminate double source taxation can be illustrated by using the previous example. This time, however, the PE is located in France,

15. I.e. up to 10 per cent.
16. I.e. up to 12 per cent.
17. However, it may be argued that in its current text, Art. 11(5) second sentence does not prohibit taxation by the HO state, but rather permits taxation by the PE state.
18. Art. 1 reads as follows: "This Convention shall apply to persons who are residents of one or both the Contracting States". However, the treaty non-discrimination provision (Art. 24) applies to nationals.
19. It is unclear whether a treaty may be more easily invoked by residents of third states in the event that the treaty in question does not contain an Art. 1 corresponding to Art. 1 of the OECD Model. See, among others, the 1979 Canadian *Hunter Douglas* and the 1990 UK *Commerzbank* cases.
20. In this sense, M. Edwardes-Ker, *Tax Treaty Interpretation. The International Tax Treaties Service* London: In-depth Publishing (1995) at Chapter 56 who also stresses how after the 1992 amendments, para. 54 of the Commentary on Art. 24 no longer contains a reference to the principle of the relative effects of tax treaties. Edwardes-Ker also reports and comments on some national courts decisions on this issue. Contrary, P. Baker, *Double Taxation Conventions and International Tax Law* (2nd Ed.) (London: Sweet and Maxwell 1994) at 76-77).

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which has a treaty with Italy, Article 11(7) of which reproduces the Tie-breaker Rule.[21] (exhibit 3).

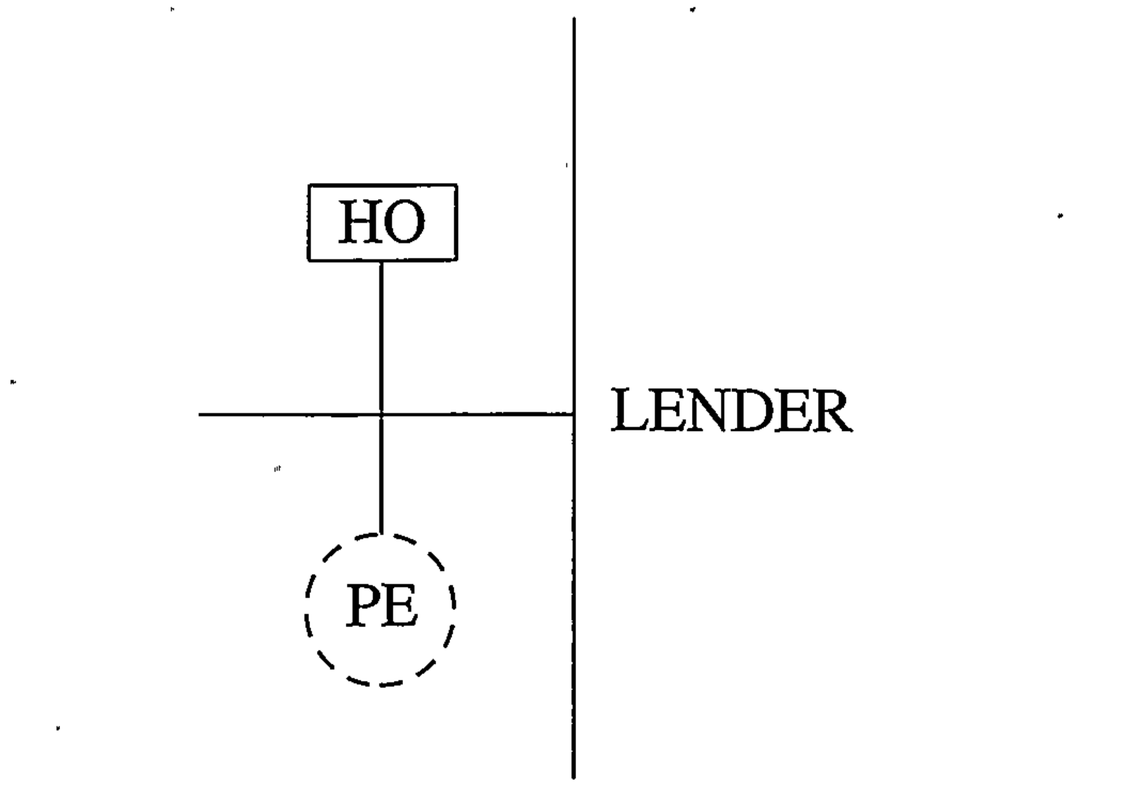

Exhibit 3

Assume that Italy agrees with the interpretation of Article 11(7) of the Italy–France treaty suggested in the OECD Commentary and agrees to give up its right to tax the interest paid to the Dutch lender.[22] Such interest will be deemed to arise in France both under the Italy–France treaty and under Article 11(6) of the France–Netherlands treaty. As a result, interest may be taxed only once at source, i.e. in France up to the maximum rate provided for in the France–Netherlands treaty.[23]

D. No source taxation

Not only may Article 11(5) second sentence of the HO State–PE State treaty eliminate double source taxation, it may even result in the elimination of source taxation altogether. This occurs if the PE State does not levy taxes on interest arising in that state. This can be illustrated with an example.

Assume this time that the PE is located in the Netherlands and the Head Office in Italy (the Lender being a resident of a third state). As mentioned, Article 11 of the Italy–Netherlands treaty provides for a limited source taxation. Under Article 11(7) second sentence of the treaty (which corresponds to the Tie-breaker Rule[24]), the interest paid to the Lender by the Italian Head Office but actually borne by the Dutch PE is deemed to arise in the Netherlands. Under Dutch domestic law interest payments are generally not subject to withholding taxes. As a result, no tax will be levied in the Netherlands regardless of whether or not the Netherlands has a tax treaty with the state of residence of the Lender.

III. THE OECD COMMENTARY AND THE "AUSTRALIAN CLAUSE"

Paragraph 30 of the OECD Commentary on Article 11(5) suggests that double source taxation could be eliminated by wording Article 11(5) second sentence as follows:

> Where, however, the person paying the interest, whether he is a resident of a contracting state or not, has in a state other than that of which he is a resident a permanent establishment or a 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 arise in the state in which the permanent establishment or fixed base is situated.

Under this provision, unlike under the standard one of the OECD Model, the interest may have its source outside both contracting states. It is interesting to note that most of the treaties entered into by Australia[25] (and also some US treaties[26]) contain a provision equivalent to the one suggested in the OECD Commentary. For sake of simplicity this type of provision is hereinafter referred to as the "Australian Clause".

Let us assume that the Australian Clause is contained in Article 11(5) of the treaty between the HO State and the Lender State. Let us further assume that there is no treaty between the HO State and the PE State or that there is a treaty between these two states but the Tie-breaker Rule[27] is not effective, under HO State domestic law, i.e. it does not bind the HO State with respect to the Lender. It is irrelevant whether there is a treaty between the PE State and the Lender State.

A. Single source taxation

Under the Australian Clause in Article 11(5) of the HO State–Lender State treaty, interest paid by the Head Office would be deemed to arise in the PE State and double source taxation would be thus avoided. No conflict between source rules would arise because the interest would equally be deemed to arise in the PE State under the OECD-type Article 11(5) of the PE State–Lender State treaty, if any. Assume that the Head Office is in Canada, the Lender is a resident of Australia and the PE is in Spain (exhibit 4).

21. I.e. of Art. 11(5) second sentence of the OECD Model.
22. The right of Italy to tax the interest is based on Art. 20 of the Italian Income Tax Law.
23. I.e. 10 per cent.
24. See *supra* note 19.
25. E.g. the interest article in the treaties between Australia and Austria, Canada, Finland, India, Italy, the Netherlands, Norway, Spain, United States, but not e.g. in the treaty with Switzerland.
26. E.g. the interest article in the US–Belgium treaty (Art. 11); the "source" articles in the treaty with Norway (Art. 24) and Brazil (Art. 5).
27. See *supra* note 19.

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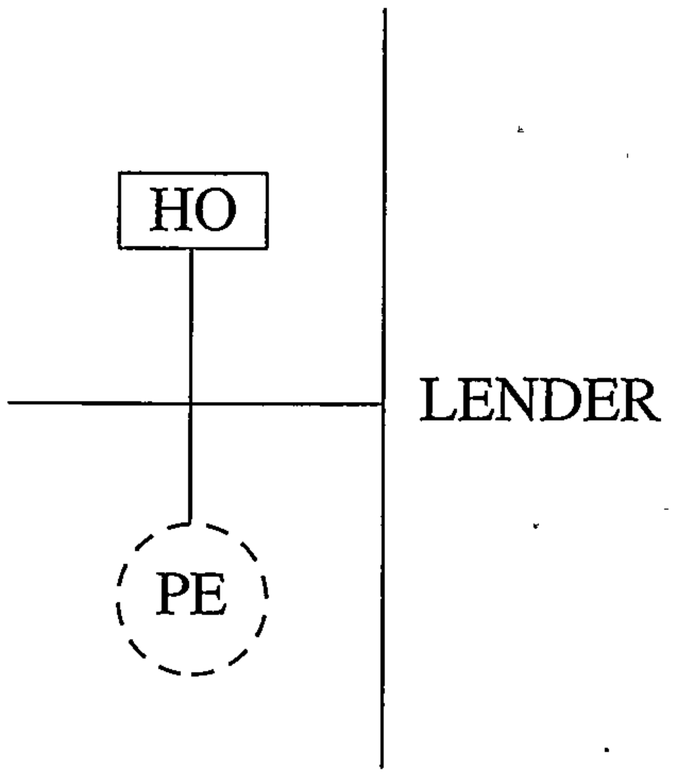

Exhibit 4

Let us further assume that, unlike Italy in exhibit 3, Canada is not prepared to regard the provision of Article 11(5) of its treaty with Spain[28] as an interest source tie-breaker rule that may benefit the Australian Lender.

Under the Australian Clause of the Canada–Australia treaty, (i.e. Article 11(5)), the interest paid by the Canadian Head Office to the Australian Lender is deemed to arise in Spain[29] and may be taxed at source only in Spain under Spanish domestic law and under Article 11 of the Spain–Australia treaty.

B. No source taxation

It should be noted that, as in the case of Article 11(5) Tie-breaker Rule, the application of the Australian Clause may lead to no taxation at source, i.e. in those situations where the PE State does not levy taxes on the interest borne by PEs located in that state.

IV. CONCLUDING REMARKS ON INTEREST DOUBLE SOURCE TAXATION

If one were to compare Article 11(5) Tie-breaker Rule with the Australian Clause, it could be pointed out that the Australian Clause is more effective in that it can no doubt be invoked directly by the Lender, who is the person most immediately affected by double source taxation. Moreover, the Lender can rely, if necessary, on the mutual agreement procedure of the treaty between the Lender State and the HO State. The weakness of the Australian Clause rests in that it may eliminate double source taxation only if there is a treaty between the Head Office and the Lender States. In comparison, on the assumption that the OECD interpretation is correct,[30] the advantage of Article 11(5) second sentence is that it is a standard clause contained in virtually all treaties following the OECD and UN Models; however, it too has a weakness since it may eliminate double taxation only if there is a treaty between the HO and the PE States and in any event, may not provide the Lender with effective protection (See Section II above).

As mentioned, both clauses may lead to no source taxation of the interest. However, whereas the Tie-breaker Rule of the HO State–PE State treaty simply causes the HO State to waive its right to tax the interest at source, the Australian Clause in the treaty with the Lender State eliminates double source taxation of residents of the HO State in the reverse situation, i.e. when the Lender is resident in the HO State. For all these reasons, it may perhaps be argued that the Australian Clause should become included in the standard Article 11(5) of the OECD Model.

Both clauses settle the conflict between source rules in favour of the PE State. It is worth discussing whether from a theoretical point of view this is an acceptable solution. In order to do so, a comparison should be made between the source rules of the two states seeking to tax the interest at source. Unfortunately, since domestic source rules, and their underlying principles, do not follow a consistent pattern, this may turn out to be a difficult exercise.

For instance, although the withholding of taxes on interest and interest deductibility are two separate issues, a few states[31] allow the deductibility of interest paid to a non-resident by another non-resident in connection with a permanent establishment in the state only if withholding taxes are levied on the interest. In these states the relation between the interest and the state, which justifies the interest having its source in that state, is that income is generated through investment in that state of the money borrowed. In fact, Article 11(5) second sentence of the OECD Model reflects this same principle.

In other cases[32] a more formalistic pattern is followed, i.e. interest is deemed to arise in the state if the payer is resident in that state, regardless of whether there is a connection between the loan and the production of income.[33]

For the purpose of settling the conflict between two domestic source rules it is suggested that the interest should have its source in the state where the borrower (i.e. the Head Office) uses the borrowed money to produce the income from which the interest is paid.[34] As a result, the interest should have its

28. Corresponding to Art. 11(5) second sentence of the OECD Model.
29. The interest is also deemed to arise in Spain under Art. 11(5) of the Spain–Australia treaty.
30. There is currently some debate on whether the OECD clause has the effect stated in the interpretation.
31. For example, Australia, the United Kingdom. On this issue see B.J. Arnold, General Reporter, in Cahiers de droit fiscal international, *Deductibility of interest and financing charges in computing taxable income*, Vol. LXXIXa (Deventer: Kluwer 1994) at 518 and 536.
32. E.g. Art. 20 of the Italian Income Tax Law.
33. E.g. loan obtained by a private individual for the purchase of a private asset; money, borrowed by a company, that the law regards as not being connected with the production of income; etc.
34. See A.L. Harding, *Double Taxation of Property and Income*, (1933) at 171.

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source in the PE State, i.e. the state where the money borrowed is utilized to produce income that may be taxed there.

This conclusion is correct regardless of whether the HO State provides relief from double taxation of the PE income through an exemption method or through a credit method. In both cases, the HO State in practice waives, either completely or partially, its tax claims on the PE income in favour of the PE State. As a result, it would seem correct that the HO State did the same with respect to the interest paid to the Lender in connection with the production of the income in the PE State. Of course, for these purposes it is necessary to properly allocate the interest between Head Office and PE. This can be done simply by applying the same domestic allocation rules applied to calculate the income of the PE under an exemption method and the maximum amount of foreign tax credit under a credit method.[35]

In conclusion, it seems correct, from a theoretical point of view, that both Article 11(5) Tie-breaker Rule and the Australian Clause seek to settle conflicting source rules in favour of the PE State.[36]

V. ROYALTIES

Article 12 of the OECD Model provides that royalties may only be taxed in the state of the recipient. However, under Article 12 of the UN Model the source state has also a (limited) right to tax royalties.[37] Since, however, a few OECD states[38] have made a reservation on Article 12 of the OECD Model concerning their right to tax royalties at source, the issue of royalties source taxation in practice also affects a number of treaties entered into by and between OECD states.

Article 12(5) of the UN Model follows the same pattern as Article 11(5) of the OECD Model. It provides that royalties are deemed to arise in the state of the payer. Also, like Article 11(5) of the OECD Model, it provides that the royalties paid by a person, whether a resident of a contracting state or not, that are borne by a permanent establishment in one of the two contracting states are deemed to arise in the contracting state where the PE is located. As a result, a triangular situation like the one discussed above with respect to interest may arise.

Unlike the OECD Commentary on Article 11, the UN Commentary on Article 12 does not deal with this triangular situation. The issue therefore arises as to whether the solutions advanced in the OECD Commentary may be applicable in this case. Given the correspondence between the OECD (and UN) interest source rule and the UN royalty source rule, it may be argued that also in the case of royalties Article 12(5) second sentence of the treaty between the HO and the PE States may be interpreted as a tie-breaker clause governing conflicting source rules.

Finally, with respect to royalties, the inclusion of the Australian Clause in the treaty between the state of the recipient and the HO State may eliminate double source taxation. Indeed, this clause is contained in virtually all the tax treaties entered into by Australia.[39]

35. The main two approaches available are the tracing approach and the apportionment method. See paras. 18.2 and 18.3 of the OECD Commentary on Art. 11.

36. From a practical point of view, it would perhaps be preferable for the Lender to have the source rules conflict settled in favour of the HO State. This would enable the Lender to assess in advance the source tax burden on the interest he receives, especially in those cases where the Lender cannot know what use the Head Office will make of the money borrowed (e.g. will the money be distributed to more than one PE?, will the Head Office itself use part of the money?, etc.). On this point see K. Vogel, (1991), *Klaus Vogel on Double Taxation Conventions* (Deventer: Kluwer, at 673). However, this does not seem a practical solution, because it goes totally against the principle of taxation in the state of the PE, contained since the 1963 draft in Art. 11 of the OECD Model.

37. Art. 12(1) of the UN Model reads as follows: "Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State".

38. Namely, Australia, Austria, Greece, Canada, Japan, Mexico, New Zealand, Portugal, Spain, Turkey and Italy.

39. See treaties mentioned in *supra* note 23.

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SOUTH AFRICA

SOUTH AFRICAN BUDGET 1997

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I. INTRODUCTION

On 12 March 1997, the new South African Minister of Finance, Mr Trevor Manuel, delivered his maiden Budget Speech. The following is a summary of the main measures announced, supplemented by some brief discussion.

II. CORPORATE TAX

A. Tax rates

The rates which remain unchanged are as follows:
- Corporation tax 35 per cent.
- Secondary tax on companies (STC) 12.5 per cent.
- The combined tax rate on distributed earnings 42.2 per cent.[1]

The gold mining tax formulae also remain unchanged.

B. Other

Notwithstanding speculation in the press, ring-fencing for gold mines remains in place. The Katz Commission has a sub-committee on Mining Tax (on which the author serves) which is likely to finalize its deliberations (on ring-fencing, amongst others) during 1997. Tax amendments which may follow the Commission's recommendations are thus likely to be announced either late in 1997, or in the 1998 Budget.

III. PERSONAL TAX

A. Tax rates

Tax rates have been dramatically reduced for lower-middle level earners, as follows:
- The effects of inflation have been reduced for all taxpayers and eliminated for those with taxable incomes less than ZAR 30,000;
- There is now only one tax bracket on taxable incomes up to ZAR 30,000.
- The marginal tax rate applicable to taxpayers with taxable incomes falling in the range ZAR 40,000 to ZAR 45,000 is reduced from 41 per cent to 32 per cent.
- The number of income brackets has been reduced from 8 to 7.
- Currently a person whose income does not exceed ZAR 50,000 per year does not have to submit a tax return. This reduces the administrative burden for both the employee and the South African Revenue Service. The limit will be increased from ZAR 50,000 to ZAR 60,000 as from 1 March 1997, relieving many thousands of taxpayers of the burden of submitting tax returns.

B. New rates

Taxable income (ZAR)	Tax rate (%)
0 to 30,000	19%
30,000 to 35,000	5,700 + 30% of the excess
35,000 to 45,000	7,200 + 32% of the excess
45,000 to 60,000	10,400 + 41% of the excess
60,000 to 70,000	16,550 + 43% of the excess
70,000 to 100,000	20,850 + 44% of the excess
100,000 upwards	34,050 + 45% of the excess

C. Rebates

The primary rebate has been increased from ZAR 2,660 to ZAR 3,215.

D. Fringe benefits

There has been a considerable increase in the tax on some fringe benefits, as follows:

1. Company cars

The fringe benefit arising from the private use of a company car is taxed at a value equal to 1.2 per cent per month of the cost of the car. For example the private use of a company car costing ZAR 100,000 has a monthly taxable value of ZAR 1,200. With effect from 1 July 1997, this percentage will be increased to 1.8 per cent.

In addition, with effect from 1 July 1997, the value to be placed on any second or subsequent vehicle is to be increased from the current level of 2 per cent to 4 per cent.

1. This rate is computed as: 35 per cent plus 12.5/112.5 of the remaining 65 per cent.

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2. Travelling allowances

At present where a taxpayer does not keep accurate records of distances travelled and the total kilometres travelled for business and private purposes do not exceed 32,000 kms, a distance of 12,000 kms is deemed to be travelled for private purposes. To bring the tax treatment of this benefit in line with that of company cars, the deemed private kilometres will be increased to 14,000 as from 1 March 1997. The taxable portion for PAYE purposes will be increased from 35 per cent to 40 per cent with effect from 1 July 1997.

3. Housing

Regarding the taxable value of residential accommodation provided to employees by an employer or by a connected person in relation to the employer – as from 1 March 1997 where residential accommodation provided as a benefit to the employee is not owned by the employer, or where the employee has an interest in the accommodation in question, such an employee will be taxed on an amount equivalent to the rentals paid and other expenditures incurred by the employer in order to provide such accommodation. The definition of the employee's interest in the accommodation will also be extended to include any connected person in relation to such employees. The percentages which are applied to the formula for determining the taxable value of the housing benefit will also be increased by one percentage point as from 1 March 1997.

4. Holiday accommodation

The value for fringe benefit tax purposes to be placed on holiday accommodation provided by an employer to an employee, is the cost incurred by the employer for the hiring of the accommodation. In any other case the employee is currently taxed on the value of ZAR 35 per person per day. As from 1 March 1997 this value is to be increased to ZAR 100 per person per day.

IV. EXTENSION OF THE SOURCE BASIS OF TAXATION

The relaxation of exchange controls announced in this Budget has tax implications. The Katz Commission has a subcommittee (on which the author served) which has completed an examination of the current source basis of taxation. The Katz Commission's report on this subject will be released within a week. In the interim, the Minister has announced the extension of the current source basis of taxation to include in the South African tax net a greater range of foreign "passive income", earned directly and indirectly.

The following are the interim measures to protect the tax base in the short term.

1. The existing provisions of the Income Tax Act which deal with the deeming of the source of income, will be extended to include passive income, namely interest, royalties, annuities and rentals not presently deemed to be from a South African source. The effect of this is that South African residents be they corporate or individual will become subject to tax in South Africa on passive income, regardless of the source, from the date that the exchange controls are relaxed.
2. The deeming provisions would, however, exclude passive income which is effectively connected with an active business operation (permanent establishment) conducted by a South African resident through a fixed facility outside South Africa.

V. THE RETIREMENT AND MEDICAL FUND INDUSTRIES

A. Tax rate – retirement funds

The tax rate on the gross interest and net rentals received by retirement funds (first imposed in 1996) remains at 17 per cent.

B. Tax base – retirement funds

There are a few expected changes to the tax base.

In the case of investments made by funds in unit trust schemes with property shares, such funds receive dividends which are derived from property companies. Since these dividends are effectively a distribution of rental income received by the property companies and having regard to the fact that such dividends are distributed before taxation, the taxation of rental income is effectively being shifted to the unit holders.

At present such dividends received by funds are neither subject to normal tax nor tax on retirement funds in the hands of the fund. Given that such dividends effectively represent rental income, they will be subject to the tax on retirement funds with effect from 1 March 1997.

In addition, where a fund lends interest-bearing instruments to a borrower payments by the borrower to the lender for compensation for the loss of interest and use of the instruments will be deemed to be interest and will be subject to the tax on retirement funds as from 1 March 1997.

C. Equal tax treatment for members of public and private funds

In terms of present tax rules lump sum benefits payable to members of retirement schemes established by law or for the benefit of local authorities (public sector funds) are not taxable. However, members of private sector funds are liable for tax on lump sum benefits.

Both the Katz Commission and the National Retirement Consultative Forum have recommended that there should be equal treatment of lump-sum benefits received by members of public and private sector funds.

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Equality between public and private sector funds of the tax treatment of lump sum payments is to be introduced from 1 March 1998 subject to the protection of vested rights.

D. Deferred compensation

The Government is extremely concerned about the practice of using some medical savings schemes and other types of salary sacrifice schemes to reduce the taxable income of a person.

The South African Revenue Service (SARS) holds the view that interest credited to a savings scheme of this nature is taxable in the hands of the member. SARS are also investigating these schemes to determine the tax treatment of contributions to such funds as well as the tax treatment of repayments and withdrawals.

VI. VALUE ADDED TAX

The VAT rate remains unchanged at 14 per cent.

VII. EXCHANGE CONTROL

Following widespread speculation on the probable easing of exchange controls on residents, measures which will implement considerable relaxation of these controls were announced by the Minister. The following are some of the important features of the package:

- with the exception of discretionary type expenditure such as maintenance payments whose limits have been substantially revised, most remaining controls on current account transactions will be abolished;
- travel allowances are increased to an annual allowance of 80,000 per adult and ZAR 25,000 per child;
- individuals will be allowed to remit an amount of capital abroad, with extended limits for the acquisition of fixed property in SADC countries; will be able to maintain foreign currency denominated deposit accounts subject to a prescribed ceiling with South African banks; and will be permitted to retain foreign income earnings in foreign currency accounts;
- corporations wishing to establish new ventures will be permitted to transfer up to ZAR 30 million as a proportion of their investment, or ZAR 50 million in the case of SADC investments;
- South African corporations will be allowed to raise foreign funding on the strength of their South African balance sheets; and when circumstances permit, South African corporations will be free to invest abroad a percentage of their assets (based on audited balance sheets) for portfolio investments;
- institutional investors will in 1997 be allowed to invest up to 3 per cent of the net inflow of funds during the 1996 calendar year; the definition of qualifying institutions for asset swaps will be broadened to include regulated fund managers, as well as to allow unit trusts more flexibility in applying the current 10 per cent limits;
- the South African Reserve Bank will supervise the implementation of a dollar/rand futures contract issued in South Africa;
- the non-resident ownership level at which foreign controlled resident entities become subject to limits on local borrowing will be raised from 25 per cent to 50 per cent;
- the limits for the completion of forms A and E for the purchase and sale of foreign exchange will be increased from ZAR 2,000 to ZAR 40,000;
- South African individuals and corporations will have to provide authorized foreign exchange dealers with a tax reference number and sign a declaration of good standing in respect of their South African tax obligations before being permitted to remit funds offshore.

VIII. OTHER MEASURES

A. Excise duties

As usual, there are considerable increases in these duties.

Excise duties are in the main specific levies per unit of volume, rather than *ad valorem* taxes on value and it is therefore appropriate that we consider these duties annually.

Substantial increases in the excise duties on tobacco products are again proposed. The rate of duty on tobacco will increase by 52 per cent, bringing the tax, including VAT, to 50 per cent of the average retail price. Smokers will have to pay an extra 27 cents per 10 cigarettes. Pipe tobacco will cost an extra ZAR 2.49 per kilogram.

The news for drinkers is equally sobering. Some of the highlights are: beer goes up by 8.15 cents per litre or about 3 cents per 340 ml can; sorghum beer increases by 2 cents per litre and sorghum flour by 5.5 cents per kilogram; unfortified wine increases by about 8 cents per 750 ml bottle; mineral water and soft drinks go up by 1.2 cents per litre; cane spirits will increase by about 66 cents per 750 ml bottle, and similar increases apply to whisky, brandy and gin.

B. *Ad valorem* customs and excise duties

The current *ad valorem* duties range between 6 and 37.5 per cent before VAT. The abolition of these duties was recommended by the Margo Commission and the Katz Commission has also indicated its unease. The Minister felt that for revenue reasons he was at present unable to justify the abolition of these duties, but reductions are in store.

The existing rates of 37.5 per cent and 32.5 per cent are to be lowered to 15 per cent. As far as motor cycles are concerned, the rates will be lowered from 32.5 per cent and 17.5 per cent (which applies to cycles with a cylinder capacity of less than 800 cm3) to 15 per cent and 7.5 per cent respectively.

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C. Marketable Securities Tax

Following the progressive reduction of the MST rate in recent years (from 1.5 per cent a few years ago to 0.5 per cent last year) this tax has now dropped to 0.25 per cent from 1 April 1997.

D. Simplification of the Income Tax Act

This year the Ministry of Finance will embark on a project to consolidate and simplify the Income Tax Act in a manner that ensures that the contents are easily understandable by all South Africans. The scope of the project is far-reaching and it is envisaged that it will take several years to complete. The project will serve as a training ground for young tax lawyers and accountants who will be appointed to help with the task of rewriting the Act.

E. Declaration of good standing

The Government intends to more vigorously enforce the tax legislation.

To this end they have decided that any South African, be it a natural person or a corporation, who wants to tender and participate in any form of contract to provide goods and services to government, or who wishes to access any of the supply-side financial assistance opportunities or other Government initiatives must be a registered taxpayer and must sign a declaration that his tax affairs are in order.

The provision of tax numbers and a declaration of good standing will also be required from individuals or corporations wanting to avail themselves of foreign currency. (See above.)

F. The final tax relief programme

With a view to broadening the tax base and addressing the problem of non-payment of tax, the Government offered a final tax, interest, penalty and additional tax relief programme to certain categories of persons in 1996/97. Following the approval of the legislation by Parliament, the period to apply for relief started on 1 November 1996 and ended on 28 February 1997.

The programme was extensive, covering both registered and unregistered persons. In the case of unregistered persons, no taxes were levied for the tax years before 1 March 1994. For registered taxpayers, interest and penalties owing for the periods before 1 March 1994 were written off if certain conditions were met.

IX. DOUBLE TAX AGREEMENTS[2]

A. General

In recent months there has been much activity on this front. During the course of 1996, and in the first few months of 1997, DTAs with the following countries were ratified:

Country	Ratification by South Africa
Korea	26 January 1996
Norway	15 October 1996
Poland	16 May 1996
Taiwan	3 September 1996
Thailand	3 September 1996

On the negotiation front the following treaties have recently been signed:

Austria	DTA signed 4 March 1996 – awaiting ratification.
Mauritius	DTA signed 1 July 1996 – awaiting ratification.
Czech Rep	DTA signed 11 November 1996 – awaiting ratification.
Italy	DTA signed 16 November 1996 – awaiting ratification.
United States	DTA signed 18 February 1997 – awaiting ratification. (see note below on the United States agreement)
India	DTA signed December 1996 – awaiting ratification.

In February 1996 it was erroneously reported in an international fiscal publication that South Africa had signed a tax treaty with Luxembourg in 1995, dealing with air transport. In fact, the treaty dealt exclusively with air transport, and had no reference to tax issues.

On a more general note, South Africa is likely to be negotiating comprehensive DTAs with a number of South American countries in 1997, in addition to the countries listed below in the "negotiation dates awaiting finalization" column.

Regarding existing DTAs, the Netherlands Finance Ministry issued a decree (IFZ 96/94 U. 3) on 4 April 1996 to the effect that South African Secondary Tax on Companies (STC) qualifies as a tax on profits "substantially similar" to the existing taxes listed in Article 2 of the DTA between the two countries. STC is thus covered by the agreement.

Regarding the new United States agreement, in a forthcoming article in the *Bulletin* the author argues that the wording of the agreement is inadequate to guarantee US shareholders a credit in the US for South African STC. A US Treasury official subsequently expressed the view that the current wording "won't be a problem", but has yet to explain why this is the case. Further developments are awaited.

2. The following information is by courtesy of the *InfoTax* electronic tax service.

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B. Current status report

The following table sets out the current status report relating to South Africa's DTA network.

1. Comprehensive agreements in place

Botswana	Denmark ([1a])	Finland ([1b])	France ([1c])
Gambia	Germany	Grenada	Hungary ([1d])
Israel	Korea ([1e])	Lesotho	Malawi
Mauritius	Namibia	Netherlands	Nicaragua
Norway([1f])	Poland ([1g])	Romania([1h])	Seychelles
Sierra Leone	Swaziland	Sweden ([1i])	Switzerland
Taiwan ([1j])	Tanzania	Thailand ([1k])	Uganda
United Kingdom	Zambia	Zimbabwe	

2. Comprehensive agreements signed by both countries, presently ratified only by South Africa

Austria	Belgium	Canada	Italy
Lesotho	Russian Federation		

3. Comprehensive agreements signed by both countries, presently unratified by either country

Czech Republic	India	Mauritius
United States of America		

4. Comprehensive agreements negotiated or renegotiated, presently unsigned by either country

Botswana	Croatia	Cyprus	India
Luxembourg	Malaysia	Malta	Namibia
Singapore	Slovakia	Swaziland	Turkey
Uganda	Zimbabwe		

5. Comprehensive agreements being negotiated or renegotiated

Argentina	Gabon	Ireland	Japan
Portugal	Tunisia	Turkey	

6. Negotiation dates awaiting finalization

Greece	Jordan	Kenya	Morocco
New Zealand	Nigeria	Spain	Ukraine
United Arab Emirates	Zambia		

7. Limited sea and air transport treaties in place

Belgium	Brazil	Greece	Ireland
Italy	Japan	Norway	Portugal
Taiwan	Spain		

Notes

1: All DTAs listed under note 1 (i.e. 1a, 1b, 1c etc.) are new, in that they have come into existence since South Africa's first fully democratic elections in April 1993.

1a: Denmark: agreement ratified by South Africa on 22 December 1995.

1b: Finland: agreement ratified by South Africa on 1 December 1995.

1c: France: agreement ratified by South Africa on 27 September 1995.

1d: Hungary: agreement ratified by South Africa on 13 September 1995.

1e: Korea: agreement ratified by South Africa on 26 January 1996.

1f: Norway: agreement ratified by South Africa on 15 October 1996.

1g: Poland: agreement ratified by South Africa on 16 May 1996.

1h: Romania: agreement ratified by South Africa on 27 September 1995.

1i: Sweden: agreement ratified by South Africa on 22 December 1995.

1j: Taiwan: agreement ratified by South Africa on 3 September 1996.

1k: Thailand: agreement ratified by South Africa on 3 September 1996.

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AUSTRALIA

TAX ACCOUNTING IN AUSTRALIA

Rick Krever

I. INTRODUCTION

Subject to a few schedular-like exceptions and a set of discrete capital gains rules, Australia's income tax system generally operates as a global tax in which all gross receipts are lumped together to ascertain total assessable income, and all deductible outgoings are lumped together to determine total allowable deductions. These two items are netted together to determine taxable income for the year,[1] on which tax is then imposed.[2]

The income tax base, i.e. what comes into assessable income has undergone a complete transformation and broadening in the past 15 years. One important consequence of that change has been to shift tax accounting issues from the quiet backwater in which they had languished for decades to the forefront of tax planning concerns. Whereas formerly taxpayers were primarily concerned with *how* a receipt or outgoing might be characterized for tax purposes, following tax reform and base broadening a prime issue became *when* the amount would be recognized for tax purposes.

This article reviews the statutory measures and case law precedents that establish Australia's rules of tax accounting, the rules that determine when income must be recognized and when expenses may be deducted for tax purposes.[3]

II. CASH-BASIS OR ACCRUAL-BASIS ACCOUNTING?

A taxpayer's taxable income is calculated as income *derived* less expenses *incurred* to derive the income. When a taxpayer derives income will depend on whether the taxpayer is subject to *cash-basis* or *accrual-basis* tax accounting rules. As is explained in more detail below, the type of accounting system applied to a taxpayer appears to be less relevant to determining when that person incurs a deductible expense.

Subject to refinements discussed further below, under cash-basis accounting, a taxpayer generally derives an amount when it is received. Again subject to the refinements discussed below, under accrual-basis accounting (sometimes called earnings-basis accounting in Australia, particularly in older court cases), a taxpayer generally derives an amount when he accrues a right to be paid (usually when the customer is invoiced), whether or not actual payment is made at the same time.

The courts have said the question of whether any particular taxpayer is subject to cash-basis or accrual-basis accounting is a question of law. For the most part, doctrinal analysis provides little guidance,[4] but taken together, legal precedents provide a fairly clear idea of the borderline between cash-basis and accrual-basis taxpayers. Generally, cash-basis accounting is applied to individuals and very small businesses and accrual-basis accounting is applied to larger businesses and to companies. Attempts by the Commissioner of Taxation to extend accrual-basis accounting to individual professionals have been successfully rebuffed,[5] while attempts to assess smaller partnerships on an accrual basis have been successful.[6]

One of the leading cases on the borderline between cash-basis and accrual-basis taxpayers, *Henderson v. FCT*,[7] also illustrates a fundamental weakness of the Australian tax accounting doctrines. The courts have never developed rules to prevent overlap or lacunae where taxpayers switch from one tax accounting system to the other. The taxpayer in *Henderson*, for example, was a member of a partnership (as irony would have it, an accounting firm). The taxpayer argued successfully on behalf of himself and his fellow partners that it was more appropriate for the firm, which had formerly submitted tax returns on a cash basis, to submit on an accrual basis. As the result of the decision in his favour, a substantial part of the firm's billings for the year prior to the change disappeared from the tax system. No income was recognized when invoices had been sent out as the firm was on a cash basis in that year. And no income was recognized when payment was made on the invoices as the firm was on an accrual basis that year. While the judge at first instance devised a rule that would have required recognition of the lost income fol-

1. *Income Tax Assessment Act* 1936 (hereinafter ITAA) Sec. 48.
2. ITAA Sec. 17.
3. This article draws from a chapter by the author in S. Ross and P. Burgess, *Income Tax: A Critical Analysis* (2nd ed) (Sydney: Law Book Company, 1996). A leading article on tax accounting in Australia, which should be consulted by all readers interested in pursuing further the law and policy of tax accounting issues, is Graeme Cooper, "Tax Accounting for Deductions" (1988) 5 *Australian Tax Forum* 23. Cooper's two chapters on tax accounting in G. Cooper, R. Deutsch and R. Krever, *Income Taxation Commentary and Materials* (2nd ed) (Sydney: Law Book Company, 1993) should also be consulted.
4. An often cited precedent, for example, simply asserts that the appropriate system is the one that will "give a substantially correct reflex of the taxpayer's true income" – per Dixon J in *Commissioner of Taxes (SA) v. Executor Trustee and Agency Company of South Australia Ltd* (*Carden*'s case) (1938) 63 CLR 108, at 154 (Full HC).
5. See, for example, *FCT v. Firstenberg* (1976) 6 ATR 297 (S. Ct. Vic); *FCT v. Dunn* (1989) 20 ATR 356 (Fed. Ct.) (no rule that sole practitioners must use cash-basis accounting, but it was appropriate in this case); see also Determination TD93/11, which deals with professional income and TD93/18, which deals with taxpayers generally, setting out some criteria used by the Commissioner of Taxation when deciding whether to apply cash- or accrual-basis accounting to a taxpayer.
6. See, for example, *Barratt v. FCT* (1992) 23 ATR 339.
7. (1970) 1 ATR 596 (Full HC).

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lowing a change in accounting methods,[8] he was overruled on appeal. Surprisingly, no legislative reform has followed.

III. CASH-BASIS INCOME RECOGNITION

A cash-basis taxpayer derives income when it is "received". A statutory measure reinforces the general principle that receipt may be actual or constructive so a taxpayer will be deemed to receive a payment when it is dealt with on his behalf.[9]

Constructive receipt implies some active control over income by the taxpayer that is, some direction in how it is used or applied or some benefit derived by the taxpayer. Thus, a cash-basis taxpayer who fails to demand payment to which he is entitled will not derive income simply by failing to call for it,[10] but the taxpayer who is presented with and refuses to accept payment will derive the income it represents when payment is tendered.[11] The former taxpayer is completely passive with respect to the derivation of income, while the latter exercises control over income in the sense of actively dealing with the funds, even if that control is only to tell another person to retain the funds.

It has been suggested in passing in a leading tax accounting case that a taxpayer who, prior to the date on which payment is due, asks for payment to be deferred past its due date would not derive the income until it was received.[12] However, many tax commentators believe a court faced directly with this situation would conclude the request amounts to control over the income and thus should constitute constructive receipt on the due date. To allow taxpayers to defer income recognition simply by requesting before a payment is made that it be delayed rather than waiting until it is tendered and then refusing to accept it would clearly undermine the policy underlying the doctrine of constructive receipt.

Actual receipt does not mean actual receipt of cash. Although there are no Australian cases confirming the point, it is generally thought that the cash-basis taxpayer paid by cheque derives the income when the cheque is presented to the taxpayer, not when it is cashed.[13]

Cash basis accounting opens many opportunities for planning. It is particularly open to exploitation and manipulative timing when applied in transactions involving an accrual-basis taxpayer paying income and a cash-basis taxpayer receiving it. Tax minimization based on this combination reached its apex in the 1980s in the "deep discount" arrangements set up by many financial institutions. Under a deep discount arrangement, a financial institution would borrow from cash-basis taxpayers using deep discount bonds or debentures that paid little or no annual interest, but which were redeemed after several years at a substantial premium over the issue price. The deep discount was in lieu of ordinary interest and usually was calculated to yield the equivalent of ordinary interest compounded over the life of the debt instrument.

Prior to 19 September 1985, when Australia added capital gains to the income tax base, some cash basis taxpayers sought to characterize the gain they realized on redemption of deep discount notes as exempt capital gains, arguing it was related to the underlying instrument and had none of the characteristics of ordinary income such as periodicity. The argument met with little success, as it was clear that the discount was in substitution for ordinary interest and, as such, it attained an income character. The taxpayers' fall-back argument, that recognition of the gain could be deferred by cash-basis lenders until redemption, was successful. The result was a significant deferral of taxation. What particularly upset the tax authorities was the fact that accrual-basis lenders treated the discount as an accruing liability and deducted it over the life of the loan as if it were in fact compounding interest. The Taxation Office was thus caught in a classic tax planning whipsaw, with the taxpayer who paid interest obtaining the benefit of an immediate deduction while the taxpayer who received interest deferring tax on the gain until well into the future.

A variation on the deep discount note arrangement was the issuance of "deferred interest" debt instruments. Interest on deferred interest debentures was calculated annually but was not payable until the debenture matured. When the instrument was redeemed, the lender would receive the principal and deferred interest. The interest rate was always much higher than that paid on debentures with ordinary annual interest or compounding interest but, not by coincidence, was always set at a rate such that the total interest received by the investor on maturity of the debenture equalled the interest that would have been paid on an ordinary compounding interest debenture. The difference was that compound interest was recognized every year, when it compounded, while deferred interest did not have to be recognized until paid upon maturity.

The government responded to the discount and deferred interest schemes with statutory provisions, contained in Division 16E of Part III of the *Income Tax Assessment Act* (ITAA), which require taxpayers to recognize deferred interest, discounts in the nature of interest, and similar interest-like returns on an annual basis, over the life of a debt. The Division applies to deferrals exceeding 12 months; thus, since the adoption of Division 16E the longest a cash-basis taxpayer can defer recognition of interest or a discount on a debt instrument is from one year to the next tax year.

8. (1969) 1 ATR 133 (HC).
9. ITAA Sec. 19.
10. *Brent v. FCT* (1971) 125 CLR 418 (High Ct.).
11. *Case 31* (1972) 18 CTBR (NS) 221. An interesting distinguishing case is *Case D7* (1972) 72 ATC 38. The taxpayer in this case was offered the alternative of a single payment or two instalment payments. The taxpayer elected to receive two payments and the Board of Review concluded that, in light of the election option, it could not be said the taxpayer constructively received the second payment until it was actually made.
12. *Brent v. FCT*, (1971) 125 CLR 418, at 430 (High Ct.).
13. This proposition derives from *Tilley v. The Official Receiver* (1960) 103 CLR 529 (High Ct.) and the New Zealand income tax case of *Ullrich v. CIR* (NZ) (1963) 13 ATD 321. A contrary position was taken in the UK case of *Parkside Leasing Ltd v. Smith* [1985] STC 63 (Ch. D.).

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IV. ACCRUAL-BASIS INCOME RECOGNITION

An accrual-basis taxpayer derives income when the taxpayer has a legal right to receive payment. Normally this arises when an invoice is issued at the completion of a contract, even though the terms of the contract may allow the customer some time in which to pay. The income is derived even if the taxpayer is unable, by reason of some legal incapacity, to enforce payment through the courts.[14]

Usually, businesses issue an invoice contemporaneously with the provision of goods or services. This is not always the case, however. Sometimes, for administrative reasons, invoices are mailed out at a later date, even though the contract for the sale or services did not preclude the taxpayer from issuing the invoice at the time the goods were delivered or the service was provided. In this situation, the taxpayer supplying goods or services will derive income when the goods or services are provided, as it is legally entitled to issue the invoice at that time and it is only for internal administrative or similar reasons that the invoice has not been presented.

There are some, and for the most part unusual, cases where taxpayers do not have the option of invoicing upon delivery. This may be the case, for example, for regulated utilities where legislation governing the utility stipulates that billing must follow the provision of services. In such cases, the general rule that income is derived as services are provided is displaced and the taxpayers will derive income upon the later presentation of the invoice to the customer.[15]

Not all invoiced amounts are treated as income to the accruals-basis taxpayer issuing the invoice. For example, if the taxpayer knows that the customer has a potential legal right to avoid part of the payment and is likely to exercise that right, the recognized income can be reduced by the amount unlikely to be paid. This often occurs with contracts that provide for discounts in the case of prompt payment. If the taxpayer is able to provide convincing evidence that, based on past performance, its customers are likely to qualify for the discount, only the discounted amounts needs to be recognized as income to the taxpayer.[16]

A. Income recognition and prepayments

Normally, suppliers have no right to payment and thus no right to issue an invoice and no capacity to derive income prior to completion of a contract.[17] However, some goods and services are sold on a prepaid or pre-invoiced basis under which suppliers invoice customers for benefits that will be supplied after the invoice is issued, sometimes in future years. Until recently, the recognition of invoiced amounts relating to the provision of future goods or services was one area in which commercial accounting and tax accounting in Australia differed dramatically.

Generally, commercial accounting procedures require taxpayers to defer or qualify recognition of some of the income where an invoiced amount is related to the provision of goods or services in future years. A variety of techniques are used for this purpose. In some cases, this is done by recognizing receipts as income but then appropriating part of profits to a "reserve" to indicate the profits are not actually available for use or distribution but are being held for eventual application to satisfy a contingent or potential liability. An alternative that is sometimes followed is to treat the income as profit of the business but to add a notation to the accounts indicating that the "income" received is subject to a contingent or potential liability and may not, therefore, reflect actual gain. A third commonly used option is to not treat the amount as income for accounting purposes and to instead credit the consideration to a "prepaid revenue account". This is recorded as a liability of the company (the equivalent of a loan) that is offset on the balance sheet by the increased asset of more money in the bank. As the goods or services are provided, the liability will be diminished and amounts will move from the prepaid revenue account to the "income" account.

The object behind all these methods is to prevent businesses from misleading the owners or potential investors as to the business' profitability by recognizing all payments received or invoiced in a year as gains. A truer picture is presented if the reader of the accounts is made aware that some "gains" derived in the year are attributable to services to be provided in future years or that they might give rise in future years to liabilities that have not yet crystallized.

Income tax rules, by way of contrast, were traditionally less concerned with qualifying or deferring recognition of income for the purpose of ensuring that a taxpayer's future obligations are noted. As far as tax law was concerned, when a taxpayer invoiced a customer, the taxpayer had economic command over the income which should be recognized as such for tax purposes. Future obligations were to be recognized by way of deductions when and if the funds were used. This general proposition has been increasingly eroded, however, and in some areas income tax law goes even further than accounting practice to defer recognition of income.

14. See, for example, *Barratt v. FCT* (1992) 23 ATR 339 (Full Fed. Ct.), where medical practitioners operating through a partnership were prohibited by the *Medical Practitioners Act* 1938 (NSW) from recovering fees for at least six months after the provision of medical services. The taxpayers were nevertheless assessable on invoiced income when accounts were presented to patients.
15. See *FCT v. Australian Gas Light Co.* (1983) 15 ATR 105 (Full Fed. Ct.), where legislation applying to the taxpayer prevented it from issuing bills or demanding payment other than on a regular three-monthly billing cycle. If there had been no such statutory provision, the income would have been derived as services were provided.
16. See *Ballarat Brewing Co Ltd v. FCT* (1951) 82 CLR 364 (High Ct.).
17. Normally, the contract itself specifies when it is completed. However, additional requirements might be read into the contract in some cases. See, for example, *Gasparin v. FCT* (1994) 28 ATR 130 (Full Federal Court), where the taxpayer was a land developer selling residential allotments. The case concerned the transfer of several allotments pursuant to a 'conditional' contract, which was conditional upon registration of a plan of subdivision. The condition was satisfied prior to the end of the year of assessment, but final settlement took place in the following year. The Full Federal Court said that no debt arose under a contract for the sale of land until the completion of the contract, which occurred on settlement, even if the contract did not impose settlement as a condition of the sale. It would appear the Court in *Gasparin* relied on property law concepts rather than commercial tax accounting principles to decide an accounting issue. It is arguable that the conditions in land law necessary for completion of a contract of sale of land are irrelevant to the question of when a taxpayer's right to income has crystallized sufficiently to be derived for tax purposes.

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The stark differences between commercial accounting and tax accounting began to dissolve in the 1960s as the courts began to allow taxpayers in selected situations to defer recognition of income where it was referable to future services to be provided by the taxpayer. The system is often referred to as *Arthur Murray* tax accounting, after the leading case in which it was endorsed by the High Court (Australia's final court of appeal).[18]

Originally, the deferral was available only where the taxpayer could show on the basis of statistical evidence the extent to which customers would seek to cancel their contracts with the taxpayer and be granted a pro rata refund of part of the sale price.[19] It was soon extended to a range of transactions where taxpayers were invoiced up front for goods or services to be provided over more than one financial year.[20]

Two situations somewhat analogous to that found in the prepayment transaction are those involving contracts requiring deposits and contracts that provide for warranties. Under the former, the taxpayer may be required to refund a deposit if the contracted sale does not proceed. Under the latter, the taxpayer may have to provide repairs or replacements for a fixed period after the sale. Once again, financial accounting practice would generally allow businesses to make reserves for amounts that should not be recorded as gross gains in the year derived because they are subject to potential repayment or expenditure in a future year. Tax accounting, on the other hand, traditionally required taxpayers to recognize the up-front payments entirely as income and then allowed deductions if and when deposits were refunded[21] or warranties honoured. One reason courts were not willing to defer up-front recognition of income was a concern that projected future liabilities might in fact never have to be met.[22]

To date, judicial precedents that allow deferral of income recognition in a prepayment situation by means of *Arthur Murray* tax accounting have not been extended in Australia to transactions involving warranties, even if the taxpayer is able to quantify with a reasonable degree of certainty the probable costs of future warranty obligations. Recently, the door was opened in New Zealand to an alternative approach that achieved a result similar to non-recognition of that part of an income receipt attributable to future warranty obligations. In *Mitsubishi Motors New Zealand Ltd.*,[23] the Privy Council affirmed lower court decisions that required the taxpayer to recognize the entire sale price up front but then allowed the taxpayer immediate offsetting deductions for the estimated warranty costs.[24] This approach, discussed further below in the context of tax accounting for deductions, has thus far not been endorsed by Australian courts.

B. Uncertainty of payment

A separate issue is the recognition of income where there is some uncertainty as to the amount of income or even whether it will be paid at all. Cases involving this issue may be divided into three broad categories: first, where the contract is fixed and the price is fixed but the actual dollar amount of consideration payable under the contract has not been calculated at the end of the year of assessment; second, where the price is fixed but the contract is subject to some contingency; and third, where the contract is fixed, but the rate of consideration is subject to variation.

The first category often arises in respect of transactions where the price is calculated by reference to an external base. For example, a taxpayer may sell, say, oil for the average Amsterdam spot price for the month or be entitled to interest equal to the average London inter-bank-offer-rate for the month and at the end of the year not have received the information necessary to calculate its income entitlement. There are no judicial precedents on this point and it remains unclear when income is recognized for tax purposes in these circumstances. The application of analogous deduction cases suggests that the amounts payable under the contract would be derived when the customer's liability to pay accrued under the contract, subject to the figures being filled in when the necessary information is available.[25] However, deduction

18. *Arthur Murray (NSW) Pty Ltd v. FCT* (1965) 114 CLR 314 (High Ct.).
19. In *Arthur Murray* the Court allowed the taxpayer to defer recognition of income on this basis even though the taxpayer was under no legal obligation to provide refunds. It did, however, demonstrate to the Court's satisfaction that as a matter of practice it provided refunds for goodwill purposes.
20. A leading case is *Country Magazine Pty Ltd v. FCT* (1968) 117 CLR 162 (High Ct.) where the taxpayer sold subscriptions to its publication for up-front subscription fees that covered delivery of a magazine over a period extending past the year in which the amount was invoiced. The taxpayer in *Country Magazine* was subject to an interesting 'whipsaw' by the Commissioner of Taxation; in effect the reverse of the whipsaw carried out by the taxpayer in *Henderson*, *supra* note 7. The taxpayer in *Henderson* whipsawed the Commissioner of Taxation by switching from a cash to accruals-basis accounting system after sending out a large number of invoices. The change in accounting systems caused a large amount of income – anything that had been invoiced but not collected at the time of the change – to simply disappear for tax purposes. Just the reverse occurred to the taxpayer in *Country Magazines*, where the Commissioner of taxation used tax accounting doctrines to whipsaw a taxpayer badly. Prior to the *Arthur Murray* case, the taxpayer in *Country Magazines*, a magazine publisher, recognized as income the entire amount of subscriptions invoiced, even though part of the amount referred to magazines that were to be provided in a future year and might be refunded if a taxpayer cancelled her or his subscription in the later year. Following the *Arthur Murray* case, the taxpayer in *Country Magazines* modified its tax accounting system, recognizing invoiced amounts only in the years in which subscriptions were actually provided. The Commissioner required the taxpayer to recognize in the first year of the new accounting system all previously invoiced amounts attributable to subscriptions delivered in that year, even though much of this income had been recognized in previous years, when the customers had been invoiced. The High Court agreed with the Commissioner, using the same logic it had adopted in *Henderson*, namely that each year must be considered separately and that there are no general principles that could be used to correct the double counting or disappearance when a taxpayer moved from one accounting system to another.
21. See, for example, the UK decision of *Elson v. Prices Tailors, Ltd* [1963] 1 All ER 231 (Ch. D.). The taxpayer company in that case received deposits on custom-made clothes which were refunded if the order was subsequently cancelled, although the taxpayer was in theory not legally obligated to provide a refund.
22. See, for example, *AAT Case 5181* (1989) 20 ATR 3694 where the taxpayer had provided house builders with a ten year warranty of its pest control treatment, but the builders had not transferred their rights to the final purchasers of the homes.
23. [1995] STC 989 (P.C.).
24. The Privy Council, which sits in the United Kingdom, is the final court of appeal for New Zealand, a legacy of the colonial era since abandoned in other former colonies such as Canada and Australia.
25. See, for example, *Commonwealth Aluminium Corp v. FCT* (1977) 7 ATR 376 (S. Ct. Vic). *Commonwealth Aluminium* involved the deductibility of an expense, royalty payments in that case, the amount of which had not been determined at the end of the year of income. The Supreme Court of Victoria nevertheless concluded the expense had been incurred and was deductible in the year of income.

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principles are often not applied in an analogous fashion to income derivation situations and there are many examples of courts allowing deferral of income recognition where some uncertainty about entitlement remains.[26] Moreover, it could be argued that since it would not be legally possible for a taxpayer to recover an unascertained amount at the end of a tax year, it cannot be said that the taxpayer has derived the amount in a tax accounting sense. On the other hand, it is clear the taxpayer in this case has a contractual right to be paid for the goods or services supplied and it is equally clear that the taxpayer has derived a benefit (of an admittedly uncertain amount) from a commercial perspective. In the absence of direct authority, the question of income recognition remains open where there is an amount uncertain.

The second category of uncertainty case involves transactions based on conditional or revokable contracts where nominated conditions must be satisfied for a transfer to become absolute. Generally, Australian courts allow taxpayers to defer recognition of income invoiced or paid pursuant to a conditional contract until the conditions for final transfer or sale set out in the contract are satisfied.[27] Prior to that time, the taxpayer has not derived income in the sense of having an unfettered right to the gain.

The tax accounting treatment of the third type of uncertainty, arising because the contract provides for variable consideration, is a little more complicated, partly because under variable consideration contracts the final consideration can be subject to either upward or downward change. Contracts involving variable consideration are quite common where the parties to the contracts are unable to agree on the value of property being sold. This is often the situation, for example, with sales of natural resource property where there is some doubt about the value of minerals below the land. In cases like these, the sale may provide for a fixed price and additional payments of a certain amount per tonne of mineral mined. Contracts involving conditional payments are also quite common in the sale of private businesses. A business may be sold for a fixed price plus a percentage of profits for a nominated period after the sale.

Where a sale contract provides for potential additional payments that would increase the total consideration, the Commissioner of Taxation allows taxpayers to dissect the contract into two parts – a sale for the certain amount and a separate entitlement to conditional payments that crystallize when the taxpayer becomes entitled to the payments. Thus, for example, where natural resource property is sold for a fixed price plus a further amount per tonne of mineral recovered, the vendor will be assessed in respect of the fixed price at the time of the sale and in respect of the contingent amounts as minerals are recovered and the additional payments fall due. These same rules apply whether the gain is assessed as judicial concept income or a capital gain.

More difficult are sales where the sale price is subject to downward adjustment. Contracts of this type are less common, but are sometimes used in transactions similar to those attracting ordinary conditional payments. In a sale where the price is subject to downward adjustment, the parties agree on a fixed price, but further agree it shall be reduced if the property does not prove as valuable as the parties believe it will be. For example, natural resource property may be sold for a notional consideration to be reduced by a specified amount per tonne for each tonne of shortfall where total production falls below the agreed production. Similarly, a business may be sold for a fixed amount to be reduced by a nominated percentage of any shortfall between actual profits in the year following the sale and profits predicted by the vendor.

The tax treatment of downward adjustments will depend on how the adjustment is structured. Unless the vendor can provide convincing evidence that it expects part of the consideration to be refunded, the vendor's income will be calculated by reference to the entire amount initially received.[28] The problem for the vendor then becomes how to recognize repayments if some of the purchase price is refunded. Because the vendor has divested itself of the income-producing property, there is no prima facie nexus between repayment and an ongoing income-producing process. Australian tax jurisprudence on allowable deductions has traditionally been fairly strict, requiring a clear nexus between an expense and *on-going* business operations before a deduction will be allowed. If the purchase and sale of property is an ancillary part of the taxpayer's business, as will be the case with many natural resource producers or explorers, repayments may qualify as ordinary business deductions.[29] The vendor may face difficulty if the gain is treated as a capital gain, however, as the repayments would probably not qualify as ordinary business deductions. Moreover, because the repayments take place after the sale of property, they cannot be tied to a disposal of assets in the year in which they are made. As a result, they cannot give rise to capital losses that might be offset against capital gains in the year the repayments are made or in future years.

Another possibility open to the vendor in transactions where consideration may be open to downward adjustment is to seek an amendment of the original return in which the entire consideration was reported. Where the sale agreement does not require payment until sometime after the year of the sale, when it is clear there will be a lower sale price than originally anticipated the vendor can seek an amendment of its return for the year in which the sale proceeds were assessed. The potential drawback to this approach is the limitation periods that apply to amendments of returns. An amendment can be made at any time if the gain was assessed as a capital gain, provided part of the consideration used in the calculation of

26. Cases referred to previously that could be cited in support of this proposition include *Gasparin*, *supra* note 17, *Ballarat Brewing*, *supra* note 16, and *Australian Gas Light*, *supra* note 15.
27. See, for example, *AAT Case 8284* (1992) 24 ATR 1085; *Gasparin v. FCT* (1994) 28 ATR 130 (Full FC).
28. The treatment is illustrated in analogous circumstances in *Case 22/95* (1995) 95 ATC 243. The taxpayer in that case was a member of a partnership that received a lease incentive payment. The partnership agreement required a partner who left the partnership within five years of the payment being received to pay back a pro rata portion of the amount distributed to that partner. The taxpayer argued that since the income represented by the payment was subject to a potential claw back, it should be recognized only at the end of the five-year period or, alternatively, on a pro rata basis over that period. The Tribunal held the income was assessable in full when received by the partnership.
29. Under ITAA Sec. 51(1).

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the capital gain was not received.[30] However, if the gain was assessed as ordinary business income, the taxpayer must seek amendment within the strict time limits allowed for amendment.[31] If the lower price is not determined until after the amendment period has expired and the consideration was treated as ordinary business income, there is no provision for altering the original assessment.

C. Instalment sales

Instalment sales in which property is sold for a series of payments instead of a single up-front payment raise two important tax accounting issues. The first is the opportunity this type of transaction formerly offered taxpayers for converting taxable interest into tax-free capital gains. The second is the opportunity for deferral resulting from the income recognition system used by the Commissioner of Taxation for one type of instalment sale.

Prior to 1985, where property yielding capital gains was sold on an instalment basis, with interest charged on the instalment payments, the gain on the sale itself was exempt from tax but interest payable on the instalments would be assessable. To avoid tax on the interest payments, vendors would sell on an instalment basis with no explicit interest charge on the instalment payments. Rather, the total sale price and resulting instalment payments would be set at a level that included an implicit interest component to compensate the vendor for the fact that consideration was paid over time instead of when the property was sold. The effect of these arrangements was to convert taxable interest into tax-exempt capital gains.

The tendency of Australian courts is to recognize legal form over economic substance. As a result, the government believed it would be unlikely to enjoy success if it attempted to address the problem of interest conversions on instalment sales by asking the courts to follow the United Kingdom's precedents and carve out an implicit interest component from instalment sales yielding tax-free capital gains.[32] Rather, it attempted to deal with the problem by legislation, introducing a provision that allowed the Commissioner of Taxation to carve the interest component out of each instalment payment.[33] The section proved impotent, however, as it provided no authority for recharacterizing part of the payment as *implicit* interest and could only operate where it could be proven that the sale price contained an explicitly agreed interest component.

The problem was addressed in 1985 on a prospective basis in so far as sales yielding capital gains are concerned, with the inclusion of capital gains in the income tax base.[34] The capital gains measures apply to disposals of assets acquired after 19 September 1985. Where a gain is assessable as a capital gain, the vendor's proceeds of disposal are defined as the amount received and receivable in the future in respect of the sale. Thus, any implicit interest components in future instalment payments become assessable when the asset is sold as part of the capital gain.[35] As a result, since 1985 it has been in the vendors' interest to structure instalment sales of property acquired after 19 September 1985 so that they include explicit interest components. This way, the interest component will be excluded from the assessable capital gain[36] and the vendor can defer tax on the interest component until it is actually paid.

The second tax accounting issue is the opportunity for tax deferral in some cases where property not yielding capital gains is sold for profit on an instalment basis. There are two types of transactions where property sold on an instalment basis can yield assessable income and not capital gains. First, where the property sold is trading stock of the vendor, the proceeds of sale will be treated as ordinary business income. Second, where the property sold is a revenue asset of the taxpayer (that is, not trading stock but property sold in the ordinary course of business) or property acquired for the purpose of resale at a profit or for sale in the course of a profit-making scheme, the net *profit* on the sale will be included in assessable income.[37]

The ITAA is silent on the measurement of gain other than capital gains from an instalment sale. As a result, the tax accounting rules for instalment sales are derived from administrative practice rather than legislative prescription.

Where property sold is trading stock, the vendor taxpayer is assessed as if the entire proceeds were realized up front, at the time of sale. This is the only instalment sale procedure that has been both reviewed and accepted by the courts.[38]

Where a taxpayer sells a revenue asset, gains are recognized on a "profit-emerging" basis. The profit-emerging basis system of income recognition is a pro rata recognition system that stretches recognition over the entire instalment payment period. Under this system, profits are calculated by determining total gain and then recognizing as income a pro rata portion of each payment.[39] Often the sale price will reflect the fact that the vendor can defer gain recognition over the instalment sale period, thus providing vendor-financed sales with

30. ITAA Sec. 160ZF.
31. The application must be made within four years, although amendment and refunds may be made outside that time provided the application is lodged in that time: see ITAA Sec. 170(3) and Sec 170(6).
32. Leading UK examples of this approach include *Secretary of State for India v. Scoble* [1903] AC 299 and *Vestey v. IRC* [1962] Ch 861.
33. ITAA Sec. 262.
34. With the adoption of Part IIIa of the ITAA.
35. ITAA Sec. 160ZD(1)(a).
36. ITAA Sec. 160ZA(4).
37. Gains from the disposal of trading stock is assessable under ITAA Sec. 25; gains from the disposal of revenue assets are assessable under ITAA Sec. 25 or Sec. 25A.
38. This approach was originally rejected by the High Court in *FCT v. Thorogood* (1927) 40 CLR 454. That case was decided on the basis of the 1922 ITAA and the facts of the case were distinguishable from most conventional business situations as the taxpayer in *Thorogood* was in the business of subdividing land, which may explain the willingness of the Commissioner of Taxation to distinguish the precedent when assessing accrual-basis taxpayers. The Commissioner continued to apply the 'up-front' recognition rule to accrual-basis taxpayers selling trading stock and his persistence paid off when the High Court finally endorsed this approach in *J Rowe & Son Pty Ltd v. FCT* (1971) 2 ATR 497 (Full High Ct.). The taxpayer in *Rowe* was a retailer which sold household goods on an instalment-sale basis and who sought to recognize the gains on a profit-emerging basis, an income recognition scheme described below.
39. Examples of cases endorsing the profit-emerging basis of income recognition include *L'Estrange v. FCT* (1978) 8 ATR 410 and *Spence v. FCT* (1967) 15 ATD 80.

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an implicit subsidy not available to vendors who require purchasers to seek loan funds from third parties. Statutory reform of this problem is unlikely, as the government apparently believes most instalment sales of property other than trading stock will be caught under the capital gains provisions, where the up-front recognition rule overcomes the deferral problem.

V. TAX LAW RULES FOR RECOGNIZING EXPENSES

The principal deduction provision of the ITAA allows taxpayers a deduction for losses and outgoings *incurred* to derive assessable income.[40] Whether the term "incurred" has the same or different tax accounting meanings for cash-basis and accrual-basis taxpayers was until recently a matter of somewhat contentious debate in Australia. One group of commentators argued that the rules for recognizing when expenses are "incurred" by a taxpayer for tax purposes parallel those for recognizing when income is "derived" for tax purposes so different rules apply to cash-basis and accrual-basis taxpayers. A second group argued that the dichotomy between cash-basis and accrual-basis taxpayers on the income recognition side is not replicated for outgoings and, subject to a few exceptions, the term "incurred" has the same meaning for both cash-basis and accrual-basis taxpayers so similar tax accounting rules apply to both types of taxpayers. The debate appears for the moment to have been resolved in favour of those in the second group, with the release in 1996 by the Taxation Office of a Draft Taxation Ruling that suggested the term "incurred" has a consistent meaning that does not vary according to the accounting system used to recognize income.[41]

The implications of the Tax Office Draft Ruling, if it is confirmed in a final ruling, are significant. Almost all cases considering the meaning of "incurred" involve accrual-basis taxpayers. Nevertheless, the Tax Office will extend the principles established by those cases to cash-basis taxpayers, which will be a generous concession in many cases. For example, if the Ruling is strictly followed, cash-basis taxpayers will be able to defer recognition of interest income until it is received, but take deductions for interest expenses on an accrual-basis. Notwithstanding its view on the correct legal principles, the Tax Office has indicated it will allow cash-basis taxpayers to use a cash-basis system for recognizing deductible expenses if they wish (that is, treating expenses as deductible when they are actually paid).

Determining when a taxpayer "incurs" an expense has proved one of the most confounding issues in Australian income tax law and has probably generated more cases than any other tax accounting issue. The cases have yielded an array of judicial pronouncements ranging from the solemn to the superficial, but all, unfortunately, provide little concrete guidance,[42] other than to show that a taxpayer must be "subjected" to an obligation to have incurred the expense.[43] Fortunately, the outcomes of the cases provide some firmer guidance.

Tax accounting cases involving deductions can be classified into four broad categories:

- where a payment is made in the year of income for benefits that are received in that year;
- where an obligation accrues to the taxpayer that it will not have to satisfy until a future year;
- where a payment is made in the year of income for benefits to be received in future years; and
- where a taxpayer obligates itself to pay in the future for benefits to be received in the future.

These four situations are discussed in more detail below.

A. Deductions for payments made in a year of income for contemporaneous benefits

Generally, the courts have taken a very pragmatic approach to the question of whether a taxpayer has incurred an expense where payment has been made and a benefit received but some aspects of the liability remain uncertain. Provided the obligation has crystallized in an economic sense, it will be treated as an expense incurred, even where some legal details of the obligation, including the actual amount, remain to be finalized or where there is a risk that the obligation might be reversed in the future.

The pragmatic approach followed by the courts in respect of both these matters is well illustrated by one of the leading cases in this area, the *Commonwealth Aluminium* case.[44] The taxpayer in that case was liable to pay royalties to the Queensland government in respect of bauxite it had mined during the year. The royalties were set by the State government on an annual basis and at the close of the year of income the government had yet to set the royalty levels for the year just ended. In the absence of firm knowledge of the royalty level, the taxpayer had based its payments on the previous year's royalty rate, on the assumption that an adjustment would have to be made after the rate for the income year was announced. The court agreed the taxpayer had incurred the cost of the royalties during the year of assessment, even though it was not until the following year that the exact amount due was calculated.

A second aspect of the case related to the possibility that the obligation might be reversed in the future. At the time of the assessment, the taxpayer was involved in a separate legal action to dispute the legality of the legislation imposing the royalty obligation. This matter remained unresolved at the close of the year of taxation. If the taxpayer won,[45] the obligation would have evaporated and the royalties it had paid during the year would have been refunded. But at the time it

40. ITAA Sec. 51(1).
41. Draft Taxation Ruling TR 96/D18.
42. While there is a dearth of cases providing positive guidance, there is no shortage of cases that explain what incurred does *not* mean – it does not, for example, mean "made" or "paid" (see *W Nevill & Co Ltd v. FCT* (1937) 56 CLR 290 at 302 (High Ct.) or "only defrayed, discharged, or borne" (see *New Zealand Flax Investments Ltd. v. FCT* (1938) 61 CLR 179 at 207 (High Ct.)).
43. See *FCT v. James Flood Pty Ltd* (1953) 88 CLR 492 at 506 (High Ct.).
44. *Commonwealth Aluminium v. FCT* 77 (1977) 7 ATR 376 (S. Ct. Vic).
45. As it turned out, it lost.

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was required to calculate its taxable income, the taxpayer was under a legal obligation to pay the royalties and the fact that the obligation might be defeasible because of external factors was not considered by the court to be relevant to whether the expense had been incurred.

B. Deductions for accrued obligations that will be satisfied in a future year

There is a clear analogy between a transaction in which a taxpayer seeks to deduct currently an expense payable in the future in respect of an accruing obligation and the situation referred to earlier in which a taxpayer seeks to deduct an expense already paid for accruing or accrued benefits. In the earlier case, payment was made but the legal details had not been finalized by the end of the year, while in the latter case payment had not yet been made. But in both cases, the taxpayer has received the benefit and admits an obligation to pay for the benefit.

Cases involving future payments in respect of accrued liabilities are less consistent than those involving payments for benefits received. The cases show courts accept as certain and fully crystallized the obligations of financial institutions and large corporations to pay interest, and those of insurance companies to pay compensation, while the obligations of businesses to provided contracted benefits to workers is seen as less certain. Thus, the courts have consistently allowed financial institutions deductions for deferred interest obligations in the year the obligation accrued, though the taxpayers were not obligated to pay the interest until a future year.[46] (Under a deferred interest arrangement, interest is not compounded but is not payable until the deposit matures.) Similarly, the discount payable on short-term promissory notes issued in one tax year and redeemable in the next is recognized and deductible on a pro rata basis over the two years.[47]

A parallel approach has been taken in the case of insurance companies seeking deductions in respect of claims for loss suffered by clients where the claims have not been submitted to the insurance companies by the end of the year of assessment. On the basis of previous years' experience, insurance companies are able to estimate with considerable accuracy the value of still-to-be submitted claims relating to each year of assessment. Courts have consistently allowed these taxpayers to treat estimated obligations based on actuarial evidence as incurred, and hence deductible, expenses.[48] This treatment has been extended to a banking group that registered as a self-insurer for workers' compensation purposes.[49]

The treatment of employers' obligations to pay accruing benefits to workers provides an interesting contrast to the treatment accorded obligations to pay future interest or future compensation (discussed above). The courts have denied employers deductions both for the cost of leave entitlements accruing for the benefit of employees[50] and the cost of fully accrued unclaimed leave entitlements (that is, entitlements where employees have satisfied all requirements to enjoy the leave, but not taken the leave by the end of the tax year).[51] The judicial rule has since been codified to protect the revenue from the risk of a future reversal of that rule.[52]

C. Deductions for prepayments

As a general rule, where a taxpayer actually makes payment prior to receiving goods or services, judicial doctrines will treat the expense as incurred for tax purposes when the payment is made, even if it refers to the future delivery of the goods or services. This rule meant that taxpayers could prepay expenses such as several years' interest payments, rental payments, or management fees to generate large up-front deductions and reduce taxable income in the year of payment. Not surprisingly, the opportunity for abuse did not remain unexploited and in the 1970s and early 1980s in particular a large number of tax minimization schemes sprung up involving deductible prepayments.

The Tax Office enjoyed no victories in its attempts to attack prepayment schemes on the basis of tax accounting principles. Courts held consistently that an expense paid was an expense incurred. Tax officials did enjoy some success, however, in more oblique attacks. For example, it was argued in some cases that the taxpayers did not satisfy the basic nexus requirement for a deduction since prepayments were made not for the purpose of deriving assessable income but rather primarily to obtain some tax advantage.[53] This approach could only be used on an ad hoc basis, however, as it depended on the facts of each case and often taxpayers could imbue a transaction with sufficient commercial flavour to avoid it being characterized as nothing more than a tax minimization scheme.

An alternative approach attempted in some cases by tax officials was to seek to have the expense characterized as a capital outlay, made to acquire a long-term benefit. Had they succeeded in characterizing prepayments as capital outgoings, the expenditures never would have been recognized for tax purposes. However, since the prepayments usually involved expenses on revenue account such as interest, rent,

46. *Alliance Holdings Ltd v. FCT* (1981) 12 ATR 509 (NSW S. Ct.); *FCT v. Australian Guarantee Corporation Ltd* (1984) 15 ATR 982 (Full F.Ct.).
47. *Coles Myer Finance Limited v. FCT* (1993) 25 ATR 95 (High Ct.). While the holding of the case is both logical and consistent with ordinary commercial accounting practice, the actual language in the decision is somewhat confusing. The Court said the loss (the difference between the amount received when the notes were issued and the amount that had to be paid upon maturity of the notes) *occurred* when the notes were issued at a discount, but six of the seven judges sitting on the Court said the loss was *incurred* for tax purposes over the life of the notes.
48. See, for example, *RACV Insurance Pty Ltd v. FCT* (1974) 4 ATR 610 (Supreme Court of Victoria) and *Commercial Union Assurance Co of Australia Ltd v. FCT* (1977) 7 ATR 435 (Supreme Court of Victoria). See Taxation Ruling IT 2663 for the Commissioner of Taxation's guidelines on the standard of estimation required.
49. *ANZ Banking Group Ltd v. FCT* (1994) 27 ATR 559 (Full F. Ct.).
50. *FCT v. James Flood Pty Ltd* (1953) 88 CLR 492 (High Ct.).
51. *Nilsen Development Laboratories Pty Ltd v. FCT* (1980) 144 CLR 616 (High Ct.).
52. The court of first instance in *Nilsen Development Laboratories Pty Ltd v. FCT* (*supra*, note 51), distinguished the *James Flood* precedent and allowed the taxpayer a deduction for accrued leave obligations; see (1978) 8 ATR 760 (S. Ct. Vic.), per Murphy J. The government, concerned with the result, moved quickly to amend the ITAA by the insertion of Sec. 51(3), which prevents deductions for leave payments until they are in fact paid. Following the amendment, the High Court reversed the lower court decision, yielding the result that had been legislated.
53. See, for example, *FCT v. Ilbery* (1981) 81 ATC 4661 (F. Ct.); *FCT v. Gwynvill Properties Pty Ltd* (1986) 17 ATR 844 (Full F. Ct.).

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or management fees, courts were rarely inclined to accept the Tax Office's characterization in these cases.[54]

While an unlucky few were caught under the various Tax Office arguments, the vast majority of taxpayers claiming deductions for prepaid expenses succeeded, and prepaid schemes cost the government millions (Treasury estimates put the figure at AUD 35 million per year) before the problem was finally addressed by legislation in 1988. Taxpayers making prepayments are now required to capitalize prepayments for benefits lasting more than 13 months. Taxpayers may then amortize the outgoing over the shorter of the period of the benefit or ten years.[55]

D. Obligations for future payments

There are no judicial cases directly on point with regard to taxpayers claiming current deductions for obligations to make future payments for future benefits. However, taxpayers and tax administrators have adopted an approach that is arguably implicit in a number of decisions.[56]

In the case of obligations relating to the current year of income, the event giving rise to the obligation has generally finished by the end of the tax year the minerals have been mined, the accidents for which insurance will be claimed have taken place, the borrower has held and used the lender's principal, and so forth. By way of contrast, a large number of factors may undermine certainty of an obligation to make payments in the future for goods or services to be supplied in the future. Accordingly, these obligations are not recognized as having crystallized in an earlier year.

Thus, where a taxpayer signs a lease to rent premises for a multi-year period and to pay for each year's rent early in the following year, at the end of the first year only the obligation to pay one year's rent will be treated as incurred for tax purposes. While a commitment to pay annually for many years may be made when the lease is signed, the obligation has not fully crystallized at that point simply because many events might intervene to make it uncertain that all future rents will be paid.

In recent years there has been some speculation that it may be possible to restrict the approach now taken to future obligations to cases where the taxpayer has received no more than a commitment to have goods or services provided in the future when it assumed the obligation to pay in the future. The situation tax advisers have in mind as a distinguishable case is where the taxpayer has received an up-front payment that obligates it to spend money in the future. This is the situation where, for example, a taxpayer sells products subject to a warranty and can show, on the basis of solid statistical evidence, what its future expenditures to honour the warranty will be. The preferred approach of such taxpayers might be to defer the initial recognition of part of the sale price that can be attributed to the warranty coverage, as might be done for commercial accounting purposes. However, as explained above, taxpayers have not succeeded in deferring income recognition in this manner. An alternative solution would be to recognize the entire sale proceeds as income but to allow a deduction for the estimated future costs of honouring the warranty, supported by appropriate statistical evidence.

It had generally been assumed that this approach would not be successful in Australia. Certainly tax authorities have declined to distinguish the warranty situation from other cases where taxpayers seek deductions for future payments even though in the warranty case the taxpayer has in fact received actual benefits at the time of the contract, not just a promise of goods or services to be delivered in the future. The Commissioner of Taxation requires taxpayers to recognize the entire sale proceeds as income, deducting warranty costs only when they are incurred.[57] However, support for an alternative approach has come from the New Zealand case of *CIR v. Mitsubishi Motors New Zealand Ltd*, discussed earlier in the context of income recognition,[58] In that case, the United Kingdom's Privy Council allowed the taxpayer, a motor vehicle manufacturer, a deduction for estimated future warranty expenses. The question has yet to be tested in an Australian court. It is highly likely that if an Australian court were to follow the Privy Council precedent in *Mitsubishi Motors*, the legislature would move quickly to overturn the result by statute.

VI. PROPOSED STATUTORY ACCRUAL RULES

The distortions and inequities caused by timing mismatches accelerated deductions and deferred recognition of income have been a matter of increasing concern in almost all developed countries. Many nations have moved or are moving to remedy the problem by the adoption of comprehensive accrual rules that require taxpayers to recognize gains and losses on an annual basis.

In December 1993 the Australian Government released a blueprint for comprehensive reform of the tax accounting rules applicable to "financial arrangements".[59] The document, popularly referred to by its short title, the "Consultative Document", recommended the taxation of all financial arrangements on an accrual basis. "Financial arrangements" were defined to include all types of debt such as loans, debentures, bonds, bills of exchange, equity investments such as redeemable preference shares that are in substance (albeit not legal form) debt investments, and derivatives such as interest swaps, interest rate futures, forward rate agreements, and financial options, as well as most foreign currency transactions.

54. One case in which a court adopted this characterization was *FCT v. Creer* (1986) 17 ATR 548 (Full F. Ct.). By way of contrast, the taxpayer in *Lau v. FCT* (1984) 16 ATR 55 (Full F. Ct.) was allowed to deduct a prepayment of management fees for a 21 year period.
55. ITAA Sec. 82KZM.
56. For example, in *Coles Myer Finance Limited v. FCT* (1993) 25 ATR 95 (*supra*, note 47), the taxpayer was denied an up-front deduction for its obligation to pay a premium on a discounted debt upon maturity. Instead, it was allowed to recognize the difference between the issue price of the debt and the redemption price on a pro rata basis over the life of the debt.
57. See Taxation Ruling IT 2648.
58. [1995] STC 989 (P.C.), discussed above at text and at note 23.
59. Australian Taxation Office, *Taxation of Financial Arrangements: A Consultative Document* (Canberra: Australian Taxation Office, 1993).

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The Consultative Document called for the application of the accrual-basis accounting rules to both accrual-basis and cash-basis taxpayers. However, it suggested individuals should be exempt from the rules unless they enter into arrangements that provide significant tax deferral opportunities or the arrangements into which they enter have a total value exceeding AUD 500,000.

Under the Consultative Document proposals, transactions would be recharacterized as if they were ordinary compounding debt arrangements. A substitute method was proposed for arrangements such as forward contracts and futures contracts and options for which it is impossible to predict at the time the contract commences or the option is sold or acquired what final gain or loss will be realized on the investment. The Consultative Document called for these arrangements to be subject to a "mark-to-market" valuation. This entails valuing investments by reference to prevailing market prices for similar investments and requiring the taxpayer to recognize the difference between the current value and the previously recognized value as an assessable gain or allowable loss.

The Consultative Document proposals generated widespread, and often critical, discussion. A committee comprising Tax Office and Treasury officials was appointed to reconsider the issue in the light of the numerous submissions prepared in response to the document. Three years later, in December 1996, the Committee released an "Issues Paper" with revised proposals.[60] The revised proposals differ from those in the original document in a number of respects. Significantly, they include traded equities in the proposed new tax accounting regime. Also, they abandon the daily compounding accrual system proposed in the Consultative Document in favour of a simplified accrual system.

To determine which system should apply to which transaction, the Issues Paper distinguished between transactions involving five types of assets: debt denominated in a foreign currency, debt denominated in Australian dollars, derivatives, physical holdings of foreign currency, and traded equity. Tax rules for each type of asset were considered in the context of three different purposes for the acquisition of the property: for trading purposes, for hedging purposes, and for investing or financing purposes. Under hedge accounting, to be applied to property acquired for hedging purposes, the recognition of gain or loss would be determined by reference to the taxation treatment of the underlying position.

The tax rules proposed in the Issues Paper are summarized in the table below:

Asset Type	Purpose of the Transaction		
	Trading	Hedging	Investing/ Financing
Foreign Currency Debt	mark-to-market recognition	accrual-basis recognition	accruals basis recognition of interest ([1]); retranslation for foreign-exchange gains and losses ([2])
Australian AUD Debt	mark-to-market recognition		accrual-basis recognition
Derivatives	mark-to-market recognition	hedge tax accounting	
Foreign Currency Holdings	mark-to-market recognition	hedge tax accounting	
Traded Equity	mark-to-market recognition		

(1) Optional mark-to-market recognition.
(2) Optional accrual-basis recognition.

VII. FUTURE DIRECTIONS

Tax accounting in Australia for the most part is based on judicial doctrines that set out rules for determining when income is "derived" and when expenses are "incurred" for tax purposes. Those doctrines have evolved over many decades in response to particular fact situations involving particular taxpayers. Not surprisingly, operating together they do not constitute an integrated and consistent whole; rather, they may lead to acceleration and deferral, providing opportunities for mismatch between taxpayers on either side of a transaction or between different complementary transactions carried out by any one taxpayer.

Statutory intervention or modification of the rules based on judicial doctrine has been rare. The main statutory rules are the accrual rules for deep discounts, spreading rules for prepayments, up-front recognition rules for capital gains (but not other types of income) realized by way of instalment sale, and the rule deferring recognition of employee leave obligations. The proposed tax accounting rules for financial instruments represents a significant new direction, with comprehensive statutory tax accounting rules applying to transactions based on a number of specified types of assets. It remains to be seen whether the proposals will be enacted and, if they are, whether they will be at the forefront of legislative intervention into the area of tax accounting or a one-off response to a relatively narrow issue.

60. Australian Treasury and Taxation Office, *Taxation of Financial Arrangements: An Issues Paper* (Canberra: Australian Taxation Office, 1996).

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 71-72 of the January 1997 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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The book gives an overview of the legal system in Hong Kong, and describes the legislative process and the system of administration. The legal process and dispute resolution are also covered. The book also

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contains the text of the Basic Law of the Hong Kong Special Administrative Region of the PRC.
(B. 58.226)

India

Divan, Gautam R.; Ramachàndran, N.,
Business operations in India. 2nd Edition.
Washington, Tax Management Inc. 1996.
Tax Management Foreign Income Portfolio, No. 966-2nd, pp. 135.
This portfolio analyses India's Companies Act, foreign investment policies, exchange control, the monopolies and restrictive trade practices legislation, Income Tax Act, the liberal tax concessions granted for new investments and industrial undertakings, the special concessions for foreign enterprises and the provisions for the computation of the taxable income of non-residents. Some import and indirect taxes such as excise duty, sales tax, customs duty and stamp duty are also discussed.
(B. 58.262)

Macau

1996 Linhas de Acção Governativa Plano de Investimentos.
Macau, Government Printer. 1996, pp. 241.
Government policies investment plan 1996. Analysis of the economic and financial situation in the Territory of Macau.
(B. 58.239)

Malaysia

Tax facts and figures 1996.
Kuala Lumpur, Coopers & Lybrand Malaysia. 1996, pp. 79.
Booklet containing handy reference tables and other information useful for a quick ascertainment of one's approximate income tax liability.
(B. 58.261)

The annual tax review 1995/96.
Kuala Lumpur, Malaysian Institute of Accountants and Malaysian Institute of Taxation. 1996, pp. 170.
Booklet intending to be a handy taxation guide. It details the latest developments in the fields of direct and indirect taxes in Malaysia. Covers a compilation of principle legislation, subsidiary legislation, interpretation, administration and pending developments.
(B. 58.260)

Foreign investment guidelines: Malaysia.
New York, United Nations. 1995, pp. 80.
The guide is intended to provide basic information needed by prospective investors interested in doing business in Malaysia. Special attention is paid to the administrative procedures, incentive and protection schemes, areas for foreign investment, general status and outline of policies and regulations on foreign investment.
(B. 58.243)

Malaysia and Singapore tax cases 1991-1994.
Singapore, CCH Asia Limited, 11 Keppel Road, 11-01 RCL Centre, Singapore 089057.
1996, pp. 760. ISBN: 981 00 8434 X.
This volume reproduces the full text of Malaysia and Singapore tax and land acquisition cases reported during 1991 to 1994. The cases reported in this volume were originally reported in the loose-leaf CCH "Malaysia and Singapore Tax Cases".
(B. 58.257)

1996 Malaysian master tax guide.
13th Edition. By CCH Tax Editors.
Singapore, CCH Asia Limited. 1996, pp. 1295.
ISSN: 0218 8287.
Practical, accurate and reliable presentation of the structure, features and ambit of Malaysian income tax law. The guide explains how the law is relevant to individuals, partnerships, corporations and other taxable entities. It also provides useful information in the areas of real property gains tax and double taxation. Incorporates changes effected by the 1996 Finance Act. The law is in force as at 15 March 1996.
(B. 58.240)

Pakistan

Bukhari, H.; Haq, I.; Sheikh Asif Salam.
Complete double taxation agreements. Volumes I and II.
Lahore, S.A. Salam Publications. 1995.
Authoritative commentary and case law, exemptions and reliefs to foreign investors in Pakistan, and texts of double taxation agreements concluded by Pakistan, compiled in two loose-leaf binders.
(B. 58.230)

Singapore

Malaysia and Singapore tax cases 1991-1994.
Singapore, CCH Asia Limited, 11 Keppel Road, 11-01 RCL Centre, Singapore 089057.
1996, pp. 760. ISBN: 981 00 8434 X.
This volume reproduces the full text of Malaysia and Singapore tax and land acquisition cases reported during 1991 to 1994. The cases reported in this volume were originally reported in the loose-leaf CCH "Malaysia and Singapore Tax Cases".
(B. 58.257)

1996 Singapore master tax guide.
15th Edition. By CCH Tax Editors.
Singapore, CCH Asia Limited. 1996, pp. 1125.
ISSN: 0218 8163.
The guide explains how the law is relevant to individuals, partnerships, corporations and other taxable entities. This edition includes a chapter on the taxation of individual, covering all issues relating to personal taxation. For companies, the book also outlines the various tax incentives available under the Economic Expansion Incentives (Relief from Income Tax) Act and the Income Tax Act. It also provides an informative chapter on tax treaties. The law in this guide is up to date to 15 April 1996.
(B. 58.241)

Sri Lanka

Foreign investment guidelines: Sri Lanka.
New York, United Nations. 1996, pp. 48.
The general status and outline of policies and regulations on foreign investment, areas in which foreign investment is promoted, incentive and protection schemes, administrative procedures and limitations, are set out in this information guide. Includes brief information on taxation.
(B. 58.244)

Thailand

Foreign investment guidelines: Thailand.
New York, United Nations. 1995, pp. 80.
Country study containing information on incentives and preferences currently available for foreign investors. Includes brief information on the corporate income tax, value added tax, specific business tax, remittance tax, personal income tax, and other taxes.
(B. 58.242)

Vietnam

Schot, Anne C.M.J.
Legal aspects of foreign investment in the Socialist Republic of Vietnam.
The Hague, Kluwer Law International, P.O.Box 85889, 2508 CN The Hague, The Netherlands. 1996, pp. 571. NLG 250.
ISBN: 90 411 0905 6.
The book outlines the legal framework for investment in Vietnam, covering the legal, financial, fiscal and employment regulations, and gives a detailed account of Vietnam's foreign investment laws. Includes texts of various regulations, guides for foreign direct investment projects and model forms with respect to representative offices, imports and exports, banking and finance, insurance, taxation, accounting, land, buildings and construction.
(B. 58.245)

EUROPE

European tax handbook 1996. 7th Edition.
Amsterdam, IBFD Publications BV. 1996, pp. 556. NLG 350. ISBN: 90 70125 84 6.
Annual handbook containing up-to-date summaries of the taxation of corporations and individuals in European countries. The taxation systems of 35 countries from Western, Central and Eastern Europe are covered, together with a chapter on the EU. (Israel will

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no longer be covered in the "European Tax Handbook", the IBFD advises readers to refer to the IBFD's publication "Taxes and Investment in the Middle East" for information on taxation in Israel).
(B. 116.048)

A tax guide to Europe.
London, Arthur Andersen. 1996, pp. 284.
This publication provides a country-by-country guide to the regimes in 41 nations in the European region. For each country, the outline of the tax system has sections on: corporate taxation, individual taxation, VAT and other direct/indirect taxes. This 1996 edition covers for the first time the following countries: Israel, Kazakstan, Latvia, Lithuania, Romania and Uzbekistan.
(B. 115.913)

Austria

Wieser, M.;Takacs, P.; Gebhart, S.; Lenneis, C.; Weninger, R.
Steuerjahrbuch 1995/96. 2 Bänden.
Vienna, Linde Verlag Wien GmbH. 1996, pp. 1640.
1995/96 Tax manual. 2 Volumes. Publication on Austrian tax law. With respect to changes in law, jurisprudence, official publications and literature, a detailed account is given of the developments in Austrian tax law in 1995.
(B. 115.884)

Tumpel. Michael.
Harmonisierung der direkten Unternehmensbesteuerung in der EU.
Vienna, Österreichische Staatsdruckerei. 1994.
Schriftenreihe Europa des Bundeskanzleramts, Band 4, pp. 484. ATS 398.
ISBN: 3 7046 0501 8.
Harmonization of direct taxation for entrepreneurs in the EU. The book deals with the harmonization provisions of the EC Treaty, the application of EC law, interpretation of EC law and already taken harmonization measures like the merger and parent-subsidiary directives and the influence of primary EC law on business taxation.
(B. 115.843)

Tichy, Georg.
Die Ausschüttungs- und Steuerbemessungsfunktion des Konzernabschlusses. Ein Plädoyer zur Berücksichtigung von Konzernstrukturen in Betriebswirtschaft und Recht.
Vienna, Linde Verlag Wien GmbH. 1996, pp. 184. ATS 372. ISBN: 3 85122 602 X.
The distribution of dividends and calculation of the tax base by way of the yearly accounts of the concern. The distribution base is explained by means of two models. The entire concern model and the parent company model. The book is useful for individuals interested in group accounting and group management.
(B. 115.765)

Hilber, Klaus H.
Kurzkommentar zur Liebhabereiverordnung. Stand: 1.10.1996.
Vienna, Linde Verlag Wien GmbH. 1996, pp. 196. ATS 315. ISBN: 3 85122 624 0.
Entrepreneurship or hobby-sphere? The author explains the criteria used to decide. This is of importance in the context of loss compensation and pre-VAT. The author also explains the latest jurisprudence in this area.
(B. 115.885)

Belgium

d'Ursel, Bernard.
Voordelen van alle aard.
Diegem, Ced Samsom. 1996, pp. 110.
Study on the taxation regime of the various benefits in kind. In addition to the income tax regime of the various benefits, i.e. refund of costs, social benefits, meals, car costs, refund of travel costs, real estate benefits, interest-free loans, stock options, different kinds of cheques, exempt benefits, the benefit originating from managers insurance, study stipendiums and outplacement. In a second chapter the author also treats the VAT regime applicable to the above-mentioned benefits.
(B. 115.879)

Code des impôts sur les revenus 1992.
(Edition 1996.2).
Diegem, Ced Samsom. 1996, pp. 779.
ISBN: 90 5334 677 5.
Second, of the bi-annual updates of the Belgian Income Tax Code as of 30 October 1996. This edition contains the Income Tax Code itself, the Royal Decree implementing the Income Tax Code and the attachments thereto and the most important legal and regulatory provisions in force.
(B. 115.901)

Delporte, Frank.
Pensioenen vanuit fiscaal oogpunt.
Diegem, Ced Samsom. 1996, pp. 186.
The contribution considers the taxation of pensions in the broadest sense.
(B. 115.910)

Scheers, Denis.
L'imposition des pensions, rentes, indemnités et allocations en tenant lieu. Revenus de source belge obtenus par des résidents.
Brussels, Etablissements Emile Bruylant S.A. 1996, pp. 588. BEF 4250.
ISBN: 2 8027 0653 5.
In-depth study on the tax regime applicable to pensions, replacement income, and other similar periodic payments. The lay-out of this in-depth study makes it both a useful tool for the practician and the theoretician. The book gives a clear overview of this complex area. The book is divided into four major parts. In the first part the author discusses pensions, periodic payments and similar payments with a professional character. The second part treats the indemnities received as a compensation for the total or partial temporary loss of income. The third part discusses the periodic payments and income from capital which according to Belgian tax law are to be considered as movable income. The fourth part discusses periodic payments which are taxed as miscellaneous income. Numerous examples illustrate this often complex subject. In addition, the author bases his discussion on the latest jurisprudence and legal doctrine.
(B. 115.906)

Aerts, D.
Het enig document.
Diegem, Ced Samsom. 1996, pp. 269.
The author discusses the Single Administrative Document in all its aspects. In the first part he discusses the various aspects of the use, filing, acceptation, validation and verification of the sole document. In addition, he discusses how a return may be rectified or withdrawn. In the second part specific attention is paid to some data listed on the sole document which may be audited. Thereby a number of possible VAT and customs duty exposures can be eliminated.
(B. 115.881)

Annuaire fiscal 1996.2
Diegem, Ced Samsom. 1996, pp. 952.
ISBN: 90 5334 646 5.
This reference pocket book which is updated twice a year (second update for 1996) gives an overview of the main provisions applicable in Belgium income tax law. The book contains the legislation up to 30 September 1996. It covers the individual income tax, corporate income tax, tax on legal entities, the taxation of non-residents and the different withholding taxes. There is also a handy chapter with keywords and one with relevant addresses which makes the book useful for practitioners. In addition there is a chapter on the procedure in fiscal matters. Finally there are also chapters on indirect taxation (VAT, registration and succession duties, mortgage and stamp duties).
(B. 115.889)

European Union

Tumpel, Michael.
Harmonisierung der direkten Unternehmensbesteuerung in der EU.
Vienna, Österreichische Staatsdruckerei. 1994.
Schriftenreihe Europa des Bundeskanzleramts, Band 4, pp. 484. ATS 398.
ISBN: 3 7046 0501 8.
Harmonization of direct taxation for entrepreneurs in the EU. The book deals with the harmonization provisions of the EC Treaty, the application of EC law, interpretation of EC law and already taken harmonization measures like the merger and parent-subsidiary directives and the influence of primary EC law on business taxation.
(B. 115.843)

Kaefer, Wolfgang.
Verfahrensakten und Erläuterungen zum EuGH-Diskriminierungsfall Schumacker.
Heidelberg, Verlag Recht und Wirtschaft GmbH. 1996.
Schriftenreihe Recht der Internationalen Wirtschaft, Band 52, pp. 453. DEM 90.
ISBN: 3 8005 2025 7.
European law and the cases of the European Court of Justice have become very important for tax matters. In this book using as an

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example the Schumacker case the complete procedure is shown including the action taken by legislators to comply with the decision. The book is especially of importance for taxpayers dealing with EC matters.
(B. 115.809)

Fallsammlung Europäisches Zollrecht.
Herausgegeben von Peter Witte und Reginhard Henke.
Herne, Verlag Neue Wirtschafts-Briefe. 1996, pp. 390. DEM 62. ISBN: 3 482 47841 4.
Customs duties and cases concerning European customs duties. The book contains an overview of all important customs matters, and is useful for students and practitioners not regularly dealing with this subject.
(B. 115.808)

Environmental taxes.
Copenhagen, European Environment Agency, Kongens Nytorv 6, DK-1050 Copenhagen K, Denmark. 1996, pp. 63. ISBN: 92 9167 000 6.
Report focusing on the environmental effectiveness of green taxes and on policy barriers and solutions to their implementation. It also tries to emphasize the value of non-energy taxes. The book attempts to be accessible to non-experts.
(B. 115.926)

Germany

Lange, Joachim; Reiss, Wolfram.
Lehrbuch der Körperschaftsteuer. 8. Auflage.
Herne, Verlag Neue Wirtschafts-Briefe. 1996, pp. 548. DEM 69. ISBN: 3 482 75418 7.
Handbook on corporation tax. The book explains all aspects of the German corporation tax, taking into account all recent tax laws in this field.
(B. 115.838)

Heinhold, Michael.
Unternehmensbesteuerung. Band 3: Investition und Finanzierung.
Stuttgart, Schäffer-Poeschel Verlag. 1996, pp. 194. DEM 49.80. ISBN: 3 7910 0895 1.
Taxation of enterprises. Investments and way of financing. The author deals with the main aspects of accounting tax law. In this book, useful for practitioners, an overview is given of accounting for investment and its tax consequences by means of cases.
(B. 115.763)

Göbes, Christian.
Die Unternehmensbesteuerung in Deutschland und Grossbritannien vor dem Hintergrund des europäischen Integrationsprozesses.
Frankfurt am Main, Verlag Peter Lang. 1996.
Mannheimer Beiträge zum öffentlichen Recht und Steuerrecht, No. 8, pp. 313. CHF 72.
ISBN: 3 631 30314 9.
Taxation of corporations in Germany and the United Kingdom in the context of European integration. The book explains the current systems for corporations in the UK and Germany.
(B. 115.845)

Stuhrmann, Gerd.
Die neue Investitionsförderung in den neuen Bundesländern. 4. Auflage.
Cologne, Peter Deubner Verlag. 1996.
Steuer Telex Beratungsschriften, pp. 126.
DEM 77.60. ISBN: 3 88606 195 7.
The new investment promotion in the five new Länder. The book provides information on the changes implemented by the 1996 Tax Law.
(B. 115.869)

Schulze zur Wiesche, Dieter.
Betriebsveräusserung, Gesellschafterwechsel und Betriebsaufgabe im Steuerrecht. Unter besonderer Berücksichtigung der freiberuflichen Praxis. 6. Auflage.
Heidelberg, C.F. Müller Juristischer Verlag. 1996, pp. 255. DEM 88. ISBN: 3 8114 5396 3.
Taxation of profits in case of the selling of a business, change of partner, contribution into a partnership or corporation or liquidation of a business. The author explains the possibilities to avoid immediate taxation and explains the tax consequences of periodical payments and interest. The tax consequences of the Tax Bill 1996 are taken into account as are the latest cases of the Supreme Court.
(B. 115.835)

Friedemann, Bärbel.
Umweltschutzrückstellungen im Bilanzrecht.
Wiesbaden, Verlag Th. Gabler GmbH. 1996.
Neue betriebswirtschaftliche Forschung, No. 196, pp. 195. DEM 89. ISBN: 3 409 13295 3.
Provisions for environmental measures in accounting law. The author deals with the question whether a provision may be formed in the context of the general accounting principles. This book is especially of interest to teachers and students as well as to practitioners.
(B. 115.795)

Meyer, Holger.
Steuer-ABC für Freiberufler. 3. Auflage.
Stand: 1. Juni 1996.
Munich, Verlag C.H. Beck. 1996.
Beck Rechtsberater im dtv, pp. 273.
DEM 12.90. ISBN: 3 423 05065 9.
Taxation of the free profession. Booklet containing an overview of all aspects like deduction of costs, insurance, real estate trade, leasing, free profession partnership, accounting regulation etc.
(B. 115.899)

Soyk, Stefan.
Mineralölsteuerrecht. Systematische Darstellung unter Einbeziehung der Mineralöltechnologie und der zolltariflichen Einreichung.
Munich, Verlag C.H. Beck. 1996, pp. 269.
DEM 38.
Customs duties and oil taxation. The author explains the history and tax base of this tax, import and export, the collection of the tax and administration procedures.
(B. 115.831)

Scheffler, Wolfram.
Besteuerung von Unternehmen. Band I: Ertrag-, Substanz- und Verkehrsteuern.
2. Auflage.
Heidelberg, C.F. Müller Juristischer Verlag. 1996.
Schaeffers Grundriss des Rechts und der Wirtschaft, Band 39, pp. 347. DEM 39.80.
ISBN: 3 8114 5496 X.
Taxation of corporations and businesses. The book contains an overview of the taxation of financial results, capital and property, VAT, and economic participation. New important legislation since 1992 has been taken into account, for example: the anti-abuse legislation, the solidarity surcharge and the law concerning the furtherance of own housing. Furthermore most important aspects of income tax, corporation tax, business tax, net wealth tax, real estate tax, VAT and inheritance tax are given.
(B. 115.892)

Harzburger Steuerprotokoll 1995. 34. Steuerfachtagung des Steuerberaterverbandes Niedersachen e.V. in Bad Harzburg vom 27. bis 29. September 1995.
Cologne, Verlag Dr Otto Schmidt. 1996, pp. 355. DEM 78. ISBN: 3 504 65202 0.
Report on a seminar held in Bad Harzburg on 27-29 September 1995 on the topic "1996 Tax Law". Contributions covered include the unitary valuation, changes in corporation tax, VAT, inheritance tax, and developments in Eastern Europe.
(B. 115.872)

Zirfas de Morón, Heidrun.
Transnationale Besteuerung im kontext der Globalisierung.
Bielefeld, Erich Schmidt Verlag. 1996.
Steuerberatung-Betriebsprüfung-Unternehmensbesteuerung, Band 29, pp. 181.
DEM 58. ISBN: 3 503 03576 1.
Transnational taxation in the context of globalization. The book refers to the trend of globalization in the world economy. Covering the wide range of planning issues such as decisions on location, legal entity, provision of capital and transfer pricing, the author points at the importance and complexity of tax implications. A pattern for transnational tax planning has been developed, to be used as a guideline by tax practitioners for multinational enterprises.
(B. 115.903)

Mack, A.; Olbing, K.; Posdziech, O.; Schwedhelm, R.; Streck, M.
GmbH in Bedrängnis.
Bonn, Stollfuss Verlag. 1996.
Beratungs Akzente, No. 17, pp. 219. DEM 98.
ISBN: 3 08 440017 2.
Close companies. The book deals with tax problems resulting from an employment relationship between a partner and a close company, especially the question as to whether the pension and salary are at arm's length. The book is particularly useful for tax advisors and the Tax Administration.
(B. 115.779)

Röhrig, Alfred; Heiliger, Maria.
Lebensversicherung und Steuerrecht.

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Bonn, Stollfuss Verlag. 1996, pp. 255.
DEM 39.80. ISBN: 3 08 365801 X.
Taxation and life insurance. The book explains the new Par. 10 (Sec. 2.2) of the Income Tax, introduced to attack abuse caused by certain financing of life insurance. It shows in a useful way the main aspects of the new regulation and the financing of corporate and private investments.
(B. 115.796)

Niermann, Walter.
Die neuen Lohnsteuer Richtlinien 1996.
Cologne, Peter Deubner Verlag. 1996.
Steuer Telex Beratungsschriften, pp. 110.
DEM 77.60. ISBN: 3 88606 173 6.
Detailed explanation of the 1996 wage tax guidelines.
(B. 115.215)

Loy, Hartmut.
Finanzierungen unter Einsatz von Lebens- und Rentenversicherungen. 3. Auflage.
Cologne, Peter Deubner Verlag. 1996.
Steuer Telex Beratungsschriften, pp. 114.
DEM 77.60. ISBN: 3 88606 155 8.
Financing by means of life and pension insurance. Overview on recent changes in German tax law. The author shows remaining tax planning opportunities in this highly complicated area.
(B. 115.714)

Umsatzsteuer Handausgabe 1995/96.
Bearbeitet von Christian Forst, Horst Treptow and Michael Langer.
Bonn, Stollfuss Verlag. 1996, pp. 888.
DEM 64. ISBN: 3 08 361695 3.
VAT law manual. Text edition on German VAT law including guidelines, law, accompanying ordinances, administrative directives, jurisprudence and the EC Sixth Directive.
(B. 115.801)

Kraeusel, Jörg.
Das neue Umsatzsteuerrecht 1996. 4. Auflage.
Bonn, Stollfuss Verlag. 1996, pp. 732.
DEM 62.80. ISBN: 3 08 313604 8.
The new 1996 VAT law. The author considers all changes to the VAT law and to the VAT Directives introduced by the 1996 Tax Law. The text of the Administrative Directives has not been included in this edition. However, in each section an alphabetical listing of key-words allows the reader to find sources of additional information as provided by administrative directives, case law and literature in 1994/95.
(B. 115.794)

Lammsfuss, Franz; Mielke, Klaus.
Fallsammlung Internationales Steuerrecht. Einkommensteuer, Körperschaftsteuer, Aussensteuergesetz, DBA-Schweiz.
5. Auflage.
Herne, Verlag Neue Wirtschafts-Briefe. 1996, pp. 317. DEM 59. ISBN: 3 482 72425 3.
Cases in international taxation. Concerning income tax, corporation tax, tax laws for non-residents and the tax treaty with Switzerland.
(B. 115.784)

Baumgärtel, Martina; Perlet, Helmut.
Die Hinzurechnungsbesteuerung bei Auslandsbeteiligungen.
Neuwied, Hermann Luchterhand Verlag. 1996, pp. 241. DEM 86. ISBN: 3 472 02323 6.
Surcharge levied where income and property are transferred to low tax countries. The authors deal with this deemed income surcharge and explain problems, legal shortcomings and uncertainties. The question as to whether the surcharge for deemed income should be maintained is discussed.
(B. 115.844)

Steuerstrafrecht. Mit Steuerordnungs-widrigkeiten und Verfahrensrecht. Bearbeitet von Brigitte Gast-De Haan, Wolfgang Joecks und Reimer Voss. 4. Auflage.
Munich, Verlag C.H. Beck. 1996, pp. 1034.
DEM 198. ISBN: 3 406 38330 0.
Fiscal criminal law. The book contains an overview of fines procedure, administration procedure, customs procedure, and investigation procedure.
(B. 115.900)

Sander, Hergen.
Volkswirtschaft. 3. Auflage.
Achim, Erich Fleischer Verlag. 1996.
Grüne Reihe, Band 7, pp. 332. DEM 59.
ISBN: 3 8168 1073 X.
Introduction to the German economy, (micro-economy, as well as macro-economy). The book deals especially with the economic circle, the balance theory and the Keynesian model.
(B. 115.807)

Iceland

The economy of Iceland
Reykjavik, Central Bank of Iceland. 1996, pp. 51. ISSN: 1024 0039.
A survey on recent developments and economic prospects. It includes information on foreign trade and balance of payments, financial markets, and foreign debt.
(B. 116.056)

Ireland

Tax Acts 1996-97. Income tax, corporation tax, capital gains tax. 6th Edition. Editor Alan Moore.
Dublin, Butterworth Ireland Ltd. 1996, pp. 1925. ISBN: 1 85475 718 0.
The book sets out consolidated versions of the Income Tax Act 1967, the Capital Gains Tax Act 1975, and the Corporation Tax Act 1976, together with the non-amending sections of the Finance Acts from 1967 to 1996, and the major statutory instruments for each tax.
(B. 115.973)

O'Callaghan, J.M.
Taxation of trusts. The law in Ireland.
Dublin, Butterworth Ireland Ltd. 1996, pp. 362. ISBN: 1 85475 616 8.
The book describes in detail how trusts, trustees and beneficiaries are taxed as at 31 December 1993. In seven parts it describes the trust law, charities and imperfect trusts, income tax, capital gains tax, corporation tax, capital acquisitions tax and local taxation. Numerous worked examples, case law references and commentaries explain the law and its practical implications. The book is an essential guide for tax practitioners, solicitors, financial institutions and students of law and tax.
(B. 115.971)

Saunders, Glyn.
Tolley's taxation in the Republic of Ireland 1996-97.
Croydon, Tolley Publishing Company Ltd. 1996, pp. 407. GBP 32.95.
ISBN: 1 86012 306 6.
A detailed annual guide covering income tax, corporation tax, capital gains tax, capital acquisition tax, residential property tax and value added tax, including the provisions of the Finance Act 1996, and double taxation relief agreements with the UK.
(B. 115.898)

Tax guide 1996-97. 5th Edition.
Dublin, Butterworth Ireland Ltd. 1996, pp. 1322. ISBN: 1 85475 708 3.
The guide provides comprehensive coverage of all areas of taxation applicable in Ireland. This fifth edition is fully updated to Finance Act 1996. The book is an essential reference guide for any person dealing with taxation on a regular basis.
(B. 115.968)

VAT Acts 1996-97. Value added tax.
5th Edition. Editor Alan Moore.
Dublin, Butterworth Ireland Ltd. 1996, pp. 799. ISBN: 1 85475 723 7.
Annual reference guide containing the Value Added Tax Act 1972 (consolidated to Finance Act 1996), the non-amending sections of, and detailed notes on, the Finance Acts from 1973 to 1996, VAT regulations (to July 1996), VAT orders (to July 1996), European Union Directives (consolidated, including the new rules on second-hand goods), European Union regulations.
(B. 115.970)

Capital Tax Acts 1996-97. Stamp duties, capital acquisitions tax, residential property tax, probate tax. 4th Edition. Editors Tom Boland and Alan Moore.
Dublin, Butterworth Ireland Ltd. 1996, pp. 725. ISBN: 1 85475 728 8.
The handbook sets out consolidated versions of the Stamp Act 1891, the Capital Acquisitions Tax Act 1976 and the Residential Property Tax Legislation (Finance Act 1983), together with the relevant non-amending sections of the Finance Acts from 1891 to 1996 inclusive. The book is an essential annual reference guide for tax practitioners, accountants, property lawyers, businessmen, financial institutions, students of law and tax.
(B. 115.969)

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Italy

Borio, Gian Franco.
La tassazione dei non residenti.
Milan, Dott. A. Giuffre Editore. 1996, pp. 143.
ITL 20.000. ISBN: 88 14 05609 9.
The book provides a quick (not in-depth) analysis of the rules applicable to non-residents, in particular, the author deals with: the concept of residence and fiscal domicile; the concept of permanent establishment; IRPEG and ILOR on non-residents; the withholding taxes on dividends, interest and royalties; the fiscal representatives of non-residents; the system of refunds; the domestic, bilateral and EC rules applicable to non-residents.
(B. 115.254)

Liechtenstein

Marxer, P.; Goop, A.P.; Kieber, W.
Gesellschaften und Steuern in Liechtenstein. 9. Auflage.
Vaduz, Liechtenstein Verlag AG., P.O.Box 133, FL-9490 Vaduz, Liechtenstein. 1996, pp. 265. CHF 78. ISBN: 3 85789 860 7.
Partnerships, corporations and taxation in Liechtenstein. This ninth updated edition contains an overview of all legal regulations, including the changes in the field of the European Economic Area, which are of importance for partnerships and corporations. The book is useful for students as well as practitioners.
(B. 115.802)

Netherlands

Slotboom, M.T.
Volledige belasting- en premieheffing bij AOW'ers?
Deventer, Gouda Quint. 1996, pp. 56.
NLG 38.50. ISBN: 90 387 0502 6.
Levying of all premiums on people over 65 who receive a state pension (AOW). The author explains the history and character of the AOW and the future problems resulting from the growing number of people entitled to the AOW. The author also investigates whether the problems should be resolved by levying premiums on people above 65.
(B. 115.799)

Vries, B. de; Dur, R.A.J.
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the harmonization of taxes. The author concludes that several inconsistencies between VAT, equalization tax and direct taxation problems are caused by the division between privileged participation income gains and non-privileged capital profits, which also result in a disadvantage at the Level of the European market. In the authors' opinion participation profits therefore should be tax exempt. The author also explains that the harmonization law results in a loss of tax innovations and it is uncertain what the effect will be for privileged corporations. In the last part of the book the desirability of a consumer tax is explained.
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The book examines the Mexican income tax law. The author explains the main concepts of income tax law, especially regarding the taxation of legal entities. Issues dealt with include: the legal aspects of tax law, general aspects of income tax law in Mexico, description of current legislation, permanent establishment, domicile and tax base.
(B. 18.928)

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Establecimiento permanente.
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Conference diary

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

APRIL 1997

International Tax Aspects of Permanent Establishments, Palace Hotel, Milan, 17-18 April 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

Offshore Tax Planning Before It Is Too Late, Marriott Hotel, London, 18 April 1997 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-637 4383, Fax: 44- 171-631 3214.

International Partnerships & Joint Ventures, Vienna, 18 April 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

International Real Estate Investment, Vienna, 18 April 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

School of Transfer Pricing, The Berners Hotel, Berners Street, London W1, 23-24 April 1997 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

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INTERNATIONAL

ADVANCE RULINGS: LESSONS FROM THE SWEDISH MODEL

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I. INTRODUCTION

Advance rulings are now commonplace in the tax administrations of most developed countries. Sweden offers an example of one of the earliest rulings systems and yet its model remains unique. This article reviews the key features of the Swedish model of advance rulings and suggests some of the lessons that can be learnt from it. It shows how the lessons might apply in a typical rulings system: that of Australia.

II. STRUCTURE

Rulings are given in Sweden by the *Skatterättsnämnden* (the Council for Advance Tax Rulings, hereinafter "the Council").[1] The Council is made up of two divisions, one dealing with questions of direct taxation and the other dealing with questions of indirect taxation.

Swedish advance rulings differ from those given in other systems in that the Council is not simply independent from the Swedish tax authority, the National Tax Board, (hereinafter "the NTB"), but is part of the court system. It has the status of a national tax court and taxpayers may appeal from the Council to the *Regeringsrätten* (the Supreme Administrative Court), which is the highest court that hears tax matters.[2] The effect is to increase significantly the value of rulings by the Council. It has also meant that stringent processes have developed to maintain the integrity of rulings.[3]

The Swedish government appoints the 18 members and 18 deputies to the Council for four years.[4] There is an overall chair of the Council who has the rank of a senior judge. The chair and three vice-chairs of the Council are permanent members, the others are part-time members, but leading tax experts in their field.[5] This ensures that the Council is seen as the leading repository of tax expertise within the court system. Council membership is drawn from both public and private sectors and has included various financial sector and industry representatives, academics, judges and members of the public service. There are also representatives of the NTB. Each division sits as a Council of a maximum of eight members, although a quorum can consist of as few as three members and a chair, if they agree on a matter.[6] Experience has shown that the position taken by Council members does not necessarily reflect their background.

An experienced and well-paid permanent legal secretariat ensures that the process is supported by expert administration and legal preparation. The secretariat is a prestigious appointment within the public service. As with other support roles in judicial bodies funded by the government, there is no question raised as to the independence of the secretariat. Nominally, for budget and salary purposes, they may fall under the NTB, but the reality is that the secretariat is completely independent, and is seen as such by taxpayers. The professional expertise of the members of the secretariat is also widely recognized.

Comment

The notable feature of the Swedish system is that the Council has the status of a court, with the associated independence. Just as important, the Council's members are leading tax experts drawn from all sections of the community. In these aspects, it provides an ideal model for other jurisdictions, representing an opportunity to provide clear and balanced interpretations of the law acceptable to all taxpayers. However, although it overcomes a major shortcoming of other systems – the tax authority both interpreting and applying the tax law – the model is unlikely to be adopted elsewhere.[7] No

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1. Lag (SFS 1951:442) om förhandsbesked i taxeringsfrågor Sec. 2. (All sections refer to this Act unless otherwise stated.)
2. Sec. 9.
3. Secs. 4 to 7.
4. Ibid.
5. Ibid.
6. Sec. 3.
7. The Swedish model has been raised for consideration in both Australia and New Zealand but has attracted little official comment. See Prebble J, "Canadian and Swedish Procedures for Advance Rulings in Income Tax Cases" (1987) 4 *Australian Tax Forum* at 217; Smith M, "Binding Rulings", Paper presented at the New Zealand Society of Accountants 1993 Tax Conference; Bentley D, "The Commissioner's Powers: Democracy Fraying at the Edges?" (1994) 4 *Revenue LJ* at 85; James S and Wallschutzky I, "The Design of an Appropriate System of Tax Rulings" (1995).5 *Revenue LJ* at 175.

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tax authority is likely to give up such a power voluntarily.[8] Furthermore, governments tend to support the wishes of their tax authority, provided the system yields the necessary revenue without causing too much offense to taxpayers.[9]

For example, in Australia the Australian Taxation Office (hereinafter the "ATO") issues rulings to provide guidance as to the interpretation and application of the tax laws.[10] Public rulings are general in nature and apply to classes of arrangements or taxpayers. Private rulings are specific and state how the ATO will apply the law to the tax affairs of a particular taxpayer. Rulings are generally binding on both the ATO and taxpayers, subject to a taxpayer's right of objection and appeal against a private ruling.

As with most rulings systems, the twin objectives of the Australian regime are to promote fairness and certainty.[11] However, it is questionable how far these aims can be fulfilled given that all rulings are made by the revenue collection agency. It is a general principle of the Australian legal system that an administrative decision-maker should be disinterested or unbiased in the matter to be decided.[12] Given that the ATO interprets the legislation that it has to apply in order to meet its revenue collection targets, the effect is a breach of the principle.

What is of more concern is that rulings are challenged in a relatively small number of cases.[13] Accordingly, in most situations, taxpayers treat rulings as the law, when their real status is that they simply give the ATO's opinion of what the law should be and how it should apply.[14] The New Zealand rulings system has tried to overcome the inherent bias in rulings issued by the Inland Revenue Department through extensive consultation, and provides detailed feedback in response to submissions.[15] This seems a second best alternative to full independence for the rulings body.

Another advantage of the Swedish system, (which New Zealand has adopted,) is that rulings are issued centrally. A flaw in the Australian system is that divergent views appear in rulings originating from different offices of the ATO around Australia.[16] With the advent of modern technology this should not be an insurmountable problem, but for quality control purposes, the reality is that a centralized body has the advantage.

III. SCOPE

The Council provides rulings on most tax matters, including the Tax Evasion Act (SFS 1995:575).[17] This means that the Council rules on diverse matters ranging from transfer pricing and the application of international double taxation agreements through to questions of law governing the implementation of basic administrative procedures.

The current Council sees one of its main roles as helping to provide business taxpayers with interpretations of the tax law to enable them to make rational investment decisions. The Council wants to ensure that the business community respects its decisions and perceives them as fair. This has become particularly important given a recent trend in applications relating to international transactions.

Rulings are given on questions of law.[18] It is not the Council's role to determine questions of fact. The Council also does not provide tax planning advice. It would dismiss a request for a ruling as to the most appropriate way to apply the law to a given fact situation where it was impossible to determine a specific outcome in advance. It would also dismiss an application requesting a ruling on a number of alternatives, that was designed to try to find the boundaries of the law, in order to implement a tax scheme. The Council restricts itself to determining matters of legal principle in relation to real fact situations. Nonetheless, the Council does rule on the legality of tax avoidance schemes in certain circumstances. The rationale is that the taxpaying community is better served if the Council prevents ineffective schemes from becoming widespread at an early stage.

The Council does not consider ruling applications that involve questions of law that are clear or already decided. The Council also dismisses applications that are not of sufficient importance. It rules on matters that are important to individuals or the community in making decisions.

The Council does not provide general rulings. Ruling requests may not involve theoretical questions, but must at least seem to relate to real situations. This gives rise to difficulties and is one of the shortcomings of the process. Taxpayers or their representatives often construct artificial cases to find out the state of the law governing a particular transaction or situation.

Most taxpayers that are going to ask for a ruling, such as major listed companies, financial sector taxpayers selling financial products and large investors investigating potential projects, cannot afford, for reasons of confidentiality, to take

8. "A rule granting extensive discretion is generally only given to decision-makers instrumental in exercising the powers of the state within society", which means that the executive tends to retain that discretion within its own authority: Bentley D, "Formulating a Taxpayers' Charter of Rights: Setting the Ground Rules" (1996) 25 *AT Rev* at 97. See further, Schauer F, *Playing by the Rules* (Oxford University Press, Oxford, 1992) at Chapter 8. The UK Inland Revenue certainly takes this view: see Inland Revenue, *Post Transaction Rulings: A Consultative Document* (HMSO 1994) at para 22.
9. For example, the Australian Government's response to the 1993 report of an inquiry into the operation of the Australian tax system, Joint Committee of Public Accounts, Report 326, *An Assessment of Tax* (AGPS, Canberra, 1993).
10. Part IVAAA and Part IVAA Taxation Administration Act 1953 (Cth).
11. Second Reading Speech to the Taxation Laws Amendment (Self Assessment) Bill 1992.
12. Refer, Allars M, *Introduction to Australian Administrative Law* (Sydney: Butterworths, 1990) at Chapter 6.
13. When they are challenged, they are often found to give incorrect interpretations of the law. For example, the ATO's interpretation of the meaning of goodwill was held to be wrong in *FC of T v. Krakos Investments Pty Ltd* (1996) 61 FCR 489.
14. Wijn J de, "The Taxation Ruling System: Help or Hindrance?" (1992) *Taxation Institute of Australia, 31st Victorian Convention Papers* at 26.
15. For a discussion of the New Zealand rulings system, see Sawyer A, "Implementing a Regime of Binding Rulings: The New Zealand Experience", paper presented at the UNSW (ATAX) Conference, Current Issues in Tax Administration, 11-12 April 1996.
16. Taxation Institute of Australia, "Public Rulings and Determinations" (1995/96) 3 *Taxation in Australia – Red Edition* at 157.
17. Sec. 1.
18. Ibid.

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many requests into the public forum. They also generally do not want a major investigation into all the circumstances giving rise to a project, product or investment, but want a quick decision as to the application of the law. Where the law has changed, they may not be able to wait for a genuine case to test the interpretation of the new law.

Accordingly, they will use a willing taxpayer and create a situation on which to request a ruling. For example, at the request of an insurance company, the spouse of one of its directors may make a ruling request as to the application of the law to a particular insurance product, developed recently by the insurance company. The spouse will say in the ruling request that he or she is considering purchasing the product. The Council is aware that this is done. Provided it does not represent an abuse of process, and because it makes applications for important rulings possible, the Council takes such applications at face value. These cases are, in any event, carefully constructed, so that it is only those with inside information who would know that the taxpayer in a case did not intend to enter into the relevant transaction.

It is unsatisfactory for taxpayers to have to construct artificial and contrived fact scenarios to generate a ruling that can have general application. There are suggestions that the NTB should be allowed to publish public rulings. This is already done on an informal basis. For example, financial institutions obtain informal rulings on tax issues connected with the issue of prospectuses: it is often essential to obtain such assurances in advance. Informal rulings do not have any legal status.

Comment

The broad scope of the Swedish system is emulated in countries offering a regime of comprehensive tax rulings. It makes the system fairer and more certain for a larger number of taxpayers, which is the aim of most rulings systems. Many systems, such as those of the Netherlands and India, offer rulings to limited classes of taxpayers or only in certain areas. The reasons are often historical or relate to resource constraints.[19]

Sweden provides a clear example of the difficulties that can arise where there is no public rulings system. It is not enough to offer private rulings when the needs of business taxpayers, in particular, demand general interpretations of the law applicable to whole classes of arrangements or taxpayers. This is where systems such as those in Australia and New Zealand have a clear advantage. The challenge is to find a way for an independent body to provide public rulings. In Sweden, much of the difficulty in doing so is constitutional. This is discussed further in part XI of this article.

IV. APPLICATIONS

Applications made by taxpayers are processed by the secretariat.[20] The formality and complexity of the process means that most taxpayers making applications are large companies or wealthy individuals. Almost all successful applications are made on behalf of taxpayers by professional advisers. However, the quality of professional advice can vary widely, so that the use of a professional adviser does not guarantee that a ruling application is accepted. All parties affected by a particular transaction may make applications.

It is arguable that the tendency for rulings to be given to large business taxpayers effectively discriminates against small businesses and individuals. However, the counter-argument is that the reason large businesses need to apply for rulings is that they are entering into complex transactions and the law governing them is equally complex. Individuals, who are subject to less complex laws, particularly following the 1991 tax reforms, are far less likely to need to make an application for a ruling.

Until recently the NTB has not been able to make a rulings application. This is now being changed with amendments to the law.[21] The private sector and some commentators opposed the changes on the grounds that the NTB is an arm of the executive and laws introduced by the executive into parliament should be sufficiently clear for the executive to implement without further interpretation by the judiciary. If laws introduced by the executive are incomplete and require interpretation prior to implementation, critics argue that the judiciary is taking on a law-making function, which is unconstitutional. Rather, the NTB should ensure that the law is changed to effect any necessary clarification. These arguments did not succeed and the NTB will now be able to apply for rulings.

As with other taxpayers, the NTB may only apply for rulings on actual cases. However, the NTB does not need the taxpayer to consent before it makes a ruling application. Commentators have argued that this is a breach of individual privacy.[22] In practice a taxpayer is notified.

Comment

Professional tax advisers are used to formulate ruling applications in most jurisdictions. The formality of the application process in Sweden as compared with that in say, Australia, where rulings are more easily accessible, would seem to make it more important to use an adviser. It is a resource issue. In jurisdictions with less complex legislation or where large numbers of taxpayers do not have to file returns, rulings are usually less important for individuals and small businesses. Accordingly, a complex ruling application process, such as that in Sweden, can more legitimately restrict the applications considered to those with a genuine problem of interpretation. Where the tax laws are complex and most taxpayers file returns, as in Australia and New Zealand, the ruling process needs to be simple and accessible. In these juris-

19. In India it is resource and policy issues which prevent the widening of the rulings system. Furthermore, there is a concern that a general ruling system could overlap with the jurisdiction of the courts. See Har Govind, "Advance Tax Rulings for Non-Residents" 2 *Asia-Pacific Tax Bulletin* 5 (1996) at 135.
20. Sec. 4.
21. (SOU 1996:44) Översyn av skatteflyktslagen – Reformerat förhandsbesked.
22. For example, in an earlier committee examining the question of taxpayers' rights, 1995 Års skatteflyktskommitté).

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dictions it takes more resources to process the greater number of ruling applications.

From a practical standpoint, where an independent body makes rulings, the revenue authorities should be able to apply for rulings in the same way as taxpayers. Arguments that the law should be detailed enough to cover every situation seem hollow.[23] It would be particularly important for revenue authorities to have the facility to request public rulings, if these rulings were made by an independent body, as the revenue authorities would usually be best situated to determine when and where they were needed.

V. PROCESS

Ruling applications are often complex. Successful applications usually provide a comprehensive analysis of the question on which they request a ruling. They include an analysis of the current law, reference to any relevant authorities, arguments on both sides of the question and reasons why the Council should decide the question in a particular way.

The secretariat prepares its own comprehensive analysis of the issues in question and provides extensive commentary on the ruling application. In order to do this, and prior to presenting the application to the Council, the secretariat liaises extensively with the applicant to obtain further information, comment and clarification. The application is also sent to the NTB for comment. The NTB comments are sent to the taxpayer for the taxpayer to provide a response. The final legal brief presented to the Council for consideration, with a recommendation by the secretariat, is of the highest standard.

A large number of applications are not formulated appropriately. The secretariat attempt to help taxpayers to reformulate their applications. They usually provide full details to the taxpayer as to why an application is unlikely to be accepted. If the taxpayer fails to reformulate the application to make it acceptable, the secretariat recommends that the Council should dismiss it. Recommendations for dismissal are generally dealt with before the main meeting of the Council by a minimum quorum.[24] In most cases the recommendations are accepted. It is usually applications by individual taxpayers that are dismissed. Many are too broad and the taxpayers are unable to reformulate them to relate to a specific issue. Many others relate to issues over which the Council has no jurisdiction, such as the determination of an appropriate valuation or matters involving inheritance or gift taxes.[25]

Approximately 40 per cent of all applications for rulings are dismissed. This seems very high. However, it is explained by the fact that the NTB often tells taxpayers that they have the option of applying for a ruling on a matter that they cannot resolve to their satisfaction with the NTB. The majority of such applications are not in fact suitable for consideration by the Council and it is these that form the bulk of the dismissals.

The Council considers all serious applications in significant detail and the members are provided with comprehensive documentation for each case. Documentation can be voluminous, particularly where applications are complex, with extensive comment by the NTB and analysis by the secretariat. The Council considers applications *de novo* and does not necessarily follow the recommendations of the secretariat. Whenever the Council feels that it should investigate some issues further before it can make a ruling, it postpones the application until the secretariat can obtain the relevant information from the taxpayer. This illustrates both a strength and weakness of the process.

The detailed investigation of each matter by the Council has ensured that it has an outstanding reputation for the quality of its decisions. It means that rulings cover all important issues and are not confined to a cursory consideration of the law. This has been particularly important in the interpretation of the law governing complex issues, such as the taxation of financial products and transactions. The price of the reputation is the time it takes to process ruling applications. The Council recognizes the problem, and is making efforts to reduce the time it takes to make rulings without sacrificing their quality.

Very occasionally, the Council or secretariat may seek input from external experts. For example, the Council may request a written opinion from an international or foreign accounting body on how particular accounting standards operate, or it may ask a foreign institution to describe the exact nature of payments the institution is making to Swedish taxpayers. Evidence from third parties often forms part of a ruling application, but even though provision is specifically made in the law for the Council to do so, it only exceptionally seeks external evidence itself.[26]

The law also provides for oral evidence in an oral hearing.[27] However, the Council always conducts its proceedings using written applications, submissions and evidence. Council meetings themselves are very informal and often involve extensive discussion of the documentation by the members before they reach a decision.

It is the Council which decides whether or not to make a ruling or dismiss a ruling application.[28] If the Council allows an application, the Council rules how the question before it is to be treated in an assessment to tax. Except in special circumstances, the ruling will only state the principles that the NTB should follow when making an assessment.

The chair of the Council usually records the ruling and then circulates it for comment and input among the other members. Dissenting members state their reasons for dissent. Full reasons support each ruling and all the judgements, including dissenting judgments, are given to the applicant. The Council tries to act with as much unanimity as possible. However, a number of different opinions are very useful to the Supreme Administrative Court when, which is likely if there is not unanimity, the matter is heard on appeal.

23. James and Wallschutzky *supra* note 7, at 183.
24. Sec. 7.
25. Sec. 1.
26. Sec. 4.
27. See for example, Secs. 4 and 6.
28. Sec. 7.

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A ruling, once made, is sent to both the applicant and the NTB by registered mail.[29] There can be no appeal against a decision of the Council to dismiss a ruling application.[30] Where the Council dismisses a ruling application, it gives brief reasons and, if the application falls within the jurisdiction of the Council (as lack of jurisdiction is a common reason for dismissal) then the applicant can redraft it and reapply.

Comment

Swedish rulings have a reputation for quality. It is not a reputation shared by the rulings in many jurisdictions. Taxpayers in Australia continually raise concerns about the quality of rulings and the ATO has responded to criticism with a major review of its Public Rulings programme and a strengthening of its quality control.[31]

Quality and service are sought after features of any rulings system as they contribute significantly to the levels of certainty and fairness, on which such systems are judged.[32] It is well documented that when taxpayers have favourable experiences within a tax system, their compliance with the tax laws improves.[33] Large taxpayers in Sweden appear to be satisfied with the rulings process. However, the large number of dismissals suggests that many taxpayers are badly served by a system that they clearly do not fully understand. This may be a particular problem associated with rulings given by an independent body. In Australia, the ATO widely publicizes key features of the self assessment system, and tries to assist taxpayers with procedural matters, such as making a ruling application. As the revenue collection authority it inevitably has greater resources than would an independent rulings body.

As suggested above, it seems that the Swedish system has an additional problem in that certain officers of the NTB tend to advise taxpayers to apply for a ruling, even where it is inappropriate, rather than to use genuine methods of problem resolution. Over time, this approach would be expected to have an adverse impact on compliance.

The Swedish system makes little use of third party or oral evidence. This is a feature of administrative decision-making generally. In Australia, the ATO publicizes its consultative approach to rulings, but its record has been poor in taking account of third party submissions.[34] New Zealand offers a contrasting approach. The Inland Revenue Department takes full account of taxpayer submissions in drafting its rulings.[35] An independent rulings body making public rulings could take far more cognizance of third party views than the Council is currently able to. The Council makes private rulings and the associated confidentiality requirements limit the possibility of third party involvement.

A particularly useful element of the Swedish system is the final form in which rulings are given to the relevant parties. Because the Council is a court, it gives a ruling as if it were a judgement. Accordingly, the parties are provided with full reasons, including any dissenting opinions. This is particularly useful to the Supreme Administrative Court if the ruling is appealed, providing a range of expert opinions on the matter. If a law is unclear, this system highlights the lack of clarity, and provides the impetus for a final ruling by the highest tax court, or for amendment by the legislature. It is an approach that cuts through any attempts to provide a ruling that takes a particular line, holding it out as the only right answer: a feature of systems where the revenue authority makes the rulings.

VI. TIMING

Rulings can take up to a year from the time of application. In certain cases, where the application is complete and there are few questions, a ruling can take only three months. However, taxpayers see this as a major shortcoming of the rulings system. Where taxpayers are contemplating major transactions, and time is of the essence, they often avoid asking for a ruling, because of the time it takes to get one.

It is often difficult to reduce the time taken if the system is to work properly. The secretariat requires time to ascertain the relevant details and to fill in any gaps in the application. The NTB needs time to consider its response and can sometimes have queries of its own before it can give an opinion. The taxpayer also needs time to consider the NTB opinion and any comments made by the secretariat. Finally, the secretariat needs to prepare the final application for consideration by the Council, together with its own recommendations. The Council too, needs time to read and consider the matter, before it can produce a reasoned ruling. Only if an applicant prepares a case exceptionally well, is the whole process streamlined.

The Council is aware of the problem of timeliness and is taking steps to reduce the time taken over rulings without sacrificing their quality. It is hoping to provide a fast-track for rulings where a taxpayer can show that it is necessary given the circumstances. The current chair hopes to be able to cut down to a month the time taken to give rulings in urgent cases.

29. Sec. 8.
30. Ibid.
31. Taxation Institute of Australia *supra* note 16; Barton GA, "The Rulings System: Twilight Zone of Tax Law" (1993) 1 *Taxation in Australia – Red Edition* at 284; Commissioner of Taxation *1994-95 Annual Report* (AGPS, Canberra, 1995) at 41; National Tax Liaison Group Minutes for Meeting of 4 June 1996 para 4.2.
32. Second Reading Speech *supra* note 11.
33. Li J, "Taxpayer Rights in Canada" (1997) 7 *Revenue LJ* (forthcoming); James S and Wallschutzky IG, "The Shape of Future Tax Administration" 49 *Bulletin for International Fiscal Documentation* (1995) at 217; Stalans L, "Talking about Tax Audit Experiences: The Procedural Content of Socialisation"' paper presented at the Internal Revenue Service Research Conference, Washington DC, 12-13 November 1992 and quoted in Wickerson J, "Measuring Taxpayer Compliance: Issues and Challenges Facing Tax Administrations" (1994) 11 *Australian Tax Forum* at 12; Roth JA, Scholz JT and Witte AD (eds), *Taxpayer Compliance*, Vol 1 (University of Pennsylvania Press, 1989) at 129.
34. Taxation Institute of Australia *supra* note 16. There is constant complaint from taxpayer representative groups at National Taxpayer Liaison Group meetings with the ATO that taxpayers have voluntarily given a vast amount of input into the ruling process at the ATO's request and yet very little that they say is ever taken on board.
35. Sawyer A *supra* note 15, at 24.

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Comment

Timing is an issue wherever rulings are made. The Swedish process can be inordinately long, but would be among the quickest if it were cut down to one month.[36] The ATO is currently trying to improve the quality and timeliness of its private rulings programme. It aims to provide routine rulings within seven weeks of application and complex rulings within a period negotiated with the taxpayer.[37] In New Zealand, regulations require that routine applications for rulings should be processed within four weeks, but more complex matters may take longer.[38]

There is a trade-off between quality and timing. The timely delivery of rulings depends upon the resources available to the body making the rulings. It should not make a difference whether that body is independent or part of the revenue authority.

VII. REVIEW

Speeding up the ruling process will not necessarily assist taxpayers, as a ruling is subject to review. A taxpayer can appeal against a ruling if it is unfavourable and the NTB can appeal against a ruling that is favourable to the taxpayer.[39] An appeal to the Supreme Administrative Court is generally not finalized in less than a year. As ruling applications usually involve complex transactions in areas where the law is unclear, taxpayers often appeal against rulings, particularly where a ruling is not unanimous.

An applicant can appeal to the Supreme Administrative Court within one month of the date on which the applicant is apprised of the Council's ruling.[40] Although many rulings are appealed, they constitute a very small proportion of the total number of appeals to the Supreme Administrative Court. However, in the tax law context they are very important, simply because the Council provides a fast-track appeal route.

If a matter progresses through the normal court system, an appeal to the court can only be made once a transaction is assessed to tax. There is no hearing in advance of the implementation of a transaction in the ordinary courts. An appeal against an assessment usually goes before the tax tribunal, is appealed to the City Court and then finally to the Appeals Court. Appeals to the Supreme Administrative Court from the Appeals Court are only given by way of special leave. The process can take about five years before an appeal is finalized.

From a timing perspective, a ruling application provides a taxpayer with a clear interpretation of the law much more quickly. The Council is also respected for giving the best interpretations of the tax law of any judicial body below the Supreme Administrative Court and, for this reason, taxpayers prefer to use the ruling process. The Council's expertise comes from its composition of leading tax experts and its specific tax law focus. In this context it is little wonder that transactions untested at law, and the interpretation of new tax legislation, tend to flow through the Council as ruling applications, and from there to the Supreme Administrative Court rather than through the ordinary court system.

A possible contrary approach may be taken by some taxpayers who may perceive that any lack of expertise on tax matters in the ordinary court system could work to their advantage. They may believe that, by using expert professional advice, they can achieve a more favourable decision than they would from the Council, with a membership of tax experts. Taxpayers may also prefer to go to the ordinary courts where earlier advantageous decisions have been made that they wish to rely on, that are technically doubtful but have not yet been the subject of a ruling application to the Council or an appeal to the Supreme Administrative Court.

Comment

The review of rulings in Sweden is very effective. It is particularly useful to have the right of appeal to the highest tax court against a ruling. It reflects the quality of the rulings that are made by the Council that the Supreme Administrative Court is willing to hear these appeals. It also means that there is a mechanism for a relatively timely review of important tax questions. A possible gap in the review process is that there is no appeal against a decision to dismiss a ruling application.

In many jurisdictions there is no right of appeal and, if there is a right, it is seldom to the highest tax court.[41] In Australia, taxpayers may appeal against unfavourable rulings made by the ATO to the Full Federal Court. Although not the highest court, it is normally the court of last resort for tax cases.[42] There are caveats to the right of appeal in Australia, which compare unfavourably with that in Sweden. The Australian courts cannot hear hypothetical cases.[43] This means that an appeal has to be heard in the year to which the application relates or it cannot be heard at all.[44] The rationale is that, once the year in which the arrangement was to be carried out passes, it becomes a hypothetical case. The problem is resolved by always applying for a ruling that will cover a potential transaction for a number of years. Nonetheless, it adds another hurdle to the appeals process.

In Australia, if the ATO does not ask for sufficient facts to make a proper decision when a ruling is made, the courts will not be able to hear an appeal against the ruling.[45] This can have unfortunate results where all the parties thought that a ruling was properly made and only discover on appeal to the

36. European practice suggests that 2-3 months is the norm for issuing rulings. See IBFD, "Ruling Practice: A European Survey and Comparison" 35 *European Taxation* 2 (1995), at 60.
37. National Tax Liaison Group Minutes for Meeting of 4 June 1996 para. 4.2.
38. Tax Administration (Binding Rulings) Regulations 1995, reg 5.
39. Sec. 9.
40. Sec. 10.
41. IBFD *supra* note 36.
42. The High Court must give special leave to appeal from the Full Federal Court. In *FC of T v. Westfield Ltd* (1991) 22 ATR 400, the High Court said that special leave will only be given in tax cases where a question of fundamental importance arises.
43. In *re The Judiciary Act and The Navigation Act* (1921) 29 CLR 257.
44. *CTC Resources NL v. FC of T* (1994) 48 FCR 397.
45. Ibid.

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Full Federal Court that it was not. The ruling is then remitted to the Commissioner, who must try to obtain the necessary additional information before making a new ruling, which may then be appealed all over again. The Swedish review system seems simpler and more effective.

VIII. EFFECT

An Advance Ruling, once made, is followed in the assessments to which it relates, to the extent that a taxpayer has entered into the relevant transaction.[46] Rulings are very clear and taxpayers cannot choose to apply only certain parts of a ruling, although there are no specific penalties for ignoring a ruling, i.e. the usual penalties and interest for late payment of tax would apply. If an assessment is subsequently appealed on a matter on which the Council has given a ruling, the courts would almost always follow the ruling, unless the transaction differed substantially in its implementation from the facts on which the ruling was made. Rulings apply only to the specific transactions set out in the ruling application.

Rulings are not unlimited in their application and usually apply for two tax years, sometimes longer if the taxpayer requests it. There is no timing advantage to taxpayers in making ruling applications as far as the payment of tax is concerned. Interest and penalties apply to late paid tax until a ruling to the contrary is given. There is no remittance of tax, interest or penalties pending the outcome of a ruling.

If the Council feels that it has made an error in a ruling, the original ruling would still stand. However, the Council can change its mind in subsequent rulings. This would not be done lightly given the respect accorded to earlier decisions and would take into account the consequences of a change in interpretation. In Sweden, emphasis is placed on the similar treatment of similar cases.

Comment

The judicial nature of Swedish rulings is a unique feature. In some jurisdictions, as rulings simply represent the opinion of the revenue authorities, they are not binding on the courts. In others, an advance ruling is followed by a court in applying the law to a particular taxpayer. In Australia, rulings are binding on the ATO to the extent that they are in favour of the taxpayer, but the courts do not consider the rulings themselves as anything more than the opinion of the ATO. However, if a taxpayer deliberately disregards a private ruling, penalties may apply. This is in the context of a self-assessment system. If taxpayers do not agree with a ruling, the proper course is for them to take the ruling on appeal to the courts rather than simply to ignore it. As Australian rulings are not judicial decisions, they may be withdrawn, subject to strict statutory rules.

IX. CHARGES

Successful ruling applications are subject to a fee of between SEK 600 and 10,000.[47] The Council fixes the fee, which, in practice, is set by the secretariat. Most applications by large taxpayers automatically attract the maximum fee. The fee can be waived by the Council in special circumstances.[48] The Council has absolute discretion over the fee to be paid and there is no appeal from its decision. The fee is payable within one month of a demand sent out with the ruling.[49] If the Supreme Administrative Court sets aside the ruling, the fee is reimbursed to the applicant.[50]

Relative to the cost of professional advice in preparing a ruling request, the application fee is small. The discretion given to the Council to vary the fee means that it is unlikely that the fee acts as a disincentive to prevent a taxpayer from making a ruling application, particularly since there is no fee applicable to unsuccessful applications. The fee may be useful in preventing trivial or unnecessary requests, but given the number of ruling applications that are dismissed on the grounds that the Council has no jurisdiction, arguments could equally be made to the contrary. It is clear from the applications that many taxpayers do see the Council as a means of obtaining tax advice, but such applications are dismissed on the grounds that the ruling is not of sufficient importance.

Comment

Australia, along with most other jurisdictions, does not charge for its rulings.[51] In contrast, New Zealand provides an example of full cost-recovery for the provision of rulings.[52] The principle of users paying for services provided is important in New Zealand: it limits the number of rulings requested and ensures that those requested can be issued in a timely manner with the resources available.[53] An application fee pays for the first two hours of the Inland Revenue Department's time, in which it determines whether it will give a ruling. The taxpayer is then given an estimate of any fees payable in excess of the application fee, together with an estimate of the time the ruling will take to prepare. Once the ruling is made, applicants receive an itemized account, providing full details of costs and disbursements.[54]

Charges and how they are made are a matter of policy. However, the New Zealand approach suggests that charges can be used to allocate scarce resources. Welfare issues are less likely to arise in relation to rulings, as those taxpayers requiring rulings are generally those with reasonable amounts of tax to pay and, therefore, should be able to pay for rulings.

46. Sec. 11.
47. Sec. 12.
48. Ibid.
49. Ibid.
50. Ibid.
51. IBFD, *supra* note 36.
52. Tax Administration (Binding Rulings) Regulations 1995 (NZ).
53. Sawyer A *supra* note 15, at 21.
54. Tax Administration (Binding Rulings) Regulations 1995 (NZ) regs 3, 4 and 5.

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X. PUBLICATION

Ostensibly there is absolute secrecy in relation to ruling applications. However, the Council is a judicial body, rather than an organ of the executive. This makes it more difficult to limit access to any information generated during the ruling process. The process used in making rulings means that information is provided to the NTB for comment and research is done by the secretariat and professional advisers. Accordingly, the risks of a breach of confidentiality are higher than in ruling processes in many other jurisdictions, where only a very small number of people would have access to the information. This reduces the attractiveness of obtaining a ruling on real transactions involving highly price sensitive information.

The Council itself is very concerned to maintain absolute confidentiality and there is no publication of details of particular cases. There is no official publication of rulings, but the Chair of the Council writes in *SkatteNytt*, a leading tax journal, and provides details of recent rulings to ensure that they can be followed by other taxpayers. The details are general enough not to reveal the identities of the applicants. If the ruling is appealed to the Supreme Administrative Court, then the full decision of that court is published.

Comment

The Council issues only private rulings. Public rulings, in jurisdictions where they are made, are published widely, so that taxpayers can follow them in arranging their tax affairs. Private rulings present issuing authorities with a dilemma: it is highly desirable that they are published, but the confidentiality of the taxpayers concerned must be protected. In Sweden taxpayers are provided with broad details of private rulings that discuss important issues or matters of principle. New Zealand does not follow this example.

In Australia, too, private rulings are not published. However, in important matters of interpretation, the approach taken in any ruling is available internally within the ATO to ensure consistency in future rulings. Nonetheless, the ATO issues rulings from a number of offices around Australia. In practice, this has led to differences in the approach taken in private rulings issued.[55] What makes it more problematic is that advanced technology has meant that national professional advisers are able immediately to compare private rulings issued to their clients (and often, each other's clients) by different offices of the ATO. Accordingly, they are able, in some cases, where different opinions have been expressed by the ATO, to approach the office most likely to give a favourable ruling. Not only does this undermine the ruling system, but it also discriminates in favour of taxpayers represented by national firms of advisers. Perhaps because of this, New Zealand uses the Swedish model and has centralized the issue of rulings.

XI. INDEPENDENCE

When reviewing the Swedish ruling system it is important to do so in the Swedish cultural context. The Swedish system is noted for its formality. There is not traditionally a close relationship between the NTB and taxpayers. Accordingly, the Council provides an important, formal and independent function in deciding matters of law important to the taxpaying community in a relatively timely manner.

The Council also ensures the constitutionality of the application of the tax law. In Sweden, great importance is placed upon the separation of powers, flowing directly from the constitution. The NTB, as an arm of the executive, is clearly separated from any official interpretation of the law. It is the role of the judiciary under the constitution to interpret the law, and that is why the Council is independent and has the status of a court.[56]

The stringent view taken in Sweden of the separation of powers also explains why, unlike in other jurisdictions, general public rulings may not be made. In Sweden, only the legislature could make binding public rulings or even rulings that were effectively binding, as they would have the nature of law. The theory is that the tax law is made and is clear. Any interpretation of the law by a body other than the legislature, that in any way extends or expands the existing law, represents the making of new law and is in breach of the constitution.

Comment

The judicial nature of Swedish rulings highlights a fundamental difference between rulings issued by an independent body and those issued by the revenue authorities. Rulings usually interpret and apply the tax law. In many jurisdictions, the transaction costs of taking a dispute to court mean that, in most cases, taxpayers prefer to avoid conflict and accept the interpretation of the law given in a ruling. This means that the interpretation effectively becomes the law for those taxpayers. The Swedish system, where an independent judicial body makes rulings, at least provides taxpayers with confidence that there is no obvious bias in the process. Where revenue authorities make rulings, there is no such assurance. The revenue collection agency performs the role of both judge/interpreter of the law and revenue collector, usually with collection targets to meet.

In this context, the Swedish constitutional position on the separation of powers merely represents a basic principle that underlies most legal systems: that in administrative and judicial decision-making there should be no bias. Where the revenue collection agency determines how the law is applied in the collection of revenue, that determination is inherently

55. Taxation Institute of Australia *supra* note 16.
56. For a discussion of these principles, see Hultqvist A, *Legalitetsprincipen vid inkomstbeskattningen* (Juristförlaget, Stockholm, 1995) chap. 3 and chap. 4.

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biased. It is in its freedom from bias that the Swedish system of rulings offers an example that should be followed.

XII. CONCLUSIONS

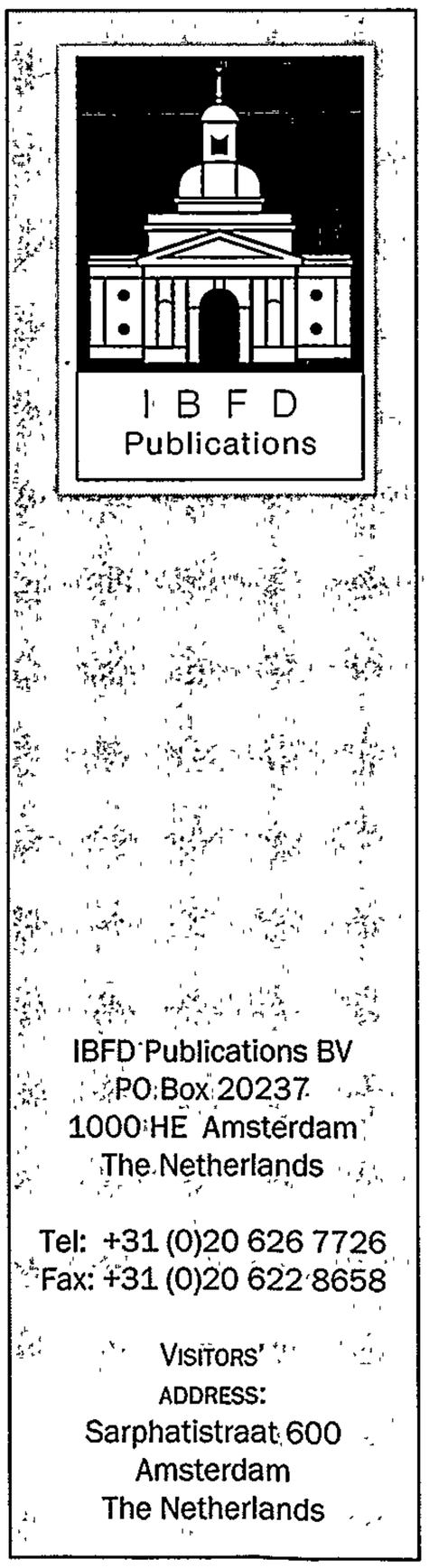
The Swedish system of advance tax rulings has been in place since 1951. Yet, it still offers a model of impartiality and independence that is the envy of taxpayers around the world. Revenue authorities, on the other hand, prefer not to consider the model, as it impacts too greatly on their power of interpretation of the tax laws. That is a significant power, particularly since rulings have the effective force of law for most taxpayers, given the cost of taking a tax dispute through the courts.

The Swedish model uses a centralized rulings system with independent experts from a wide range of backgrounds. The result is rulings of a high quality that are respected by the courts and by taxpayers. The system is made more useful by its broad scope and more effective because of the role of the secretariat in ensuring that applications are comprehensive. An additional advantage of the Swedish system is that private rulings are published, albeit in a form designed to protect the confidentiality of the applicants. These are all factors open to criticism in other rulings programmes.

Where the Swedish model falls down is on the time it takes to make rulings. However, this is a problem area for most rulings systems and, in most jurisdictions, there are constant efforts made to speed up the rulings process.

In 1951 the concept of charges for rulings to contribute towards their cost was an innovation. New Zealand has one of the most recently developed ruling systems and it has built on this concept to incorporate a user-pays approach. In contrast, Australia does not charge for rulings. Charging for rulings is a matter of policy, and no one option is necessarily better than another.

The rulings system in Sweden may be nearly 50 years old, but it has a number of features that are included as sophisticated elements of newly developed systems. Most important, in an age where taxpayers' rights are given increasing weight by governments and revenue authorities alike, it offers a model that can provide taxpayers with genuinely independent and impartial rulings.



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FRANCE

NEW TAX DEVELOPMENTS TO ENCOURAGE FOREIGN INVESTMENT IN FRANCE: HEADQUARTERS, LOGISTICS CENTRES AND TAXATION OF EXPATRIATES

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I. INTRODUCTION

At the beginning of 1996, the French government demonstrated its desire to encourage the establishment of foreign companies in France. Given their economic importance, headquarters and logistics centres of multinational groups constituted a specific target.

Although the French tax system already provided for a special status for headquarters and their employees, it was not perceived as being sufficiently generous compared to those offered by neighbouring countries.

France's competitive position regarding logistics centres was even less favourable since no special tax treatment was available, even though several European countries already applied attractive regimes.

It is in this context that the tax administration has published an important Instruction[1] aimed at offering an favourable tax environment to headquarters and logistics centres. This Instruction also provides for tax relief for expatriate employees located in France.

II. HEADQUARTERS: OFFICIAL RECOGNITION OF INCENTIVES

For a number of years, headquarters of multinational groups have already benefited from an advantageous tax status in France the purpose of which is twofold:

- To simplify the taxable income calculation.
- To reassure companies that their taxable income would not be contested by the tax administration in the case of a tax audit.

Indeed to achieve the above objectives and as the nature of services rendered by headquarters and the status of the beneficiaries (inter-group services) makes it difficult to determine a market price, the headquarters taxable income may be determined on the basis of a percentage of operating costs (cost plus) fixed by the tax administration under the terms of a prior ruling.

This tax status results from a simple administrative tolerance, the conditions of which, until now, have not been clearly defined either in terms of access or procedures, by any official publication. It is, in particular, in order to fill this vacuum that the tax administration decided to publish its own doctrine.

The recent Instruction issued by the tax administration also has the advantage of offering new opportunities, by making the headquarters regime more in line with the needs of international groups.

A. Publication of the administration's doctrine

By deciding to formalize the rules applied to headquarters by way of an Instruction, the tax administration has, for the first time, officially defined the applicable tax rules. The following rules are thus confirmed:

- The headquarters' tax treatment is available under a prior ruling procedure.
- The very nature of headquarters is to direct, manage, coordinate and control activities for the exclusive benefit of group companies. As a result, those services which headquarters may well render to companies outside of the group are taxed under normal rules.
- The headquarters may be organized as a French corporate entity, as a French branch of a foreign company or even as a division of a French company.
- Generally speaking, the costs used to calculate the cost plus are the headquarters' day-to-day operating expenses. These costs include the various expenses incurred during a financial year, (e.g. operating interest, depreciation, etc.) but exclude provisions for charges and corporate income tax.

1. Instruction of 21 January 1997 (BOI 13-G-1-97).

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On the other hand, operating results which are not strictly connected with the headquarters activity are taxed under standard rules (dividends, capital gains and losses on asset disposals).

- These basic costs are increased by a margin negotiated with the tax administration, which corresponds to the profit level which would have been generated on these same services if supplied by an independent party. Even if the tax administration avoided setting a general margin rate in its Instruction, in practice, this rate, often set at 8 per cent, ranges from 6 to 10 per cent. Headquarters must invoice their services to group companies at cost plus the agreed mark-up.
- Taxable income generated by headquarters, and calculated in compliance with the ruling, is liable to corporate income tax at the standard rate (36.66 per cent for 1997, and theoretically 33.33 per cent thereafter) and may not be challenged by the tax administration.

B. New opportunities

The tax administration has relaxed its doctrine so as to adapt the headquarters' regime to the needs of multinationals.

1. Extension of territorial competence

Until now, the territorial competence of headquarters was limited to a specific geographical zone. They were not authorized to act on a worldwide level.

Taking account of the fact that multinational groups are often organized on a sectorial rather than on a geographical basis, the new Instruction sets no limits on the territorial competence of headquarters. They may now operate either on a world-wide basis or for a specific geographical zone. In all cases, however, services rendered by headquarters must, mainly, benefit group companies located outside of France.

2. Extension of the headquarters tax status to French groups

Until now, only the headquarters of multinational groups, controlled from outside of France, were eligible for the special regime. As a result, French groups with international activities tended to locate their headquarters abroad in countries where a more appropriate tax status is offered like Belgium.

In order to remedy this situation, which was all the more difficult to justify in that it discriminated against French groups, the favourable tax status is now available to the headquarters of French groups.

3. Definition and extension of eligible activities

"Eligible activities" comprise direction, management, coordination or control in the following specific fields: administration, data processing services used for internal group management, strategy, human resources, communications, public relations, supply and collation of information, research and development.

In addition, to encourage the development of financial activities in France, the Government has decided to extend the headquarters' tax status to undertakings in the banking and finance sector, for all the eligible activities above plus also for certain functions specific to the banking and finance sector: i.e. back office and financial analysis.

4. Partial exemption for sub-contracting expenses and disbursements

The freedom of action of headquarters was, until now, limited by the fact that subcontracting expenses and disbursements incurred for services rendered to the group were included in the cost plus basis, whereas these types of services did not necessarily justify a margin.

The administration's stance is now more flexible in this respect, without, however, fully meeting the demands of international groups. Disbursements are now excluded from the cost plus basis to the extent that they do not exceed 10 per cent of headquarters costs excluding disbursements. Subcontracting expenses are also excluded up to a limit of 50 per cent of headquarters costs, excluding subcontracting costs.

This partial exemption should offer headquarters new opportunities in the areas of internal organization and the provision of group services.

5. Application of the Instruction to pre-existing headquarters

The Instruction may not only apply to future headquarters but also to those already agreed. The latter may waive some of the terms of their existing ruling and choose to benefit from the provisions of the Instruction should these be more advantageous. It is likely that this will often be the case, given the new rules applicable to disbursements and sub-contracting. However, as each ruling is specific and its terms and conditions reflect the date at which it was granted,[2] headquarters whose status has already been agreed upon should carefully consider which of the available schemes best suits their interests.

Nevertheless, if activities exercised as per the existing ruling are to be modified, it is necessary to obtain preliminary approval from the tax authorities prior to being able to benefit from these new provisions. This can trigger the need to renegotiate the terms of the existing ruling.

III. LOGISTICS CENTRES: CREATION OF AN APPROPRIATE TAX SYSTEM

Until publication of the Instruction, logistics centres did not benefit from any particular tax treatment in France. They were thus open to the risk of seeing their transfer pricing policy challenged by the tax administration.

2. The tax administration's doctrine has developed considerably over the last 15 years.

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Given this, a number of multinational French and foreign groups decided to locate their logistics centres in other countries which offered more favourable tax conditions, for example, the Netherlands or Belgium.

Faced with this situation, France had to react and introduce a tax system attractive to these centres. This is what has been done by offering logistics centres, under certain conditions, the opportunity to benefit under a prior agreement from the same tax rules as those applicable to headquarters.

A. Legal structure and operating rules

A logistics centre may be organized as a French corporate entity or as the French branch of a foreign company. Unlike headquarters, they may not form part of a division of a French operating company or of a holding company. In addition, if the legal structure so allows, a logistics centre may coexist in the same structure as a headquarters.

As the role of a logistics centre is to render logistics services to group companies, all services rendered to companies outside of the group are taxed in accordance with standard tax rules.

There are no limitations on the territorial competence of a logistics centre. However, their services must mainly benefit companies located outside of France.

B. Eligible activities

The eligible activities of logistics centres are precisely defined by the tax Administration. Generally, a logistics centre may only be involved in preparatory or ancillary activities. It cannot therefore, perform activities normally inherent to manufacturing or marketing units. A logistics centre may not, for example, be involved in the transformation of raw materials or of semi-finished goods, or the making of alterations to finished goods.

The table below summarizes those activities which may be carried out by a logistics centre:

Services concerning raw materials and supplies intended for group companies	Services concerning commodities and finished products of group companies and rendered on behalf of group companies	Other services
• purchases in the name of group companies • warehousing • management • packaging • transport and delivery only to group companies • labelling	• warehousing • management • packaging • labelling • transport and delivery	• taking of orders • preparation, printing and sending of invoices • administrative formalities connected with the centre's activities

The logistics centre is able to purchase raw materials and supplies in the names of the companies for which they are intended. It may also make purchases on its own behalf. However, if it does so, then any profits connected with its own purchases are taxable under standard tax rules.

At present, it seems that logistics centres may neither purchase nor sell the goods and finished products of group companies even though they perform logistics services relating to these goods and products. Clearly, these restrictions concerning the ownership of goods do not, in a number of cases, meet the needs of multinational groups. We believe that, as was the case for headquarters, the logistics centres tax status will develop in a favourable direction. Provided that logistics centres do not bear the risk of exchange losses, responsibility for goods or losses thereof, it could be argued that inter-group purchases and sales of goods should be completed at cost price, with only the services rendered by the logistics centre being remunerated.

Moreover, where a logistics centre issues invoices outside of the group, these invoices must be prepared in the name of the group company which actually completes the sale, and client payments must be paid to this same company. The logistics centre may not, therefore, take on the role of a reinvoicing centre.

C. Taxation of logistics centres

Tax rules applicable to logistics centres are similar to those applied to headquarters. The centres are taxed on a cost-plus basis, the margin being negotiated with the tax administration with reference to arm's length operations. The logistics centres must issue their invoices, increased by the agreed margin, which is expected not to exceed that accepted for headquarters.

Costs included in the cost-plus calculation are identical to those described above for headquarters, i.e. day-to-day operating costs, excluding the purchase price of the goods. The new rules applicable to disbursements and subcontracting will be applicable.

These rules may be combined with those benefiting tax warehouses which allow for advantages in relation to VAT and customs duties, as well as the business tax exemption for companies located in tax favoured areas.

IV. NEW TAX RULES FOR EXPATRIATES

A significant part of the recent Instruction deals with the taxation of indemnities and expense reimbursements paid to expatriates.

The tax administration defines expatriates as being persons who were not domiciled in France, under the terms of French domestic law or tax treaties, during the year preceding their arrival in France, and who are employed in France for a period which will not exceed six years.

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Until now, the tax administration allowed for favourable tax treatment to be applied only to those expatriates working for headquarters. Headquarters status was frequently sought principally to obtain preferential treatment for expatriate benefits.

As was the case with corporate income tax, the expatriate ruling resulted from a simple administrative practice which was never officially confirmed.

Thus, the new Instruction has the following advantages:
- it confirms and adapts the tax rules applicable to reimbursements and indemnities paid to expatriates working for headquarters;
- it extends the provisions to expatriates working for logistics centres; and
- it allows for a personal income tax exemption for a series of *professional expenses* paid to expatriates who are neither employed by headquarters nor logistics centres.

A. Expatriates working for headquarters and logistics centres

In order to make the tax environment even more enticing for logistics centres, the tax administration has decided to extend tax rules previously reserved to headquarters expatriates to those working for logistics centres. This means that the tax rules, subsequent to approval, are as follows.

1. Tax rules

Indemnities and expense reimbursements paid to expatriates are split into three categories, each of which is treated in a different way for tax purposes.

The first category of expenses is exempt from personal income tax. This exemption is explained by the nature of the expenses concerned, which in practice correspond to genuine professional costs directly incurred in connection with the expatriation.

The second category allows for the possibility of income tax exemption for individuals, in respect of those indemnities and expense reimbursements assessed under standard corporate income tax rules at the level of the headquarters or logistics centre.

The advantages of this taxation method are twofold. First, it allows for tax savings in that the corporate income tax rate is often lower than the individual's marginal income tax rate. Secondly, as is often the case, where the expatriate benefits from a tax equalization policy, these provisions avoid the need for the employer to "gross-up" tax and social security reimbursements.

It should be borne in mind that the benefit of this second category is reserved to expatriates who (apart from the fact that they should be employed in France for a period which must not exceed six years) were not domiciled in France, for the five consecutive years preceding their arrival in France.

The third category includes all those reimbursements and indemnities of a personal nature which are not eligible for a specific tax regime. Items falling into this category are taxable under standard tax rules.

2. Redefinition of categories of expenses

The tax administration has rethought the split between the three categories. The general tendency is to increase the number of types of expenses exempt from income tax (category 1) and restrict the definition of expenses falling within category 2.

The increase in the number of types of expenses in category 1 is a result of the tax administration's redefinition of the concept of professional expenses inherent to expatriation. The tax administration has until now refused to consider as being of a professional nature, certain expenses that, by their very nature, were closely linked to the expatriate status. This was the case, for example, with the annual trip to the home country (home leave), or school fees in the host country. This position was all the more unjustified in that these expenses were already considered as professional expenses by the social security authorities or by case law and were, thus, exempt from social security contributions.

The table below details those expenses which now fall within category 1. Those in italics fall into this category for the first time.

hometrips
- pre-assignment house-hunting trip for the expatriate and spouse
- *annual trip to the home country for the expatriate and family*
- annual trip for dependent children at school abroad to visit their parents
- emergency trips to the home country for the expatriate and *family*

cars
- *car rental at the beginning and the end of the French assignment for a maximum two-month period*
- *cost of obtaining a French driving licence*
- *expenses for technical conversion of cars*
- *car registration costs*

housing
- *agency fees for finding rented accommodation in France*
- home country furniture storage
- moving and travel costs at the beginning and the end of the assignment
- accommodation costs during the removal period for the expatriate and family
- additional rental costs of renting two homes simultaneously at the beginning and the end of the assignment *for a maximum three-month period*
- *caretaking costs for home-country residence*
- customs charges

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other

- *school fees for expatriates children*
- language lessons for the expatriate *and family*
- *administrative* and tax support fees

Expenses in the second category are restricted to the following reimbursements:

- reimbursement of additional housing costs incurred on the expatriate's accommodation in France;
- reimbursement of excess taxes and social security contributions.[3]

It should be noted that the reimbursement of excess taxes is limited to that resulting from tax equalization on the expatriate's salary, and not on worldwide family income.

Similarly, additional social security contributions falling within category 2 only concern contributions made to compulsory schemes.

All indemnities or expense reimbursements not listed for categories 1 or 2, are included in category 3. Examples of such expenses include expenses incurred for decorating an apartment or for the purchase of a car.

B. Expatriates working for a structure other than a headquarters or a logistics centre

One of the major innovations resulting from the new Instruction concerns expatriates working for structures other than headquarters or logistics centres. Indeed, such persons are now automatically exempt[4] from income tax on those indemnities or expense reimbursements included in category 1 as described above.

At first sight, it might appear surprising that the tax administration has included such a provision in an Instruction which is mainly aimed at headquarters and logistics centres.

This provision, does however, supplement the wide range of tax provisions aimed at encouraging investment from foreign companies in France, including headquarters and logistics centres. We have also seen how the tax administration has redefined the concept of professional expenses inherent to expatriation for headquarters or logistics centres. As the intrinsic nature of these expenses as professional expenses arises as a result of their connection with expatriation, and not because the beneficiary works for a headquarters or logistics centre, it would be difficult to imagine how this new definition could not be applied to all expatriates, regardless of the host structure.

In any event, this provision has the merit of harmonizing the tax and social security treatment of these expenses (exemption) and of adapting French tax rules to constraints connected with expatriation.

V. CONCLUSION

This Instruction is significant for two reasons:

- Firstly, to the best of our knowledge, it is the first time that the tax administration has actually constructed and published "from scratch" an exception to traditional tax rules in the absence of any supporting legislation. This highlights the interest of the French Government in multinational groups.
- Secondly, unlike in many other countries, little room is left in the French tax system for ruling procedures. Therefore, the tax administration's adoption of this procedure for the headquarters and logistics centres tax regime should be seen as a move towards greater flexibility in applying tax legislation.

3. I.e. excess compared with what would have been paid in the home country.
4. There is no need to request any administrative approval.

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EUROPEAN UNION

ACT, DIVIDENDS AND UK WITHHOLDING TAX: WE ARE NOT AMUSED[1]

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I. INTRODUCTION

On 1 January 1992, the EC Directive of 23 July 1990,[2] better known as the EC Parent-Subsidiary Directive, came into force. The focus of the EC Parent-Subsidiary Directive (hereinafter referred to as the "Directive") is on cross border dividend payments by subsidiaries to their parents, where both companies are located in the EU.

Pursuant to Article 4 of the Directive the state of the parent company, which receives distributed profits from its subsidiary, shall refrain from taxing such profits, or grant the parent company a tax credit for underlying corporation tax on those profits and the amount of withholding tax (if any) levied by the state of residence of the subsidiary, up to the amount of the corresponding domestic tax.

Article 5 of the Directive provides for an exemption from withholding tax where a subsidiary distributes its profits to its parent company, provided the parent company holds at least 25 per cent of the capital of the subsidiary.

Article 7 of the Directive provides that the term "withholding tax" shall not cover an advance payment or prepayment (*précompte*) of corporation tax to the state of residence of the subsidiary which is made in connection with a distribution of profits to its parent company. In the second paragraph of this article another exception is made: "The Directive shall not affect the application of domestic or agreement based provisions designed to eliminate or lessen economic double taxation of dividends, in particular provisions relating to the payment of tax credits to the recipient of dividends".

It is thus clear that the French précompte is not considered a withholding tax under the Directive. However, it is far less clear whether the UK's advance corporation tax (hereinafter referred to as ACT) and the related (half) tax credits provided for under certain UK tax treaties, are in accordance with the terms of the Directive.

Before questioning whether the levying of certain ACT is prohibited under the Directive a brief outline of the UK imputation system is set out below..

II. UK IMPUTATION SYSTEM

Under UK tax law, whenever a resident company pays a dividend, it must pay ACT.[3] This ACT is calculated as a fraction of the dividend (currently 20/80) and may be set off (subject to certain limitations) against the company's corporation tax liability (if any), thus operating as a prepayment of corporation tax.

At the same time a UK resident individual shareholder receiving such a dividend receives the benefit of a tax credit. He is liable to income tax on the aggregate of the dividend and the tax credit.[4] The tax paid by the resident company on the profit distributed is "imputed" to the shareholder and may be credited by him against his liability to income tax on his income. Unless he is liable to income tax at the higher rate (40 per cent) the tax credit will extinguish his income tax liability.

The ACT on the dividend matches the tax credit given to the recipient shareholder. This ensures that tax has been collected equal to the credit granted.[5]

Where a group income election is in force dividends paid within a UK tax group, may be paid without accounting for ACT. In the case of dividends paid to non-resident companies, however, the position is different since ACT must be paid in respect of the dividends. Under UK domestic law the receiving company, if not holding the shares through a permanent establishment, is in principle liable to income tax at the lower rate (1996 20 per cent) without entitlement to a tax credit. However, tax credit refunds may be granted under tax treaty provisions.

Where no tax credit refund is available UK tax law provides that no income tax assessment shall be made on that person in respect of income tax at the lower rate on the amount or value of the dividend.[6] And so a non-resident company which is not

1. This article is amongst others based on the information provided by a group of Dutch multinational companies involved in a procedure challenging the UK withholding tax.
2. Council Directive 90/435/EEC of 23 July 1990, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States; *Official Journal* No. L 225 of August 1990, at 6.
3. Sec. 14 ICTA 1988.
4. Sec. 20 ICTA 1988.
5. Sec. 231 ICTA 1988.
6. Sec. 233(1) ICTA 1988.

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entitled to a tax credit refund will not have any additional liability to tax on the dividend because it is only liable to income tax at the basic 20 per cent rate.[7] Therefore, in the absence of any tax credit provided for under a treaty, a non-resident corporate shareholder suffers no tax on the dividend received. ACT paid by the distributing company will be available for offset against its mainstream corporation tax liability.

However, entitlement to (one-half) tax credit under a treaty is sufficient to trigger a UK charge to tax at the level of the foreign parent.[8]

III. TAX TREATY CREDIT FACILITY

UK tax law sets out provisions which apply to UK double tax treaties. Under these provisions tax treaty benefits will, notwithstanding anything in any enactment to the contrary, have effect in relation to income tax and corporation tax insofar as they provide *inter alia* for (i) relief from income tax in respect of income and (ii) the right to a tax credit in respect of qualifying distributions, e.g. dividends made to persons not resident in the United Kingdom by UK resident companies.[9]

One example of a tax treaty article providing such benefits is Article 10 of the UK–Netherlands tax treaty ("the Treaty"). Article 10 contains provisions concerning both the tax liability on dividends and the payment of a tax credit. Pursuant to Article 10(3)(c) a Dutch resident company which receives a dividend from its UK subsidiary is entitled to "a tax credit equal to one-half of the tax credit to which an individual resident in the United Kingdom would have been entitled had he received those dividends, and to the payment of any excess of that tax credit over its liability in the United Kingdom."[10]

Article 10(3)(a)(ii), however, provides as follows:

> "(ii) Where a resident of the Netherlands is entitled to a tax credit in respect of such a dividend under subparagraph (c) of this paragraph tax may also be charged in the United Kingdom, and according to the laws of the United Kingdom, on the aggregate of the amount or value of that dividend and the amount of that tax credit at a rate not exceeding 5 per cent."

The UK subsidiary will be subject to ACT in the normal manner with respect to the dividend payment to the Dutch resident company. In addition, in cases where the Dutch company is entitled to the (one-half) tax credit the UK company will also be obliged to withhold from that tax credit 5 per cent of the dividend plus half the tax credit.

IV. POSITION OF THE UK INLAND REVENUE

In a consultative document issued by the UK Inland Revenue reference was made to Article 7(2) of the Directive. The Inland Revenue stated:

> "In the Government's view the expression "provisions relating to the payment of tax credits" in that paragraph refers to all the provisions of double taxation agreements relating to the calculation and payment of tax credits, including the provisions requiring a deduction from the amount of the dividend and tax payable in respect of tax charged in the United Kingdom. Accordingly, arrangements for the payment of tax credit under double taxation agreements are outside the scope of the Directive."

This statement reflects the Inland Revenue's current position. One may therefore assume that any challenge will be resisted very strongly by the Inland Revenue, since they consider the 5 per cent (deduction) levied pursuant to Article 10(3)(a)(ii) of the UK–Netherlands tax treaty to be an abatement of the tax credit rather than a withholding tax.[11]

V. POSITION OF CERTAIN EUROPEAN COUNTRIES

In the literature several attempts have been made to challenge the Inland Revenue's view that ACT is just an advance payment of corporation tax within the meaning of Article 7 of the Directive. One argument was[12] derived from the fact that a UK company would have no liability to UK mainstream corporation tax on a dividend received from, for instance, a German subsidiary. The German company pays tax on its distributed profits at 36 per cent and an additional 5 per cent

7. Sec. 1(2)(a) ICTA 1988.
8. A UK charge to tax will be triggered under Sec. 20 ICTA 1988, displacing the provisions of Sec. 233(1). Sub-section (2) of Sec. 20 states that "....any such distribution in respect of which a person is entitled to a tax credit shall be treated as representing income equal to the aggregate of the amount or value of that distribution and the amount of that credit, and income tax under this Schedule shall accordingly be charged on that aggregate." Under Sec. 231(3) ICTA 1988 a non-resident who is entitled to a tax credit "may claim to have the credit set against the income tax chargeable on his income .... and ....., where the credit exceeds that income tax, to have the excess paid to him."
9. Sec. 788 ICTA 1988.
10. Art. 10(3)(c) full text: "The provisions of sub-paragraph (b) of this paragraph shall not apply where the beneficial owner of the dividend is a company which either alone or together with one or more associated companies controls directly or indirectly 10 per cent or more of the voting power in the company paying the dividend. In these circumstances a company which is a resident of the Netherlands and receives dividends from a company which is a resident of the United Kingdom shall, subject to the provisions of sub-paragraph (d) of this paragraph and provided it is the beneficial owner of the dividends, be entitled to a tax credit equal to one half of the tax credit to which an individual resident in the United Kingdom would have been entitled had he received those dividends, and to the payment of any excess of that tax credit over its liability to tax in the United Kingdom."
11. J.D.B. Oliver, "Withholding tax and tax credits, with some reflections on Union Texas, *British Tax Review*, 1992, at 245-247: "On the other hand section 231(1) of the Taxes Act 1988 (formerly Finance Act 1972, s.86(4)) provides that a person, not being a company resident within the United Kingdom, who is entitled to a tax credit may claim to have the credit set against the income tax chargeable on his income, and where the credit exceeds that income tax, to have the excess paid to him. That suggests it is a reduction of the tax credit; there is not withholding tax as such but the only way in which any part of the tax credit can be received by the shareholder is on the basis that he accepts it first be applied to offset any income tax liability on the dividend. The dividend itself is undiminished by the tax charge and is indeed exempt from *withholding tax*, while the reduction, through offset, of the tax credit is permitted because of the Directive is not to affect provisions relating to the payment of tax credits to the recipient of dividends." The abatement "theory" is also shared by Eamonn Mc Gregor, "Implementation of the EC Parent-Subsidiary Directive in the Various Member States", 46 *Bulletin for International Fiscal Documentation*, 7 (1992), at 340.
12. J. Graham, "The EC Parent-Subsidiary Directive and UK Advance Corporation Tax: Abuse by the Tax Authorities?", 32 *European Taxation*, 10 (1992), at 353 published before the introduction of the Foreign Income Dividend Scheme and the UK Headquarters Regime.

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withholding tax[13] on payment of the dividend to the UK company. In the UK a tax credit is given with respect to the income received. The UK company subsequently distributes all the dividends to its Dutch parent company. As the UK company has no activity other than to hold shares in the German company, it has no liability to UK corporation tax on the profits of the year concerned. It is argued, therefore, that ACT is not an advance payment of corporation tax within the meaning of Article 7 of the Directive but is instead either corporation tax on the dividend received, which is prohibited pursuant to Article 4 of the Directive, or a withholding tax on the dividends paid which is prohibited pursuant to Article 5 of the Directive.

It can, however, also be argued that a UK company is fully liable to tax on dividends received from a non-UK subsidiary.[14] The resulting tax liability may (subject to certain conditions being fulfilled) be relieved by a credit for overseas tax paid on the profits out of which the dividend is paid. In view of the fact that the German tax rates are higher than the UK tax rate, it could be argued that tax relief for the underlying German tax paid results in no further UK tax being payable. This would indeed imply that ACT paid could not be offset against mainstream corporation tax since at present there would be no liability to that tax. However, this still would not make ACT a final tax since the ACT would be carried forward indefinitely until it could be offset against mainstream corporation tax.

Another approach taken by a group of Dutch multinational companies, contesting the Inland Revenue's position, is that Article 10(3)(a)(ii) of the UK–Netherlands double tax treaty ("the Treaty") imposes a tax (not exceeding 5 per cent) on the aggregate of the dividend and the tax credit.

Since the company is entitled to a tax credit, it should be subject to UK income tax at the lower rate under Sections 20 and 207A ICTA 1988 with respect to the distribution. However, Article 10(3)(a)(ii) limits the rate of this tax to 5 per cent. As mentioned above the tax is charged on the aggregate of the dividend and half the tax credit to which the company is entitled to by virtue of Article 10(3)(c).

The concluding phrase of Article 10(3)(c) states that the company is entitled to "payment of any excess of that tax credit over its liability to tax in the United Kingdom". This implies that the tax to which the company is liable pursuant to Section 20 (as limited by Article 10(3)(a)(ii)) is to be withheld when payment of the tax credit is made to the company.

The argument is therefore that the deduction of the 5 per cent tax on payment of the tax credit in accordance with Article 10(3)(a)(ii) falls to be treated as a withholding tax within the terms of the Directive.

The 5 per cent tax reflects the tax charged in accordance with the laws of the United Kingdom. It is charged in respect of a dividend and by reference to the aggregate of the amount of that dividend and the tax credit. It is collected by withholding.[15] It is not excluded by Article 7(1) of the Directive since it is not an advance payment of corporation tax.

Article 10(3)(a)(ii) is not merely a provision relating to the calculation and payment of tax credits, or a provision requiring a deduction from the amount of the dividend and tax credit.[16] Article 10(3)(a)(ii) specifies the level of tax to be charged according to the law of the United Kingdom with reference to the payment of a dividend. The tax charge is imposed under section 20 ICTA 1988.

That Article 10(3)(a)(ii) relates to a charge to tax is also clear from Article 22(2)(c) of the Treaty which provides for a credit to be granted against Dutch tax[17] for "the tax paid in the United Kingdom on these items of income". If Article 10(3) provides only for a deduction from the amount of the *tax credit* to be paid then this reference to *tax* paid in the United Kingdom would be inappropriate.

Article 5(1) of the Directive has direct effect pursuant to the doctrine developed by the European Court of Justice. Under this doctrine a provision of an EC Directive will apply directly to a Member State if it contains a clear and precise obligation imposed on a Member State, is unconditional and leaves no discretionary powers to the Member State. The only discretion affecting Article 5(1) relates to the two-year minimum shareholding period. Subject to the fulfilment of this requirement the Directive should have direct effect so that any provision in UK or treaty legislation resulting in anything other than an exemption of withholding tax will not be valid.

Article 7(2) of the Directive preserves the provision for payment of the tax credit pursuant to Article 10(3)(c) of the Treaty, but it does not prevent Article 5(1) of the Directive from eliminating the withholding tax pursuant to Article 10(3)(a)(ii) of the Treaty and Section 20 ICTA 1988.

Although the scope of Article 7(2) is somewhat obscure, it cannot be the case that it preserves all provisions in tax treaties relating to dividends paid between parents and subsidiaries. At the time the Directive was concluded, comprehensive tax treaties existed between most EU Member States. If the dividend articles of these treaties were meant to be left untouched by the Directive, then the scope of the Directive would have been very limited indeed. Similarly, the scope of Article 7(2) can also not be limited to treaties in existence at the time of conclusion of the Directive. If subsequent treaties' dividend articles may override the Directive in their entirety, then the Directive would be deprived of all force.

13. Art. 5, para. 3 of the Directive allowed Germany to levy a 5 per cent withholding tax until 1996.
14. J. Kortenoever, "Toepassing moeder/dochterrichtlijn, *Weekblad voor Fiscaal Recht* 1994/6113, at 1116-1117.
15. J.D.B. Oliver, "Withholding tax and tax credits, with some reflections on Union Texas, *British Tax Review*, 1992, at 245-247: "One argument might proceed as follows: (i) Tax is being levied partly on the dividends and partly on the tax credit; (ii) The Term "withholding tax" as used in the Directive is intended to describe any tax *charged* on the dividend and is not limited to tax *withheld* from the dividend; (iii) To the extent that tax is charged on the dividend it contravenes the Directive and it matters not that the tax charged is collected by way of a withholding from the tax credit rather than a withholding from the dividend."
16. See Inland Revenue Consultative Document;"EC Direct Tax Measures", at 21.
17. The fact that pursuant to the Netherlands participation exemption dividends received are not included in a company's taxable income, does not reduce the validity of this argument.

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A key question is which provisions are preserved by Article 7(2) and which are not. Article 7(2) refers expressly to "provisions designed to eliminate or lessen economic double taxation of dividends". The 5 per cent withholding tax is not covered by Article 7(2). Article 10(3)(a)(ii) and Section 20 ICTA 1988 have the effect of imposing UK tax, not of eliminating or lessening economic double taxation.

When analysing the phrase "eliminate or lessen economic double taxation of dividends" one should distinguish economic double taxation from juridical double taxation. Economic double taxation implies that the same profits are subject to taxation in the hands of different persons, here both the company which derives those profits and the shareholders to whom those profits are distributed. Juridical double taxation arises when the same profits are subject to taxation in different countries in the hands of the same person. Provisions for the relief of economic double taxation include dividend tax credits, split rate systems and dividend deduction systems. Provisions for the relief of juridical double taxation include the reduction in withholding taxes in tax treaties, as well as provisions for foreign tax credit or exemption of foreign income found in treaties and in domestic law.

Article 10(3)(c) of the Treaty – which extends the dividend tax credit – is a provision designed to eliminate or lessen economic double taxation. Article 10(3)(a)(ii) has no such purpose. It merely reduces to 5 per cent the UK tax which would otherwise be payable with respect to a dividend. Like similar provisions in other tax treaties reducing the level of withholding tax, it is designed to reduce juridical double taxation. But again, all such withholding taxes are no longer permitted by virtue of Article 5(1) of the Directive, and they are not preserved by Article 7(2).

A fall back position is that the withholding tax should be imposed only on the credit and that the dividend itself must remain exempt from withholding tax.[18]

VI. COUNTER ARGUMENTS UK INLAND REVENUE

Broadly speaking the two key issues are firstly whether the deduction of 5 per cent of the aggregate of the dividend and half the tax credit in calculating the tax credit payable pursuant to Article 10(3) of the Treaty is a withholding tax disallowed by Article 5(1) of the Directive, and, secondly, assuming that the first question is answered in the affirmative, whether it is nevertheless permitted by virtue of Article 7(2).

The Inland Revenue argues that the 5 per cent withholding is not a withholding tax i.e. even though the deduction allowed by Article 10(3)(a)(ii) takes the *form* of a charge to tax on the aggregate of the dividend and the tax credit it is in substance an abatement of the half tax credit to which the non-UK company is entitled pursuant to Article 10(3)(c) of the Treaty. In the absence of a tax treaty provision a Dutch parent would not be entitled to a tax credit in respect of the distributions of its UK subsidiary, nor would it be chargeable to UK income tax in respect of those distributions. Article 10(3) of the Treaty does, therefore, not introduce a charge to tax on distributed profits where there would otherwise be no such charge. On the contrary, the purpose of Article 10(3) is to confer upon residents of the Netherlands the benefit of an entitlement to a tax credit in certain circumstances.

The economic effect of Article 10(3) is that a Dutch parent company receives a half tax credit, less the abatement pursuant to Article 10(3)(a)(ii), in addition to the full amount of the distributed profits. As a matter of substance, therefore, the Inland Revenue feels that, Article 10(3) neither imposes, nor gives rise to, a withholding tax on distributions made to the Dutch parent by its UK subsidiary. The true effect of Article 10(3)(a)(ii) is to abate the half tax credit to which the Dutch parent is entitled pursuant to Article 10(3)(c). The means by which the abatement is calculated and retained by the UK does not alter this.

Accordingly, the tax charged upon the Dutch parent company pursuant to Section 20 ICTA 1988 in pursuance of the abatement allowed by Article 10(3)(a)(ii) of the Treaty is not a withholding tax on distributed profits within Article 5(1) of the Directive.

In the previous section it is mentioned that the fact that Article 10(3)(a)(ii) relates to a charge to tax is also clear from Article 22(2)(c) of the Treaty which provides for a credit to be granted against Dutch tax for "the tax paid in the United Kingdom on these items of income". According to the Inland Revenue there is, of course, good reason for the abatement being in the form of a charge to tax on the aggregate of the dividend and the tax credit payable. The tax credit is abated in this way to enable the recipient of the dividend to obtain credit against the Dutch tax payable on that income. By adopting this form the provisions of Article 22(2)(c) can be applied to the abatement in the same way as they apply to tax on other income.

Further the Inland Revenue disagrees that the purpose of Article 7(2)is limited to preserving the provision in Article 10(3)(c) of the Treaty relating to the payment of tax credits when the preceding articles of the Directive cannot conceivably have any effect with regard to the payment of tax credits per se.

The Inland Revenue agrees that the scope of Article 7(2) is not entirely free from doubt. What is nevertheless obvious however, is that it preserves provisions relating to the payment of tax credits. Article 10(3) is just such a provision, as the first sub-paragraph of paragraph (3) clearly indicates.

The Inland Revenue denies that the subparagraphs (a)(ii) and (c) of Article 10 can be treated as distinct provisions. Article 10(3)(c) cannot be read in isolation from the remainder of paragraph (3). The entitlement granted to the Dutch parent by paragraph (3) is to half a tax credit less an abatement. The Inland Revenue emphasizes in this connection that within

18. D. Bouzoraa, "The Parent-Subsidiary Directive: Denkavit's Lessons, 37 *European Taxation*, 1 (1997), at 14." "This view is supported by the findings of the European Court of Justice in Denkavit that Article 5 of the Directive (which provides for withholding tax relief) is of fundamental importance so that other provisions of the Directive must be strictly interpreted."

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paragraph (3) the abatement provision precedes the provision which grants the entitlement to the half tax credit.

As stated above Article 10(3)(c) is a provision which is designed to eliminate or lessen economic double taxation. It is the Inland Revenue's view that it is not tenable to isolate Article 10(3)(a)(ii) and to argue that this provision is designed to reduce international double taxation, and, therefore, that it is not within Article 7(2) of the Directive. On the contrary the Inland Revenue feels that Article 10(3) read as a whole is clearly concerned with lessening the economic double taxation of dividends. Moreover, the Inland Revenue argues, that within Article 10(3) subparagraph (a)(ii) is concerned with the method by which the tax credit granted to the Dutch parent by that Article is calculated. Accordingly, Article 10(3)(a)(ii) is a provision which falls squarely within the kind of provision relating to the payment of tax credits that Article 7(2) upholds.

Finally, the Inland Revenue questions the purpose of Article 7(2). It cannot have been intended to preserve the payment of partial tax credits per se, as their payment is not affected by the Directive. The Inland Revenue is of the opinion that its purpose must surely be to ensure, for the avoidance of doubt, that the United Kingdom's method of calculating the tax credit payable under its tax treaties is not affected by the Directive.

VII. THE *HOECHST* CASE, AN ALTERNATIVE?

In the previous paragraphs the non-discrimination provisions as provided for in Article 24(5) of the OECD Model Convention[19] were not invoked. Article 24(5) provides:

> "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."

Hoechst UK and its parent Hoechst AG have asked for a declaration that the obligation of Hoechst UK to account for ACT is discriminatory,[20] both under the Articles 6, 52 and 58 (freedom of establishment) of the Treaty of Rome and Article 20(4) (non-discrimination) in the double taxation treaty concluded between the United Kingdom and Germany. Hoechst AG has claimed restitution or compensation for ACT paid by Hoechst UK or alternatively payment of the tax credit in respect of the dividends paid by the UK subsidiary.

In the Hoechst case the dividends were being paid to a German parent. Unlike the treaty between the United Kingdom and the Netherlands, the United Kingdom–Germany treaty has no provision for payment of part of the tax credit to the recipient of the dividend nor any corresponding provision to withhold the 5 per cent tax. [21]

If the UK subsidiary is able to use the ACT (because of the availability of taxable profit, resulting in a full recoverability of ACT against mainstream corporation tax liabilities) payment of ACT by the UK subsidiary and refund of half of the ACT credit to the Dutch parent is more advantageous than successfully invoking the prohibition against discrimination which would eliminate the UK subsidiary's liability to ACT. Hoechst AG claimed that it was treated unfavourably in comparison with a UK parent, which would be prohibited discrimination. Since a UK parent is not subject to tax on a dividend from its UK subsidiary, it generally cannot claim a refund of ACT. Only when the UK parent has suffered a taxable loss and decides to treat the dividend it has received (and on which ACT was paid by the UK subsidiary) as income against which losses can be offset, is the parent entitled to a refund of the ACT that is related to the dividend received. Since the foreign parent (Hoechst AG) does not have and will not have UK losses it will never be able to demonstrate that it is in a comparable situation to the UK parent.

Hoechst also claims it is treated unfavourably in comparison with parent companies located in other EU Member States. This comparison results from the application of the most favoured nation principle. A German company cannot claim a tax credit refund under the double tax treaty and Hoechst claims that this is discriminatory and that Hoechst should not be treated more unfavourably than parent companies in other EU Member States (e.g. the Netherlands) and should be entitled to a refund of one half of the tax credit. It appears somewhat surprising that Hoechst is not taking any point on the Directive.[22] Even if Hoechst wins on the MFN argument this would not be of assistance to Dutch parent companies since they are already entitled to the treatment as provided in the UK–Netherlands treaty.

VIII. CONCLUSION

A "Hoechst claim" will not help Dutch multinationals with UK subsidiaries. Since the Inland Revenue is not willing to alter their standpoint that the 5 per cent levied pursuant to Article 10(3)(a)(ii) is an abatement of the tax credit, covered by Article 7(2) of the Directive, an appeal can be filed to be heard by the Special Commissioners. The Special Commissioners will then have the authority to refer the question directly to the European Court of Justice. An appeal to this Court is necessary to obtain an answer to the question "5 per cent, withholding tax or not?".

19. For a consideration of their application see: D. Hughes, "Non-Discrimination: A consideration of Article 24(5) OECD Model Convention, 50 *Bulletin for International Fiscal Documentation*, 9 (1996), at 390.
20. Sec. 247 ICTA 1988: group income election , a 51 per cent UK subsidiary of a UK parent may opt for the payment of dividends without accounting for ACT.
21. Moreover, if no ACT has to be paid with a dividend distribution by the UK subsidiary, then there is no basis for a refund of half the tax credit to the Dutch parent pursuant to Art. 10(3)(c) of the treaty.
22. I.e. they take the 5 per cent withholding tax for granted.

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CHINA

THE IMPACT OF CHINA'S NEW TAX LAWS ON FOREIGN INVESTMENTS

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I. INTRODUCTION

To invest in China effectively and profitably, it is necessary to understand China's investment and taxation laws.

Foreign investors may invest in China using the following business structures:
- Equity joint ventures;
- Limited liability companies;[1]
- Contractual joint ventures;[2]
- Wholly foreign owned enterprises.

II. TAXATION FOR FOREIGN INVESTORS

Foreign investment enterprises are subject to the following taxes:
- Enterprise income tax
- Indirect taxes:
  - value added tax
  - consumption tax
  - business tax
- Land appreciation tax
- Real estate tax
- Resource tax
- Stamp tax
- Individual income tax
- Other taxes

III. ENTERPRISE INCOME TAX

Until 30 June 1991, Chinese foreign equity enterprises were subject to income tax under the Chinese Foreign Equity Joint Venture Income Tax (JVIT). Foreign enterprises were also subject to income tax but under the "Foreign Enterprise Income Tax" (FEIT).

Both these tax laws were repealed and replaced by "The Income Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises" which was passed by the National People's Congress on 9 April 1991 and became effective on 1 July 1991.

A. Corporate tax rate

Under the new income tax law for foreign enterprises and joint ventures, the corporate tax rate is 30 per cent. A local tax of 3 per cent of taxable income is also payable.

Reduced tax rates and tax exemptions are available to foreign investors:
- 20 per cent withholding tax on "passive" income;
- 15 per cent for Special Economic Zones (SEZs) and Economic & Technological Development Zones (ETDZs);
- 24 per cent for Open Coastal Economic Zones (OCEZs);
- start up tax concessions for enterprises with foreign investors (see below).

B. Tax concessions

Generally a two-year tax exemption and 50 per cent tax reduction during the subsequent three years is available.

Such tax reduction and exemption applies to SEZs, ETDZs, OCEZs, agricultural and export oriented businesses.

Tax rebates are given if profits are not repatriated but reinvested in the business. Tax credits are granted to relieve any foreign taxes paid.

C. Taxable income

Taxable income is total income in a year less deductible items for that tax year.

Total income includes the following:
(i) Income from production and business operations;
(ii) Income from the transfer of property;
(iii) Interest income;
(iv) Income from leasing;
(v) Income from royalties and licence fees;
(vi) Dividend income;
(vii) Other income.

Deductible items for the purposes of computing taxable income are costs, expenses and losses. They include interest expenses, salaries and wages, employees' union expenses, donations for community benefits and charitable donations.

1. Foreigner's minimum shareholding 25 per cent.
2. I.e. a contract between the parties.

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Non-deductible items include the following:
(i) Expenditure of a capital nature;
(ii) Expenditure on the acquisition or development of intangible assets;
(iii) Fines in relation to illegal business operations and losses incurred on confiscation of property;
(iv) Surcharges on overdue tax payments, fines and penalties in relation to various types of taxes;
(v) That portion of losses incurred due to natural disasters or accidents, covered by compensation receivable;
(vi) Donations for community benefits and charitable donations in excess of the deductible amounts; and donations other than those for community benefits or charitable donations;
(vii) Expenditure on any sponsorship;
(viii) Other items of expenditure that are not incurred in the course of earning income.

D. Administration

A taxpayer pays his income tax to the local authority where the enterprise is situated. Income tax payable is calculated on an annual basis and provisional tax payments are made on a monthly or quarterly basis. Provisional payments must be made within 15 days from the end of each month or quarter. The final settlement must be made four months from the end of the tax year.

Accounting statements and provisional income tax returns must be filed within 15 days from the end of each month or quarter. The final accounting statements and income tax returns must be filed within 45 days from the end of the tax year.

IV. INDIRECT TAXES IN CHINA

The Industrial and Commercial Consolidated Tax and the Product Tax have been repealed and replaced by a new system of indirect taxes. The new indirect taxes comprise value added tax, consumption tax, and business tax.

V. VALUE ADDED TAX (VAT)

VAT is one of the most important indirect taxes.

China's VAT regime has the advantage of having a more uniform tax rate structure.[3] Like the GST in Singapore, taxpayers can claim back the input credits on purchases.

A. Who is liable ?

VAT is applicable to both Chinese nationals and foreign individuals and entities including foreign investment enterprises, foreign enterprises, joint stock companies, state-owned enterprises, collectively owned enterprises and private enterprises.

B. Tax rates

VAT is imposed whenever goods and certain services are sold or imported.

The tax rate is 17 per cent for taxpayers selling or importing goods and 13 per cent for taxpayers selling or importing:
- food grains, edible vegetable oils;
- tap water, heating, air-conditioning, hot water, coal gas, liquified petroleum gas, natural gas, coal/charcoal products for household use;
- books, newspapers, magazines;
- feeds, chemical fertilizers, agricultural chemicals, agricultural machinery and plastic covering film for farming; and
- other goods as regulated by the State Council.

For taxpayers who provide repair and replacement services, the tax rate is 17 per cent.

The tax rate is 0 per cent if the goods are for export, unless otherwise regulated by the State Council.

VAT does not apply to the sale of land, buildings or other immovable property. However such transactions are liable to business tax.

C. VAT on sales

The VAT payable by taxpayers on sales is computed as follows: Turnover (i.e. gross receipts exclusive of VAT) x Appropriate VAT rate *minus* Input VAT paid on purchases.

Any excess credits in respect of VAT paid may be carried forward.

D. VAT on imports

VAT on imports is computed as follows:

Import price + Insurance and freight + Custom duty + Consumption tax x Appropriate VAT rate

For taxpayers dealing in goods or providing taxable services with different tax rates, the sales amounts for goods or taxable services with different rates are computed separately. The tax payable is the balance of output tax for the period after deducting the input tax for the same period, i.e.:

Tax payable = Output tax for the period *minus*: Input tax for the period.

Any excess input tax may be carried forward to subsequent periods.

Input tax on the following items is not available as a credit against output tax:
- Fixed asset purchases;
- Goods purchased or taxable services used for non-taxable items;

3. The Industrial and Commercial Consolidated Tax and Product Tax which both had too many tax rates.

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- Goods purchased or taxable services used for tax exempt items (see list below);
- Goods purchased or taxable services used for group welfare;
- Abnormal losses[4] of goods purchased; and
- Goods purchased or taxable services consumed in the production of work-in-progress or finished goods which suffer abnormal losses.

For small-scale taxpayers engaged in selling goods or providing taxable services, a simplified formula for calculating VAT is adopted. The rate of tax for these taxpayers is 6 per cent.

The criteria for determining small-scale taxpayers are prescribed by the Ministry of Finance. Any adjustment to the rate applicable to small-scale taxpayers is regulated by the State Council.

E. VAT exemptions

The following items are exempt from VAT:
- Self-produced agricultural products sold by agricultural producers;
- Contraceptive medicines and devices;
- Antique books;
- Importation of instruments and equipment directly used in scientific research, experiment and education;
- Importation of materials and equipment from foreign governments and international organizations as assistance free of charge;
- Equipment and machinery required to be imported under contract processing, contract assembly and compensation trade;[5]
- Articles imported directly by organizations for the disabled for special use by the disabled; and
- Secondhand goods.

Except for those items mentioned above, the VAT exempt/reduced rate items are regulated by the State Council. Local governments or departments do not have the power to regulate tax exemptions or reductions.

F. VAT minimum threshold

There is an exemption or reduction in the VAT rate to 5 per cent where the turnover does not exceed certain threshold amounts, i.e.

Sale of goods		
Monthly turnover	CNY 0 – CNY 599	Exempt
	CNY 600 – CNY 2000	5%
Sale of taxable services		
Monthly turnover	CNY 0 – CNY 199	Exempt
	CNY 200 – CNY 800	5%
VAT on transaction basis		
	CNY 50 – 80 per day or per transaction	5%

The time at which a liability to VAT arises is
(a) In the case of sales of goods or taxable services, the date on which the sales consideration is received or the date the documentary evidence of the right to collect the sale consideration is obtained.
(b) In the case of importation of goods, the date of input declaration to the customs office.

G. Assessment period

The filing period for VAT assessment is one day, three days, ten days, fifteen days or one month depending on the amount of VAT payable. The actual period is determined by the competent tax authorities according to the magnitude of the VAT payable. Where VAT cannot be assessed in regular periods, the tax is assessed on a transaction-by-transaction basis.

VI. CONSUMPTION TAX (CT)

Consumption Tax (CT) is an additional tax (i.e. in addition to VAT) imposed on a limited range of (mostly luxury) goods. It is imposed before the levy of VAT.

A. Who is liable?

All enterprises and individuals engaged in the production, subcontracting for processing or the importation of taxable consumer goods within China are liable to CT. Manufacturers, importers and processing subcontractors are therefore taxpayers for CT purposes.

The items liable to CT are specified in a list which includes tobacco, cigarettes, alcoholic drinks and alcohol, spirits, cosmetics, fire crackers and fireworks, gasoline, diesel oil, motor cars and motor cycles, minibuses and vans.

B. Consumption tax rate

CT rates vary from 5 per cent to 45 per cent. Alternatively set amounts may be charged based on the volume of trade. For vehicles, the tax rate is based on the type of vehicle. The table showing Consumption taxes currently in force is shown in Appendix A.

Generally for normal cases, the formula for computing CT is as follows:
Selling price inclusive of all charges except VAT x Appropriate CT rate
or The assessable quantity x Appropriate CT rate

4. Losses other than normal losses, e.g. losses arising from natural diasters, improper management etc.
5. Compensation trade is a form of direct foreign investment through which Chinese enterprises purchase technology and equipment from foreign investors on credit. The purchase price and interest is then paid off with products the Chinese enterprise produces.

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There are special rules for determining the assessable value of goods for self consumption or for processing under subcontracts. For imported goods, the assessable value is determined by the cost, insurance and freight and the import duty.

C. Consumption tax exemptions

Goods manufactured for export are generally exempt from CT. The procedures for exemption of exported taxable consumer goods are regulated by the State Administration for Taxation.

D. Assessment period

The CT assessable period varies, it can be one day, three days, five days, ten days, fifteen days or one month. The taxpayer's actual assessable period is determined by the competent tax authorities having regard to the magnitude of the tax payable. If the CT cannot be assessed in regular periods it will be assessed on a transaction-by-transaction basis.

VII. BUSINESS TAX (BT)

Business tax is the principal indirect turnover tax on the provision of services.

A. Who is liable?

BT is imposed on entities and individuals engaged in the provision of services; the transfer of intangible assets; or the sale of immovable properties.

B. Business tax rate

The BT rate varies from 3 per cent to 20 per cent.

The items liable to BT and the applicable tax rates are determined in accordance with the "Business Tax Taxable Items and Tax Rates Table" attached to the Regulations on Business Tax (See Appendix B).

The State Council is empowered to make any adjustments to the taxable items and tax rates. The specific tax rates applicable to taxpayers engaged in entertainment businesses are determined by the People's governments of the provinces, autonomous regions and municipalities which are directly under the control of the central government.

For taxpayers engaged in taxable activities falling under different tax categories, the turnover, transfers and sales amount for each taxable category must be accounted for separately. If the turnover has not been accounted for separately, the higher tax rate applies.

For taxpayers providing taxable services, transferring intangible assets or selling immovable properties, the tax payable is computed by reference to the turnover and the prescribed tax rates. The formula for computing the BT payable is as follows:

Tax payable = Turnover × Tax rate

The tax payable is computed in *Renminbi*. The turnover of the taxpayer settled in foreign currencies is converted into Renminbi based on the exchange rate prevailing in the foreign exchange market on the date of settlement i.e. when cash is received.

Turnover is the total consideration and all other charges receivable from the buyers for the provision of taxable services, transfer of intangible assets or sales of immovable properties, except in the following cases:

- For transportation enterprises which carry passengers or cargoes from the territory of the People's Republic of China to overseas locations and trans-ship passengers or cargoes to other transportation enterprises overseas, the turnover is the balance of the transport charges for the whole journey less the transport charges paid to the subcontracted transportation enterprises.
- For trade enterprises which organize tourist groups to travel outside China and subcontract to other travel enterprises overseas, the turnover is the balance remaining after deducting the tourist charges paid to foreign subcontract travel enterprises.
- For the main contractors in the construction business who subcontract work to others, the turnover is the balance of the total contract sum less the payments made to the subcontractors.
- For re-lending businesses, the turnover is the balance of interest on lending less the interest on borrowing.
- For businesses buying and selling foreign currencies, marketable securities and futures, the turnover is the balance of the selling prices less the buying prices.
- Other situations as regulated by the Ministry of Finance.

C. Business tax exemptions

There is provision in the Regulations for exemption from BT. Below is a list of exempt items.

- Nursing services provided by nurseries, kindergartens, homes for the aged, welfare institutions for the handicapped, matchmaking and funeral services.
- Personal services provided on an individual basis by the disabled.
- Medical services provided by hospitals, clinics and other medical institutions.
- Educational services provided by schools and other educational institutions, and services provided by students participating in work-study programmes.
- Agricultural mechanical ploughing, irrigation and drainage, prevention and treatment of plant diseases and insect pests, plant protection, insurance for farming and husbandry, and related technical training services, branding and the prevention and treatment of diseases of poultry, livestock and aquatic animals.
- Admission fees for cultural activities conducted by a memorial hall, museum, cultural centre, art gallery, exhi-

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bition hall, academy of painting and calligraphy, library and cultural protective units; admission fees for cultural and religious activities conducted at places of religious worship.

The State Council has the power to add to or to vary any item on the above list and exempt any person or item. Local governments or departments are not empowered to regulate any tax exemption or reduction.

For taxpayers who qualify for tax exemption or who produce items chargeable at a reduced rate, the turnover is accounted for separately. If the turnover is not separately accounted for, no exemption or reduction is allowed.

The time at which a liability to BT arises is the date on which the consideration for the provision of services is received or documented evidence of the right to collect the consideration is obtained by the taxpayer.

BT must be withheld by the purchaser of immovable or intangible property.

D. Assessment period

The BT assessable period is five days, ten days, fifteen days or one month. The taxpayer's actual assessable period is determined by the competent tax authorities having regard to the magnitude of the tax payable by the taxpayer. Tax that cannot be assessed in regular periods may be assessed on a transaction-by-transaction basis.

VIII. LAND APPRECIATION TAX (LAT)

LAT is imposed on the sale of real estate, e.g. sale of land use rights, sale of commodity properties and other sales of interests in real estate.

The LAT is a tax in addition to IIT or Enterprise Income Tax. It aims to regulate the conduct of land and real estate transactions, adjust the benefit from land appreciation and safeguard the rights and interests of the State.

A. Who is liable?

LAT is imposed on entities and individuals receiving income from the transfer of state-owned land use rights, buildings and facilities.

B. Land appreciation tax rate

The tax rate varies from 30 per cent to 60 per cent depending on the percentage of the land appreciation value.

Land appreciation value	LAT tax rate
Not exceeding 50% of deductible items	30%
50% – 100%	40%
100 – 200%	50%
Over 200%	60%

The appreciation amount assessable is the balance of proceeds received by the taxpayer less allowable deductions. The allowable deductions are:

- the purchase cost of the land use rights;
- costs and expenses incurred to develop the land;
- costs and expenses incurred in the construction of buildings;
- taxes related to the transfer of real estate including BT; and
- other deductible items as stipulated by the Ministry of Finance.

C. Land appreciation tax exemptions

Exemptions from LAT apply to the following items:

- the sale of an ordinary, non-luxury residence with the approval of the tax authorities; and
- real estates taken over or repossessed by the State.

D. Administration

Taxpayers must file tax returns for transfers of real estate within seven days of signing the real estate transfer agreement and pay the tax due within the period specified by the tax authorities.

Unless the LAT due is paid, the Department for Land Administration and the Department for Real Estate Administration will not process the relevant title change and the official transfer of title will not be effected and recognized by the Government.

IX. REAL ESTATE TAX (RET)

Real Estate Tax is applicable to holders of land use titles.

A. Who is liable?

RET is imposed on entities and individuals.

B. Real estate tax rate

The RET rate varies from 1 per cent to 5 per cent according to the Provinces. The rate is determined by local provincial government, and the tax is based on property valuations.

C. Real estate tax exemptions

Government bodies and individuals' properties not used for carrying on a business are exempted from RET. A tax reduction may be granted by local government.

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D. Assessment period

The tax is assessed by the local authorities on an annual basis and payable by instalments. The values are revised once every three to five years.

X. RESOURCE TAX

Resource tax is imposed on mineral products.

A. Who is liable ?

The resource tax is imposed on all entities and individuals engaged in the exploitation of mineral products or the production of salt. The tax is levied on mineral products like crude oil, gas, coal, metals and salt.

B. Resource tax rate

The Resource tax taxable items and tax amount range are as below:

Taxable items	Tax amount range
Crude oil	8 – 30 yuan/ton
Natural gas	2 – 15 yuan/1,000m^3
Coal	0.3 – 5 yuan/ton
Other non-metal ores	0.5 – 20 yuan/ton or m^3
Ferrous metal ores	2 – 30 yuan/ton
Non-ferrous metal ores	0.4 – 30 yuan/ton
Salt	
Solid salt	10 – 60 yuan/ton
Liquid salt	2 – 10 yuan/ton

The resource tax payable is computed in accordance with the assessable volume of the taxable products and the prescribed unit tax amount. The formula is as follows:

Resource tax payable = Assessable volume x Unit tax amount

C. Resource tax exemptions or reductions

Crude oil used for heating or repairing wells in the course of exploiting crude oil is exempt from resource tax.

If taxpayers sustain substantial losses due to reasons such as accidents or natural disasters, tax reductions or tax exemptions may be considered and granted at the discretion of the People's government of the Provinces, autonomous regions or municipalities.

The State Council may prescribe items for resource tax reduction or exemptions.

D. Assessment period

The assessment period for resource tax is one day, three days, five days, ten days, fifteen days or one month to be determined by the tax authorities.

Resource tax that cannot be assessed in regular periods may be assessed on a transaction-by-transaction basis.

XI. STAMP TAX

Stamp tax is imposed on documents.

A. Who is liable?

Stamp tax is payable by all entities and individuals who execute or receive documents as specified in the Regulations concerning stamp tax.

The following are regarded as documents subject to stamp tax:

- contracts or documents relating to: purchases and sales; undertakings for processing; contracting for construction projects; property leasing; commodity transfers; warehousing; loans; property insurance; technology contracts;
- documents transferring property rights;
- business account books;
- certificates evidencing rights or licences; and
- other documents which the Ministry of Finance determines to be taxable.

B. Stamp tax rate

The amount of stamp tax payable is calculated according to the nature of the taxable document:

- on the basis of a percentage rate; or
- a fixed amount per document.

C. Stamp tax exemptions

The following documents are exempt from stamp tax:

- duplicates or copies of documents on which stamp duty has been paid;
- documents executed when property is donated to the government, social welfare units or schools; and
- other documents approved by the Ministry of Finance for exemption from stamp tax.

D. Administration

Tax stamps are affixed to taxable documents and they must be cancelled along the border with a seal or drawn line.

Tax stamps must be affixed to taxable documents at the time of execution or upon receipt.

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XII. INDIVIDUAL INCOME TAX

The new "Individual Income Tax Law of the People's Republic of China" (new IIT) was adopted on 31 October 1993, and came into effect on 1 January 1994.

The aim of the new IIT was to consolidate and replace the three existing taxes:
- the Individual Income Tax of 1980 which applied to foreigners,
- the Individual Income Regulatory Income Tax of 1986 which applied to Chinese citizens and
- the Household Income Tax or the Self-Employed Individual Income Tax of 1986 which applied to Chinese citizens.

The new IIT law applies to foreign individuals, Chinese citizens, individually owned businesses and to income derived under contracting and leasing operations.

A. Who is liable?

The new IIT seeks to tax:
- Chinese resident individuals on their worldwide income; and
- non-residents on all income derived from within China.

The new IIT law provides that an individual is liable to tax on income derived from sources within and outside China if he is domiciled in China,[6] or resides in China for a full year.

B. Individual income tax rates

The new IIT rates are as follows:

Wage and salary income	5% – 45%
Individually owned business	5% – 35%
Other income	20%

C. Taxable income under individual income tax

IIT is levied on the following categories of income:
(1) Wages and salaries;
(2) Income from production or business operations of individual industrial and commercial households;
(3) Income from fees from contracted operations or leasing of enterprises and institutions;
(4) Remuneration for personal services;
(5) Authors' royalties;
(6) Fees for the use of proprietary rights;
(7) Interest, dividends and bonus dividends;
(8) Rental income;
(9) Income from the transfer of property;
(10) Incidental income (or windfall gains);
(11) Other income that shall be determined to be taxable by the finance department of the State Council.

D. Tax deductions and exemptions

A deduction of 800 yuan is allowed in calculating monthly taxable income on wage and salary income. An additional deduction for expenses of 3200 yuan is allowable for foreign individuals.

The following items are exempt from IIT:
- awards for achievements in science, education, technology, culture, public health, physical culture and environmental protection granted by the provincial people's governments, ministries and commissions under the State Council, the People's Liberation Army units at army level and above and by foreign or international organizations;
- interest income on saving deposits and national debt obligations and other financial debentures issued by the state;
- subsidies and allowances received under the state uniform provisions;
- welfare benefits, survivors pensions and relief payments;
- insurance indemnities;
- military severance pay and demobilization pay received by members of the armed forces;
- settlement pay, severance pay, retirement pay and retirement living allowances received by public servants and workers under state uniform provisions;
- income derived by the diplomatic agents and consular officers and other personnel who are exempt from tax under the provisions of the relevant laws of China;
- income exempt from tax as stipulated in the international conventions to which the Chinese Government is a party and in agreements it has entered into; and
- income exempt from tax with the approval of the finance department of the State Council.

Tax reductions may apply to the following items upon approval:
- income derived by disabled persons, unsupported aged persons or members of a martyr's family;
- where the taxpayer suffers major losses caused by disasters;
- in other cases in which reduction is approved by the finance department of the State Council.

A credit is allowed for foreign taxes paid on income derived from sources outside China.

E. Administration

Foreign individuals must register with local tax authorities within 30 days of entering China.

Tax is payable on a monthly basis and must be remitted to the State Treasury within seven days after the end of each month.

Normally the payer will act as withholding agent. Tax withheld from wages and salaries must be paid to the State Treasury by the employer.

6. Art. 1 "Individual domiciled in China" is defined as an individual who maintains a household registration or permanent place of residence in China.

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XIII. TAX PLANNING ISSUES AND STRATEGIES

Foreign investors investing in China will no doubt expect attractive returns on their investments. To achieve this, it is necessary to consider some tax planning issues and strategies, e.g. the availability of tax incentives, tax reductions, tax exemptions, tax rebates, reinvestment incentives and benefits provided under the relevant tax treaty such as reduced withholding tax rates etc.

A. Residence and source

The concept of residence of the taxpayer and the source of income are fundamental to the Chinese tax system.

The determination of the residence of an individual is based principally on physical presence or domicile in China.

In the case of enterprises, the determination of residence status is based on the location of the head office where effective control and management of the entity is exercised.

The Chinese tax laws do not have specific rules dealing with the source of business income. Generally income is deemed to arise at the place where the business activities take place. The place of contract can be considered a significant factor in determining the source of income.

A resident of China is taxable on his worldwide business income, whereas a non-resident is taxable only on business income derived from a Chinese source.

B. Foreign tax credit

A taxpayer may claim credit for income taxes paid abroad on income earned outside China. However such credit cannot exceed the Chinese tax payable on the income earned abroad.

For business enterprises, losses may be carried forward five years. There is no distinction between capital losses and non-capital losses. Individuals may not carry losses forward.

C. Withholding taxes

Dividends, interest, royalties and taxable capital gains payable to non-residents are subject to a final withholding tax of 15 per cent of the gross payment. The rate may be reduced by tax treaties to 7, 10, 12 or 15 per cent. No withholding tax is levied on business profits remitted overseas.

D. Reinvestment incentives

A tax rebate of 40 per cent of the income tax paid may be made if the income is reinvested for a period of at least five years. However, the reinvestment must be either in the original venture or in another investment enterprise.

If the foreign investor invests its profits in an export-oriented or technologically advanced enterprise for a period of at least five years, the investor may receive a full refund of the income tax already paid on the reinvested amount.

E. Fines and penalties

A fine is imposed where a taxpayer fails to pay tax within the time limitation. It is normally computed on a daily basis from the day on which the payment is required to be made at the rate of 0.2 per cent of the amount of the tax unpaid.

Penalties are imposed if the taxpayer or tax withholding agent fails to comply with the law. The amount of penalties varies from CNY 2,000 to CNY 10,000 depending on the nature and the seriousness of the offence.

Tax evasion is a serious offence and severe penalties are imposed under both the tax and criminal law.

For tax evasion offences, a penalty not exceeding five times the amount omitted or underpaid is imposed.

If the amount of tax evaded exceeds CNY 100,000 seven years imprisonment will be imposed in addition to the penalty.

Tax compliance should be strictly adhered to when formulating any tax planning strategies to avoid penalties and imprisonment.

XIV. FEATURES AND IMPACT OF THE CHINA–SINGAPORE TAX TREATY

China has concluded tax treaties with over 40 countries.

The agreement between Singapore and China concluded on 18 April 1986 was ratified on 12 December 1986.

The Singapore–China treaty provides for reduced withholding tax rates on certain types of income and tax sparing relief.

Some of the benefits of the double tax treaty are discussed below.

A. Reduction in withholding tax rates

The normal withholding tax rate is 20 per cent on gross income from dividends, interest, royalties and other non-business income sourced in China by a foreign enterprise. However, under the treaty, the following reduced rates apply to payments by an entity in China to a non-resident entity.

Dividends

Beneficial ownership in Chinese entity	Withholding tax on dividend paid to Singapore company
Less than 25%	12%
More than or equal to 25%	7%

Interest & royalty	Withholding tax
Paid to beneficial owner	10%

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To qualify for the reduced rates the payments must not be linked to a permanent establishment or fixed base in China from which independent personal services are performed on behalf of the Singapore company.

With regard to interest and royalties, the payments must be at arm's length third party rates. Payments which contravene these conditions will be subject to the regular Chinese corporate tax rate of 33 per cent.

B. Double Tax Relief (DTR) in Singapore

DTR is claimable in Singapore by the Singapore company to the extent of Singapore tax payable on the same income that has been taxed in China.

In the case of dividends, where the Singapore company owns 10 per cent or more of the shares in the Chinese company, it is permitted to claim underlying tax credit. This is the corporate tax paid on the income out of which the dividend was paid. Article 24(3)(a) deems the underlying tax to be 10 per cent of gross dividends if paid by a joint venture with Chinese and foreign investors and 20 per cent in other cases. Underlying tax credit is in addition to DTR claimable for withholding tax of 7 per cent or 12 per cent.

In the case of interest and royalties, the Chinese tax paid is deemed to be 20 per cent of the gross interest or royalty although withholding tax is only 10 per cent in these instances.

Furthermore, DTR is available in Singapore for Chinese withholding tax on technical service fees and management fees.

Finally the Singapore–China tax treaty contains tax sparing provisions. Essentially these provisions allow DTR to be claimed by the Singapore company in Singapore even if Chinese tax has not been paid by virtue of tax incentives accorded to the China company.

APPENDIX A

CONSUMPTION: TAXABLE ITEMS AND TAX RATES (TAX AMOUNTS) TABLE

Taxable items	Scope of charge	Tax unit	Tax rate/Amount
I. Tobacco			
1. Grade A cigarettes	incl. imported cigarettes		45%
2. Grade B cigarettes			40%
3. Cigars			40%
4. Cut tobacco			30%
II. Alcoholic drinks and alcohol			
1. White spirits made from cereal			25%
2. White spirits made from potatoes			15%
3. Yellow spirits		ton	240 yuan
4. Beer		ton	220 yuan
5. Other alcoholic drinks			10%
6. Alcohol			5%
III. Cosmetics	incl. cosmetic sets		30%
IV. Skin-care and hair-care products			17%
V. Precious jewellery and precious jade and stones	incl. all kinds of gold, silver, jewellery and precious stone ornaments		10%
VI. Firecrackers and fireworks			15%
VII. Gasoline		litre	0.2 yuan
VIII. Diesel oil		litre	0.1 yuan
IX. Motor vehicle tyres			10%
X. Motorcycles			10%
XI. Motor cars			
1. Those with a cylinder capacity (i.e. emission capacity) of 2, 200 ml and above			8%
Those with a cylinder capacity of between 1,000-2,200 ml			5%
Those with a cylinder capacity of less than 1,000 ml			3%
2. Cross-country vehicles (four-wheel drive)]			
Those with a cylinder capacity of 2,400 ml and above			5%
Those with a cylinder capacity of less than 2,400 ml			3%
3. Minibuses and vans	less than 22 seats		
Those with a cylinder capacity of 2,000 ml and above			5%
Those with a cylinder capacity of less than 2,000 ml			3%

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APPENDIX B

BUSINESS TAX: TAXABLE ITEM AND TAX RATES TABLE

Taxable items	Scope of charge	Tax rate
1. Communications and transportation	Transportation by land, air and pipeline, loading, unloading and delivery	3%
2. Construction	Construction, installation, repair, decoration and other engineering work	3%
3. Finance and insurance		5%
4. Posts and telecommunications		3%
5. Culture and Sports		3%
6. Entertainment	Singing bars, dance halls, karaoke lounges, commercial music halls, musical teahouses, billiards, golf, bowling and amusement facilities	5%-20%
7. Servicing	Agency, hotel catering, tourism, warehousing, leasing, advertising and other services	5%
8. Transfer of intangible assets	Transfer of land-use rights, patent rights, unpatched technologies, trade marks, copyright and goodwill	5%
9. Sale of immovable properties	Sale of buildings and other attachments to land	5%

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NETHERLANDS

THE DUTCH UNILATERAL DECREE FOR THE AVOIDANCE OF DOUBLE TAXATION

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I. INTRODUCTION

In the absence of a tax treaty, the Netherlands tax system contains a system of unilateral rules for the avoidance of double taxation. The rules concerned are laid down in the *Decree for the Avoidance of Double Taxation* (hereinafter: Decree) of 1989. A number of important changes to this Decree, including a replacement of the overall method by the per-country method were introduced in 1994; they are effective as from 1 January 1995. To implement the Decree, the State Secretary of Finance has issued a substantial number of rules in the Implementing Regulation, and has later clarified some issues in a separate Decree. This article examines the most important features of the new regime applying to unilateral relief.

II. THE SYSTEM OF DOUBLE TAXATION RELIEF IN GENERAL

According to the Decree, the major method for the avoidance of double taxation is the exemption-with-progression method. Consequently, all income from foreign sources is included in taxable income, but unilateral relief is granted for the following foreign-source income:

(a) income derived from a foreign permanent establishment or permanent dependent representative who has the power to conclude contracts;
(b) income from foreign-situs immovable property; and
(c) rights in the profits of an enterprise (bonds and shares excluded), the management of which is situated abroad, provided this foreign-source income is subject to tax on income at a national level in the foreign country and a tax treaty does not contain a provision affecting the item of income.

The tax relief is granted in the form of a reduction of the tax amount by a percentage equal to the percentage that the foreign-source income bears to the worldwide income. Foreign-source losses deducted in preceding years may reduce the tax relief.

Furthermore, a credit is granted for dividends, interest and royalties (including service fees) arising from certain developing countries, which are subject to income tax (including withholding tax) in the source country, provided that such income is not exempt from income tax in the Netherlands.

The way in which relief from the avoidance of double taxation is granted according to the Decree, automatically applies to most of the effective tax treaties concluded by the Netherlands.

III. OVERALL VERSUS PER-COUNTRY METHOD

In the old Decree, the results from all countries were set-off against each other (overall method). In the amended Decree exemption is granted on a per-country basis.

Example 1

Assume the foreign net income from country A amounts to (10), from country B to 5 and from country C to 5 and that the total net income amounts to 100. Under the old Decree, the fraction for the computation of foreign net income would not result in any exemption for foreign net income (as the total foreign net income (5 + 5 – 10) is zero). However, according to Article 3(4) of the new Decree, the negative foreign net income from country A can be carried forward to be set-off against positive foreign net income from country A in the following year. However, an immediate exemption is granted for the positive foreign net income from countries B and C. The fraction for the computation of this exemption (assuming an applicable tax rate of 50 per cent in the Netherlands) is $^5/_{100}$ x 50 per cent = 2.5 for both country B and for country C. The total exemption under the new Decree, therefore, amounts to 5.

Under the old Decree, there was a "built-in" ceiling limiting the relief to be granted: the fraction for the computation of the relief could never result in a refund to the taxpayer. Under the new Decree, this ceiling is maintained.[1]

Example 2

Assume that the foreign net income from both country A and country B amounts to 150 (75 each) and that the total net income amounts to 100. Without the above mentioned addendum to Article 3(1), the computation of the relief would have

1. This can be concluded from an addendum to Art. 3(1) of the new Decree which implicitly refers back to the overall method.

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resulted in relief of 150/100 x 50 per cent = 75. As a result of the addendum, the maximum amount of the relief is 50, as the total Dutch tax is 50 per cent of 100 i.e. 50

IV. CARRY-FORWARD

If, as a result of the above mentioned ceiling, the total net income in a certain year is insufficient to give full relief for the foreign net income, then the excess foreign net income for which no exemption could be given is carried forward to the next year.[2] This carry-forward is applied on a per-country basis.

Example 3

Total net income	100
Foreign net income	
From country A	70
From country B	80
From country C	(10)

According to Article 3(3) of the Decree, an amount of 50 (70 + 80 – 100) can be carried forward to year 2. The Implementing Regulation prescribes that the smallest amount has priority. Consequently 70 from A is exempt as well as (100 – 70=) 30 from country B. The balance from B (80 – 30=) 50 is carried forward to year 2.

According to the new Decree, the surplus is carried forward each year, until it is fully absorbed. In line with changes to the Individual Income Tax Law and the Corporate Income Tax Law, the carry-forward is no longer limited to eight years; instead, the surplus can be carried forward indefinitely. The effect of the new rule can be illustrated as follows.

Example 4

	Year 1	Year 2
Total net income	50	80
Foreign net income	60	10

In year 1, there is only room for granting an exemption of 50; therefore, 10 (60 – 50) is carried forward to year 2. In year 2, the total net income (80), will be deemed to constitute foreign net income up to the amount of the surplus to be carried forward. The fraction for the computation of the relief is therefore: (10 + 10)/80.

V. FOREIGN-SOURCE LOSSES

The rules with respect to foreign-source losses (the so-called "catch-up rules") remain the same subject to certain modifications necessitated by the adoption of the new per-country method. Accordingly, if foreign negative net income from a particular country has reduced worldwide income, no compensation or relief will be granted for foreign-source positive income from this country in later years. The foreign-source losses will be carried forward indefinitely.

VI. INTERACTION OF CARRY-FORWARD AND CATCH-UP RULES

Under the old Decree, the effect of the carry-forward rule and the catch-up rule was interrelated. Under the new Decree, this is no longer the case.

Example 5

	Year 1	Year 2	Year 2 (after carry-forward)
Total net income	50	50	50
Foreign net income			
From country A	(40)	100	60
From country B	30	50	50
From country C	50	(40)	(10)

In year 1, there is a maximum reduction in the amount of 50. The amount of 30 from country B (being the smallest amount) prevails over the income from country C. Consequently, there is a reduction for the income from C up to 20 (50 – 30), the balance of 30 being carried forward to year 2. In year 2, an amount of (10) (i.e. (40) + 30) remains for country C. The loss from country A (40) of year 1 is regarded as a negative part of the income from country A in year 2. In year 2, an amount of 60 ((40) + 100) remains for country A. After the carry-forwards, the smallest amount derived from a foreign country will qualify for relief in year 2 in the first instance. As a result, the income from country B (i.e. 50) is fully used for the reduction in year 2 and there is no room left for any further reduction of the income from other countries. According to the new Decree, the results from country A (i.e. 60) and country C (10) will be carried forward to year 3.

VII. ADMINISTRATIVE RULES

The amounts qualifying for carry-forward to the next year are determined by the tax inspector at the time when the tax assessment is issued. Such a determination by the tax inspector may be appealed against within 6 weeks of its issue. The validity of such a determination is connected with the carry-forward of the foreign net income from year 1 to year 2, and from year 2 to year 3, etc. The validity of the determination ceases, if a new determination is made, if the foreign net income has been completely relieved or if it has otherwise been taken into account.

Example 6

	Year 1	Year 2	Year 3	Year 4
Total net income	50	50	50	50
Foreign net income				
From country A	70	60	50	20
From country B	(10)	–	–	10

2. This can be concluded from Art. 3(3) of the Decree (so-called *stallingsregeling*).

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The inspector made the following determinations in respect of income from country A:

Year 1	20 (70 – 50);
Year 2	30 ((60 + 20) – 50)[3]
Year 3	30 ((50 + 30) – 50)[4]
Year 4	No determination is issued, as there is sufficient room for granting the exemption.

For country B, a determination is issued for years 1, 2 and 3.[5] In year 4, the loss of 10 originating from year 1 is considered to be a negative part of the income of 10 obtained in year 4 and no further determination is issued.

VIII. APPEALS AGAINST THE INSPECTOR'S DECISION

According to Article 3a(1) of the new Decree, appeals can be lodged, against the determination concerning the amount of the foreign net income to be carried over. This, however, only applies if the taxpayer did not have an opportunity to lodge such an appeal against the determination in earlier years. In other words, appeals should be lodged for each year's determination separately, and may only apply to the eventual increase of the carried forward amount.

Example 7

	Year 1	Year 2	Year 3	Year 4
Total net income	50	50	50	50
Foreign net income	60	60	60	60

The inspector issues a determination in year 1 for 10, in year 2 for 20 (10 + 10), in year 3 for 30 (20 + 10) and in year 4 for 40 (30 + 10). The taxpayer can lodge an appeal each year against the annual increase of the amount to be relieved, but no appeal can be lodged against the increase in earlier years.

The taxpayer also has an opportunity to lodge appeals, if the tax inspector's decision is not issued simultaneously with the tax assessment.

IX. RECTIFICATION OF MISTAKES MADE BY THE TAX INSPECTOR

According to Article 3a(5), the tax inspector can rectify his own mistakes concerning the carry-forward of the negative foreign net income. Normally, such a carry-forward decision of a foreign source loss has to be issued simultaneously with the tax assessment. If the tax inspector has omitted to issue such a determination, the amount is nonetheless taken into account in the following year as a negative part of the foreign-source income.

Example 8

	Taxable years						
	1	2	3	4	5	6	7
Foreign net income	(20)	(30)	(10)	–	60	–	–

Assume that the tax inspector omits to issue a determination in year 1. As a result, he issues a determination for year 2 of 30, instead of 50. An amount of 40 (30 + 10) is carried forward to year 3, and subsequently also to year 4. In year 5, he discovers the mistake made in year 1.

In order to give the Decree a maximum effect in this respect, an exemption should be made in the amount of nil (i.e 60 – 60), thus rectifying the mistake made in year 1. However, based on the text of the Decree, there are strong doubts as to whether the tax inspector is still allowed to rectify if he has already issued new decisions before he discovers his mistake.

X. REVISION OF THE FOREIGN NET INCOME

Article 3a(3) of the new Decree provides the possibility to revise the amount of the foreign net income which is carried forward to another year in a number of cases. These include where:

(a) As a result of a carry-back of losses, the assessment is reduced.
(b) The tax inspector issues an additional assessment.

Example 9

	Year 1	Year 2	Year 3
Total net income	50	50	50
Foreign net income	90	60	–

40 (90 – 50) is carried forward to year 2. In year 2, 50 is exempt, while 50 ((40 + 60) – 50) is carried forward to year 3. As a result no tax is due in year 3. If it appears in year 4, that the income obtained in year 1 has to be increased by 50, the tax inspector issues an additional assessment relating to year 1, and the entire foreign net income is exempt in year 1. The amount carried forward to year 2 is revised and reduced to nil. The amount carried forward from year 2 to year 3 is also revised and reduced to 10 (60 – 50). The tax inspector also issues an additional assessment for year 3.

(c) The amount of the foreign income is too high and has to be reduced.

In the above cases, it is not necessary that the tax inspector issues a separate determination with respect to the revised amount of income. This also applies to later years in which the income has to be revised because of the fact that the income in the first year was revised. The reason for this pro-

3. The determination issued in year 1 ceases to have effect.
4. The determination issued in year 2 ceases to have effect.
5. The determination for years 2 and 3 having the effect that the earlier determinations for years 1 and 2 cease to have effect.

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vision is expediency: if one of the above cases occurs, this could mean that the foreign net income obtained in a number of countries and for a number of years has to be revised. All relevant changes can be made by one determination per country, i.e. preferably in a year in which an assessment has not yet been made.

Example 10

	Year 1	Year 2	Year 3
Total net income	50	50	50
Foreign net income	200	–	–

150 is carried over from year 1 to year 2, 100 from year 2 to year 3 and 50 from year 3 to year 4. In the assessment year 3, the inspector discovers that the foreign net income in year 1 amounted to 190. Instead of issuing new separate determinations according to which an amount of 140 is carried forward from year 1 to year 2 and an amount of 90 from year 2 to year 3, he now only issues a determination regarding the carry-over of an amount of 40 from year 3 to year 4.

XI. EMIGRATION OF ENTITIES

If an entity is incorporated under foreign law, but effectively managed in the Netherlands, such an entity is considered to be a resident taxpayer for purposes of Dutch law. If such an entity incurs foreign-source losses, the tax inspector issues a determination according to which such a foreign-source loss is carried forward to the following year. If, however, the place of effective management of that entity is transferred to another country in year 2, the entity ceases to be a resident taxpayer and the rules for the unilateral relief from double taxation are no longer applicable. Therefore, the tax inspector no longer allows the carrying over of the foreign-source losses to the following year, i.e. the foreign-source losses are extinguished. If the effective management of that entity is transferred back to the Netherlands in year 4, the relief which would normally not be granted under the Decree is available.

To avoid the possible abuse of such situations the Decree contains an anti-abuse rule. It applies to all cases in which a taxpayer ceases to be a resident (other than by way of liquidation) and in which the taxpayer returns to the Netherlands within eight years after emigration. The article applies if, in the year preceding the year in which the taxpayer ceased to be a resident taxpayer, an amount of foreign negative net income eligible for relief has been determined in accordance with Article 3a of the Decree. In such a case, the foreign negative net income is deemed to have been determined in the year preceding the year in which the taxpayer ceases to be a resident taxpayer.

XII. CREDITS

For purposes of the application of the credit method, the overall-method has been maintained. Therefore, the tax due on dividends, interest and royalties which are part of the balance of positive and negative income has to be computed in accordance with Article 5 of the Decree. It should be noted, however, that tax treaties have to be applied separately, as they contain an independent provision regarding the relief from double taxation. Under the new Decree, the term during which the tax on dividends, interest and royalties can be credited is no longer limited: if no foreign tax can be credited as a result of Article 5 in the year concerned, that tax is considered to have been levied by the other country in the following year.

It should be noted that foreign taxes on dividends, interest and royalties can only be credited if they are derived from the developing countries as listed in an implementing regulation to the Decree. The decision as to whether a country is a qualifying country is made after consultation with the Minister of Development Aid; it depends on the amount of the per capita gross domestic product in the country concerned. The list of qualifying countries was amended, effective as per 1 January 1995.

Under the new Decree, the credit is limited to the lower of:
(1) the amount of tax actually levied by the source-country;[6]
(2) the amount specified by the following formula:[7]

$$\frac{\text{Dividends, interest, royalties less costs}}{\text{Worldwide income}} \times \text{Tax on worldwide income}$$

(3) (in the case of dividends received from developing countries) 25 per cent.[8]

The first limitation

If, in a certain year, there is no room to take all taxes levied by a foreign country into account, then any surplus amount is considered to be levied by the foreign country in the following year (Article 5(3) of the Decree). In other words, the amount of taxes levied by a foreign country has to be increased by uncredited amounts of tax which have been carried forward. Because the first limitation is based on gross receipts and the credit under Article 5(1)(b) of the Decree is based on net results, the relief will be restricted to the second limitation in the majority of cases.

The second limitation

The numerator of the above fraction consists of the amount of dividends, interest and royalties to be taken into account in the year concerned less the costs directly related thereto. Theoretically, although not expressly stated in the text of the Decree, there are two ways to take these costs into account;
(1) "the semi-net method": the amount of the foreign dividends, interest and royalties reduced by the costs directly related thereto;

6. Art. 5(1)(b)).
7. The credit for the foreign tax on dividends, interest and royalties can be lower than the foreign tax actually paid (Art. 5(1)(b), as the Netherlands does not wish to provide relief for a higher amount of tax than it would have levied itself on this income. Therefore, the Netherlands, as well as many other countries, impose this second limitation to the credit. This limitation is expressed by a fraction which is very similar to the one in Art. 3(1) of the Decree.
8. The third limitation (Art. 5(2)) only refers to dividends, i.e. not to interest and royalties.

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(2) "the net method": the amount of the foreign dividends, interest and royalties reduced by all costs related thereto.

Carry-forward of uncredited taxes levied at source

If the foreign tax on dividends, interests and royalties is higher than the (proportionately attributed) Dutch tax thereon, part of the tax will remain uncredited. Pursuant to Article 5(3), the foreign tax which remains uncredited can be carried forward to the next year. The first limitation in the next year is increased by the amount of the uncredited tax levied at source. The second limitation is not affected by this carry-forward. Therefore, the numerator of this fraction is not, as in the case of the exemption method, increased by that part of the income for which no relief has been granted.

The following example illustrates this point (assuming a corporate tax of 40 per cent and a foreign withholding tax of 25 per cent):

Example 11

	Year 1	Year 2	Year 3
Profits less losses	200	200	200
Foreign-source interest	100	20	–
Costs	80	–	–
Relief is granted as follows:			
	Year 1	Year 2	Year 3
First limitation	25% x 100 = 25	(25% x 20) + 17= 22	14
Second limitation	$\frac{100-80}{200}$ x 80 = 8.	$\frac{20}{200}$ x 80 = 8	$\frac{0}{200}$ x 80 = 0
To be credited	8	8	0
Carry-forward	25 – 8 = 17	22 – 8 = 14	14

XIII. "PASS-THROUGH" ENTITIES

Under the old Decree, a popular tax planning device was the use of entities which disposed of a large amount of accumulated foreign net income, before fully or almost fully terminating their business.[9] In order to stop this abuse, a new Article 10 has been added to the Decree. The provision likewise applies for taxes on dividends, interest and royalties which would normally qualify for a credit.

According to Article 10, foreign-source profits which "can" be carried forward pursuant to Article 3(3) of the Decree will not be taken into account for purposes of the computation of the relief under Article 3(1). This implies the following:
If an entity ceases its business in year 1, the foreign-source profits are carried forward to year 2. If there is a change of shareholders in year 2, the foreign-source profits thus carried forward are no longer taken into account in that year, nor are they carried forward to any future year.

Example 12

Assume that foreign profits of 200 have been carried forward from 1996 to 1997. In 1997, the entity ceases its business (without going into liquidation). In May 1998, new shareholders take over the entity and new business operations start. By the end of 1998, the net result amounts to 100 and the foreign net income amounts to 50. Although an amount of 200 has been carried forward from 1997 to 1998 (there is no change of ownership at the beginning of 1998), the amount thus carried forward is left out of consideration for purposes of the computation of the relief in 1998 and is not carried forward to 1999.

The provision does not prevent application of the relief in cases in which the entity benefits from the relief (up to the amount of the profits carried forward) in the same year in which all conditions of Article 10 of the Decree are met (i.e. where the cessation of business and change of ownership occurs in the same year.

Example 13

Assume that foreign-source profits were carried forward to 1996, that the entity ceases its business on 1 March 1996 and that the original owners can no longer benefit from the relief after 1 April 1996. In such a case, the entity can still claim application of the relief for the entire 1996 tax year.[10]

9. Once the business was terminated the original shareholders in the entity would no longer have been able to benefit from the relief for foreign-source profits.
10. This can be concluded from the wording of the provision, according to which foreign profits are no longer taken into account in the following year, i.e. in the financial year following the year in which the conditions for relief were met.

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Conference diary

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

MAY 1997

Global Transfer Pricing Strategy in Today's International Market, Forum Hotel, Central London, 7-8 May 1997 (English):

ICM Marketing Ltd, 5 Cavendish Square, London W1M OBX, Tel.: 44-171-436 5735, Fax: 44-171-436 5741.

"Das neue Doppelbesteuerungsabkommen zwischen Österreich und den USA", Wirtschaftsuniversität Wien, A-1090 Wien, Augasse 2-6, 12 May 1997 (German):

Institut für österreichisches und internationales Steuerrecht, z.Hd. Frau Bergmann und Frau Neunteufl, Wirtschaftsuniversität Wien, Althanstraße 39-45, A-1090 Wien, Tel.: 43-1-313 364890, Fax: 43-1-313 36730.

Cross-Border Distribution of Investment Funds, Hotel Inter-Continental, Luxembourg, 16 May 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail:mlw@ibfd.nl

Application of Tax treaties (advanced course), Amsterdam, The Netherlands, 21-23 May 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail:mlw@ibfd.nl

IMN, Tax Planning Strategies Using Derivatives, Stakis London Metropole, London, 28-29 May 1997 (English):

Information Management Network, Inc., 25 West 45th St., Suite 1505, New York, NY 10036, Tel.: 1-212-768 2800, Fax: 1-212-768 2484, E-mail: imnreg@aol.com

JUNE 1997

Internet and Taxation of International Electronic Commerce, Leiden University, Leiden, The Netherlands, 6 June 1997 (English):

PNO Congress Committee, P.O. Box 11026, 2301 EA, Leiden, The Netherlands, Tel.: 31-71-527 7830, Fax: 31-71-527 7813.

IIR & BNA, Transfer Pricing Policy, Forte Post House Regents Park, London, 9-10 June 1997 (English):

Vanessa Kahr, Customer Service Manager IIR Ltd, 6th floor, 29 Bressenden Place, London SW1E 5DR, Tel.: 44-171-915 5182, Fax: 44-171-393 0313.

IMN, Tax Planning Strategies Using Derivatives, Warwick Hotel, New York, 18-19 June 1997 (English):

Information Management Network, Inc., 25 West 45th St., Suite 1505, New York, NY 10036, Tel.: 1-212-768 2800, Fax: 1-212-768 2484, E-mail: imnreg@aol.com

International Tax Aspects of Permanent Establishments, Amsterdam, The Netherlands, 19-20 June 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail:mlw@ibfd.nl

International Licensing, Amsterdam, The Netherlands, 20 June 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

Executive Transfers in Europe, Amsterdam, The Netherlands, 20 June 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

IBC, Transcontinental Trusts Conference 1997, The London Park Lane Hilton Hotel, London, 30 June and 1-2 July 1997 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

JULY 1997

The 1997 Summer Leasing School, The Berystede, Ascot, Berkshire, UK, 7-9 July 1997 (English):

Samantha Roper, Asset Finance International Seminars, Nestor house, Playhouse Yard, London EC4V5EX, UK, Tel.: 44-171-779 8793, Fax: 44-171-779 8603, E-mail: qm8o@dial.pipex.com

AUGUST 1997

Summer Course Principles of International Taxation, Amsterdam, The Netherlands, 18-29 August 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

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INTERNATIONAL

TRENDS IN SOCIAL TAXATION

Dr David Williams

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I. INTRODUCTION

"The task is to carry out...a more adequate comprehension of the doctrine of the social, rather than the individual, forces in taxation"

(Seligman, *Essays in Taxation,* 1908)

This article is designed to supplement the debate about trends in taxation with an examination of social taxation. To this end, the article addresses two topics. First, it comments on discerned trends and possible trends in social taxation, reflecting on a century since the first social security schemes were introduced. Second, the review of trends is underpinned by an attempt to clarify what should be included in the discussion: what are social taxes, social charges and social contributions, and when should they be compared with other taxes?[1] There is no assumption, however, behind this article that social taxes are a necessary or desirable form of taxation – or the reverse. This was and is in debate at both ends of the century, but it raises issues beyond the scope of this survey. Nor are the wider issues of the nature, value and effects of earmarked or hypothecated taxes addressed – although it may rightly be observed that social security charges and taxes can be viewed as the most important of the earmarked taxes.[2]

II. TOWARDS APOCALYPSE OR ZENITH?

A recent overview by the European Commission, commenting on developments in the last two decades within Western Europe notes that: "Between 1980 and 1994, the European average of the implicit tax rate on employed labour increased from 34.7 per cent to 40.5 per cent. The same rate for other factors of production decreased from 44.1 per cent to 35.2 per cent. The rate for other types of income was broadly stable, rising slightly from 13.1 per cent to 13.8 per cent."[3]

With what should we be impressed if we review the developments in the social aspects of taxation during the last century? One of the clearest trends is the growth of the income tax. But this did not occur in a vacuum. Social insurance contributions and charges and direct taxes can be viewed as one in charting the growth of the social activities of the state.

A century ago, the idea of social insurance was starting to develop. I do not wish to retell the history of the creation and introduction of social insurance first in Germany,[4] then in Great Britain[5] and other states. The idea was adopted around the turn of the century as a desirable way of bettering the lot of some members of the "state family" otherwise than through general taxation. The initial approach of social insurance was limited rather than universal.[6] Its strength lay in providing a financial structure to ease the economic pressures of the "new" industrial structures upon their workforces.[7]

1. There is much potential confusion of language in this area, and the following definitions are therefore offered for the terms used in this article and related discussion in order to assist the reader to obtain a clear view of what is intended. The chameleon term "social" is used to indicate arrangements or institutions that are public general schemes for the personal benefit of individuals, with the public element being defined by general law or other processes associated with government. *Social taxes* are taxes that are earmarked or hypothecated in some way so that the funds collected from the tax are expended for social purposes. The designation of a payment as a *tax* is discussed at length below. A *social contribution* is a payment to a social insurance scheme. This may be stated more generally to be a form of *social charge* where it is designed to reflect specific payments to social insurance schemes including those from persons who cannot directly themselves benefit from the scheme. In this article, however, the term *social contribution* is used to cover all payments into a social insurance fund, while *social charge* is confined to the meaning of a payment into a social welfare fund. In other words, a payment is either a social contribution or a social charge. However, the usage of other terms is not meant to be mutually exclusive. In other words a social contribution or social charge may both, in a particular context, be forms of social tax. *Social insurance* is used to designate insurance schemes that are state-mandated and state-regulated whereby persons are required to contribute to a fund from which persons are entitled to claim social benefits, but where claims for benefit may only be made by members of the scheme, and where membership involves at least some liability to pay contributions. Family and dependents of members are also usually allowed to claim on the basis of the member's contribution liability. A scheme where beneficiaries need not be contributors or members may be described as a *social welfare* scheme. There is clearly room for individual national approaches to blur possible distinctions between these two kinds of schemes and finance. One scheme may organize by means of a social insurance scheme what another state organizes by means of a social welfare scheme (for example, health care). *Social security* tends to be used as a global term to include the totality of social insurance schemes within a state, and sometimes social welfare schemes too. It is usually therefore a more imprecise term than those already defined, and is also used in political contexts to refer generally to the social budget of the state.

2. G. Anderson, in "The fiscal significance of user charges and earmarked taxes", Chap. 2 in R. Wagner, ed., *Charging for Government: User Charges and Earmarked Taxes in Principle and Practice*, at 20. The comment is specifically related to the OASDI contributions in the United States.

3. Commission of the European Communities, Taxation in the European Union: Report on the Development of Tax Systems, November 1996, para 2.2 (EC, 1996).

4. Compulsory social insurance – that is, state organized insurance – started with the schemes introduced by the German government under Bismarck at the end of the nineteenth century.

5. The National Insurance scheme is a British one not a United Kingdom one. A separate, though now substantially similar, scheme applies in Northern Ireland.

6. Nonetheless, both the German and British schemes were, in context, surprisingly broad in their scope on introduction: see Orme Clark, *The National Insurance Act* 1911 (Butterworths, London, 1912).

7. For a recent rehearsal of the strengths and weaknesses of the concept of social insurance, and a survey of the critical literature, see A.B. Atkinson *Incomes and the Welfare State*, Chap. 11 (Cambridge University Press, 1995).

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Contemporary writers, including lawyers, appear to have adopted the view that the compulsory contributions of employees and employers to social benefit funding were not part of the taxing operation of the state, but some separate activity.[8] Can we take that view today?

A realistic view of the fiscal provisions within our states at the end of the present century reveals the social budget (social transfers – including schemes such as social housing, health and education) dominating the public finances of most developed states. Much of this high social budget must in practice be financed on a continuing basis, as in many states little of it is funded. This has led in many states to high social contributions and charges and high taxes. It could be argued that this is as it should be, with the citizens of the state looking after the state family. In other words, it is simply major states enjoying for the first time this century a peace dividend.[9] The respite from actual wars and cold wars was expected by some to lead to tax cuts, although these did not affect the social budget. That expectation has proved short-lived, and hence there has been less room than some might have hoped to absorb growing social costs.

During the last decade of the century we are seeing, I suggest, two shifts in thinking about the social budget. First, we have seen the rapid dismantling of the largest European social experiment of them all – the Soviet system.[10] Second, we hear increasingly from those with a feeling of foreboding – almost of impending crisis[11] – about the extent to which market economies can finance social provision. A century ago, the process of elaborating the doctrine of the social forces in taxation was beginning. We must ask whether we are ending the century by turning away from that approach. The implication is that social insurance is but another of the passing phases in the development of the political economy. Is it only the Soviet experiment that has proved a transitional process, or is social insurance also a transitional process?

The 1996 deficit of the French national social security system was reported to be running at FRF 48.6 billion (USD 9.45 billion).[12] That was after the Juppé reforms – which caused such social unrest in France earlier in 1996 – cut social security expenditure by about FRF 31 billion for the year. The French system is one of the most generous and complete of social security systems in major economies, but it has now been hovering on the brink of bankruptcy for some years. Nearly half of the public revenues of France are contributions to the social security funds and the special taxes aimed at supporting those contributions.[13] Two thirds of expenditure is on the social budget. The overall budget deficit was 5 per cent of GDP and the share of taxes taken by the GDP was high.[14] The French government's reaction to those figures was that "there is no question" of raising contributions or taxes to meet the deficit. It had reached the limit. This illustration of a major system which it is sensed is approaching crisis poses an open challenge to social insurance. One French solution has been to use general taxes to fund part of the deficit in social contributions.[15] It is, I suggest, one reason that a discussion of taxes and tax trends must examine the identity of social taxes and contributions if it is to be comprehensive.

A. Trends in social contributions and charges in the OECD

All the modern highly-developed states have large welfare infrastructures. Most of them place a large part of the infrastructure in the public domain. In the case of France and its continental neighbours, the infrastructure is essentially public. By contrast, current state practice in the use of social contributions to finance social insurance and social welfare schemes varies widely. There are those states – Australia and New Zealand being the most developed – with minimal social contributions. Workers are expected to belong to a compulsory but private pension system. Any social benefits paid by the state are funded from general taxes. Denmark used to be in that category, but has over the last few years introduced a social contribution besides its private schemes. Denmark stands in contrast, (as does Iceland,) to the other Nordic states, which have significant social contributions imposed on employment income.[16]

At the opposite end of the spectrum are states with social contribution and charge mechanisms that have come to dominate their public revenues in recent years. France is in this category, as are many states of the former Soviet Union (FSU). In the FSU states, as in France, the funds channelled

8. One of the first British books on the then new National Insurance scheme was Orme Clark, *supra* note 6. It nowhere mentions tax, although it does comment that the 1911 Act "is perhaps the most novel and far-reaching measure that has ever been passed by Parliament. It is novel in that it applies principles of compulsion which it has hitherto been believed it would be impossible to apply to the British people." (at xxvii). Clark also observes, in a brief comparison of the British scheme with "the other great State National Insurance scheme" – Germany – that the German scheme is wider than the British, and also that, compared with 115 sections of law in the 1911 Act, "the latest revision of the German Insurance Law contains, it is reported, some 3800 articles" (at xxix).

9. Taking the same period of 1980 to 1994 (conveniently the period used by the World Bank in its 1996 World Development Report) defence expenditure dropped in all the high-income economies apart from Singapore. Health, education and social transfers formed over half the total budget expenditure in 1994 in all those economies save for, again, Singapore and also the United Arab Emirates (in both of which it had risen sharply over the period) and Israel and Spain (in both of which it was 49 per cent). In 1980, by contrast, it was under half total budget expenditure in the United States, the United Kingdom, Italy, and Canada of the G7 states as well as several other states.

10. *The World Development Report 1996, From plan to market*, (Oxford University Press, 1996) contains an overview of, and an extensive selection of the enormous literature about, this process.

11. The term "crisis" is increasingly used in both the literature and the media in this context. The writer remains agnostic to the evocation of this emotive term not least because it is deployed in part as a challenge by those arguing for radical change.

12. Financial Times, 11 June 1996, at 3.

13. The OECD Annual Revenue Statistics contain total figures for collection of social security contributions/taxes, and the figures in this article are drawn from that source if not otherwise specified.

14. Figures taken from the World Development Report 1996, see *supra* note 9.

15. Another French solution was to introduce proposals for a funded pension scheme (proposal adopted by the national Assembly, 22 November 1996). A further set of reforms involved cutting the benefits obtained by reference to particular levels of contributions. See, on these and other proposals "Retraite: tout ce qui va changer", *Le Nouvel Observateur 1674*, 11 December 1996, at 6.

16. For a recent review of the Scandinavian welfare systems, see *Comparative Welfare Systems*, ed. B. Greve (Macmillan, 1996), especially Chap. 6, "The Nordic Welfare Model and the European Union" by R. Ervik and S. Kuhnle.

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through social contributions can approach half the total tax collection of the state. In some states – e.g. Slovenia[17] – they have crossed the halfway mark. Between the two extremes are the other major economies, such as those of the United States, Japan, the United Kingdom, and Italy that have social contributions and social insurance arrangements but also leave some part of the social budget to be met either from general taxation or by mandated private means.

Behind these general statements there is an unremitting pressure to find social funding. One clear trend throughout the second half of the century is a growth in the use of social contributions and charges to meet this demand. Further, the growth in social contributions is such that in most OECD states the social contributions are now more important than income tax. The OECD's statistics show that in 1955 Austria, Belgium, Germany, Italy, Portugal and New Zealand had social contributions that, in total, collected more than income tax. Since then, of course, New Zealand has abandoned separate social contributions and, indeed, parts of its social infrastructure. But the trend elsewhere is of the relative growth of social contributions. By 1965, contributions in France, Greece, Luxembourg, the Netherlands and Spain had also exceeded income tax, while in Japan the two were returning roughly equal revenues. By 1992, Japanese social contributions were the larger collector of revenue, and Norway and Switzerland had also joined the list. In the United States and the United Kingdom the proportion of revenues derived by social contributions as compared with income tax had also risen, but had not exceeded the income tax (though in the United States it is steadily catching up, on present trends). Of the major economies only Canada has an income tax growing faster than social contributions.[18]

The methods of collection and delivery of social contributions and charges also vary widely. In the United Kingdom, everything in the core provision of welfare is delivered to and by executive agencies of the state.[19] In many states – Germany, some states of the former Soviet Union, and the United States – the system is national and mandatory, but is at one remove from the Budget and central government. In other states – for example, Finland – the institutional basis is not part of the state machine even at one remove, although the contributions are still compulsory. Australia, as we have noted, has privatized the major burden of saving towards pensions – although there is still significant state involvement in both the duty to make contributions and the way those contributions are held and distributed. Measures to cut back the substantial income tax privileges of these arrangements in the 1996 Budget met with predictable criticism. In other words, even here the state is still heavily involved in the business of pensions. Superficially, the range of social insurance and welfare structures within the OECD states therefore varies almost to the maximum[20] but in all of them (bar, possibly, New Zealand) the state is heavily involved in one way or another.

B. Reasons for the trends

This relative growth of social contributions and charges is a reflection of the underlying pressures on social insurance and social welfare schemes over the last four decades. Those same pressures are continuing. Others have illustrated clearly that they will make the funding of the social budget a growing problem in most states over the next two to three decades.[21] Stated simply, nearly every country – developing and developed – faces an increasingly adverse shift in the age dependency ratio, the key ratio of earners to dependants.[22] The size of the working population in most states is rising much less sharply than the population of those over working age. In some states, such as Denmark and Italy, the ratios are sufficiently adverse that the total population of the states is going to fall while that part of it that is retired is still growing swiftly.[23] Recent reports in the United Kingdom suggest that it should be added to the list of countries with predicted declining populations. In the United Kingdom this is because of the number of women electing not to have any children. Even if, therefore, we pay no attention to social contributions or taxes, we cannot avoid noting that we must either take some politically unpleasant decisions about public expenditure or make other changes that increase the number of workers in the population in new ways to reverse the age dependency trends. It may be that a shift in the ratio of female

17. My information comes from the Ministry of Finance in Ljubljana, but I have not seen the statistics. The reason is a particularly adverse demographic ratio of retired people to employees, exacerbated by a low retirement age. Slovenian officials point out that their social contributions were the highest of any state, at 64 per cent of payroll a couple of years ago. This is now being reduced.
18. These statements are derived from the OECD's annual volumes of Revenue Statistics. The totals of social contributions and income tax are measured against the GDP of the state.
19. This statement is somewhat contentious, as education and housing benefit are delivered by local authorities, and are funded in part by local taxation (the Council Tax). However, cumulative developments have brought both the delivery of those services and the funding levels increasingly under national control.
20. For a critical review of attempts to categorize state welfare models see P. Baldwin, "Can We Define a European Welfare State Model", Chap. 2 in *Comparative Welfare Systems* (*supra* note 15).
21. Most dramatic in title is the World Bank report, Averting the Old Age Crisis, published in 1995. It should be noted that not everyone agrees with its answers, but few dissent from the central thrust of the report that there is a demographic crisis approaching for which some answers must be provided.
22. Definitions vary to some extent, but the key ratio is usually taken as those aged over 65 compared with those aged between 16 and 64. Where the retirement age is not 65, this will obviously need adjusting, as it should if the age at which working life starts is not 16. In the United States, the ratio of current workers per social security beneficiary was a comfortable 16.5 in 1950, when current schemes were taking their present shapes. By 1960, this had sorted itself out to 5.1, but from that point it steadily declined to 3.7 to 1 in 1970 and 3.2 to 1 in 1980. It is predicted to stay at that level until after 2000, when it is predicted to decline to 2.0 to 1 in 2030 (*The Economist*, 14 December 1996, at 54, "Social Securities?" quoting figures from Sternbusiness). A similar trend is occurring in most other developed states, although at different rates and with differing times at which the most adverse ratio is reached. A lower retirement age rapidly leads to a more serious situation. For example, in France the retirement age in many funds is 60, and in some 55. The retirement age of 60 gives a dependency ratio in France currently of 2.7, dropping to 2.0 in 2015. This explains the greater urgency of French reforms compared with those in the United States: *Le Nouvel Observateur* cited at *supra* note 15.
23. For a good account of this problem see the work of Richard Disney and others of the Institute of Fiscal Studies in London (especially Disney's recent inaugural lecture at QMW).

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workers to male workers will provide a solution in some states.[24] That or any other route to a solution must affect our discussions indirectly even if it does not do so directly.

The cost of the longevity of pensioners is compounded by the growing unit cost of their health care. This is becoming increasingly expensive both as technology improves and expectations rise, but also as cheap methods of treatment such as penicillin and quinine start to lose effect. This argues for a real increase in the cost of social budgets even without demographic changes. Less dramatically, we could chart similar pressures at work in other areas of social expenditure such as housing costs. Those changes, inevitably, reinforce the underlying demographic pressures. In other words, the trends indicated in the last paragraph are set to continue for up to another four decades before there is any easing of the underlying pressures. Can the fiscal systems of states sustain that kind of growth in social burden, and can they do so without changing from the existing frameworks for handling the funding of social insurance and social welfare? This is the dilemma facing those charged with reviewing the methods of collecting social taxes and charges.

C. Trends in other states

Nor is there a consistent picture among the new economies or other developing states.[25] Of course, the poorest states are not able to organize social schemes except on extremely limited bases. Much of Asia now presents a different picture. Among the so-called tiger states we find a heavy compulsory long-term savings scheme in Singapore, with a lesser but also significant model in Malaysia. We also find high social contributions in India. Korea has been expanding its social security systems this decade. Nevertheless, in Thailand, also a tiger economy, contributions are still low. Support is still found by many in the extended family and in subsistence farming, as it is in much of China.

For completeness, we should note those states that do not need social contributions to be paid by earners, because they are paid directly from state wealth. I refer to the Gulf states and similar countries, and also the smallest states and territories like Bermuda, where the state can fund hospitals and pensions with minimal taxes or contributions, perhaps from oil revenues or from revenues from tax haven activities.

It is not my task in this article to develop stories of crisis from these trends. They do, however, pose a challenge. Should our reaction to the problem be that of retreat,[26] or should we still be moving forward? Do we continue to discern the slow and laborious growth of justice in taxation or are we reminded of Seligman's "one lesson from the history of taxation", that the ethical ideals of a tax system themselves depend for their realization upon the economic forces that are continually transforming the face of human society?[27]

This brief sketch is designed to emphasize the lack of a pattern in the approaches taken by states to the use of social contributions and charges to fund social insurance and welfare schemes. In this disparate range of choices, it may seem optimistic to think about general trends. Nonetheless, they are clearly there. The arrangements states deploy have a higher profile than they had two decades ago. They are often operating in different contexts to those for which they were designed four or more decades ago. Furthermore, their importance will continue to become more significant. It is against that background that I suggest that we need to examine rather more closely how funds are now transferred for social purposes. We cannot ignore a form of income that is a significant part of the public tax revenues of each of the G7 states, and of all but three of the OECD member states. Equally, to see the full picture we cannot ignore the significant compulsory transfers taking place in those states – and others – under other names. Any account of the income tax and its effects at the present time is not complete without an account also of social taxes, contributions and charges.

III. ARE SOCIAL CONTRIBUTIONS AND CHARGES FORMS OF TAXES?

Despite the contention in the last paragraph, many surveys do ignore social taxes and contributions altogether. This appears sometimes to be for pragmatic reasons. Sometimes it is for doctrinaire reasons.[28] On the other hand, there are many who say that whether a social contribution is or is not a tax does not matter. To the macroeconomist or public finance commentator, it may not matter what we call the payments. If we view the payments in terms of their efficacy, or in terms of the economic burdens they place on individuals or business, that is a fair observation. Another view is that it is obvious what the payments are, and names do not matter. However, we must resist the false logic of viewing the system as a whole, and then offering proposals for reform for only one part of it. Again, from the point of view of the analyst that may be so, because the analyst has a clear view of the pos-

24. Patricia Apps has suggested that this applies to Australia.
25. For an overview see the World Bank report on Aging, note 3. See also K. Nielsen, "Eastern European Welfare Systems in Comparative Perspective", Chap. 10 in *Comparative Welfare Systems* (*supra* note 16).
26. The argument for retreat is put pithily in "A false choice", *The Economist*, 14 December 1996, at 20: " ... privatisation would lighten the demographic cloud which threatens to bring vastly greater federal budget deficits [in the United States]. Without reform, Congress will one day either have to raise taxes or penalize millions of pensioners. Neither is exactly a vote winner." For contrasting views in France, including those opposing privatization, see *Le Nouvel Observateur*, *supra* note 15, and the article that follows on at 30, "Les germes d'une privatisation de la retraite".
27. Seligman, "A quarter century's progress in taxation", (1908) Proceedings of the American Economic Association, also incorporated into later editions of his *Essays in Taxation* (Seligman, 1911), at 18.
28. I remember, for example, being strongly criticized by the formidable Professor Nooteboom of the Netherlands at the International Fiscal Association Congress in 1983 (when for the only time at the annual IFA congresses social contributions were a major item of discussion) for daring to suggest in the plenary session that social security contributions were taxes. He told me from the chair of the Congress that social contributions were certainly not taxes, but were insurance of the same kind as compulsory property insurance in certain cantons of Switzerland. Nobody, I might add, came to my defence. I was told in the corridors afterwards that no one at that time would call social contributions in the Netherlands a tax for fear of the consequences – and I do not recall that the person making that comment was joking. See the annual Cahiers for that year. The report before the Congress was on social security contributions as a factor in international trade by MNEs.

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ition and does not engage in false logic. Is that true of everyone affected by the system?

Viewed in other ways – including I suggest the way many of the public view things – the distinction may be important. To a lawyer, it can be important. This is because of the constitutional and administrative limitations placed on state powers to tax, and which do not apply to private payments to pension plans. Similarly, the controls applied to taxes and similar payments are often different in quality to those applied to private pension and insurance schemes. The discipline – or lack of it – of the marketplace replaces the political discipline – or lack of it – applying to public funds.[29]

I suggest it also matters from a political point of view, partly because public perceptions of taxes are often sharply different to perceptions of social contributions, and even of social charges. For example, if we include social contributions as taxes, but exclude compulsory contributions to private pension schemes (as current OECD and IMF statistics show), Australia is a low-taxed state, while France is a high-taxed state. If we exclude all contributions, public and private, France becomes a low-taxed state. Conversely, if we include both sets of payments, Australia's low tax status is forfeit. Which is right? The economic reality is that the populations of both states are subject to heavy labour-related taxes and social contributions and charges. Is it perceived that way by voters and those for whom they vote?

Is it right to include social contributions and charges in a survey of taxes?

I would like to take up these underlying issues of definition and attitude, both pragmatic and doctrinaire, to see if there is some more solid basis for a consistent discussion of social contributions and charges, and similar payments, in the context of taxes. I shall discuss, in furtherance of the debate, the following linked policy questions:

(A) When is it accurate to call a social contribution or a social charge a tax?

(B) Is it relevant in answering question (A) that the contributions or charges are paid to a non-state entity?

(C) Is it relevant in answering question (A) that the contributions are accumulated so that there is no cross-subsidy between contributors.

1. Compulsion

Are social contributions and social charges taxes? In the fully rehearsed view of Seligman, social contributions and charges would be regarded as receipts from the exercise of the taxing power of the state, but sometimes not as taxes. Most social charges would normally be categorized as taxes, but social contributions may be categorized as special assessments or sometimes fees.[30] The assumption of the international agencies in presenting revenue statistics is that some of them – those paid through public schemes – are tax, rather than non-tax, public revenues. This is because social contributions share with taxes the essential characteristics that they are *compulsory, unrequited, non-returnable receipts for public purposes*.[31] This definition implicitly assumes that some kinds of contribution – for example, those to Australian superannuation schemes – are not within the definition. That we must also examine.

These views, and others, accept the common feature of compulsion.[32] It is the use of the coercive power of the state that, I suggest, should be used as the dividing factor in what we are to count as social contributions. If the contributions are voluntary, then according to this view they are not taxes. If they are compulsory, then they are taxes. This distinction should be apparent on the face of the legislation necessary to require the compulsion. The issue of compulsion is critical. It is the one common feature of all taxes, and therefore the one common reference point for any general or comparative discussion. It marks the point at which the state has decided to interfere with the market – or personal choice – in a direct way. How it has chosen to do so is a matter of means rather than ends.

The argument that the crucial factor of compulsion is central to the debate can be justified from several standpoints. There is, it is suggested, a fundamental difference between telling someone: "If you want to do this, you must do it this way, and not that way", and telling that person "You must do this, and you must do it this way". That is the difference between allowing someone to contribute to a socially regulated insurance scheme, and compelling that person to do so. The com-

29. The argument that social insurance is justified by, and perhaps caused by, market failure has been well rehearsed in the literature: see Barr, "Economic theory and the welfare state" 30 *Journal of Economic Literature* at 741; Stiglitz, *Economics of the Public Sector*, Chap. 12 (Norton, New York, 1988). For a recent reflection on these arguments, see A.B. Atkinson, *Incomes and the Welfare State*, Chap. 11 (Cambridge University Press, 1995). Each of these references contains further relevant references to the literature on this topic.

30. Seligman pursues his analysis at length in "The classification of public revenues", Chap. XIV in his *Essays on Taxation* (first published in 1895). His final classification is of revenues as: quasi-private prices; public prices; fees; special assessments; and taxes. A payment is a tax only if the special benefits to the payer are only incidental. As the special benefit increases, and the public purpose becomes less significant, so we shift through the scale towards prices. The term *special assessment* has now dropped out of public usage, as has the technique. It is well illustrated in the history of my wife's school in rural England. This was rebuilt exactly a century ago – when Seligman was writing – as a result of voluntary fund-raising. The funds were raised voluntarily because the state passed a law operative in 1893 requiring all local areas to provide adequate elementary education for all children. If there was insufficient local provision, local residents were required to form a local school board, and impose a special property levy on the area to meet the cost of building a new government school. In my wife's area, the local community did not want to lose control of their school (which was church based) and did not want to impose a formal levy on themselves. They therefore found the money without the special assessment and built the school themselves. Had they imposed the special assessment, it would have been that community, rather than the state, that would have benefited – hence the special category in Seligman's analysis. A modern view of his analysis would therefore find a sharper distinction than did he between taxes and fees.

31. See *A Manual on Government Financial Statistics* (IMF, 1986) on which the IMF and World Bank annual statistical publications are based. To similar effect see the OECD annual *Revenue Statistics*, which use the same definition – although they show social contributions separately from other taxes in most tables. It is understood that the approach of including social contributions in this way is now being reassessed. Certainly, there is no acceptance within organizations such as these, or between states, that income tax and social contributions should be regarded as essentially the same for purposes such as double taxation relief.

32. This was the feature regarded by Clark as central to the novelty of the National Insurance scheme in 1911 (Clark, 1912).

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pulsion implies both an invasion of the freedom of choice of the individual and of the individual's property rights in her or his own income and savings, and the introduction of a means of compulsion – by use of the criminal law or by imposing obligations on the relationship between employers and employees. It creates a monopoly diversion of income or savings. It therefore involves state or public authorities unavoidably in the administration or supervision of the process. It also enables the state authorities to assume compliance with the scheme so that alternatives may be ignored, and therefore alters the political debate.

Viewed in this way, it is irrelevant that the law – or even the constitution – does not use the term *taxes* for the payments. The decisive issues are that the state has set a social framework within which individuals are compelled to arrange their affairs and that powers of the state are used to ensure the transfer of resources from those individuals through appropriate distribution channels. Whatever may have been the position in the past, and whatever the linguistic derivations of the terms used, any other answer, I suggest, now serves to confuse. It may, of course, be politically expedient to confuse everyone about the identity of a payment for reasons such as the increased public acceptability of the rate of imposition, and the decreased propensity to avoid or evade social contributions in some states,[33] but those are matters of presentation only.[34]

2. Contribution or insurance?

Is the existence of compulsion sufficient by itself to identify social contributions and charges as taxes? The counter argument is that a scheme of insurance is nonetheless insurance because people are compelled to be insured. Contributors pay in certain amounts and receive a direct benefit for doing so. The current benefit is knowing that there is in place a set of financial safeguards against unemployment, disability or old age. The actual future benefit is, as with all insurance, speculative.

The argument that compulsory insurance is not taxation is strengthened by noting that in some schemes the contributions are compulsory, but the levels of contribution are not set by the state. For example, insurance against the liability of employers for injury to employees is compulsory in many states, but takes fundamentally different forms. In France, it is part of the state scheme. In Britain, it is imposed by separate laws and the insurance cover is provided through the marketplace.[35] It is an offence in both states for an employer not to have insurance against employee liability, but the mechanisms are very different. However, in both states, although in different ways, the rates of insurance are not set by the state, but by the market and the actuarial advisers to the suppliers of the cover. The key difference is that in one country the rate is generalized, while in the other it is, at least in theory, individualized to the person insured. This also poses the practical difficulty that the state authorities may not know how much is paid by way of compulsory contributions. Such figures therefore are not likely to turn up in national statistics.[36]

If we focus on the insurance aspect only, we may argue that neither the British nor the French employer schemes are social insurance schemes with contributions that count as taxes. Official accounts of the two systems usually treat the French system as within social insurance (and, therefore, for current purposes, as a tax-based scheme) while the British system is treated as a private matter. The suggested approach would treat both as forms of taxation regardless of the differences in the way the funds are handled. It does so because the premiums are compulsory, and are enforced. The existence of the benefit is required by law. It is suggested that the method of delivery of that benefit is irrelevant for present purposes. Only in this way can we take a true view of the social commitments and funding arrangements of a state.

A major area for such compulsion is that of pensions. For example if, when I take on a form of employment (perhaps in the public sector), my employer must make contributions to a pension fund for me, or must make reserves in its accounts to reflect the liability to fund my pension – which it is obliged to pay – in due course, is that taxation?[37] I suggest when we are trying to look at the total patterns of tax revenues and what trends appear in those patterns, we should note these kinds of indirect obligations or concealed taxes.

3. Institution

Does it matter that the social contributions are paid to a non-state body? I suggest that it does not, provided that the framework within which the funds are collected and delivered is that of the state.[38] In other words, the funds derived from the compulsory contributions and charges are available only for specified social purposes. I suggest that the key element here is whether the payments are for the purposes of pursuing government social policy, rather than the fact that they are routed through an agency of government administration. This use for such purposes is therefore a second element that must be present to link a social contribution or charge to taxation.

For example, if a state decides to institute a national health system funded by compulsory contributions from the popula-

33. I do not regard this as a universal observation. The reverse is argued to be true in some states.

34. This was recognized in British literature a generation ago. See for example J. Coffield, *A Popular History of Taxation* (Longman, 1970), at 180 : "It is only a disguised form of taxation".

35. The British social security scheme also includes entitlement to statutory sick pay and incapacity benefit and an industrial injuries disablement benefit for long term disablement for those injured at work. For many years there was a separate, higher benefit for those injured in this way financed by a separate industrial injuries scheme, but it was merged into the general benefit scheme in stages some years ago.

36. For example, the OECD Revenue Statistics do not include such items.

37. The question is stated in the alternative to reflect the differences in the Anglo-American way of doing these things, and the German way. The United Kingdom has recently varied the approach by removing the element of compulsion, but introducing bribes through the contribution and tax system to get people to provide pensions in other ways. This has been spectacularly successful, except that the regulatory mechanisms proved woefully inadequate and much misselling of pensions took place.

38. Historically, a relevant example is the United Kingdom national insurance scheme which, when first introduced, was run by private institutions with most of the administration left to the insured. See *supra* note 3.

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tion at large, then it matters little what is the contractual link between individual hospitals, doctors and nurses on the one hand, and the state on the other. The funds pay the doctors; the doctors treat the public as their patients; and the public have to contribute the funds. The circle is complete.

The system compels the public to contribute the funds, and prevents the use of those funds for purposes other than the provision of public health. The fact that some states have national health services funded entirely by the public while other states do not put the services as such in the public domain, and others again have chosen to transfer the delivery of the services from the public domain to the private sector by privatizing the means of delivery is, I suggest, not decisive.

Of course, there are strong arguments about the *merits* of market-determined rates, and market-regulated institutions, rather than politically-determined rates and publicly accountable institutions. Not least, it has been argued throughout this century that the market can deliver supplies of pensions only imperfectly and at considerable expense and risk, while public provision can overcome these problems.[39] I do not wish to be understood as dissenting from such arguments – or agreeing with them. The issue here is not which is a better way of achieving the object, but a recognition that once the state has decided to interfere in the market, then responses to the interference by public and private agencies are both essentially similar in relying on the power of the state to ensure that they collect their funds.

4. Contribution or saving?

Does there have to be some cross-subsidy in the system before it becomes a form of taxation? I have in mind here schemes such as the Singapore and Malaysian compulsory savings schemes. This gets us near the limits of the idea of compulsion. It also picks up a term in the standard statistical definition: taxes are non-returnable payments.[40] Is the state here appropriating the funds, with a promise to return them later, or is it securing only the use of the funds? Further, if the funds, and their income, are accrued to the benefit of the individual and the family only, so that the benefit to the state is only indirect, does that alter the answer?

As with all attempts to draw a line, this case tests the demarcation suggested above. Clearly, in the view of the governments imposing these kinds of schemes they are not tax schemes, or insurance schemes, but savings schemes. The two additional elements of the absence of cross-subsidization and the return of the savings are the crucial factors in that argument. For the purposes of our present survey, however, I suggest that we should again treat these as within the scope of our survey, not removed from it. This is essentially because systems such as that in Singapore use the coercive power of the state for the collection of the funds, to regulate the way in which the funds are held, and also to control the conditions under which and the purposes for which the individual can withdraw the funds. In so doing, the savings are fulfilling public objectives and removing the need for other forms of funding for support of the public generally. The schemes differ only in degree from contributory schemes whereby a person can only benefit in full if he or she has contributed in full (the case with many social insurance schemes). Indeed, from the point of view of a full contributor in, say, Singapore and the United States of America, there may be little difference save in the compulsory levels of payments in and the entitlements to payments out. In both cases, the funds held are invested in government securities, with a return therefore determined by the securities in which the investments are placed.

5. Games with names

This argument about whether social contributions and charges are taxes may be regarded, nonetheless, as somewhat to the side of the main issues. It has been pursued for two reasons. The first is that unless we know what we are examining, we cannot decide what is happening to our subject matter. The second is that the discussion reveals significant practical pressures on how we label things. We have touched on several ways in which the state can impose social security arrangements while maintaining that the funding of those arrangements does not involve taxation:

(a) a compulsory scheme without cross-subsidies is a savings scheme, and the payments made are savings not taxes;
(b) a compulsory scheme imposing an obligation to engage in risk-pooling arrangements of a regulated kind but provided by the marketplace is insurance, and the payments are premiums not taxes;
(c) a variant on the last point is that of arrangements for employment-related compulsory pension schemes, where the payments to the arrangements are pension contributions not taxes;
(d) a scheme which provides help to the general public or specific needy categories may impose tariff or token charges as an additional element to state support or contributions.

The recognition of the common issues involved in these different formulations of schemes is of importance because it would seem that these "games with names" may be on the increase. The pressures to reduce taxation have applied, above all, to the rates of direct personal and corporate income tax. As we have seen, these pressures have coincided with pressures to expand social expenditure. One solution is to look for ways of ensuring that social insurance and social welfare is funded by means other than an income tax. What has clearly happened in recent years is that growing levels of payments are made by or for potential beneficiaries of social insurance and welfare while ensuring that the payments are not called "income tax". That process would seem to have had a capacity to fool many people for much of the time,[41] or,

39. See, in particular, Stiglitz, *Economics of the Public Sector* (Norton, New York, 1988), Chap. 12 for a concise statement of the arguments for public systems. See also the other works cited at *supra* note 29.
40. See the definition quoted at *supra* note 30.
41. Certainly, in the United Kingdom there is traditionally less propensity to avoid social contributions than income tax, and a much lower rate of appeals against determinations of liability. However, over the last few years this tendency is less obvious.

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alternatively, to have given the obligation to pay a more convincing basis. Whatever the reason, it is confirmed by the European Commission noting in its recent report[42] that between 1980 and 1994, the main increase in the burden of taxes and social charges on labour was through social contributions (an increase of an average of 1.5 per cent of GDP).

IV. WHO PAYS THE PIPER?

There may be a further, less obvious, reason why there is disagreement about the "true" nature of social contributions and charges. It may be that the nature of those contributions has been changing while the names used, and the superficial appearances of schemes, have not. When first introduced, the German scheme imposed a schedule of contributions depending on the band of income within which an employee was paid. The British scheme imposed a flat rate, depending on the age and sex of the employee. Over the intervening century this flat-rate approach to contributions has been abandoned. Nearly all social security contributions are now collected as earnings-related payments by employers, by employees or by both.[43]

There was also no standard approach to the way in which the burden of the contribution is shared between the employer and the employee. Variations reflected different conceptual bases of the framework of social security. In the former Soviet model, the state – through the state-run employer – was the provider of all good things, including the whole of social security. Therefore, it was natural for the employer to pay the social contributions, with the employee bearing either a token cost or no cost at all. Elsewhere in Europe, things were seen as a partnership between the state, the employer and the employee, so the contribution was shared among all three, but not in any particular way. In some other parts of Europe and in the United States, the plan was a form of self-help, a partnership between employer and employee from which the state was said to be excluded. This partnership was, and is, reflected by an equal share in the costs of contributions between employers and employees. These approaches might now seem to be disparate reactions to the same issue, but they reveal, it is suggested, something more fundamental about the individual systems from which they were derived. It was this that differentiated the schemes from income taxes. In the case of a Soviet-style system, there was no contribution by the employee. Rather, the benefits received after work ended were part of the reward for work. The attitude by the schemes that worked on a partnership basis of funding had perhaps the same rationale but a radically different approach to its realization. Other schemes were based on worker solidarity, and others again on a paternalistic attitude of the state assisting the partners in work as a sort of huge family. All contrasted with the simple basis of income tax – a measure of the taxable capacity of individuals to contribute to the common good.

What has happened, and is continuing, are subtle shifts in the relationships between the various contributors. A series of pressures has come to bear on the question of who pays. The former Soviet system has failed, as has the converse attitude in some other states that you can keep the state out of general social schemes. By contrast, in others, the state has quietly opted itself out to place the burden on employers and employees but without the rationale of a partnership, and in others again, there is a drive to privatize the provision of social benefits. We have already noted the general pressure on states to keep income tax down, and therefore to divert costs elsewhere. Shifting the burden of social security schemes from the state to others is, for some states, the only major way in which such costs can be reduced. The burden is transferred to some form of social contribution, or the "game of names" is employed to disguise the methods used to fund schemes. Pragmatism has produced answers in producing funds that paradigms do not.[44]

There are also other pressures at work. The first is the globalization of the economy. Payroll costs were of little concern to employers even 20 years ago.[45] Now, as the French government is uncomfortably aware, payroll costs are part of total labour costs, and total labour costs may make an employer, or a nation, uncompetitive.[46] Employers are therefore concerned to see their payroll taxes and contributions minimized. The two simplest ways of doing this are to lobby for a transfer of costs to employees, and to seek to avoid and evade contributions. States are also concerned to make the costs of social security more transparent. There is still a profoundly misjudged, but understandable, belief in states that were formerly part of the Soviet system that it is the job of the state to provide for its citizens, but that there is no correlative duty on citizens to fund the state.[47] Why should there be if for decades citizens have had no need to pay for the largesse of the state? All these pressures reinforce a trend towards ensuring that employees bear a larger share of total contributions.[48] In the

42. See *supra* note 3.
43. For a comparative description of the details of employee and employer contributions see D.W. Williams, "Social security taxation" in *Tax law Design and Drafting*, ed. V. Thuronyi (IMF, Washington, 1996).
44. "... the present 'state of the art' in most welfare state research has been characterized by a lack of theory. Most welfare state analyses lack a clear understanding of concepts..". Thomas Boje in "Welfare-state models in Comparative Research", Chap. 1 in *Comparative Welfare Systems* (*supra* note 16). Perhaps this reflects, and also helps explain, a similar vacuum in ideas by those charged with adjusting the systems.
45. When I was preparing the United Kingdom national report on social contributions for the 1983 IFA Congress, I spoke to the heads of taxation of several of the United Kingdom's largest companies. Without exception, they told me that social contributions were not a concern. Most told me that they were not able to quantify the social contributions borne by their companies. In recent years, that benign indifference has ceased.
46. This is currently a major theme in European Commission thinking. See *supra* note 3.
47. One of the major problems in economies in transition is the failure to pay social contributions. While experience in Western Europe is that contributors pay social contributions more readily than income tax, authorities in countries like Russia have reported the reverse to be the truth. An element in this is the distrust of the ordinary individual as to the way in which the contributions will be used.
48. This shift can be convenient to the state for another reason. Employer social contributions are usually deductible against profits tax. Employee contributions are often not deductible. A transfer of the burden from employer to employee may therefore save the state some tax revenue. However, that is but a small part of the shifts of funds between the social security system and the tax system that occur unavoidably in every state. These shifts also shift the burden of funding, but chasing that issue is beyond my present focus.

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FSU, this means breaking away from a traditional pattern where the employer pays 30 per cent or more of payroll to the fund, while the employee pays only 1 per cent or nothing at all. That total has gone up in many states, but the increases have been shifted to the employee. Employees now pay more than 13 per cent in the Czech Republic and 10 per cent in Hungary.[49] Perhaps the most dramatic shift was in the Netherlands, where the main burden of social security has been placed firmly on the employee. The shift was so great (the employee rate is now more than 30 per cent) that for some years employers were required to pay a compensation allowance to employees to reflect the decreased cost on the employer and increased cost on the employee resulting from the shift.

However, a shift away from employer funding, or indirect funding from other sources through a state "contribution" towards direct and transparent funding by employees, is a shift towards the tax base of the income tax and a shift away from the original rationales for separating social contributions and charges from the income tax. This presents us with a paradox: social contributions are increasingly similar to income tax while political pressures argue towards the increasing need to emphasize the differences.

Linking contributions and benefits

One way of distinguishing a social contribution from an income tax is the linkage between contributions and individual benefit entitlement. The main social security cost is the funding of retirement pensions. It is here, however, that the increasing burden of funding is being particularly felt. This has resulted in increased sums being raised from contributions and those increased contributions have, inevitably, led to increased avoidance and evasion.

One response to these forces is strengthening the link between contributions and benefits. Previously, a pensioner in some states could qualify for a state pension after paying contributions for only a few years. One aim of the reforms is to ensure that those contributions are paid through the lifetime of the individual. What was a 5 or 10 year qualification period is becoming 35 or more years. Non-payment used therefore to be irrelevant except in the few years leading up to retirement. The plan is that an erratic career will in future lead to a small pension, or perhaps none at all.

This linkage is only possible if there is an identifiable contribution for each employee, and clear records are maintained of those contributions. That imposes greater administrative costs on those running the scheme, and greater compliance costs on employers. The advantages of imposing contributions on employees, and linking those contributions to benefits, are the removal of the ignorance of the employee about pension funding, some damping of the employee's indifference to whether employers pay contributions or not, and a reduction of benefit where contributions are reduced.

V. SIMPLIFYING THE SYSTEM

Compliance costs add to the burdens that employers see themselves as bearing under a social security system. What are those compliance costs? They are broadly the same as those imposed on employers in collecting personal income tax from employees. They must act as agents of the tax authorities, and the social security authorities, in collecting most of the amounts paid out and transferring them to the tax authorities. If the burden of contributions is a flat rate across payroll generally, then the compliance task is simple. The employer accounts for a share of the payroll. If, however, the employees are required to contribute, and records are kept of those contributions, the task is more difficult.

In a scheme based on employee contributions the employer may be faced with accounting for both tax and contributions on each employee. This adds to the direct cost of the contributions the need to pay for the machinery to ensure compliance. Attention to this compliance cost has drawn attention to another aspect of contributions: differences between the tax base for contributions and the tax base for income tax. If there are differences between these tax bases, then this imposes a need for separate calculations of tax liability and contribution liability. This has generated in some states – notably the United Kingdom – a pressure to make the tax base for contributions the same as the tax base for income tax. This is something that the Netherlands achieved in its reforms a few years ago.[50]

The logical consequence of this trend is – as the Dutch system illustrates – that there is a convergence between personal income tax liability and employee social contribution liability. This convergence can also be used by the state authorities to cut their own costs and strengthen both systems. The collection and enforcement machinery of the tax authorities can be harnessed to collect social contributions, or the reverse. For example, in the United States and the United Kingdom the taxpayer identification number used by the tax authorities is, in fact, the social security number of the taxpayer. Both tax authorities, using this number and their income tax powers, collect most of the social contributions as agents for the social schemes.

The use of tax collection powers is also useful where employers start using tax avoidance techniques to reduce the cost of social contributions. A country that has gaps in its social contribution tax base as compared with its income tax base may be attracted to the use of its income tax anti-avoidance powers to dampen down the contribution avoidance.

Where does that take us? It takes us further towards a position where personal income tax and personal social contributions are increasingly difficult to distinguish. Therein lies a

49. Current rates are taken, for the purposes of this article, from the current edition of International Tax Summaries by Coopers & Lybrand.

50. The Netherlands scheme now closely coordinates the employee's social contributions and income tax liability, placing the two together in a coordinated scheme of rates so that, in effect, employees pay a rising rate of total tax and contributions as income rises, of which one part is identified as specific contributions and the other as general tax revenue.

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dilemma for the reforming government. If it becomes increasingly obvious that individual social contributions are just another name for some extra income tax, then the result is that many states have experienced increases in the effective rate of income tax at a time when there is supposed to be a decrease. If that is high on the political agenda of a government, it must ensure that there is not too much convergence between social contributions and personal income tax. In other words, the system must be left with at least some opaqueness and inefficiency. The price of that inefficiency has to be paid by the employer.

Contracting out of the problem

How else can the rational employer respond to the increasing pressures of the social security system? One answer has been to seize the learning of business schools, and engage in downsizing, outsourcing and empowered rationalizations – in other words, shedding staff. Employees become self-employed and full-timers become part-timers. These changes may be neutral for income tax purposes, but they usually have a sharp effect for social security purposes. Traditionally, the self-employed have inhabited a sort of twilight on the edge of state social security schemes. Philosophies involving partnerships tend to break down. There are no traditional paying agents. There is much less cooperation from taxpayers. Ideas such as unemployment and absence from work due to sickness or disability are less meaningful, and employer liability loses all meaning. The answer, in some states, is to leave the self-employed to their own devices. In others it is to give the self-employed partial membership of the state schemes. Few treat the self-employed as "honorary employees" fully participating in the state system.[51]

Part-time working and short-term contracts impose different pressures, and problems on a traditional social security scheme. There are often minimum levels of earnings before contributions become payable. A series of part-time jobs may leave the employee below those minima for each job. Unless the contributions are calculated on an annual basis, the employee may end up working, paying income tax, yet being outside the social security system. Even if the employee's contributions can be calculated annually, what happens to each of the several employers?

Another means of contracting-out is to employ people in the grey economy. Without being able to put figures to it, anecdotal evidence suggests that this is a serious factor in many states. It is unlikely that it is decreasing at a time when both the actual costs and the compliance costs of contributions are increasing. A fourth way of contracting out is to move the jobs to a cheaper jurisdiction. Herein, arguably, is perhaps the biggest challenge in the future facing social security funding. Can we let the world's economy develop so that the workers are all in one part of the world and the pensioners are all in another? That is an exaggeration, but if we take away the hyperbola, the issue is still there.

How should the "rational state" react? The fashionable answer is that the state should withdraw from the provision of all but the basic levels of pension. We should adopt Chilean schemes.[52] However, if we adopt the wide view of what we regard as taxation as argued above, we see rather more clearly that this is not fundamentally changing what is going on – rather it is in part a change of names and in part a change from the public administration of schemes to private administration.

VI. SUMMARY

There are no tidy conclusions from a problem that is expressed against so many external factors and variables, but we can pull some threads together:

1. Social security costs have been growing, and will continue growing, in almost every state. In some states, the shift in the age dependency ratio is one that has set alarm bells ringing. This factor is reinforced by the expectations of citizens further increasing actual and potential costs.

2. The upward pressure on social costs has come against a background of pressures on states to reduce their budgets, and in particular to reduce personal income tax rates for political reasons and corporate income tax rates for competitive reasons.

3. One result is an upward trend in social contribution rates. This shift has either caused or coincided with a growing awareness of the payroll costs to employers and states of social security schemes.

4. Another result is that social security contributions are often felt to be less value for money than used to be the case.

5. Social security funding has often been seen as a bipartite partnership between employer and employee, or a tripartite partnership between employer, employee and the state. In other countries it has been seen as the responsibility of the employer or the state. Both the employer and the state have been keen in recent years to shift at least part of the burden on to the employee. This has been done by direct transfers of the burden from the state and from the employers, by indirect transfers using what I have termed contracting out by employers, and also by transferring the burden of providing social security to schemes that are, in name at least, not regarded as social security.

6. Employers have become more conscious of those social contribution costs they still bear, both substantive costs and compliance costs. A previous benign indifference has been replaced by the same approach as is used for taxation. This has resulted in measures being taken to reduce contributions by any appropriate means.

7. For this and other reasons, some states have been aligning their income tax and social contribution schemes more

51. Sweden is one state that integrates the self-employed, but this imposes a high price as the self-employed individual is expected to pay at a rate reflecting both the employer's and the employee's contributions. Yet, if that is not done (as in the United Kingdom) the result may be a subsidy of the self-employed.
52. This is the core of the views expressed by the World Bank.

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closely. How far can that go before we end back where we started?

Most of the responses of states in recent years to the pressures on social security funding have been pragmatic. Funds have been found in the Colbertian way.[53] Schemes have been trimmed to meet short-term needs to balance the books, with less attention to the future. This article has examined only two aspects of this problem, namely what is happening to social contributions and charges, and how far those contributions and charges are, and should be, regarded as part of taxation. In doing so, it may be viewed as itself accepting the weakening of a system that depends on balancing income and outgoings. It does so, however, as a response to the pragmatism.

The key underlying questions are how far the state is regarded as the means to ensure the well-being of its members, and how much those members have to pay to secure that well-being. It may be that the social insurance model of the welfare state is coming towards the end of its useful life. Maybe such schemes will fade in response to newer patterns of employment and retirement. That, however, does not mean that the state is required to withdraw from the role it has adopted for most of this century of requiring workers to pay for provision for their own and others' welfare needs. As the century ends, the fundamental shift towards using compulsion to ensure contributions towards the better welfare of the individual – the point on which Clark expressed so much surprise in 1911[54] – remains, even if the means are changing. The emphasis on the social, rather than the individual, approach remains in the underlying methodology of developed states, although they may, at the superficial level, feel the need again to place more emphasis on the individual.

53. That is, by plucking the maximum amount of feathers from the appropriate parts of the anatomy of geese so that they do not hiss too much.
54. See *supra* note 6.

Conference diary

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

JUNE 1997

IMN, Tax Planning Strategies Using Derivatives, Warwick Hotel, New York, 18-19 June 1997 (English):

Information Management Network, Inc., 25 West 45th St., Suite 1505, New York, NY 10036, Tel.: 1-212-768 2800, Fax: 1-212-768 2484, E-mail: imnreg@aol.com

International Tax Aspects of Permanent Establishments, Amsterdam, The Netherlands, 19-20 June 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

International Licensing, Amsterdam, The Netherlands, 20 June 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

Executive Transfers in Europe, Amsterdam, The Netherlands, 20 June 1997 (English):

Institute of Taxation European Branch, 61 Chandos Place, London WC2N 4HG, Tel.: 44-171-836 3266, Fax: 44-171-836 1457.

IBC, Transcontinental Trusts Conference 1997, The London Park Lane Hilton Hotel, London, 30 June and 1-2 July 1997 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-631 3214.

JULY 1997

The 1997 Summer Leasing School, The Berystede, Ascot, Berkshire, UK, 7-9 July 1997 (English):

Samantha Roper, Asset Finance International Seminars, Nestor house, Playhouse Yard, London EC4V5EX, UK, Tel.: 44-171-779 8793, Fax: 44-171-779 8603, E-mail: qm8o@dial.pipex.com

AUGUST 1997

Summer Course Principles of International Taxation, Amsterdam, The Netherlands, 18-29 August 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

SEPTEMBER 1997

International Tax Avoidance and Anti-Avoidance, Amsterdam, The Netherlands, 25-26 September 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

OCTOBER

International Tax Aspects of Electronic Commerce, Amsterdam, The Netherlands, 3 October 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

51st Congress of the International Fiscal Association, New Delhi, 19-24 October 1997 (simultaneous translations into French, English, German and Spanish):

IFA General Secretariat, World Trade Center, Beursplein 37, 3011 AA Rotterdam, The Netherlands, Tel.: 31-10-405 2990, Fax: 31-10-405 5031.

Non-Discrimination, Amsterdam, The Netherlands, 30-31 October 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

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UNITED KINGDOM

HYBRID ENTITIES AND FINANCING STRUCTURES A VIEW FROM THE UNITED KINGDOM

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This article is based on a paper given by the author at the Annual Meeting of the IFA United States branch in New York on 28 February 1997.

I. INTRODUCTION

The use of hybrids in the context of cross-border investment and financing in the United Kingdom has had a long history. Hybrids in this sense have focused specifically on the different categorizations of entities or instruments between two countries. For example, a common form of financing for UK subsidiaries of foreign based multinationals was through the use of dual resident companies. Until 1988, the United Kingdom adopted a central management and control test for determining the residence of companies. Other jurisdictions such as the United States adopt an incorporation test only. As a result, a company formed under the laws of one of the United States but managed and controlled in the United Kingdom was resident in both countries for the purposes of the tax laws of both countries. Thus, a single company could be a member of a UK tax group and a US tax group permitting losses, particularly in the form of interest charges to be used in both places. This arrangement was attacked by legislation and the utility of such structures is now significantly curtailed.[1]

A second form of cross-border financing arrangement has involved hybrid investment instruments. Typically, these instruments were designed to be treated as debt of the issuer for UK tax purposes, thus permitting an interest deduction. In the other country, for example the United States, the instrument was treated as equity in the hands of the holder, thus permitting access to underlying or indirect foreign tax credit on payments received pursuant to the instrument. This form of arrangement was similarly terminated for instruments issued by UK companies in 1992.[2]

A third fairly common form of hybrid entity in the context of US–UK transactions over the last decade has been the UK unlimited liability company. Such entities are taxed as corporations in the United Kingdom. However, the Inland Revenue Service (IRS) has ruled in certain cases that they should be taxed in the United States as partnerships. Where the structures call for a United States based entity, in some circumstances an S Corporation might be used, being treated as a corporation for United Kingdom tax purposes and a flow through entity for US tax purposes. The introduction of the "check-the-box" regulations in the United States has introduced a new degree of flexibility, which may create opportunities through differing classification of entities.[3]

II. UK ENTITIES

There are several somewhat confusing terminological issues in relation to entity classification in the United Kingdom. Under the Income and Corporation Taxes Act 1988, "corporation tax" is charged on the profits of "companies" (TA 1988 Section 6(1)). A company is generally defined in TA 1988 Section 832(1) to mean "any body corporate or unincorporated association, but does not include a partnership, a local authority or a local authority association". Specific exceptions to this definition are found in Section 832(2).

That section makes the definition subject to the provisions of two areas of legislation dealing with anti-avoidance, namely Sections 703 to 709 which deal with the cancellation of tax advantages from certain transactions in securities and Sections 774 to 777 which contain anti-avoidance provisions relating to transactions between a company dealing in land or securities and its associated companies, sale of personal earnings and certain other transactions in land. Other exclusions apply in defining the circumstances in which persons are connected and generally Section 768 treats authorized unit trusts as companies for most purposes. A general exclusion also indicates that the definition does not apply "where the context otherwise requires because some other definition of "company" applies".

The most important general conclusion about the definition is that it generally requires reference to the underlying corpor-

1. See Income and Corporation Taxes Act 1988 ("TA 1988") Sec. 404.
2. See TA 1988 Sec. 209(2)(e)(vii).
3. See for example "Cross-border Planning under Check-the-Box Proposals" Stanley C. Ruchelman and Harold L. Adrion, *Tax Planning International Review* July 1996 at 3; "Check-the-Box Regulations Adopted" Stanley C. Ruchelman, *FT World Tax Report* January 1997 at 11.

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ate law, rather than to specific tax definitions as to what constitutes a company. It is only in exceptional cases that tax law definitions are applicable.

Companies generally are formed under the various companies acts applicable separately to England and Wales, Scotland and Northern Ireland.[4]

A company may be formed with or without limited liability. Companies with limited liability are either limited by shares where the company has a share capital or are companies limited by guarantee where the company has no share capital. In this case, the liability of its members is limited to such amounts as the members undertake to contribute to the assets of the company in the event of it being wound up. A company limited by shares means the liability of its members is limited to the amount, if any, unpaid on their shares.[5]

Companies may also be public or private. A public company must be a company limited by shares and must meet certain minimum capital requirements. A private company is any company which is not a public company.[6]

Corporations cover a broader scope. A corporation may be defined as a body of persons (referred to as a "corporation aggregate") or an office (referred to as a "corporation sole"), which is recognized by the law as having a personality which is distinct from the separate personalities of the members of the body or the personality of the individual holder for the time being of the office in question. Corporations are created either by royal charter of incorporation from the Crown or by authority of Parliament.

Cases which have considered the meaning of these terms in relation to domestic entities have tended generally to focus on various forms of unincorporated associations, rather than business entities.[7]

The principal business entity under domestic law which is distinguished from corporations is the partnership. A distinction must be recognized in this area between English law and Scottish law. Under Scottish law, partnerships do have separate legal personality. Under English law (and that of Northern Ireland), they do not. Partners are generally liable for the debts of the partnership. Exceptions only exist in relation to the limited partners of limited partnerships. The absence of any judicial consideration of the status of domestic entities under domestic tax law is likely because the distinction between corporations and partnerships under domestic law is assumed to be fairly clear.

In the corporate finance context, characterization as a company has taken on an increased significance in recent years. The important tax reforms and codifications in the corporate finance area have resulted in significant differences between the treatment of companies and other taxpayers. New rules relating to foreign exchange, gains and losses, new financial instruments and debt financing (now called loan relationships) apply to entities within the charge to corporation tax.[8] These are UK resident companies and branches of non-UK resident companies. Where business entities do not qualify as companies, other rules apply which have developed over a long period of time and may produce anomalous results in some circumstances.

III. FOREIGN ENTITIES

The characterization of foreign entities as a company is to be determined under the rules of English conflict of laws by reference to the general law of the country of incorporation in the case of a corporate entity. English law will recognize the existence of a corporation duly created in a foreign country as a matter of common law.[9] Whether the entity in question is a corporation will depend on the law of the country where it is formed.

The only statutory recognition of this rule applies if a question arises whether a body which purports to have or, as the case may be, appears to have lost corporate status under the laws of a territory which is not a recognized state should or should not be regarded as having legal personality as a body corporate under the law of any part of the United Kingdom. Under the Foreign Corporations Act 1991, if it appears that the laws of that country are at that time applied by a settled court system in that territory, the question and other material questions relating to the body must be determined and account must be taken of those laws as if the territory were a recognized state.

There are few cases either in tax or general law on this. An entity which according to its proper law possesses certain aspects of separate personality may not necessarily be regarded as a corporation. In *Von Hellfeld v. Rechnitzer & Mayer Frères & Co*,[10] it was held that a French partnership could not be sued in its own name in the absence of evidence that by French law the partnership was a different legal entity from its partners. In *Dreyfus v. IRC*,[11] the court referred to French law in determining whether an SNC (Société en Nom Collectif) constituted a company or not. UK resident members in the SNC successfully proved that under French law, an SNC was a legal person. Consequently, the members were not liable to UK super tax on the entity's profits as they arose. In that case, the question was whether the entity was a partnership or a company.

As a result of these rules, the possibility arises for entities to be treated as corporations for UK tax purposes even though in the country of their formation, they may be deemed to be fiscally transparent by the local tax law.

4. See generally Company Act 1985 (1985 C6).
5. Companies Act 1985 Sec. 1(2).
6. Companies Act 1985 Sec. 1(3).
7. For example, *Conservative and Unionist Central Office v. Burrell* [1982] STC 317 CA; *Frampton v. IRC* [1987] STC 273.
8. The principal rules were introduced in Finance Act 1993 (Foreign exchange gains and losses), Finance Act 1994 (Financial Instruments) and Finance Act 1996 (Loan Relationships).
9. *Henriques v. General Privileged Dutch Co., Trading to West Indies* (1728) 2L Case D Raym 1532; *Newby v. Von Oppen & Colt's Patent Firearms Manufacturing Co.* (1872) LR7 QB 293; *Lazzards Brothers & Co v. Midland Bank Limited* [1933] AC289 HL.
10. [1914] 1 Ch 748 CA.
11. 14 TC 560.

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IV. TREATY CLASSIFICATION

The precise manner in which an entity is classified for treaty purposes will depend upon the particular treaty in question. Article 3(1)(b) of the OECD Model defines a company as "any body corporate or other entity which is treated as a body corporate for tax purposes. Although the first part of the definition is similar to the UK domestic law definition, it requires the status of a body corporate to be determined by reference to tax rules rather than the general law. This definition itself does not explain which contracting state's tax purposes are relevant in this respect. On a first reading, it might be taken to refer to the contracting state for the purposes of the tax of the contracting state where the convention is to apply. In other words, where UK tax is in question, UK classification is relevant. This would, as described above, point to the domestic general law of the other contracting state.

Classification of an entity as a company under Article 3(1)(b) does not automatically confer treaty benefits. Article 1 limits the application of treaties to persons who are residents of one or both of the contracting states. As a result, recourse must be had to Article 4(1) which defines a resident of a contracting state to mean any person who under the law of that state is liable to tax therein by reason of his domicile, residence, place of management or other criterion of a similar nature. In other words, it is the tax law of the country of residence that determines whether the entity is "a resident of a contracting state" and therefore within the personal scope of the treaty. Furthermore, under Article 1, the partnership must be a person. Can treaty benefits be available in the United Kingdom, therefore where UK law would classify the entity as a corporation but the foreign law would classify the entity as a partnership? The answer to this question appears to depend on whether the other contracting state would treat the partnership as such as a resident of that state for the purposes of its domestic tax laws. A related question is whether the partnership is regarded as a "person" for the purpose of Article 1. The answer to both questions would appear to be affirmative in at least some countries.[12]

V. TREATY BENEFITS

Where a foreign entity is treated as a corporation for UK purposes and qualifies for treaty benefits, the significance of this classification varies from treaty to treaty.

Most UK treaties, and indeed the OECD Model, do not generally distinguish between benefits available to companies as opposed to other taxpayers. Classification as a company will principally determine entitlement to treaty benefits as a person resident in a member state.

The principal area where a distinction is drawn between the treatment of companies and other entities is in relation to dividends paid and received.

Dividends Paid

A number of UK treaties permit a repayment of the tax credit associated with dividend payments to qualified residents of treaty countries. If the UK entity pays dividends to a company which holds directly or indirectly at least 10 per cent of the voting shares of the UK corporation paying the dividend, it will be entitled to payment of one half of the credit that a UK resident individual would be entitled to, subject to withholding of 5 per cent on the credit repaid plus dividend under a number of such treaties. In most of these treaties, all other taxpayers typically receive repayment of the whole credit subject to a 15 per cent withholding on the dividend plus credit repayment.[13]

Dividends Received

The distinction for 10 per cent shareholders also exists in relation to dividends received. Where a UK corporation receives a dividend paid by a non-resident company, treaties will typically permit the UK shareholder owning at least 10 per cent of the voting shares of the non-resident corporation to credit not only withholding tax paid on the dividend, but underlying corporation tax paid by the non-resident corporation on its taxable profits.[14] Other shareholders typically are only entitled to credit for tax at the shareholder level.[15]

VI. US ENTITIES AND THE US–UK TREATY

Not all UK treaties follow the OECD Model. The most significant of those that do not is the treaty with the United States. It is significant not only because it deviates considerably from the OECD Model, but also as a result of the new flexibility given under US federal tax law, under the "check-the-box" regulations, to elect corporate or transparent status for a wide range of entities for US federal taxpayers.

The US–UK Treaty does not follow the OECD Model and contains its own somewhat extended definition. A corporation means any one of the following:

(i) a US corporation;
(ii) a UK corporation; or
(iii) any body corporate or other entity of a third state which is treated as a body corporate for tax purposes by both contracting states.[16]

A US corporation is either:

- a corporation which is created or organized under the laws of the United States or any state thereof or the District of Columbia; or
- any unincorporated entity treated as a corporation for US tax purposes.[17]

A UK corporation is any body corporate or unincorporated association created or organized under the laws of the United Kingdom excluding a partnership, local authority or a local authority association.[18]

12. The issue was considered in detail at the 1995 IFA Congress in Cannes. See *Cahiers de Droit Fiscal International Volume LXXXa* "International Tax Problems of Partnerships, Kluwer 1995.
13. See for example UK–Netherlands Treaty, Art. 10.
14. See for example UK–Netherlands Treaty Art. 22(1)(a).
15. See for example UK–Netherlands Treaty Art. 22(1)(b).
16. Art. 3(1)(a).
17. Art. 3(1)(b)(i).
18. Art. 3(1)(b)(ii).

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Limited liability companies formed in the United States for example, may qualify for transparent status under the "check-the-box" regulations. On the basis that a limited liability company is treated as a corporation under the laws of the state in which it is incorporated, it will likely be viewed as a company for UK tax purposes and for the purposes of making a claim under the US–UK Treaty. The implications of this are as follows.

Dividends

The LLC will qualify for the benefits under Article 10(2)(a)(i). This permits a US corporation which alone or together with other associated corporations controls directly or indirectly at least 10 per cent of the voting stock of the UK corporation paying the dividend to payment of a tax credit equal to one half of the credit that a UK resident individual is entitled to subject to withholding of 5 per cent of the credit repaid plus dividend.

Interest

Entitlement to elimination of withholding tax on interest paid to US residents will apply regardless of characterization of the entity.[19] If the LLC for example is a US corporation and thus a US resident for treaty purposes, it should benefit from treaty provisions.

Characterization of the LLC as a company will also bring into play Article 16 of the US–UK Treaty. This is a limitation of benefits provision. Its application is restricted however to dividends, interests and royalties. It essentially adopts a disqualification test based on the liability of the entity to US federal taxation. Treaty benefits relating to these items of income are not available to a corporation if:

Firstly
- tax upon it in its country of residence on the dividends, interests and royalties in question is substantially less than the tax generally imposed by that state on corporate profits; or
- the corporation is a US resident and receives more than 80 per cent of its gross income from non-US sources in accordance with Sections 861(a)(1)(B) and (a)(2)(A) of the US Internal Revenue Code; and

Secondly
- 25 per cent or more of the capital of the corporation is owned directly or indirectly by one or more persons who are not individual residents of the contracting state of residence of the entity or nationals of the United States.[20]

Article 16(2) provides certain exceptions from this general rule where the recipient of the income is a US corporation. The limitations do not apply where such a corporation is more than 75 per cent owned by:

- a US corporation which itself receives 20 per cent or more of its gross income from US sources; or
- a non-US corporation which would not be treated as a close company for UK tax purposes by virtue of that section (TA 1988 Section 415). This section generally excludes from the definition of a close company those where at least 35 per cent of the voting power is beneficially held by the public and the shares have been both listed and dealt in on a recognized stock exchange; or
- a UK resident corporation in which more than 50 per cent of the voting power is controlled directly or indirectly by UK resident individuals.

While a United States based LLC is likely to qualify for treaty benefits as described, it is not unlikely that the Inland Revenue will take an active interest in claims by LLCs, particularly in the light of the flexibility given to US taxpayers by the "check-the-box" regulations. Concerns about treaty shopping will mean that cases that are potentially within Article 16 will be particularly carefully examined.

In this regard, it should be noted that there are two application forms for relief under the US–UK treaty dealing with interest and dividends. One for individuals taxpayers and the other for corporations. An LLC would be required to fill in the corporate claim form. In some cases, particularly if more than 25 per cent of the voting power is held by non-US persons, more extensive information may be required in order to succeed with a treaty claim.

It should be noted that if the LLC falls within Article 16 because a part of its capital is owned by non-qualifying non-US persons, the LLC will be completely disqualified from claiming the benefit of the US–UK Treaty (*Steele v. European Vinyls Corp. (Holdings) BV*).[21] There is no possibility of apportionment on the basis of part US ownership of the LLC.

If, in addition, members of an LLC are resident in a third country, they may have difficulty in qualifying for treaty benefits under their own treaties with the United Kingdom. If the LLC is treated as a company, the shareholders will be viewed as separate and distinct persons who will not be shareholders in the UK company paying the dividend. Although in some situations, the Inland Revenue has attempted to argue that the ultimate recipient of interest in a back-to-back financing arrangement is the beneficial owner, it will not look through the structure in order to allow relief at the rate that might be provided in a treaty with third country resident shareholders.

VII. CHARACTERIZATION OF DIVIDENDS FOR FOREIGN TAX CREDIT

The risks in using hybrid instruments in cross-border transactions was illustrated well by the High Court in the recent decision of *Memec Plc v. IRC*.[22] A UK company (Plc) held directly or indirectly through four wholly owned UK subsidiaries the entire share capital of a German resident and incorporated company (GmbH). Plc and the subsidiaries each owned 20 per cent of GmbH's shares. GmbH owned all of the shares of two German resident and incorporated trading subsidiaries. Dividends were paid by the trading subsidiaries to GmbH which paid dividends to its UK shareholders and credit for German tax was given pursuant to the Germany–UK treaty.

19. Art. 11(1).
20. Art. 16(1).
21. [1995] STC 31 (CHD) and [1996] STC 785 (CA).
22. [1996] STC 1336 (ChD).

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On 14 February 1995, GmbH entered into a silent partnership under German law whereby Plc was the silent partner. It made a capital contribution to GmbH and obtained in return a contractual right to payment of 87.84 per cent of the annual profits of the partnership.

Under German law GmbH remained the owner of the business assets and of the income from those assets. Plc as the silent partner had no proprietary interest in the assets. GmbH ran the business. A silent partnership has no separate legal personality under German law.

The question arose as to whether Plc was entitled to credit in respect of the German trade tax (Gewerbesteuer) suffered by the subsidiaries on profits paid by them to GmbH and in whose profits Plc took a share by virtue of the silent partnership agreement. No dispute arose as to the creditability of German corporation tax. Three issues were identified as being relevant to the question.

A. Characterization of the partnership

The first issue revolved around the transparency of the silent partnership. In the Chancery Division Robert Walker J. noted that the formation of the silent partnership provided Plc with a new source of income replacing dividends from GmbH. The dispute was, however, whether the income should be identified as dividends from the trading subsidiary, divisible and distributable after expenses as prescribed by the partnership agreement or should be identified as Plc's contractual right under the partnership agreement to payment of the prescribed share of partnership profit.

After considering the categorization of entities under both foreign and English law he concluded that the arrangement embodied in the silent partnership was not transparent. Transparency, he said, is normally associated with a situation where the ultimate recipient of the underlying income in question has a beneficial interest in it from the start. If the income is not transmuted at some intermediate stage, for example by the need for trustees to exercise a discretion or by its being packaged so as to reach the ultimate recipient in the form of a fixed annuity or other form which is different from the underlying income, then the entity is transparent.

In this case, the silent partnership provided Plc with a new source of income, namely the partnership replacing dividends. Plc therefore did not receive or become entitled to dividends paid by the trading subsidiary. It was only entitled to an amount determined by reference to the dividends rather than the dividends themselves. Consequently it could not qualify directly for treaty relief by way of credit for trade tax paid by the trading subsidiary by virtue of Article XVII (1) (a) and (b) of the UK–Germany Treaty. Consequently the interposition of GmbH and the partnership required analysis.

B. Treaty meaning of "dividend"

The taxpayer argued that Plc ought to be entitled to credit for underlying tax allowed by Article XVIII (1) of the treaty as operated by Section 801 of TA 1988. In considering this the court noted the differences in the systems of corporation tax around the world and the possible ways in which double taxation might be addressed as set out in the commentary to the 1963 OECD draft Convention on which the UK–Germany treaty was based. He also noted that the commentary was written before the United Kingdom introduced corporation tax.

The treaty addresses the question of dividends paid by a German trading company to a UK resident shareholder by giving credit for the 15 per cent withholding tax. Credit for underlying tax suffered by the German company is allowed only if the recipient shareholder is a company controlling 25 per cent of the votes in the German company. This credit would extend to trade tax suffered by the German company itself. It would not permit credit for trade tax suffered by a German subsidiary of the German company paying a dividend to a UK company.

Article VI of the treaty contains a definition of dividends for the purpose of that article (which limits withholding tax on dividends to 15 per cent). The definition includes "income arising from participation in the capital and profits of a company resident in the Federal Republic of Germany and the income derived by a sleeping partner from his participation as such". The taxpayer argued that the definition of dividends in Article VI was for the purpose of that article only and that for the purpose of the relief from double taxation provisions of Article XVIII, reliance should be had on Article II (3) which requires undefined terms to carry the meaning under the domestic law of the contracting state in question.

The taxpayer's position was supported by a decision of the German Federal Tax Court on the Germany–Switzerland treaty and the views of Professor Klaus Vogel. The taxpayer also argued that the extension of the credit was necessary to achieve an elimination of double taxation which was one of the main objectives of the treaty. The Crown argued that given the divergence of tax systems, relief by way of credit cannot be expected to mesh together exactly.

It was held that although perfect symmetry may be unattainable that should not be a reason for rejecting as much symmetry as can reasonably be achieved by the distributive provisions of Article VI and the relieving (tax credit) provisions of Article XVIII of the treaty. Therefore the references to dividends in Article XVIII for credit purposes under the treaty do include distributions of silent partnership profits.

C. The meaning of "dividend" under domestic law

The foreign tax credit provisions of Taxes Act 1988 contain no special definition of "dividend". It was noted that the term originally referred to the dividing up of profits among several people and had different meanings in different circumstances, although generally today it is viewed as a payment out of part of the profit in respect of a share of a company. The statutory provisions dealing with distributions referred only to companies. Although it was noted that the foreign tax credit provisions have to cover a variety of commercial entities which may be relevant to claims for treaty or unilateral relief, the court held that for domestic law purposes the term "dividend" did not include distributions of profits made by a

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silent partnership for the purpose of the foreign tax credit rules. Since the foreign tax credit provisions are made subject to the rules of domestic law the taxpayer had to succeed on the meaning of dividend, both in the treaty and in the domestic foreign tax provisions, which it failed to do.

VIII. LIMITATION OF BENEFITS

The United Kingdom does not adopt a general limitation of benefits article in its treaties. Limitation provisions have appeared in numerous treaties over the years. The current UK position is to seek protection against treaty abuse in respect of dividends, interests and royalties on a systematic basis. This is also extended to the other income article in order to cover payments in respect of new financial instruments. Typically, such provisions now deny the benefit of the specific treaty article if the main purpose or one of the main purposes of any person concerned with the creation or assignments of the rights in respect of which the dividend, interest, royalty or other income is paid is to take advantage of the article by means of that creation or assignment.[23] This is not however the only approach that has been taken.

For example, Article 10(3)(d)(i) of the UK–Netherlands Treaty adopts a look-through test in relation to dividends. Netherlands companies only qualify if they are listed on a Netherlands stock exchange and European requirements for listing are met, particularly relating to the minimum value of shares listed, transferability and dispersion of the shares. This generally means that the shares must be freely negotiable and that at least 25 per cent of the subscribed capital should be in public hands, or a lower percentage if the market will operate properly.

Non-public companies will only qualify if they are not controlled by a person or two or more associated or connected persons who or any of whom would not have been entitled to a tax credit if any of them had been the beneficial owner of the dividends. The provision thus differs from the US treaty in that if it is owned by shareholders in a suitable treaty jurisdiction, treaty benefits may still be available. There are however two important traps in this provision. Firstly, since the test is expressed in the negative, if anywhere in the chain, the Netherlands company is controlled by persons who would not themselves qualify for the tax credit, then benefits under the UK–Netherlands Treaty are unavailable. Secondly, as a result of the extremely broad definition of associated or connected persons, many commercial joint ventures will find that if the joint venture vehicle is a Netherlands company or one which controls the Netherlands company, that treaty benefits may be lost even if one minority participant in the joint venture does not qualify for the tax credit. As a result of the decision in the *Euro Vinyls*[24] case, most typical joint venture shareholders agreements will have this effect.

A further important distinction is that the look-through provisions only apply in relation to dividends. Article 11(6) of the UK–Netherlands Treaty contains an early form of what has now become the standard UK limitation of benefits clause. It prohibits the application of the treaty benefits if the debt claim in respect of which the interest is paid was created or assigned mainly for the purpose of taking advantage of the interest article and not for bona fide commercial reasons. Although the Inland Revenue has not succeeded in applying this type of wording in relation to similar domestic law provisions relating to interest with much success, it may be effective in countering more blatant forms of treaty shopping.

IX. HYBRID ENTITIES AND THE PARENT-SUBSIDIARY DIRECTIVE

The official view in the United Kingdom is that the EC Parent-Subsidiary Directive (90/435) does not apply to affect ACT on dividend payments made by UK subsidiaries of EU parent companies.[25] There are several general observations that may be made on the application of the Directive in this context. Broadly speaking, the Directive prohibits withholding taxes on profit distributions paid by European Union companies to parent companies in other EU Member States.[26] The threshold for ownership in order to qualify as a parent company is 25 per cent of the capital of the subsidiary.[27] In addition, the parent company's state of residence is required to eliminate double taxation fully by adopting an exemption or credit system for underlying tax.[28]

In order to qualify for benefits under the Directive, it is necessary to be a "company of a Member State". There are four requirements in this regard. The entity must:

(i) take one of the forms listed in the annexe to the Directive. In each case, companies must either be in the form of a private company or public company recognized generally for the purposes of European corporate law and, in particular, the First Company Law Directive (68/151), the Second Company Law Directive (77/91) and the Third Company Law Directive (78/855);
(ii) be considered to be resident in a Member State according to the tax laws of that Member State;
(iii) not be treated as resident outside the EU for the purposes of any treaty entered into between a Member State and a third country;
(iv) be subject to corporate income tax imposed by one of the Member States.[29]

There is no particular requirement that the company be resident in or subject to corporate income tax in the country of incorporation as long as it is subject to corporation tax in one Member State. However, it would appear unlikely that a company might qualify as a partnership in one Member State and as a company in another for the purpose of application of the Directive. Despite this, the fact that either a parent company or a subsidiary may be treated as a partnership under the tax laws of a third country, such as the United States, would not itself exclude the application of the Directive.

23. See for example Art. 12 UK–Guyana Treaty.
24. *Steele v. European Vinyls Corp. (Holdings) BV* [1995] STC 31 (CHD) and [1996] STC 785 (CA).
25. Inland Revenue: EC Direct Tax Measures – A Consultative Document 1991.
26. Art. 4.
27. Art. 3(1).
28. Art. 4.
29. Art. 2.

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PORTUGAL

THE TAXATION OF DERIVATIVE FINANCIAL PRODUCTS IN PORTUGAL

Adelaide Passos

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I. INTRODUCTION

Despite the existence of a market for derivative financial products in Portugal, including a regulated exchange (the Oporto Exchange), until very recently there was no specific tax law in Portugal for these products. Instead, these instruments were subject to the general tax principles.

Decree-Law 257-B/96 of 31 December 1996 establishes the income tax regime of financial derivatives, while Decree-Law 85/96 of 29 June 1996 regulates the stamp tax applicable to these instruments. From a VAT point of view no specific legislation has yet been published. Therefore the normal VAT rules still apply to financial derivatives.

In this article we will analyse the income tax regime applicable to financial derivatives as introduced by Decree-Law 257-B/96.

II. INCOME TAXATION

A. The concept of financial derivatives

The tax legislator has opted for not giving a definition of financial derivatives. In the explanatory note introducing the new tax rules for these instruments, it is stated that derivative financial instruments constitute original forms of utilizing classical financial instruments.

In various provisions of the tax law reference is made to swaps, forward exchange agreements, futures and options, which are the most commonly used derivative financial instruments. There is no doubt that these constitute derivative financial instruments for Portuguese tax purposes.

Since in Portugal there is normally a direct relationship between the accounting treatment of a transaction or instrument and its tax treatment we believe that the accounting characterization of a financial derivative should also be relevant for tax purposes. In this regard, Portuguese Accounting Directive No. 17 (hereinafter: Directive 17), applies to futures traded on a regulated exchange and to non-financial institutions. Importantly, Directive 17 describes the attributes of a financial derivative. According to Directive 17 financial instruments display two fundamental characteristics:

- they have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument; and
- their fair value depends on the fair value of the underlying primary financial instrument.

Futures, forwards, options and swaps are given in that Directive 17 as typical examples of financial derivatives.

It is also submitted that the concept of a financial derivative as adopted in the 1995 General Report of the International Fiscal Association on the Tax Aspects of Derivative Financial Instruments might have a persuasive influence for Portuguese tax purposes. Under that definition "a derivative financial instrument is one under which the payment rights and obligations of the parties (and therefore the value of the contract) derive from the value of the underlying cash or physical market (e.g. foreign exchange, securities, commodities) or from particular financial indices or combination of indices".

The main characteristics of derivative financial instruments according to the concept adopted in that General Report are similar to those highlighted above and accepted by Directive 17.

B. Characterization of the gain

Within the context of the Portuguese income tax system the characterization of the income/gain under the Personal Income Tax Code (the IRS Code) determines the tax regime applicable to that income/gain.

In the case of individuals this characterization determines not only whether the income/gain is taxable or exempt but also the allowable deductions and the applicable tax rate.

It is also based on this characterization that the levying of a withholding tax is made and the appropriate rate determined. The withholding of tax on gains on derivatives is particularly important for the following reasons.

If the recipient is a non-resident, other than a foreign resident company with a permanent establishment in Portugal, the levying of a withholding tax will determine whether the non-resident has a liability for Portuguese taxation and, if so, it normally limits that liability to a flat rate on the gross amount

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received without the non-resident having any further obligation to submit an annual income tax return.

For resident individuals because they may either only pay the withholding tax on the gross income/gain received or opt to also disclose that income/gain in their annual income tax return and pay tax at normal progressive tax rates. In this latter case the withholding tax will be considered to be a payment on account of the final income tax due. Under this regime specified deductions may then be allowed in the calculation of the taxable income.

For resident corporate taxpayers or Portuguese permanent establishments of foreign companies, although the withholding tax is considered as an advance payment on account of the final tax due[1] the cash-flow impact that the withholding normally has may be very significant.

Prior to the enactment of Decree-Law 257-B/96 no specific reference was made in the IRS Code to the nature or classification of the income/gains arising on financial derivatives. These are now classified under one of three categories of income as follows:

- income from commercial or industrial activities;[2]
- income from farming;[3] or
- investment income.[4]

The gain arising on the following types of financial derivatives is deemed to constitute investment income:

- currency swaps;
- interest rate swaps;
- combined currency and interest rate swaps; and
- forward exchange agreements that hedge the risk of and are linked to an underlying asset or liability namely a bank deposit or securities.

The gain on financial derivatives, other than on the derivatives referred to above, will be classified as farming income provided the taxpayer carries on farming activities and the gain is attributable to those activities.

In all other cases the gain arising on financial derivatives is classified as commercial or industrial income.

C. Substance over form

The new legislation empowers the tax authorities to disregard the form in terms of which an operation/transaction (including a series of operations/transactions) has been undertaken if that form differs from the substance (presumably the commercial substance) of the operation/transaction and to tax the transaction/operation in accordance with its substance.

A point to stress is that only with respect to transactions which are either presented in the form of a financial derivative instrument not being in substance so, or vice versa, can the authorities reclassify and tax the respective gain/income in accordance with the commercial substance of the transaction.

This is a new measure within the Portuguese tax system since the legal form of a transaction or series of transactions is in general accepted even if in some instances the substance might indicate a different objective.

The scope of this principle appears to be wider in the case of corporate taxpayers than for individuals, where the reclassification of a gain seems to be limited to gains on instruments deemed to give rise to investment income (see above). In general, it should also only be with respect to instruments deemed to give rise to gains characterized as investment income that tax avoidance may occur in the case of individuals.

III. TAXATION OF INDIVIDUALS

A. Investment income

When the gain is deemed to constitute investment income, the amount taxable is calculated as follows:

- currency swaps or forward exchange agreements – as the positive difference between the agreed exchange rate for the future sale/purchase and the market rate of exchange on the date the contract is concluded for the same pair of currencies;
- interest rate swaps or combined currency and interest rate swaps – as the positive difference between the two rates and, in addition in the case of the currency-interest rate swaps, the exchange gain on the amounts swapped.

One therefore must assume that in a normal swap of currencies where the initial exchange and future re-exchange are at the same exchange rates there will be no gain for accounting purposes and therefore similarly no gain for tax purposes.

Another inference from the above rules is that it is the net payment to pass between the two (swap) parties that represents the gain subject to the withholding tax. Problems may however arise if instead of a net payment there is a flow each way on a gross basis at different times. Although the gain subject to withholding tax still appears to be the net amount between those two payments, difficulties may arise as to determining the date the tax withheld should be paid to the tax authorities (see below).

If the swap or forward exchange agreement has been assigned or cancelled, the taxable amount is in principle the amount, if any, paid for the assignment or cancellation of the operation. The limitations referred to below when dealing with corporate taxpayers on the taxation of payments made in respect of the assignment or cancellation of these instruments apply with the necessary adaptations to individuals.

The gross taxable income calculated in terms of the above rules is subject to a withholding tax of 20 per cent with the entity making the payment being obliged to withhold the tax. The events triggering the liability for withholding tax are therefore:

1. A refund will be given if no or a lower corporate tax is due.
2. Art. 4 (2) (g) – category C.
3. Art. 5 (2) – category D.
4. Art. 6 (1) (p) – category E).

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- when the interest becomes due and payable during the life of the instrument; or
- at the settlement date of the instrument or the date of its assignment/cancellation.

The individual taxpayer, being a resident, has the option of including that income in his annual income tax return and pay tax at normal progressive rates up to 40 per cent. In general, the rate applicable to the individual's total taxable income (including the gain on the above derivatives) will be higher than the 20 per cent withholding tax. Hence, in most instances, individuals should opt against including the gain on these derivatives in their annual income tax returns.[5]

Where the individual is a non-resident the withholding tax is always a final tax. (See below for a discussion of the impact of Portuguese double tax treaties on the withholding tax).

B. Farming income and commercial or industrial income

As stated above, if the individual carries on farming activities and the gain on the derivatives is attributable to those activities it will be classified as farming income.

If the gain on the derivatives is not deemed to be investment income and it does not constitute farming income, it will be classified as commercial or industrial income. At first sight it might then seem not to matter whether or not the taxpayer carries on any commercial or industrial activity, since the income in any event will be classified as commercial or industrial income. Nevertheless the distinction is relevant in view of the fact that the corporate tax rules will apply in calculating the quantum and timing of the gain (see below) if the gain is attributable to a commercial or industrial activity carried on by the individual. The same corporate tax rules will also apply in the case of the gain being qualified as farming income.

Where the individual does not carry on a commercial or industrial activity or the gain is not attributable to that activity, he will have to disclose for tax purposes only a realized gain/loss. It is submitted that in calculating that gain he is entitled to deduct the costs directly incurred in connection with the instrument such as commissions paid. He may offset against the gains realized in a year the losses incurred in the same year on the derivatives and be taxed on the net gain. If a net loss is realized he is entitled to carry it forward for a period of five years but can only offset it against gains on derivatives realized in future years and not against other types of income or gains.

The tax law does not establish any rules for attributing the gain/loss to the commercial, industrial or farming activity carried on by the taxpayer. This question will have to be resolved on the basis of the relevant facts and circumstances. In this context it will be necessary to prove the existence of a close connection between the derivatives in question and the particular activity carried on by the taxpayer.

It is submitted that even when the individual derives gains which are classified as investment income (see above), if these are attributable to a farming, commercial or industrial activity they should be added to those types of income and taxed accordingly. The withholding tax suffered on those gains would then be considered as a payment on account of the final tax due.

A final point to note is that it might be possible that the number, frequency and size of the transactions in derivatives undertaken by the individual may indicate that the individual is carrying on a trade in these instruments.

C. Tax benefits

Until the year 2001 (inclusive), the net gains on futures, options on shares, and indices on shares, traded on a regulated exchange are taxed at a final and top rate of 10 per cent.

The net gains on other futures and options traded on a regulated exchange are taxable according to the following schedule:

Tax Year	Percentage of the Gain Taxable
1997	50%
1998	60%
1999	70%
2000	80%
2001	90%

In the same way, up to the year 2001, a loss incurred on these instruments is only allowed as a current deduction to the extent of the above yearly percentages. The balance of the loss, not allowed as a current deduction, may be carried forward for a period of five years but again, up to the year 2001, it can only be set off against future taxable gains at the percentage which, in accordance with the above table, is applicable to the year in which the loss will be used. For example, if in 1997 the individual realizes a net loss of 1,000 on these instruments and in the year 1999 a gain, he may set off against that gain a tax loss carried forward of 850 calculated as follows:

Loss deductible in 1997	– 50% of 1,000	500
Plus Balance of the loss deductible in terms of the percentage applicable for the year it will be used	– 70% of 500	350
Total loss deductible in 1999		850

As mentioned before, if the individual does not carry on a farming, commercial or industrial activity to which a loss incurred for the year on these instruments can be attributed, he will be entitled to carry forward the loss for a period of five years and set it off against a gain incurred on the same type of instruments. The calculation of the loss deductible for the year in question follows the above rules.

If, on the other hand, the loss is attributable to a farming, commercial or industrial activity carried on by the individual, that loss will be allowed as a current deduction against

5. I.e. since then they only suffer the 20 per cent withholding tax.

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income generated from that activity but, up to the year 2001, only to the extent of the percentages set out above. It further appears that if the individual cannot currently deduct that net loss against his farming, commercial or industrial income he may carry it forward but can only offset it against a future net gain realized on the same category of instruments, subject to the limits imposed by the above table for the year in which the loss will thus be used.[6] This regime is only applicable up to the year 2001 inclusive.

The wording of the above provisions do not specifically limit the tax benefits to instruments traded only on a Portuguese regulated exchange. However, in the explanation to the legislation introducing these tax benefits, it is stated that these benefits are granted due to the need to develop Portugal's regulated exchange.

It is therefore probable that in practice the authorities may try to restrict those benefits to qualifying instruments traded on the Portuguese regulated market. In the view of the writer this position, if taken by the Portuguese tax authorities, cannot be justified by the wording of the legislation.

IV. THE TAXATION OF COMPANIES

A. Introduction

A company's taxable profit is calculated on the basis of its accounting profit adjusted for tax purposes.

As mentioned above, there is a directive (Directive 17) which applies to the accounting treatment of futures traded on a regulated exchange. This directive closely follows the accounting principles laid down by International Accounting Standard (IAS) 32, Financial Instruments: Disclosure and Presentation of June 1995 and Exposure Draft (ED) 48 – Financial Instruments of January 1994. In the absence of other Portuguese accounting directives on derivative financial instruments the accounting principles of the International Accounting Standards Committee will apply to areas not covered by Directive 17.

In the case of credit and financial institutions Instruction No. 109/96 of the Bank of Portugal should be relevant.

Decree-Law 257-B/96 establishes specific tax rules as to the way the gain/loss on derivatives should be calculated for tax purposes, and the timing of the recognition of that gain/loss. Additionally, it grants specific tax benefits on the taxation of derivatives.

In taxing financial derivatives the Portuguese tax law distinguishes between instruments traded on a regulated exchange from over-the-counter (OTC) derivatives. The tax law further acknowledges the use of derivatives in hedging transactions by allowing a deferral of the taxation of gains on hedging instruments. However, for these purposes only a narrow economic concept of hedging is accepted. Amongst others, insurance companies, banks and financing companies are denied the right to the tax treatment of derivatives as hedging instruments.

In the case of symmetrical positions the loss on one of the positions may only be deductible to the extent that it exceeds the untaxed gain on the other position (see below).

B. Valuation of open contracts

The basic rule is that derivatives that are traded on a regulated exchange market must be valued at the year end on a mark-to-market basis. The related unrealized gain or loss will either be taxable or deductible.

The gain/loss on OTC financial derivatives is taxable or deductible in the year the contract matures unless a gain has been realized or a loss has been incurred in relation to the instrument in a previous year.

C. Hedging

Where a derivative traded on a regulated market provides a hedge against a risk which can arise in the following year on another type of transaction to be concluded in a different market and subject to a different valuation system, the taxation of the gain is postponed until the hedge operation is unwound. Unrealized losses, however, continue to be deductible on a current year basis.

The conditions for the deferral of the taxation of the gain on the derivative operation that has been entered into as a hedge against the risk on an underlying transaction are as follows:

- the derivative operation must be designed to effectively eliminate or reduce the real risk arising on an underlying transaction;
- there should exist a firm commitment in relation to the underlying transaction;[7]
- that underlying transaction must be of a different nature from the derivative operation i.e. it should belong to a different market and be subject to a different valuation method;
- an economic relationship should exist and there should be a high correlation between the asset/liability being covered and the hedging transaction (or derivative operation);[8] and finally
- after taking into consideration the above correlation, the value of the derivative operation must not exceed the value considered necessary to cover the risk of the underlying transaction.

If at any time one of the above conditions is not met the tax treatment of the operation as a hedge is no longer applicable. Moreover, if the taxation of the gain on the derivative instrument has been postponed on the basis that the instrument

6. In this way, the individual will be allowed a higher relief for the loss (the relief partly calculated in terms of the percentage applicable for the year the loss will be used) but he is restricted to the type of profits against which that loss carried forward is offsetable.
7. This includes a future commitment on an underlying transaction undertaken in prior years but which has not yet been finalized or an underlying transaction on which the probability of being concluded in the following year is high.
8. I.e. one should expect that the gains on the hedging transaction will cover the possible losses on the underlying transaction.

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hedges a qualifying underlying transaction and this transaction is not completed within the prescribed period, the gain will be taxed in the year that it should have been taxed if it was not for the tax hedging treatment. Under these circumstances, the taxpayer will have to pay compensatory interest on the tax that should have been paid if it was not for the tax hedging treatment.

If the taxpayer has an assessed loss, that loss will be adjusted accordingly and there will be no liability to compensatory interest. The present rate of compensatory interest is 12 per cent. Compensatory interest is not tax deductible.

The law deems the following operations to be excluded from being treated as part of a hedging operation:

- those intended to cover risks of third parties or establishments of the entity taking the cover which are taxed under a different regime;
- those entered into by investment funds, funds of funds, venture capital funds, pension funds, insurance companies, credit and financial institutions; and
- those not identified by the taxpayer as hedging operations in the respective tax form.

D. Symmetrical positions

Where the company holds symmetrical positions, other than in the context of a hedge, the loss (whether realized or unrealized) on one of these positions can be deducted from taxable profits only to the extent it exceeds the untaxed gain on the other position and provided the taxpayer has completed a specific tax form disclosing the symmetrical positions and filed it with its annual income tax return.

Position is defined as the direct or indirect holding of financial derivatives, securities, foreign currencies, negotiable debt instruments, loans or a commitment relating to these instruments.

Positions are deemed symmetrical when their values or their yield are closely correlated in such a way that the risk of value or yield variation pertaining to one position is compensated by the other position. In this context, it is not necessary that the positions in question be of the same nature or traded on the same market place nor have the same term.

Investment funds, funds of funds, venture capital funds, pension funds, insurance companies and credit and financial institutions are specifically excluded from this regime.[9]

E. Cancellation and assignment of swaps and forward exchange agreements

If a swap or a forward exchange agreement is assigned or cancelled with payment or receipt of settlement values the following applies:

- the amounts due are considered as profit or loss in the tax year in which the contract has been cancelled; and
- the amounts deductible are limited to the lower of the following:
  - (i) the settlement payments or termination payments made in accordance with the original contract; or
  - (ii) the market value of operations bearing the same characteristics of the operations assigned or cancelled and namely with a term equal to the remaining term of the operation assigned or cancelled.

In the same way, the cost of acquisition of a position in an existing swap contract is only acceptable for tax purposes if it does not exceed the following:

- the settlement or termination payments as included in the original contract; or
- the arm's length price for a similar operation covering the remaining period. The parties to the contract must prove that an arm's length price was used.

Fees paid to intermediaries for arranging swaps are generally taxable receipts in the hands of the intermediaries and allowable expenditure for the payer.

F. Tax benefits – futures and options

The net profit on futures and options traded on a regulated exchange which do not constitute a tax hedge is taxable up to the following percentages:

Tax year	Taxable percentage
1997	50%
1998	60%
1999	70%
2000	80%
2001	90%

The current year deductibility of a net loss on those instruments will similarly be restricted by reference to those annual percentages. The balance of the non-deductible loss may be carried forward and, up to the year 2001, it may be set off against the net taxable profit arising on the same type of instruments. However, the set off is restricted to the percentage applicable for the year in which the loss will be used (see table above).

For example if in 1998 the company realized a net loss on these instruments of 6000, the amount of that loss that could be carried forward and used in 1999 is as follows:

Loss deductible in 1998	– 60% of 6000	3,600
Plus Balance of the loss deductible in 1999	– 70% of 2,400	1,680
Total loss deductible in 1999		5,280

Since the taxpayer enjoys a partial exemption on the taxation of these gains, in terms of the general corporate tax rules, the net loss carried forward attributable to these gains cannot be offset against profits from the taxpayer's normal trading activity. Given that no tax benefits will apply to these instruments as from the year 2002 onwards, the net loss brought

9. These entities cannot therefore recognize for tax purposes symmetrical positions with the loss on one position being deductible only to the extent that it exceeds the untaxed gain on the other.

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forward on these instruments should from that date be fully allowable as a set-off against other trading income.

For the reasons referred to above when dealing with the taxation of individuals, the tax authorities are likely to restrict in practice the tax benefits to instruments traded on a national regulated exchange. Again, if the authorities take this position, in the view of the writer, their interpretation cannot be justified in terms of the wording of the relevant legislation.

G. Withholding tax

Where the gain is characterized as investment income it will be subject to a 20 per cent withholding tax. For the characterization of the gains as investment income and the calculation of the amount subject to withholding tax etc. please refer to the taxation of individuals above.

The withholding tax will be allowed as a credit against the final corporate tax due. If no corporate tax is due the withholding tax will be refunded within three months after the date on which the company submitted its income tax return provided it did so within the prescribed time limits.

There is a dispensation from withholding tax on gains classified as investment income paid to financial institutions subject to Portuguese corporate taxation (e.g. Portuguese banks or Portuguese branches of foreign banks).

V. THE TAXATION OF INVESTMENT FUNDS

A. General rule

Income obtained by investment funds or venture capital funds, constituted under Portuguese law, other than on swaps or other instruments the income of which is deemed to constitute investment income, is taxable at a flat rate of 25 per cent computed on the net income of each period.

These funds are however subject to a 20 per cent withholding tax, which constitutes a final tax, on gains on derivatives characterized as investment income (see the characterization rules above).

B. Tax benefits

Portuguese investment funds or venture capital funds also enjoy a reduced 10 per cent flat rate on gains realized on futures, options on shares and indices on shares traded on a regulated market.

Investment funds are also entitled to the same percentage reduction on the taxation of their net gains arising from other futures and options traded on a regulated exchange as well as to the same rules for the carry-forward of a loss on those instruments as individuals (see above).

As discussed above in all likelihood the benefits will be restricted to instruments traded on a Portuguese regulated exchange.

C. Hedging – symmetrical positions

Investment funds and venture capital funds are not entitled to either the tax hedging treatment or to the tax regime applicable to symmetrical positions.

VI. THE TAXATION OF NON-RESIDENTS

A. Withholding tax

Non-residents (excluding foreign companies with a Portuguese permanent establishment to which these gains are attributable) are subject to a 20 per cent withholding tax on gains paid by Portuguese residents and characterized as investment income. See above for the list of derivative financial instruments the gains on which are deemed to constitute investment income.

In the case of swaps the amount subject to the withholding tax is the net payment to pass between the two swap counterparties. Please refer above for a more detailed analysis of the gain taxable as well as the events triggering the liability to withhold the tax.

B. Non-resident financial institutions

Gains arising from swaps made by non-resident financial institutions with credit institutions headquartered in Portugal are exempt from taxation in Portugal.

C. Double tax treaties

The Portuguese double tax treaties in general closely follow the wording of the OECD Model Tax Convention applicable at the date that the treaty was negotiated.

The term interest is generally defined in Portuguese double tax treaties as income from debt-claims of any kind. The fact that the debt-claim carries a right to participate in profits or is secured by mortgage does not change the interest nature of the related income. In general, in Portuguese tax treaties the definition of interest is further extended to cover "other income assimilated to income from money lent by the taxation law of the state in which the income arises". Under normal circumstances payments made under derivative financial instruments do not arise from a debt-claim. Although in some instances a currency or interest rate swap or a forward exchange contract may have as an underlying transaction a debt-claim, those derivatives are nevertheless a legally independent and separate transaction from the underlying debt-claim. The fact that under Portuguese domestic legislation gains on currency and interest rate swaps and under certain circumstances forward exchange agreements are, like interest, classified as investment income and subject to the same withholding tax rate of 20 per cent in itself does not mean that those gains are assimilated to interest for treaty purposes.

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Accordingly, in principle, these gains cannot be included in the definition of interest for treaty purposes but instead should be classified as either "business profits" or as "other income". If characterized as business profits the non-resident will be exempt from withholding tax unless the gains are attributable to a local permanent establishment. In most treaties concluded by Portugal an exemption from withholding tax will also be achieved by the non-resident under the "other income" provision as the right to tax this income is normally allocated exclusively to the state of residence. Some of the treaties, e.g. those with Germany, France and Finland make that exclusive allocation to the state of residence of the right to tax that income dependent on the fact that the income is taxable in the country of residence. In particular, the treaties with Brazil and the United States allocate to both States the right to tax "other income".

Finally it should be remembered that the Portuguese domestic tax legislation includes provisions empowering the tax authorities to tax these transactions in terms of their substance as opposed to their form. Thus, it may be possible that where the contracts in question constitute disguised loans, the related gains may then be reclassified as interest. Under these circumstances, though Portugal may levy a withholding tax on those gains, it will, on the other hand, be obliged to reduce the rate of that withholding tax according to the interest clause of the respective treaty.

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CANADA

TAX PLANNING FOR IMMIGRATION TO CANADA

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I. INTRODUCTION

Canada's political stability and economy together with its business immigration programme, have made it a logical choice for people who wish to emigrate from Hong Kong, South Africa and other jurisdictions. Many US executives are temporarily relocated to Canada by multinational employers.

This article deals with the special considerations for a US executive who is transferred to Canada for three years as well as planning for US citizens immigrating to Canada who wish to give up their US citizenship. It also deals with tax strategies for others planning to immigrate to Canada.

In particular, the article focuses on the Canadian tax implications where a person, who is not resident in Canada, forms a trust outside Canada for the benefit of his spouse and children. An immigration trust can provide significant tax savings and the trust and the beneficiaries will not be subject to Canadian tax on income or capital gains earned or realized outside Canada for the first five years of Canadian residency and possibly longer.

II. RESIDENCY

A resident of Canada is subject to Canadian income tax on worldwide income. A person will become a resident of Canada at such time as the person moves to Canada with the intention of residing in Canada. A person who spends more than 182 days in a year in Canada is deemed to be resident in Canada. The precise date of becoming a resident may depend on the date the person becomes a landed immigrant, moves to Canada with his or her family or commences employment in Canada. A person earning employment income will require a social insurance number. For the year of immigration, the immigrant will be taxable in Canada on Canadian source income received before immigration and on worldwide income earned after the date of immigration. The first tax return of the new immigrant must be filed by 30 April following the year of arrival. Personal exemptions will have to be prorated based on the time spent in Canada.

III. DRAFT FOREIGN REPORTING REQUIREMENTS

On 5 March 1996, Finance Minister Paul Martin and Revenue Minister Jane Stewart jointly released draft legislation to implement the new foreign reporting requirements announced in the 27 February 1995 Budget. Also released were draft information returns that will be required to be filed under these new rules in 1998. The 5 December 1996 Notice of Ways and Means motion proposed changes to the foreign reporting rules. Individuals will not be required to file foreign property information returns for the year in which they first became resident in Canada.

The annual reporting requirements are intended to discourage Canadians from attempting to hide assets offshore in foreign trusts or foreign corporations or in foreign investments (e.g. bank accounts, stocks, etc.). The reporting requirements will provide Revenue Canada with an opportunity to audit additional offshore transactions with a view to either challenging them based on deficiencies in their structure or, alternatively, to recommend that changes in the legislation be made in order to curb abuses. In order to ensure compliance, significant penalties are proposed for any violations of the new reporting requirements. Among other things, the new reporting requirements will have the following effects:

- Taxpayers with interests in foreign property such as shares, bank accounts, real property (other than personal-use property) in excess of CAD 100,000 will be required to report and provide details of such holdings.
- Taxpayers with foreign affiliates will have to provide additional financial and tax information with respect to each controlled foreign affiliate.
- Beneficiaries of certain non-resident trusts will have to file an information return for the year in which they receive a distribution or a loan from the trust.
- Persons who have transferred or loaned property to a non-resident trust will be required to file an annual information return in respect of the trust.

Failure to comply with these requirements will result in substantial penalties.

IV. US CITIZENS IMMIGRATING TO CANADA[1]

There are special Canadian and US tax considerations for US citizens immigrating to Canada. It is assumed that the individual would be deemed to be resident in Canada under the tie breaker clause of the Canada–US treaty. As a US citizen

1. I wish to thank James Croker of the Washington office of Alston & Bird, LLP for reviewing my comments on the US tax implications.

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the person will be required to continue to file US tax returns. If the US citizen owns shares of US private companies, the shares would be deemed to be acquired for Canadian tax purposes at fair market value.

For US purposes, the personal holding company, foreign personal holding company, personal foreign investment company and Subpart F rules would continue to apply. In order to avoid the negative impact of these provisions, the US citizen may wish to ensure that all investment income is annually distributed.

In addition, the Canadian foreign accrual property income rules would operate to attribute undistributed foreign passive income earned in an offshore (non-Canadian) corporation or trust to the US citizen – Canadian resident. Although other immigrants to Canada can legitimately use offshore trusts to avoid Canadian tax on income earned by the trust for a period of five years (see the discussion on immigration trusts below), a US citizen would be required to continue to report the income of the offshore trust for US tax purposes.

Some US citizens apply for residency in a Caribbean country prior to immigrating to Canada and settle a trust in a tax haven. After moving to Canada they give up their US citizenship in order to avoid US tax on the accumulation in the offshore trust. They may become Canadian landed immigrants and ultimately Canadian citizens. Canada taxes based on residency and not citizenship. This strategy may enable the immigrant not only to benefit from the five-year tax holiday afforded by an immigration trust but also to subsequently leave Canada and move to a tax haven without continuing to be subject to Canadian or US tax except in respect of Canadian and US-source income. Section 877 of the Internal Revenue Code would have to be considered as it may create a lingering (ten year) liability for US tax on certain income. Measures have been passed in the United States to restrict the ability of individuals to return to the United States if they renounce their citizenship for tax avoidance purposes.

To the extent that a US citizen must file both Canadian and US tax returns, the individual will be subject to the higher tax of the two jurisdictions. Attempts to shelter income are often frustrated as the result of the different deductions which may be claimed on each return. Investments which are based on favourable provisions of the Income Tax Act may be of no or little benefit to a US citizen as the deductions may not be available on the US return.

Some relief is available for earned income. A US citizen may claim the foreign earned income exclusion and not be subject to US tax on USD 80,000 of earned income subject to satisfying all of the qualifications.

Foreign tax credits should provide some relief against double taxation. However, a foreign tax credit for Canadian tax may not generally be claimed in excess of the US tax that would have been payable on the income. As a result the higher tax rate of the two jurisdictions will apply.

Canada will not recognize contributions to an IRA (a US pension) and the United States will not allow deductions to a registered retirement savings plan (RRSP) in Canada. A deferral of US tax on the investment income earned in an RRSP may be available in the United States by virtue of Article XVIII, paragraph 7 of the Canada–US Tax Convention. Under the foreign retirement arrangement provision in paragraph 81(1)(r) of the Income Tax Act earnings accumulating in an IRA are not taxable in Canada.

In Canada, each individual files a separate tax return. There are personal tax credits available including a marital credit. There are no joint returns.

Canada does not impose a gift tax or an estate tax. Gifts to family members are deemed to occur at fair market value. There is a deemed disposition at fair market value for Canadian tax purposes the instant before death of depreciable and non-depreciable capital property and land inventory except to the extent that the property is bequeathed to a spouse or to an exclusive spouse trust in which case there is a roll-over. Although Canada does not impose a gift tax, a US citizen resident in Canada would be subject to US gift tax.

Canada has income attribution rules which operate to tax the transferor who transfers property to a spouse or minor child or to a trust for such a person. The transferor is taxable on all capital gains realized by a spouse and on any income earned on the transferred property or substituted property by a spouse or by a minor child.[2] This would include income or capital gains realized on assets transferred to family members prior to immigration.

A US citizen who resides in Canada may benefit from a CAD 500,000 Canadian capital gains exemption on the disposition of shares of a qualified small business corporation or a qualified farm. However, the capital gains exemption would not be recognized for US tax purposes.

If the US citizen wishes to invest in a Canadian venture, US entities such as an S corporation or a limited liability corporation (LLC) should generally not be used. There is a risk of double tax as payments from Canada to a US entity would be subject to Canadian withholding tax. Canada would treat the S Corporation or LLC as a corporation for Canadian tax purposes. The Canadian resident would be fully taxable on all distribution from an S Corporation or from an LLC. It should be noted that Canada does not provide treaty relief to an LLC as an LLC is not liable to tax in the United States. In other words, Canadian withholding tax at the rate of 25 per cent will apply to passive income paid to an LLC (e.g. dividends, rent, royalties, interest or management fees). A compromise may be to use a Nova Scotia unlimited liability corporation which qualifies as a hybrid entity (i.e. as a flow through entity) for US purposes and a corporation for Canadian purposes. However, a Canadian resident US citizen would not receive a foreign tax credit in Canada for any undistributed income of the Nova Scotia company which is taxable for US purposes.

Canada has a principal residence exemption. Canadian residents may not deduct the interest relating to the purchase of a residence but are not taxable on the profit on resale. A US citizen will be subject to the US replacement property rule or the proposed USD 500,000 US exemption on the sale of a

2. I.e. a child under age 18.

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residence. For US purposes, the interest pertaining to the Canadian residence, may be deducted within prescribed limits.

For an employee who is relocated to Canada, the treatment of employee benefits will be of concern. Canada does not allow the deduction by an individual of moving expenses from a location outside Canada to Canada. The treatment of employee stock options and other benefit plans will be different in Canada than in the United States. Canada will tax payments to an employee made in order to cover part of the cost of acquiring a home but may not tax payments made to cover the loss on the disposition of a former residence.

If a person resident in Canada subsequently moves back to the United States or to another country, Canada has a departure tax. Basically there is a deemed disposition of all assets other than Canadian real estate, inventory used in a Canadian business, employee stock options and rights to pension income. Some relief is available to a person who leaves Canada within five years of immigrating. The exemption is for an individual who resides in Canada for less than 60 months during the ten years prior to departure. Gifts and bequests of assets made during the five years are exempt from departure tax. As a result of the step-up of the cost of assets, other than taxable Canadian property, on immigration, it is only the gain after immigration which will be subject to Canadian departure tax if the individual leaves within five years. It is also proposed that an individual who departs Canada owning assets in excess of CAD 25,000 file a list of assets with Revenue Canada.

V. IMMIGRATION TRUSTS

Generally, Canada has rules known as the foreign accrual property income rules which would tax a resident of Canada on undistributed passive income of a non-resident trust or corporation in which he is a beneficiary or shareholder as the case may be. However, it is possible for an individual, who is planning to immigrate to Canada to form a discretionary trust, resident outside Canada, for his family, in order to have the trust earn income and capital gains free of Canadian tax for a period of five years. More aggressive structures are possible which would permit an extension of the five-year period. The general anti-avoidance rule would have to be considered. Significant assets would be required to merit this type of planning. US citizens should be cautious as they would continue to be taxed in the United States on the income earned by the trust unless and until US citizenship is renounced.

It is also possible for relatives residing outside Canada and who have not previously resided in Canada for 60 months to settle trusts outside Canada, for the benefit of Canadian residents which could provide the Canadian beneficiaries with tax free income beyond five years.

Care must be exercised in selecting a settlor of the trust. If a US citizen is a settlor, the US grantor trust rules may apply. Australia has complicated international rules which would tax the settlor. In the United Kingdom, a UK settlor would have to be concerned about UK gift and inheritance tax.

The Canadian case of *Thibodeau Family Trust v. The Queen*, (F.C.T.D.) 78 DTC 6376, in which a Canadian resident was one of three trustees, established that a trust would not be resident in Canada where the majority of the trustees were not resident in Canada, the trust deed establishing the trust required decisions to be made by a majority of the trustees, the trust property was located outside Canada and the trust was administered outside Canada.

The court rejected the argument that the residency of a trust should be determined based on central management and control. As a result of this decision, it is generally accepted that the residency of a trust is determined by the residency of the majority of trustees. It has been suggested that a more appropriate test would be the place where the trust is administered. In Interpretation Bulletin IT-447 Revenue Canada confirms that a trust will generally be resident where the trustee who manages the trust or controls the trust assets resides. Revenue Canada does caution that the residency of the settlor or the beneficiaries may be determinative of the residence of the trust where these persons exercise a substantial portion of the management or control (Interpretation Bulletin IT-447, paragraph 5).

In summary, the majority of trustees should all be resident outside Canada and no person resident in Canada should have the authority to control the trust.

A. Five-year tax exemption

The beneficiaries would not be taxable on the undistributed income of the non-resident trust until all of the following conditions are satisfied:

(a) in any taxation year a person beneficially interested (i.e. a present or contingent income or capital beneficiary) in the trust was a person resident in Canada,[3] was a non-arm's length corporation or trust of such person or a foreign corporation controlled by the individual and up to four other Canadian residents or controlled by the individual and related parties; and

(b) the trust or a non-resident corporation, that would be a controlled foreign affiliate[4] of the trust if the trust were resident in Canada has acquired property directly or indirectly[5] from a resident beneficiary or person related to a beneficiary or the uncle, aunt, niece or nephew of the beneficiary who is resident in Canada at any time during the 18-month period before the end of the current taxation year of the trust and (in the case of an individual), was resident in Canada for a period or periods totalling more than 60 months (subparagraph 94(1)(b)(I) and Section 94(6)).

3. Subpara. 94(1)(a)(I).
4. I.e. a corporation controlled by the taxpayer and not more than four other persons resident in Canada or a related group of which the taxpayer was a member.
5. This includes the provision of financial assistance such as a back to back loan.

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It is this last requirement which created the opportunity for the five-year holiday. It is a cumulative test and would include any time an individual was previously resident in Canada.

A beneficiary would include any person who has an immediate or future, absolute or contingent right to income or capital of the trust (Section 248(25)). Section 94 also applies where the beneficiary acquired his interest by way of purchase, gift or power of appointment by a person resident in Canada who is related to the beneficiary or is the uncle, aunt, niece or nephew of the beneficiary.

If, for example, an inter-vivos (or testamentary) trust is settled by a parent, who continues to reside outside Canada, in favour of children who are immigrating to or who are residents of Canada, then the exemption from Canadian tax would continue indefinitely provided the parent does not reside in Canada. If the settlor immigrates to Canada, then the tax exemption would be limited to five years. If the settlor previously resided in Canada and then returns to Canada, the prior period of residency in Canada would be counted in the five-year calculation. The settlor must also have been resident in Canada in the previous 18 months.

If the amount of income or capital to be distributed depends on the discretion of any person, the trust would be a discretionary trust. If the trustees only have discretion as to the timing of distributions, the trust would be non-discretionary. Once the other requirements noted above are met (e.g. once the settlor has resided in Canada for five years), a discretionary trust would be deemed to be resident in Canada for purposes of Part I of the Act and would be taxable on its taxable income earned in Canada and its foreign accrual property income. It is not subject to tax on active business income earned outside Canada directly or in a corporation owned by the trust. The beneficiaries are jointly and severally liable for the tax.

If the trust is non-discretionary, the trust is deemed to be a non-resident corporation for any beneficiary having at least a 10 per cent interest. The beneficiaries would then be taxable on the foreign accrual property income of the trust (i.e. the foreign income other than active business income).

Such trusts would typically provide that the income is to accumulate and that distributions of capital only are to be made during the period of the tax exemption. As the trust would likely be resident in a no-tax or low-tax jurisdiction, there would be little or no tax on current income. The accumulating income would be added to capital which would be available for a tax-free distribution to the Canadian beneficiaries in a subsequent taxation year (paragraph 12(1)(m) would not apply to tax the beneficiaries on accumulating income). Subparagraph 104(13)(c)(ii) excludes capital distributions from a beneficiary's income. As the beneficiaries would not be required to purchase their interest in the trust, the trust should qualify as a personal trust. As a result, the provisions of paragraph 104(13)(c), which requires the inclusion in income of an amount payable in the year by a trust to a beneficiary, would not apply.

B. Attribution

One of the concerns in structuring such trusts is to ensure that Section 75(2) of the Act would not apply to attribute the income to the Canadian resident prior to the expiry of the five-year tax exemption. This rule may apply to a non-resident trust. Section 75(2) applies where the trust property may revert to the settlor or where the settlor may determine to whom the property is to be distributed (e.g. by power of appointment). Where applicable, the settlor will be required to report in Canada all income or taxable capital gains from the property while he is resident in Canada (i.e. the five-year tax exemption would not apply).

Revenue Canada has confirmed that a genuine loan or a bona fide sale of an income producing property would not constitute a reversion for the purposes of Section 75(2) (see Revenue Canada Roundtable, Report of proceedings of the 38th Tax Conference, 1986 Conference Report, Question 46, page 51:24). If funds were loaned to the trust, there is also an argument that Section 75(2) would apply only to income earned on the property settled on the trust and not to income earned on funds borrowed by the trust.

In 1986, Revenue Canada confirmed that the fact that the settlor is also a beneficiary of the discretionary trust will not trigger Section 75(2) provided he alone does not control the exercise of the discretion. The distribution of the settled property to the settlor in his capacity as a capital beneficiary may not result in triggering Section 75(2). In 1989, however, Revenue Canada cautioned against any transfer of property by a beneficiary to the trust. For this reason, the settlor must not be a beneficiary of the trust. This will be most problematic where the would-be resident is single and thus cannot settle a trust for the benefit of his or her spouse and children.

Section 75(2) poses a problem as the immigrant would want to participate in the trust and to receive income or trust property in the future. If, for example, the husband and wife jointly settled the trust for their benefit and the benefit of their children, Section 75(2) could apply. One solution may be to have the husband settle a trust for the benefit of his wife and children. The wife could settle another trust for the benefit of her husband and children. As the settlor in each case would have no reversionary right to the trust assets, Section 75(2) would not apply.

The general attribution rules in Sections 74.1 and 74.2 which attribute income distributed to beneficiaries in the case of a trust for a spouse or minor children and capital gains in the case of a trust for a spouse, would have to be considered as they may apply once the transferor becomes resident in Canada. However, attribution may only arise once income is paid or payable to a beneficiary. As capital rather than income would be distributed during the tax holiday, the attribution rules should not pose a practical problem. The immigration trust indenture would typically require that income be accumulated and the trustees would be authorized to make capital distributions. As the trust would qualify as a personal trust, the capital distributions would not be taxable.

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The sale of property or loan of funds to a foreign corporation owned by a non-resident trust would be subject to the corporate attribution rules in Section 74.4 of the Act if the spouse or minor children of the settlor are beneficiaries of the trust. Where applicable, the individual would be taxable on imputed income.

Section 94.1 of the Act would apply if the settlor becomes a Canadian resident and has indebtedness in a non-resident corporation. The individual would be currently taxable on imputed interest income. Careful planning is therefore required if property is to be transferred or funds loaned to a non-resident corporation.

It is recommended that funds be given, rather than loaned to the trust where the settlor plans to immigrate to Canada. Section 56(4.1) of the Act applies to attribute income to an individual who has loaned property at less than a reasonable rate of interest directly or indirectly by means of a trust to a particular non-arm's length individual and it may reasonably be considered that one of the main reasons for the loan was to reduce or avoid tax by causing income from the loaned property to be included in the income of the particular other individual. Where Section 56(4.1) applies, any income for a taxation year of the particular individual from the property (not business income or capital gains) that relates to the period during which the individual was resident in Canada and not dealing at arm's length with the other individual shall be deemed to be income of the individual. In other words, if funds were loaned to the trust and the settlor subsequently became a resident of Canada, Section 56(4.1) may apply to tax him on all income from property earned by the trust. However, this rule may not apply if the income is accumulated in the trust. There is also an exception to this rule in Section 56(4.2) which applies where (i) interest was charged on the loan at a rate equal to or greater than the lesser of the prescribed rate in effect at the time the loan is made and the rate that would have been charged between arm's length parties, (ii) the interest is paid within 30 days after the end of the particular year; and (iii) the interest in respect of each taxation year preceding the particular year was paid within 30 days of the end of each year preceding taxation year.

On the expiry of the tax exempt period, the trust may either be liquidated or in some instances it may be more advantageous to change the trustees to Canadian trustees in order that the trust may become resident in Canada.

1. Change of residence

While subparagraph 94(1)(c)(I) would operate to automatically deem the discretionary trust to be resident in Canada, for purposes of Part I of the Act, on the expiry of the five years, it does not deem the trust to become resident in Canada. On becoming resident in Canada, there would be a potential step-up in the cost base of the trust property, other than taxable Canadian property. This may be accomplished by replacing the trustees with trustees resident in Canada. Paragraph 128.1(1)(c) would deem the trust to have acquired each property, other than taxable Canadian property, at a cost equal to its fair market value at that time. This would apply to the shares of Canadian public companies and to non-Canadian assets. This would protect any gain on such assets accrued while the trust was not resident in Canada.

2. Liquidation

A liquidation may be considered because the trust would be taxable in Canada on all of its income, other than foreign active business income, at top personal marginal rates. On a liquidation, the beneficiary would be deemed to dispose of his capital interest for proceeds equal to its adjusted cost base and the beneficiary acquires the trust property distributed to him at its tax cost to the trust (Section 107(2)) which may have been increased on the change of the trustees to Canadian trustees. In other words, the property may be rolled out of the trust to the beneficiary.

In some cases, once the beneficiary has become a Canadian citizen (three years after immigration) and thus achieved the goal of political security, the individual may choose to become a non-resident of Canada in order to avoid paying Canadian tax on non-Canadian source income. The individual would remain a Canadian citizen. If the individual has resided in Canada for less than five years, no departure tax would arise with respect to property owned when the person became a Canadian resident.

C. General anti-avoidance rule

The general anti-avoidance rule (GAAR) applies to any transaction that is a tax avoidance transaction unless it does not constitute an abuse or misuse of the Act read as a whole. If a transaction which results in a tax saving was undertaken primarily for bona fide non-tax purposes, it will not be an avoidance transaction and thus will not be subject to GAAR. If a transaction is tax motivated and thus an avoidance transaction, the only defence is that it does not result in an abuse or misuse of the Act read as a whole.

If GAAR is applicable, Revenue Canada may disallow a deduction, reallocate a deduction, recharacterize a payment or ignore the tax effects that would otherwise result. In essence, if a transaction results in a tax benefit and is not motivated by a bona fide non-tax purpose, it will be necessary to demonstrate that the plan does not contravene the object and spirit of the Act. Information Circular IC-88-2 issued by Revenue Canada on 2 October 1988 elaborates that, in its view, although a taxpayer may rely on specific provisions of the Act, the consequences may be so inconsistent with the general scheme of the Act that they cannot have been within the contemplation of the parliament. It is arguable that as Section 94 of the Act specifically contemplates a five-year tax exemption for a trust settled by a non-resident, the proposal is not contrary to the object and spirit of the Act and as a result, GAAR would not apply. At the 1989 Revenue Canada Round Table, Revenue Canada confirmed that, while the creation of the trust may be an avoidance transaction, GAAR would not apply on the basis that the transaction would not normally constitute a misuse of or an abuse having regard to, the provisions of the Act. If more aggressive structures are used with the intent of perpetuating

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the tax free period beyond five years, there is a risk that Revenue Canada may seek to apply GAAR.

D. Trustees

Trustees would have to be selected in the appropriate tax haven [6] Alternatively, family members who do not immigrate to Canada may be trustees provided their acting as trustees does not make the trust resident in a taxable jurisdiction. Considerations involved in choosing a tax haven are political stability, no taxation or exchange control, favourable trust laws, excellent communications, location of suitable banks and trust companies, and accessibility. Some trust companies charge a significant start-up fee plus ongoing fees and possibly a closing fee. Careful planning by the would-be immigrant prior to taking up residency in Canada can yield substantial tax savings. Planning may also be required prior to the expiry of the tax holiday.

E. Trust provisions

The trust indenture may contain certain investment restrictions. These may depend on whether the trustee is to invest the money or whether an outside money manager is to be retained. For example, the trust may provide that the investments are to be restricted to certain types of investments (e.g. investments having a triple A rating) or may provide that the trustees must only invest in investments chosen by a money manager designated by the protector.

The trust may but need not have a protector. The protector would be someone whom the settlor has chosen to act as advisor to the trust. The protector may have to be consulted with respect to sales of investments or trust distributions. If the protector has too much control, the protector may be viewed as a trustee. It is recommended that the protector not be resident in Canada.

For purposes of Section 75(2), the trust should be irrevocable and the trust assets should not revert to the settlor. A charity may be named as a contingent beneficiary in the event of a catastrophe.

The trust may also contain emergency provisions which would cause the trust to change jurisdictions in the event, for example, of potential instability in the tax haven. The protector may have the ability to change the trustee (e.g. appoint a replacement trustee in another tax haven) or a standby trustee may be named in the trust indenture. The trust can, under this provision, be made a resident of Canada after the expiry of five years.

The trust should also permit the automatic transfer of assets owned by the trust to another jurisdiction.

The trust may restrict the ability of the trustees to disclose information concerning the affairs of the trust to anyone other than the protector or investment advisor unless required by the laws of the jurisdiction of the trust.

The settlor may have the power with the trustee(s) to amend or vary the trust provisions other than those pertaining to the appointment of the beneficiaries.

The settlor may also provide the trustees with a non-binding letter of wishes designed to limit the power of the trustees without the settlor being considered to control the trust.

F. Summary

In summary, it may be possible for an individual who plans to immigrate to Canada with his family, to form a trust outside Canada which would not be subject to Canadian tax. Typically, this would involve the following:

(1) A trust would be settled in a tax haven by way of a gift from a non-resident of Canada, who is not a beneficiary of the trust:
(2) The trustees would be non-residents of Canada.
(3) No additional funds would be loaned to the trust by the settlor.
(4) The trust would be irrevocable and would be discretionary.
(5) All trust investments would be made outside Canada.
(6) The trust indenture would require that the annual income be accumulated and the trustees would have the power to make capital contributions to the beneficiaries.

The Canadian beneficiaries of the trust would not be subject to tax on accumulations for five years where the person who has transferred property to the trust immigrates to Canada and has not previously resided in Canada. Such trusts are only recommended for an individual who has assets in excess of CAD 1 million as a result of the costs of forming and maintaining the trust.

6. E.g. Bahamas, Anguilla, Cayman Islands, Bermuda, Cook Islands, Isle of Man, Channel Islands of Jersey or Guernsey, Barbados.

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SOUTH AFRICA

NEW UNITED STATES–SOUTH AFRICA TREATY

THE POSITION OF US SHAREHOLDERS – CONFUSION SURROUNDS THE DIVIDEND TAX CREDIT

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I. INTRODUCTION

South Africa and the United States signed a new Double Tax Convention on 17 February 1997. The Convention still needs to be ratified. This article examines the document's provisions insofar as they relate to US shareholders, with specific reference to the controversial tax credit area.

II. TAXES COVERED BY THE TREATY

As will be seen below the definition of "South African tax" in Article 2 is critical. The definition includes South African "normal tax" and South African Secondary Tax on Companies (STC).

Normal tax is defined in Section 5 of the South African Income Tax Act (Act 58 of 1962, as amended) to comprise "income tax". STC, in turn, is distinct from normal tax (although legislated for in the same Income Tax Act). It is a tax levied on South African Companies when they distribute dividends to shareholders (whether local or foreign). The tax is levied, in broad terms, on the net dividend position of the company for the period since the last dividend distribution. By "net dividend position" is meant the excess of the company's dividend declared over its dividend income. The current STC rate is 12.5 per cent – as recently as 1995 the rate was extremely high, 25 per cent.

South Africa has had no other withholding tax on dividends since the abolition of non-resident shareholders' tax in 1995.

III. DIVIDENDS

Article 10 provides that the payor State's power to tax dividends cannot exceed:

(a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 10 per cent of the voting stock of the company paying the dividends; and
(b) 15 per cent of the gross amount of the dividends in all other cases.

Conventional limitations exist for permanent establishments, fixed bases, income from immovable property, and capital gains, as well as branches of government.

IV. LIMITATION ON BENEFITS

Article 22 reflects the stringent limitation of benefits rules common in more recent US conventions. In particular, a resident of a contracting state will be entitled to benefits otherwise accorded to residents of a contracting state by this Convention only to the extent provided in the article.

V. ARTICLE 23 – ELIMINATION OF DOUBLE TAXATION

Paragraph 1 of this article deals with residents and citizens of the United States. It provides that, in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States will allow to such a person (being a resident or a citizen of the United States) as a credit against the United States tax on income:

(a) the South African tax paid or accrued by or on behalf of such citizen or resident; and
(b) in the case of a US company owning at least 10 per cent of the voting stock of a company which is a resident of South Africa and from which the US company receives dividends, the South African income tax paid by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.

The use of the undefined term "South African income tax" in (b) rather than the term "South African tax" (which is defined to include STC) implies strongly that (b) does not embrace STC. This seems logical, provided that (a) covers STC. The question thus arises as to whether (a) embraces STC. If STC is a tax paid or accrued on behalf of the shareholder, the answer would be that (a) does embrace STC. However, in fact STC is levied on the company, and not on the shareholder, implying that (a) does not embrace STC. But, if this is the case, why mention STC at all in the Convention?

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It seems probable that (a) was meant to embrace STC, and, therefore requires amendment. The addition of the words "– or by the payor on distribution of the income to such citizen or resident" to (a) would be one way to eliminate the problem.

Alternatively, if it was intended that (b) should embrace STC, then the removal of the word "income" from the phrase "South African income tax" would suffice, since the phrase "South African tax" is defined in Article 10 to include STC.

Paragraph 2 of this article deals with US citizens who are residents of South Africa. It provides that:

(a) with respect to items of income that under the provisions of this Convention are exempt from US tax or that are subject to a reduced rate of US tax when derived by a resident of South Africa who is not a US citizen, South Africa will allow as a credit against South African tax, only the tax paid, if any, that the United States may impose under the provisions of this Convention, other than taxes that may be imposed solely by reason of citizenship under the saving clause of paragraph 4 of Article 1 (General Scope);

(b) for purposes of computing US tax on those items of income referred to in subparagraph (a), the US will allow as a credit against US tax the income tax paid to South Africa after the credit referred to in subparagraph (a); the credit so allowed will not reduce the portion of the US tax that is creditable against the South African tax in accordance with subparagraph (a); and

(c) for the exclusive purpose of relieving double taxation in the United States under subparagraph (b), items of income referred to in subparagraph (a) will be deemed to arise in South Africa to the extent necessary to avoid double taxation of such income under subparagraph (b).

Once again, the reference in (b) to South African "income tax" appears clearly to exclude STC.

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A general introduction to the country presents geographical, political, economic, legal and social background information. This is followed by a detailed survey of the business environment, foreign investment, exchange control and fund repatriation – together with details of the operation of South African corporations and the approach to branches of foreign companies.

Information provided is arranged under the following broad subject areas:

- *Income tax*
- *Capital transfer taxes*
- *Regional levies*
- *Levy on financial services*
- *Stamp duty*
- *Transfer duty on land*
- *Customs and Excise duties*

Taxation & Investment in South Africa includes a series of appendices giving current rates of taxation. All available tax treaties concluded by South Africa are also included.

1997 INITIAL SUBSCRIPTION: NLG 465
1997 renewal of existing subscription: NLG 210

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

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(B. 116.077)

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Die Organschaft. Körperschaftsteuer, Umsatzsteuer, Gewerbesteuer. 2. Auflage.
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(B. 116.100)

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Taxation of estates. The law in Ireland.
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(B. 113.243)

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Editors Victor Uckmar and Carlo Garbarino.
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Monograph on the Italian fiscal crisis. The author describes the weakness of the Italian tax system, in particular the general inefficiency of the Tax Administration. The author is in favour of maintaining the current taxes and believes that the challenge for the Italian Government is the reform of the Tax Administration. The book provides an effective picture of the Italian tax environment and contains suggestions and forecasts on what should or might happen in the future. It also constantly compares the Italian system with that of other European states.
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Netherlands

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Taxation of cooperative societies and their members. The book deals especially with the determination of profits in case of a cooperation, the financing of a cooperation, the fiscal position of participants/individuals and participants/corporations. A comparison is made with the regime of the close company and the requirements for a change in a close company are explained. The book is very useful for researchers, practitioners and students interested in the tax regime for cooperations.
(B. 116.033)

Arendonk, H.P.A.M. van; Bartel, J.C.K.; Brink, W.; a.o.

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Wegwijs in de belastingheffing van ondernemingen. 2nd Edition.
Lelystad, Koninklijke Vermande B.V. 1996, pp. 314. NLG 69. ISBN: 90 5458 305 3.
Taxation of entrepreneurs. Revised and updated edition of book dealing with all income tax regulations regarding the determination of taxable profits which apply to sole entrepreneurs and partnerships. It also includes corporate income tax regulations regarding termination of taxable profits regulations for corporations. Moreover, the book deals with the taxation of income from shares and income received by substantial shareholders. The book is a useful guide for students and practitioners.
(B. 116.064)

Fiscaal Memo 1.
Deventer, Kluwer. 1997, pp. 306. NLG 31.50. ISBN: 90 200 1859 0.
Fiscal Memo 1 contains a complete overview and explanation of all taxes, social security contributions and the system of student grants. The booklet contains the forfeits, rates, exemptions and amounts of deductions as of 1993, together with a lot of practical information. It is useful for persons who are familiar with the tax laws. Finally, it contains an overview of important bill proposals, press releases and recent tax information.
(B. 116.138)

Dun, M. van.
Fiscale aspecten van aandelenvennootschappen met een dubbele vestigingsplaats.
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Fiscal aspects of dual-resident companies. The study analyses the position of dual resident companies in the Netherlands. The book explains the history of the establishment fictions in the various tax laws, the consequences of a transfer of the legal seat and the determination of the profit of a company established under Netherlands law with a dual residence. The author notes that dual residence may result in special problems, for example concerning the participation exemption, the fiscal unity, the merger facilities and the taxation of investment companies. The book also deals with the withholding tax problems and the credit problems a dual resident has to deal with. With regard to the income tax the author investigates whether the establishment fictions are effective and the application of income tax fictions. Finally, some procedural aspects like the compliance duties of dual residents are explained.
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Bellingwout, J.W.
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Bolivia

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La Paz, Ediciones Peña del Villar. 1996, pp. 500.
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Introduction to the Canadian law of income tax. The book covers personal income tax, with chapters on corporations, partnerships and trusts. It is designed for law students doing their first course in income tax law and for lawyers who need a refresher in the basic principles of personal income tax.
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(B. 116.168)

Duncan, Garry R.; Peck, Elizabeth J.
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Scarborough, Carswell Thomson Professional Publishing. 1995, pp. 388. USD 26.50.
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(B. 116.171)

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INTERNATIONAL

OECD Tax Developments in the 1990s

Ken Messere

Ken Messere was head of OECD Fiscal Affairs Division from 1971 to 1991 and author of *Tax Policy in OECD Countries: Choices and Conflicts* (Amsterdam: IBFD, 1993). Since then he has been a consultant for OECD, IMF and the World Bank in Eastern Europe and North Africa. In addition, Mr Messere has been working on the forthcoming book referred to in footnote 3.

I. PRELIMINARY REMARKS

This article is primarily about what has been happening in the OECD tax world during the 1990s, how it has differed from the past and what is likely to happen during the remaining years of the 20th century. The future speculations focus on two issues: first: are tax levels likely to increase, decrease or remain roughly the same? Second: are countries' tax profiles likely to come closer together, further apart or remain more or less as they are now? On this second issue, a distinction should be made between "convergence" and "common trends". To illustrate the difference, here is a hypothetical two-country example over the period 1985 to 1994.

	Country A 1985-1994		Country B 1985-1994		Difference between Country A/Country B 1985-1994	
	%	%	%	%	%	%
Ratio of total tax receipts to GDP	42	50	35	37	7	13
Ratio of personal income tax receipts to GDP	18	25	15	20	3	5
Top rate of personal income tax	60	55	45	30	15	25
Standard rate of VAT	20	25	13	15	7	10

These two countries share the same trends in that they have both increased their total taxation to GDP ratio (henceforth TTR), their personal income tax receipts to GDP ratio and their standard rate of VAT and have reduced their top rate of personal income tax; but, as shown in the last two columns, their divergence is greater in 1994 than it was in 1985. Thus these two hypothetical countries share a common trend, but in many respects their tax systems have become more divergent. It is accordingly misleading to use the terms "common tax trends" and "tax convergence" synonymously, since a common trend does not entail tax convergence. This point is made early, because in the literature these two terms have been used interchangeably when discussing whether the forces making for "convergence" will or will not overcome individual governments' desire to preserve their fiscal sovereignty. In this article the expressions tax profiles "coming closer together" or "moving further apart" are used when these terms are not explicitly a reference to either the presence or absence of common trends or to convergence and divergence.[1]

What has happened in the past is of relevance to the issues discussed and Section II summarizes briefly tax trends and main government tax preoccupations between 1960 and 1996. Section III in somewhat greater detail does the same over the last decade, concentrating in particular on how the tax climate and government preoccupations have changed between the mid-1980s and mid-1990s. Section IV analyses tax revenue developments between 1985 and 1994 and between 1990 and 1994 and is subdivided into changes in tax levels, changes in the tax mix, and changes in the share of revenues accruing to various sectors of general government. Section V discusses changes in the nominal rates of personal and corporate income tax and of VAT as well as the flattening of the personal income tax schedule. Section VI considers the influence of the European Union on domestic tax trends. Finally, Section VII speculates on what might happen during the rest of the century in relation to tax levels and the approximation or otherwise of OECD countries' tax systems.

This article does not cover international tax issues except in so far as they may influence changes in the tax systems of particular countries.[2] Also lacking from this article is a detailed study of the tax system of any particular country.

Examination of what has been happening to the tax systems in a number of countries together with the reasons why they have happened (often due to current political and pressure group influences) provides one reason for scepticism about the likelihood of countries tax profiles coming closer together,[3] for though taxation is a major political issue in most countries, it seems that what other countries do is barely mentioned by politicians and the media, except perhaps in Canada concerning the United States and in New Zealand concerning Australia.

1. I prefer not to use the word "harmonization" which has been used to mean "identity" "convergence" and "common trends".
2. Accordingly nothing is said about developments in double taxation treaties, transfer pricing practices, country cooperation to reduce international tax evasion through withholding taxes or improvements in exchanges of information among tax authorities, or the border tax adjustments to be applied when goods cross European Union frontiers.
3. I have just edited and contributed to a book which describes in detail what has been happening over the last decade in OECD countries (the G7 plus the Netherlands, Spain and Sweden), the bulk of the book consisting of ten chapters written by experts from these countries. This book is to be published late 1997 or early 1998 by the Oxford University Press under the title "The tax system in industrialised countries".

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II. A BRIEF SURVEY FROM 1960 TO 1996

A. Economic growth (1960-1975)

During this period, apart from the blip that followed the first oil shock in the early 1970s, continuous real growth and low unemployment levels enabled tax levels to increase in all but the poorest OECD countries (Greece, Portugal, Spain and Turkey then under non-democratic regimes) with little political opposition. Most of the increase in tax levels arose automatically through the effect of fiscal drag on income tax schedules. Rates were high and bands were narrow, so that without change to nominal rates inflation and growth pushed taxpayers into higher brackets and the value of their standard basic and family allowances were eroded. As income was increasing in real terms these income tax increases were barely noticed and if noticed generally approved of because of a consensus, particularly in the richer European countries, in favour of the welfare state, which in its turn permitted social security contributions to be raised without protest. Another reason for the rise in taxation was the introduction of VAT in 14 European countries between 1968 and 1973.[4] Thus between 1965 and 1975 the unweighted OECD average total tax receipts to GDP rose from 26.3 per cent to 34.4 per cent and in OECD Europe from 27.2 per cent to 36.1 per cent (see table 1). Governments had their economic and financial problems, but obtaining sufficient tax revenues was not one of them.

Because of the general satisfaction with the public finances, apart from the move to VAT there was little in the way of major tax reform during these 15 years. The most important were changes to the corporate tax system in a number of countries generally away from classical systems to zero rate, split rate or partial imputation systems.

Another tax trend that occurred in many countries during the 1970s was a move from family taxation to individual taxation with regard to earned income. This was a (mostly) uncontroversial response of governments to women's liberation pressure groups and the rapid increase of women in the labour force. In fact the family unit played a relatively minor part in the relative tax bills of different social groups, and its effect in isolation was to subsidize wealthy couples in the labour market and penalize low earning couples. Probably in order to reduce such penalization there was a corresponding move from tax allowances for minor children which favoured the rich because their value was a function of the marginal rate of tax, to tax credits or payments outside the tax system which did not vary with income.

B. Stagflation without tax reform (1975-1984)

The first oil shock in the early 1970s already slowed down growth, but it was not until the late 1970s that there appeared to be consequences for governments' tax policy. The period of inflation plus low growth together with higher levels of unemployment had a dramatic effect on the revenue raising capacity of governments. Each year between 1965 and 1977 the average OECD TTR rose by something like 0.75 per cent per year, but between 1977 and 1980 it remained static only to resume its increase in 1981 but thereafter at a much slower rate (see table 1). Once voters' real disposable income failed to increase and they were paying more income tax solely because of inflationary fiscal drag, governments became obliged to offset fiscal drag in order to resist wage demands which would cause further cost push inflation. The effect of taxation on inflation as well as inflation on taxation became governments' main preoccupation in the tax area. Some governments indexed the rate schedule in full or in part, some indexed allowances, some made ad hoc adjustments to both, but from the late 1970s the income tax lost its position as the most buoyant revenue source. Following the second oil shock in the late 1970s, governments began to use taxation as a means of influencing the supply and demand for energy. Otherwise, with rare exceptions once VAT had been introduced, there was little in the way of tax reform, until the mid 1980s. This was perhaps due to the perception of politicians that as more and more voters were becoming aware that the taxes they paid was one of the main reasons why increases in their real income had come to a stop, tax reform would not be a popular measure to take on, especially among those who paid little tax because they could use or even abuse the extensive personal and corporate income tax reliefs then in force. Nevertheless there was increasing dissatisfaction with the personal and corporate income tax system, which was seen by economists and tax specialists as inequitable, non-neutral and complex. Of special importance was the prevalence of very high nominal rates of personal and corporate income tax which in practice applied to an increasingly narrow base due to the numerous and often arbitrary expense related tax reliefs.

C. Tax reforms over the last decade (1984-1996)

Between 1984 and the early 1990s most OECD countries reduced the rates of their personal and corporation tax and widened the base of these taxes by reducing or abolishing income tax reliefs. In some countries these reforms continued or began in the 1990s. In addition between 1990 and 1996, nearly all countries raised their standard rate of value added tax by 1 to 3.5 percentage points. More is said later about these changes, particularly in Section V B and table 6.

4. Whether to conform to Common Market requirements, to increase revenues, to provide a more efficient general tax on goods and services, or to rely less on income tax. Together with the European greater attachment to the welfare state, its introduction explains why revenues increased more rapidly in most European countries than in Australia, North America and Japan, where consumption taxation was relatively low. These latter countries relied primarily on the highly elastic income tax which is one explanation why TTRs increased more in these countries than in those of Southern Europe which relied mostly on the less elastic social security contributions and consumption taxes.

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III. CURRENT ISSUES

A. Main changes in governments' preoccupations since the mid-1980s

The tax policy climate in the mid-1990s is very different from that of the mid-1980s. Following the radical changes in the late 1980s and early 1990s, reforms have increasingly shifted to administrative matters for most governments accept that business requires stability in tax laws. Recent changes typically concentrate on reducing administrative and compliance costs, and improving the quality of the tax administrations as well as relationships between the tax authorities and taxpayers.

Changes in governments' public finance preoccupations have also occurred. The flattening of tax rates and the considerable fall in inflation solved a number of problems. Most important how to deal with the effect of inflation on income tax burdens has ceased to be a problem and offsetting fiscal drag is now undertaken only as a politically reassuring gesture after governments have increased the yield through base widening. Also the flattening of rates has enabled countries which tax the individual's earned income rather than the families to do the same with their investment income, as there is now less danger of couples artificially splitting their investment income.

Since 1989, fiscal deficits have replaced the impact of inflation as governments' central preoccupation.

B. Fiscal deficits

Except in Greece and Italy, fiscal deficits were quite small during the latter half of the 1980s and between 1985 and 1989 were decreasing in most countries, but thereafter increased sometimes to unprecedented degrees, reaching their peak in 1993. (OECD average –3.5 in 1985, –1.3 in 1989 and –4.5 in 1993). Since 1993 they have been falling and by 1996 are expected to be around 1985 levels. (See *OECD Economic Outlook* 60 Annex table 30. (Paris: December 1996)). Though fiscal deficits are expected to continue to fall over the next years, they remain a primary concern of many governments, partly because of the Maastricht criterion, and more is said about the problems involved in the concluding section.

C. The taxation of savings

Another area that has attracted greater government attention in recent years is to level the playing field in respect of the tax treatment of savings. In the mid-1980s, progressive expenditure taxes plus cash-flow corporation taxes were widely advocated, whereas nowadays, governments generally recognize that such a radical departure from present tax systems would present too many practical problems. One currently favoured solution would allow the deduction of income from all kinds of savings from the income tax base, which, of course, would have the effect of reversing recent base widening trends as well as resulting in a regressive rather than progressive expenditure tax. It is generally believed that such deductions would have little effect on the level of savings, although most certainly they would affect the form that savings take. Changes in the tax treatment of savings could also simplify the tax system as well as help to reduce opportunities for certain kinds of tax evasion, but whether such changes should take the form of unlimited deductions of income from savings is also a political issue.

D. Back to schedular taxation

Until 1985 there had been a move away from schedular taxation (applying different rates to different kinds of income), towards global taxation of income. Portugal in the 1980s was about the last of the OECD countries to abandon the old form of schedular taxation. More recently schedular taxation has returned in new forms including:

- introduction of alternative minimum taxes (Canada and the United States);
- supplementary taxes on gross income (Denmark and Norway);
- anti-shelter provisions (United States); and
- most recently, a two-rate schedule that combines a progressive rate on earned income and a low flat rate on capital income, the latter sometimes equal to the corporate tax rate and/or the lowest marginal rate on earned income (most of the Nordic countries).

E. New attitudes to net wealth taxes

Over the last few years a new attitude has arisen in countries with net wealth taxes. A 1983 OECD report on capital taxes noted that apart from France, Ireland and Spain net wealth taxes were generally around 50 to 100 years old, that 50 per cent of OECD countries with them had never seriously considered abandoning them, and that 50 per cent of OECD countries without them had never seriously considered adopting them. Things have changed recently. There have been proposals to reduce or abolish these taxes in Austria, Denmark, Netherlands, Norway and Sweden. This is perhaps due primarily to the increasing mobility of capital with the fear of capital flights from countries with such taxes.

However, this remains a political choice for governments and for example, the 1994 Swedish social democratic government reversed the proposal of the previous anti-socialist coalition to abolish these taxes. Also it is possible that it was political motivation rather than fear of capital flights that led to these proposals since (I believe) they were generally made by right wing governments which had replaced socialist or social democratic governments. Certainly political concerns were the reason for the adoption then abolition of the Irish net wealth tax and in France, such a tax was introduced by a socialist government, abolished by a right wing government and then reintroduced by a socialist government. Also it was a socialist government that introduced the Spanish net wealth tax.

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F. Marginal effective tax wedges (METW)

In the corporate tax area, there has recently been a growing interest among governments in establishing marginal effective tax wedges on capital income, with a view to reducing tax distortions within and between countries. By demonstrating that tax systems are generally not neutral as between the taxation of different assets,[5] towards financing sources or different sectors in the economy, these studies have had some influence on national legislation (see OECD 1991 pages 174-5 for some examples, including moving tax depreciation nearer to economic depreciation and reducing differences in average effective tax rates as between different sectors of the economy). Also the base broadening referred to earlier, undertaken for other reasons, has generally reduced differences in METWs, even if the reduction of nominal rates within countries has intentionally increased differences in METWs as between countries, in certain circumstances to attract capital investment (see Ruding 1992). However, calculation of the METW rests upon a number of assumptions about the firms considered (manufacturing, service, financial, etc., established or new, rate of growth, asset structure, etc.) and the effects on direct and portfolio investment have to be treated separately. Also while the larger MNEs may have a good idea of their own METWs and how to reduce them, there is evidence (e.g. written submissions to the Ruding Committee) that the more numerous smaller firms are more concerned with nominal rates of corporate tax compared to those of their competitors in other countries, however misleading nominal rates may be as a guide to effective rates.

G. Fiscal federalism

Another issue much discussed in recent years in a number of countries is that of fiscal federalism. The expression is used both normatively to suggest that subordinate levels should have more taxing and spending powers and positively to pose the question what are the arguments for and against giving them such extra taxes and spending powers. These arguments have been frequently summarized and are not repeated here. It is perhaps, however, relevant in discussing recent trends that there has recently been more pressure, for example in France, Spain, the United Kingdom and the United States for greater taxing and spending powers to be given to regional or local government and greater resistance from central government because of their concern with their fiscal deficits. Some idea of what has happened over the last decade is given in table 5 and Section IV C below.

H. Income distribution

Whilst the progressivity of the tax system generally and the income tax system in particular have always been a matter of political debate, studies in most countries have shown the tax system as a whole to be generally proportional, the mild progressivity of the personal income tax being offset by the mild regressivity of most of the other major taxes. When governments take a step away from progressivity in one direction they tend to increase it in another. For example, the rate flattening of the late 1980s taken in isolation reduced progressivity, but it was offset by other factors such as increasing tax thresholds and family allowances and by base broadening. The latter took the form of either bringing into the tax net previously exempt income such as capital gains or a greater range of fringe benefits or, alternatively, reducing or abolishing expense-related tax reliefs such as that on interest – in both cases placing a relatively greater tax burden on high income taxpayers. In the 1990s there have been suggestions to take this process a stage further by having a single flat rate tax with no reliefs. This was proposed by certain Republican candidates during the 1996 US election campaign. Whether or not it would be possible to have a progressive income tax with only one rate is debatable but the apparent unfairness of a flat rate income tax, led to its abandonment by the Republican party. Though it is unusual for a government systematically to use the tax system over a long period with the intention of providing greater equality or inequality, it does sometimes happen. For example, during the 1980s and early 1990s the British government deliberately made the tax system less progressive by substituting higher VAT and social security contributions for lower income tax, introducing a poll tax and abolishing a tax on gifts.

I. The unemployment and poverty trap

The effect of payroll taxes (usually employers' social security contributions) and the tax benefit system as a whole on unemployment levels has become more important as unemployment has increased in most countries over the last decade. Because payroll taxes fall most heavily on low-paid and part-time workers, employers have reduced their labour costs by insisting on their work force working longer hours rather than taking on new labour. Countries with particularly high payroll taxes (France, Italy and Spain) have abolished or reduced these taxes for special cases (e.g. youths, part time workers). A second problem is that taking up labour in the formal economy may result in withdrawal of benefits, often of roughly the same amount, thus providing no incentive to seek work (the unemployment trap) or if in work at low levels of pay again there may be withdrawal of benefits if income increases, thus removing incentives to work overtime, earn productivity bonuses etc. (the poverty trap). Attempts have been made recently in the United Kingdom and the United States to alleviate this problem by providing benefits to lower paid parents in work, but the increase in the shadow economy is doubtless due in part to the unemployment and poverty traps.

J. Environmental taxes

Finally, during the 1990s, there has been much more discussion than hitherto on introducing or increasing environmental

5. E.g. buildings are usually treated more generously than machinery and machinery more generously than inventories.

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taxes. However, this discussion is perhaps of more relevance to environmental policy than tax policy, since the few existing environmental excises bring in little revenue. Important revenues would result only from a heavy tax on carbon emissions as recommended by the European Commission, but international considerations render the introduction of a heavy tax unlikely in the near future. However, the already highly taxed activities of drinking, smoking and motoring may also be regarded as pollution taxes which could justify further increases.

IV. TAX REVENUE DEVELOPMENTS

Table 1
Total tax revenue as percentage of GDP

	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Canada	25.9	27.0	28.1	28.9	31.1	31.3	30.8	31.3	30.9	33.3	32.4	31.8	31.2	30.8	30.6
Mexico															
United States	24.3	24.6	25.7	25.1	27.6	27.4	25.9	26.6	26.6	27.1	26.7	26.0	26.7	26.6	26.5
Australia	23.2	22.6	23.4	23.2	24.0	24.2	24.7	23.8	25.3	27.1	27.5	28.0	28.0	26.8	27.5
Japan	18.3	17.8	18.3	18.5	18.8	19.7	20.0	20.7	22.5	23.0	20.9	21.8	22.3	24.0	24.4
New Zealand	24.7	25.6	25.4	25.2	25.2	27.4	27.5	27.2	28.5	31.3	31.1	30.7	33.2	31.8	32.7
Austria	34.7	35.4	35.3	35.3	35.8	35.7	36.4	36.9	37.1	38.1	38.6	38.5	39.1	41.4	41.0
Belgium	31.2	33.3	34.0	34.8	35.0	35.7	36.7	37.0	38.0	38.9	41.8	42.2	43.8	45.0	45.5
Czech Rep.															
Denmark	29.9	32.5	33.1	36.0	35.7	40.4	43.5	42.9	42.4	44.2	41.4	41.6	41.9	43.4	44.5
Finland	30.3	31.5	32.4	32.8	31.3	32.5	34.1	34.6	35.5	34.7	37.7	41.7	41.9	38.2	36.7
France	34.5	34.3	34.7	34.9	35.8	35.1	34.5	34.9	35.0	35.5	36.9	38.7	38.7	38.6	40.2
Germany	31.6	32.2	32.2	32.2	33.9	32.9	33.4	34.8	36.3	36.5	36.0	36.8	38.2	37.9	37.8
Greece	22.0	23.7	24.8	25.7	25.7	25.3	25.2	25.4	23.8	24.6	25.5	28.0	28.5	28.8	30.1
Hungary															
Iceland	26.2					27.0					29.6				
Ireland	25.9	27.9	28.5	28.9	29.6	31.0	32.1	30.6	30.7	31.1	31.3	34.8	33.1	31.3	30.9
Italy	25.5	25.3	26.2	27.0	26.4	26.1	26.9	26.9	24.4	25.7	26.2	27.1	27.4	27.4	26.6
Luxembourg	30.6	30.3	31.0	30.0	30.2	30.9	33.6	34.2	34.7	35.8	42.8	43.0	47.7	48.7	45.5
Netherlands	32.7	34.1	35.1	35.8	36.1	37.0	38.8	39.6	41.1	41.6	42.9	42.6	43.3	43.9	44.3
Norway	33.3	34.6	36.6	37.7	39.1	39.3	42.4	44.9	45.3	44.8	44.9	46.2	47.3	46.6	45.7
Poland															
Portugal	16.2	16.7	17.3	17.4	18.1	20.3	20.0	19.7	19.3	19.8	21.7	23.6	24.1	23.3	22.9
Spain	14.7	13.6	16.9	16.1	16.4	16.9	17.1	18.1	18.7	18.1	19.5	19.5	21.4	22.8	23.3
Sweden	35.0	35.8	36.7	38.8	39.8	39.8	40.6	42.0	41.2	42.3	43.4	47.6	49.9	50.3	49.0
Switzerland	20.7	21.5	21.6	22.6	23.7	23.8	23.5	23.9	26.3	27.3	29.6	31.3	31.6	31.6	31.1
Turkey	10.6	10.7	11.4	11.3	12.2	12.5	14.3	14.6	15.2	14.1	16.0	16.3	17.1	16.6	15.7
United Kingdom	30.4	31.6	32.9	34.5	36.1	36.9	34.8	33.3	31.3	34.9	35.5	35.3	34.7	33.0	32.6
Unweighted average:															
OECD Total	26.3	27.1	27.9	28.4	29.0	29.5	30.3	30.6	30.9	31.7	32.5	33.6	34.4	34.3	34.1
OECD America	25.1	25.8	26.9	27.0	29.4	29.3	28.3	29.0	28.7	30.2	29.6	28.9	28.9	28.7	28.6
OECD Pacific	22.1	22.0	22.3	22.3	22.7	23.8	24.1	23.9	25.4	27.1	26.5	26.8	27.8	27.5	28.2
OECD Europe	27.2	28.0	28.9	29.5	30.1	30.5	31.6	31.9	32.0	32.7	33.8	35.3	36.1	36.0	35.8
EU 15	28.3	29.2	30.1	30.7	31.1	31.8	32.5	32.7	32.6	33.5	34.8	36.1	36.9	36.9	36.7

Table 1 (cont.).
Total tax revenue as percentage of GDP

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Canada	31.6	33.6	33.5	32.9	33.0	33.1	33.7	34.7	34.0	35.1	36.5	36.7	36.4	35.8	36.1	n/a
Mexico	17.4	16.9	17.4	19.4	18.7	18.3	17.4	18.4	17.7	18.6	18.6	18.9	19.4	19.7	18.8	n/a
United States	26.9	27.3	27.1	25.5	25.5	26.0	25.8	27.1	26.9	27.0	26.7	26.8	26.7	27.0	27.6	n/a
Australia	28.4	29.3	29.6	28.4	30.0	30.0	30.9	31.1	30.7	30.6	30.8	29.1	28.7	28.8	29.9	31.3
Japan	25.4	26.2	26.6	27.0	27.1	27.6	28.4	29.7	30.3	30.7	31.3	30.8	29.2	29.1	27.8	n/a
New Zealand	32.9	3.8	34.5	32.1	32.2	33.3	33.7	36.5	36.0	38.7	37.6	36.3	36.2	35.6	37.0	38.1
Austria	41.2	42.5	41.2	41.1	42.4	43.1	42.9	42.3	42.0	41.0	41.3	41.9	43.2	43.5	42.8	42.0
Belgium	44.4	45.0	46.4	46.4	47.4	47.7	47.1	47.5	46.0	44.5	44.8	44.9	44.9	45.6	46.6	45.9
Czech Rep.														47.8	47.3	45.8

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Denmark	45.5	45.3	44.5	46.5	47.6	49.0	50.8	51.5	51.7	50.7	48.7	48.8	49.2	50.3	51.6	51.7
Finland	36.9	38.9	37.8	37.6	39.2	40.8	42.4	40.1	43.3	43.4	45.4	46.9	46.8	45.4	47.3	45.8
France	41.7	41.9	42.8	43.6	44.6	44.5	44.0	44.5	43.8	43.7	43.7	43.9	43.7	43.9	44.1	44.5
Germany[1]	38.2	37.7	37.7	37.4	37.6	38.1	37.7	38.0	37.7	38.2	36.7	38.2	39.0	39.1	39.3	39.1
Greece	29.4	29.6	33.4	33.9	34.9	35.1	36.9	37.2	34.9	34.6	37.5	39.0	40.8	41.2	42.5	n/a
Hungary												42.4	42.4	42.0	41.0	n/a
Iceland	29.2	30.2	30.6	28.1	29.7	28.4	28.5	28.9	31.5	32.5	31.4	31.4	32.2	31.3	30.9	30.9
Ireland	33.8	35.0	36.5	38.0	38.8	36.4	37.2	37.4	39.0	35.4	35.2	35.8	36.2	36.4	37.5	35.4
Italy	30.2	31.4	33.7	35.8	34.9	34.5	36.0	36.1	36.7	37.9	39.1	39.7	42.1	43.8	41.7	46.8
Luxembourg	46.3	47.8	49.1	51.8	50.1	46.7	44.0	44.5	43.3	42.3	43.6	42.9	42.5	44.3	45.0	43.7
Netherlands	45.0	44.4	44.7	46.0	44.2	44.1	44.9	47.5	47.6	44.9	44.6	47.2	46.8	47.7	45.9	44.4
Norway	47.1	48.7	47.9	46.6	45.8	47.6	50.0	47.9	43.1	41.3	41.8	41.8	41.0	40.2	41.2	42.7
Poland												37.2	38.2	42.4	43.2	43.6
Portugal	25.2	26.7	27.4	28.9	28.4	27.8	29.4	27.6	30.1	30.8	31.0	31.7	33.4	31.4	33.0	33.9
Spain	24.1	25.4	25.6	27.5	28.8	28.8	30.6	32.5	32.8	34.6	34.4	34.7	36.0	35.0	35.8	34.2
Sweden	48.8	50.1	49.1	49.8	49.5	50.0	52.5	55.4	54.8	55.5	55.6	53.7	51.0	50.1	51.0	50.2
Switzerland	30.8	30.6	31.0	31.6	32.3	32.0	32.5	32.0	32.6	31.7	31.5	31.2	31.9	33.2	33.9	34.4
Turkey	17.9	19.0	18.4	17.2	14.3	15.4	17.5	18.8	17.8	18.7	20.0	21.0	22.4	22.7	22.2	21.1
United Kingdom	35.3	36.5	39.0	37.3	37.9	37.9	37.6	37.2	37.1	36.2	36.4	35.7	35.1	33.4	34.1	35.2
Unweighted average:																
OECD Total	34.1	34.9	35.4	35.6	35.8	35.9	36.5	37.0	36.9	36.7	37.0	37.4	37.6	38.1	38.4	n/a
OECD America	25.3	26.0	26.0	25.9	25.7	25.8	25.6	26.7	26.2	26.9	27.3	27.5	27.5	27.5	27.5	n/a
OECD Pacific	28.9	29.7	30.2	29.2	29.8	30.3	31.0	32.4	32.3	33.4	33.2	32.1	31.4	31.2	31.6	n/a
OECD Europe	36.4	37.2	37.7	38.2	38.3	38.3	39.1	39.3	39.2	38.8	39.1	39.5	39.9	40.5	40.8	n/a
EU 15	37.7	38.5	39.3	40.1	40.4	40.3	40.9	41.3	41.4	40.9	41.2	41.7	42.0	42.1	42.5	n/a

1. Unified Germany beginning in 1991.

Source: Revenue Statistics 1990-1995 table 3, and 124 for 1995 estimates (OECD, Paris 1996)

A. Total tax revenues to GDP

1. General trends

Table 1 provides TTRs for OECD countries between 1965 and 1994 with estimates for 1995 for most of them.[6] Sections II A and B have already commented on developments in the unweighted OECD average which increased considerably between 1965 to 1977 and then remained stagnant for three years. There followed a large increase between 1980 and 1981 and a consistent, but slight increase between 1981 and 1987 and a very slight decrease between 1987 and 1989. Since 1989 the pattern of 1981 to 1987 has been repeated, that is to say a consistent but very slight increase in each year between 1989 and 1994. The TTR was higher in 1994 than in 1989 in all countries except Australia, Japan, New Zealand, Iceland, Norway, Sweden and the United Kingdom.[7]

2. Convergence and divergence

Convergence of total tax ratios in a given country occurs between two years, if the deviation from the average OECD TTR is less in the second year than in the first and divergence occurs when the reverse is the case. To put it differently, convergence entails that either a country with a below average TTR increases it by more than the average change between the two years or that a country with an above average TTR increases it by less than the average increase. Divergence occurs when the reverse is the case. (To simplify presentation I do not take into account decreases, which until recent years have occurred rarely, but the same principle applies.)

The results of convergence and divergence as shown in table 2 explain nothing, but merely give an indication as to whether countries which rely less on the public sector have caught up or whether, on the contrary, a country's attitude towards high taxes and government expenditure gathers momentum so that spending-prone governments have spent more and taxed more while governments relying more on the private sector continue to do so.

If the majority of countries show a convergent trend during the two years in question one can talk of countries' TTRs coming closer together and if the contrary, of moving further apart. The results provide an answer to one aspect of the question are countries' tax systems getting closer together or moving further apart. It should however be recalled that convergence and divergence are used to cover both very extreme and very mild departures from a no change situation, so it can give only a very rough guide to TTR trends, even more so because in some countries there are large changes in the intermediate years not covered.

During the 1970s and 1980s I wrote various articles on tax convergence and divergence and some of the results for each country are summarized on pages 76-77 of Messere (1993). Here is a brief summary of the earlier results together with the more recent comparisons shown in table 2.

6. Table 1 also includes available data for Mexico, The Czech Republic, Hungary and Poland, which because of lack of data for earlier years are not covered in this article.

7. It should be observed that experience shows that the estimates for the last year (1995) will be revised for most countries and figures for 1993 and 1994 may be revised for some as a result of recalculation of total tax yield or GDP.

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Years covered	Number of countries covered	Number of convergent countries	Number of divergent countries
1965-1972	15	6	9
1965-1974	15	6	9
1965-1989	24	12	12
1975-1989	24	16	8
1982-1989	24	16	8
1985-1994	24	17	7
1990-1994	24	14	10

For the reasons explained in Section II A divergence in TTRs predominated in the period from 1965 to 1974. Convergence has increased since then and was at its highest during the 1980s. Between 1990 and 1994, however, there was only a slight trend towards convergence.

Table 2

Convergence and Divergence of total tax receipts to GDP 1985 to 1994 and 1990 to 1994

	1985	1990	1994	(1994 minus 1985)		(1994 minus 1990)	
Australia	30.0	30.8	29.9	-0.1	D	-0.9	D
Austria	43.1	41.3	42.8	-0.3	C	1.5	C
Belgium	47.7	44.8	46.6	-1.1	C	1.8	C
Canada	33.1	36.5	36.1	3.0	C	-0.4	D
Denmark	49.0	48.7	51.6	2.6	D	2.9	D
Finland	40.8	45.4	47.3	6.5	D	1.9	D
France	44.5	43.7	44.1	-0.4	C	0.4	C
Germany	38.1	36.7	39.3*	1.2	C	2.6	D
Greece	35.1	37.5	42.5	7.4	C	5.0	C
Iceland	28.4	31.4	30.9	2.5	D	-0.5	C
Ireland	36.4	35.2	37.5	1.1	C	2.3	C
Italy	34.5	39.1	41.7	7.2	C	2.6	D
Japan	27.6	31.3	27.8	0.2	D	-3.5	D
Luxembourg	46.7	43.6	45.0	-1.7	C	1.4	C
Netherlands	44.1	44.6	45.9	1.8	C	1.3	C
New Zealand	33.3	37.6	37.0	3.7	C	-0.6	C
Norway	47.6	41.8	41.2	-6.4	C	-0.6	C
Portugal	27.8	31.0	33.0	5.2	C	2.0	C
Spain	28.8	34.4	35.8	7.0	C	1.4	D
Sweden	50.0	55.6	51.0	1.0	C	-5.6	C
Switzerland	32.0	31.5	33.9	1.9	D	2.4	C
Turkey	15.4	20.0	22.2	6.8	C	2.2	C
UK	37.9	36.4	34.1	-3.8	C	-2.3	D
US	26.0	26.7	27.6	1.6	D	0.9	D
OECD Unweighted average	35.9	36.7	38.4	2.5		1.7	

* First year to include United Germany.

C = Convergent	Convergent	17	14
D = Divergent	Divergent	7	10

Source: as table 1

B. The tax mix

1. General trends

Though various countries have their own special revenue sources, over 95 per cent of tax revenues derive from the six forms of taxation listed below and this has been the case for many years. In fact one can ignore the smallest sixth category of miscellaneous property and capital taxes, since there are unlikely to be any dramatic changes in reliance on them. Table 3 accordingly gives details only of the first five of the six categories of taxes shown below.

Unweighted OECD average percentage of total receipts

	1985	1990	1994
1. Personal income tax	30.5	29.9	27.5
2. Corporate income tax	7.8	7.6	7.5
3. Social security contributions	23.3	23.6	25.9
4. VAT and sales taxes	15.5	17.3	17.5
5. Excises and other specific taxes on goods and services	15.1	12.3	12.7
6. Property & capital taxes	4.9	5.3	5.2
Total of above taxes*	97.1	95.8	96.3

* There may be small discrepancies to the totals due to rounding differences.

Source: Revenue Statistics 1965-1995 (OECD 1996)

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Before turning to table 3, it may be mentioned that various governments, academics and pressure groups have been arguing for three kinds of changes to the tax mix.

First, for well-known reasons, not repeated here, there has been much advocation for a move from income taxation to consumption taxation.[8]

Second, in a few countries (France, Italy and Spain where employers' contributions are extremely high) a switch from payroll taxes to VAT has been suggested. The argument is that doing so would move some of the initial burden from labour input to consumption as a whole thus reducing a disincentive to taking on especially unskilled and part-time labour. In addition, such a move might improve international trade balances, since VAT but not payroll taxes is rebated when goods cross frontiers. In the long term tax shifting of payroll taxes into lower wages and exchange rate adjustments may invalidate these two arguments. But in the short run increases in payroll taxes may be reflected in both lower profits and higher prices and in the European Union there are constraints on exchange rate adjustments. There have been many representations from employers in France, Italy and Spain, who regard payroll taxes as a non-wage labour cost, claiming that they are at a competitive disadvantage compared with other countries having much lower payroll taxes.

Third, in a few countries, a move from the employees' social security contributions base towards an income tax base has been advocated even though the proceeds may remain earmarked for social welfare benefits. Here the argument is between those who regard contributions as social insurance contributions rather than taxes and those who regard them as a regressive form of taxation, with flat rates, no thresholds, low ceilings and no allowances for family circumstances. The Nordic countries earlier and the Netherlands recently have largely integrated the two levies and other countries have reduced the regressivity of contributions by imposing floors and increasing or abolishing ceilings.

In addition, without rational argument, a number of governments have moved from unpopular income taxes to social security contributions, based on the assumption that employees will more readily accept increases in employers' social security contributions.

8. Messere (1993) at 31-35 provides six reasons for a move from income to consumption taxation as well as five reasons against such a move.

Table 3

Particular tax receipts as a percentage of total tax receipts (to nearest percentage point)

	(1) Personal Income Tax			(2) Corporate Income Tax			(3) Social Security Contributions			(4) VAT and Sales Tax			(5) Excises and other specific Taxes on Goods and Services		
	1985	1990	1994	1985	1990	1994	1985	1990	1994	1985	1990	1994	1985	1990	1994
Canada	35	41	37	8	7	7	13	14	17	13	14	15	13	9	9
United States	38	38	36	7	8	9	25	26	25	8	8	8	8	7	8
Australia	45	43	40	9	14	14	zero	zero	zero	8	8	8	21	15	15
Japan	25	27	23	21	22	15	30	29	35	zero	4	5	12	7	8
New Zealand	60	46	45	8	6	12	zero	zero	zero	10	22	23	12	9	9
Austria	23	21	20	3	4	3	32	33	35	21	21	21	10	9	8
Belgium	35	32	31	5	5	6	32	34	33	15	16	16	8	8	9
Denmark	50	53	54	5	3	4	4	3	3	20	21	19	13	11	11
Finland	42	38	37	3	5	4	17	22	26	20	21	18	14	12	12
France	13	12	14	4	5	4	43	44	43	20	19	17	9	8	9
Germany	29	28	26	6	5	3	36	37	39	16	17	18	9	9	9
Greece	14	14	10	3	5	6	36	31	35	17	26	22	21	15	17
Iceland	19	26	30	3	3	2	2	3	8	33	32	32	26	17	14
Ireland	31	32	31	3	5	9	15	15	14	21	21	20	22	20	17
Italy	27	26	25	9	10	9	35	33	31	14	15	15	9	11	11
Luxembourg	26	23	21	18	16	17	26	27	27	12	14	13	11	11	13
Netherlands	19	25	20	7	7	7	44	37	42	16	16	15	7	7	9
Norway	22	26	26	17	9	8	21	26	24	18	19	21	18	15	16
Portugal	n/a	16	19	n/a	8	7	26	27	26	13	20	23	29	23	21
Spain	20	22	23	5	9	5	41	35	39	15	16	15	13	10	10
Sweden	39	38	37	3	3	5	25	27	27	14	15	16	12	9	9
Switzerland	35	34	34	6	7	6	32	33	37	9	10	8	8	7	7
Turkey	27	27	24	9	7	6	14	20	16	23	20	30	12	7	6
United Kingdom	27	28	28	12	11	8	18	17	18	15	17	20	14	13	14

Source: as table 1.

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Table 3 shows that between 1990 and 1994 there were a number of large changes (taken as 3 percentage points or more of total tax receipts) in the tax mix and that these were in very different directions.

Canada	a move from personal income tax (–4) to social security (+3)
Australia	a decline in the personal income tax share (–3)
Japan	a move from personal (–4) and corporate (–7) income tax to social security (+6)
New Zealand	an increase in the corporate income tax share (+6)
Finland	a move from VAT (–3) to social security (+4)
Greece	a move from personal income tax (–4) and VAT (–4) to social security (+4)
Iceland	a move from excises (–3) to personal income tax (+4) and social security (+5)
Ireland	a move from excises (–3) to corporate tax (+4)
Netherlands	a move from personal income tax (–5) to social security (+5)
Portugal	an increase in the personal income tax and VAT share (+3)
Spain	a move from corporation tax (–4) to social security (+4)
Switzerland	an increase in the social security share (+4)
Turkey	a move from personal income tax (–3) and social security (–4) to VAT (+10)
United Kingdom	a move from corporation tax (–3) to VAT (+3)

One can detect two trends during the 1990s. The first is the increase in the social security share of 3 or more percentage points in eight countries, most often, but not invariably representing a shift from the personal income tax. The increase in the share of contributions may be due at one level to increases in pensions and unemployment benefits resulting from the higher proportion of pensioners and unemployed and at another level in their greater acceptability than an increase in other taxes, since taxpayers believe they are getting a quid pro quo. The second trend is that for the first time since the 1960s, there has been a slight increase in the ratio of receipts from excises to GDP. The decline of these receipts for most of the period during 1960 to 1990 has been generally attributed to negative fiscal drag. Being subject mainly to specific rates of tax their real value declines during inflation unless governments raise the rates, something unpopular with both producers and consumers. This reversal during the 1990s is perhaps due to a combination of lower inflation, the increase in motoring and the European Union's agreed minimum rates (see Section VI D below).

Of the other main taxes there has been a slight increase in the share of receipts from VAT and a slight decrease in the share of the personal income tax receipts and hardly any change to the corporate income tax share. In view of the rate increase of VAT in many countries during the 1990s, a greater switch to VAT as a revenue source may be predicted over the next years.

Between 1985 and 1994 the following were the more significant changes in the tax mix (taken as 5 percentage points or more of total tax receipts).

Australia	a move from personal (–5) to corporate (+5) income tax
Japan	a move from corporation tax (–6) to social security (+5) and VAT (+5)
New Zealand	a move from income tax (–15) to VAT (+13)
Finland	a move from personal income tax (–5) to social security (+9)
Greece	an increase in the VAT share (+5)
Iceland	a move from excises (–12) to personal income tax (+11) and social security (+6)
Luxembourg	a decrease in the personal income tax share (–5)
Norway	a decrease in the corporate income tax share (–9)
Switzerland	an increase in the social security share (+5)
Turkey	a move from excises (–6) to VAT (+7)
United Kingdom	an increase in the VAT share (+5)

During this longer period there has been a larger decline in the average share of personal income tax receipts and a corresponding larger increase in the share of receipts from contributions and VAT. The average share of receipts from property taxes, which had been consistently declining between 1965 and 1985 has been slightly increasing since 1985. There was a slight decline in the share of receipts from excises etc. and little change in the share of receipts from the corporate taxes.

2. Convergence and divergence

Convergence occurs in any given country between two years in respect of the ratio of receipts from a particular tax to GDP, if the ratio is nearer to the OECD average ratio in the second year than it was in the first year and divergence occurs when the reverse is the case.[9] It follows that convergence occurs when a country with above OECD average receipts from that particular tax to GDP increases it below the average OECD change over these two years: convergence also occurs when a country with below OECD average receipts from a particular tax to GDP increases it above the OECD average increase in receipts from that particular tax to GDP. Divergence occurs when the reverse is the case. (As in the case of convergence and divergence of TTRs, to simplify presentation I do not amplify to take into account decreases – see Section IV A 2 above).

9. An alternative and equally valid method of defining convergence and divergence of tax structures is to compare changes in the share of different taxes in total tax receipts instead of changes in their yield as a percentage of GDP. As indicated in footnote 1 to table 4, some changes in the number of convergent and divergent countries would result. However, as earlier indicated, these results are of limited analytical interest and are intended only as a rough illustration of whether countries' profiles have come closer together or further apart with respect to revenues received from particular revenue sources.

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The main arguments for convergence are that excessive reliance on a particular source of revenue tends to be distortive and provoke taxpayers' resistance, because of its transparency, whereas diversification of revenue sources may be more acceptable since different kinds of tax are paid, at least initially, by different people (earners, businesses, consumers). On the other hand, there are often practical reasons for countries to remain divergent, particularly when there is little taxpayer resistance as in the 1960 to 1975 period. For example an increase (or adoption in the case of VAT) in a previously low source of revenue may involve a substantial reorganization of government tax departments as well as increased compliance costs for business. The opposition in the United Kingdom in the 1960s, in Switzerland in the 1970s and in Canada and Japan in the 1980s to introducing a VAT, an opposition which still prevails in Australia, provide examples. Sometimes tax eccentricities fade away but sometimes they have remained sustainable over many years, and still remain.

For example in the early 1950s the UK obtained more revenue from the tax on cigarettes than from the whole of its general consumption tax, the purchase tax that was replaced by VAT in 1973. In 1965 excises and similar taxes on drinking, smoking and motoring accounted for well over 40 per cent of total tax receipts in Iceland, Ireland, Portugal and Turkey and a third of total tax receipts in Greece. As late as 1980 they still accounted for over a quarter of tax receipts in these five countries. In Ireland the tax administration then affectionately called these excises, the "old reliables" because of the political and technical difficulties of subjecting farmers to income tax and the resentment of salary and wage earners who bore the whole income tax burden. However, over time with the widening of the income tax net and the introduction of VAT the share of receipts from excises has consistently declined in Ireland. Another extreme example during the early to mid 1980s was that around 60 per cent of the total receipts of New Zealand derived from the personal income tax, and it was taxpayer discontent with the distortions involved together with a reforming Minister of Finance that permitted the introduction of a broad based VAT with consequential reduction in reliance on the income tax. Denmark on the contrary has since 1975 obtained over half of its tax revenues from the personal income tax with only 3 per cent from social security contributions, while since 1965 France has obtained a higher share of its revenues from social security contributions (43 per cent in 1994) than any other OECD country and the lowest share of personal income tax revenues (14 per cent in 1994) except Greece.

During the 1970s and 1980s I carried out various tests over different periods concerning the convergence or divergence of countries' reliance on particular sources of revenue, using the methodology described in the first paragraph of this section rather than the alternative described in footnote 9. For most taxes the results varied greatly according to the two years compared, with generally more countries showing a convergent than a divergent trend. This was the case with personal and corporate income taxes and VAT or sales taxes. However, no matter what periods were compared, nearly all countries were divergent regarding social security contributions and for the most part convergent regarding excises etc. (taken as short hand for taxes on specific goods and services). The social security receipts to GDP increased in nearly all countries, no matter what years in the 1960s to 1980s were compared, but almost invariably it *increased* by more percentage points in those countries where this ratio was above the OECD average in the earlier year. On the contrary, the excise etc. receipts to GDP decreased in nearly all countries, whatever years were chosen, but usually it *decreased* by more percentage points in those countries where this ratio was above the OECD average in the earlier year.

Rather than repeating all these tests, table 4 provides details only on these two levies, which in the past showed almost universal divergence in the case of social security contributions and predominantly convergence in the case of excises etc. Table 4 shows these trends no longer apply over the decade 1985 to 1994. However, between 1990 and 1994, the earlier predominance of divergence from the average of revenues from social security contributions has resumed with increases in contributions occurring in all countries except France, Norway, Sweden, Turkey and the United Kingdom and of course in Australia and New Zealand which do not have contributions: the larger increases generally occurring in countries with an above average contributions to GDP ratio in 1990. For the first time since records were available in 1960, more countries have diverged from the excise receipts to GDP ratio and for the first time this ratio has increased consistently throughout the 1990s in 14 countries, albeit by small amounts, and the above average increases usually occurred in countries where the 1990 excise to GDP ratio was above the OECD average.

C. Attribution of tax revenues by subsectors of general government

Table 5 provides the relative share of tax resources allocated to the various subsectors of general government for the years 1985 and 1994. Figures shown under state and local government include revenues from those taxes which the subordinate level of government has no power to vary the rate or base, if revenues are shared between different levels of governments. Statisticians have generally preferred this categorization even though some writers would claim these shared taxes are more akin to grants than taxes.[10] The supranational column refers invariably to taxes paid to the European Union, whose revenues derive mostly from a percentage of a hypothetical VAT base. This is simply an allocative formula which might be replaced by GDP per capita, and being clearly a grant and not a tax, the amounts are not included in the figures shown in the first column of table 5. There has been a slight decrease in the share of EU revenues between 1985 and 1994 in all countries that were members in 1985.

10. In most countries subordinate levels are able to vary the rates and/or base of their taxes, but within strict limits.

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Table 4

Convergence and divergence of Social Security Contributions and excises etc. as percentage of GDP (1985 to 1994) and (1990 to 1994)

	Social Security Contribution					Taxes on Specific Goods and Services				
	1985	1990	1994	1994 minus 1995	1994 minus 1990	1985	1990	1994	1994 minus 1985	1994 minus 1990
Australia	zero	zero	zero	0.0(D)	0.0(D)	6.2	4.7	4.5	-1.7(C)	-0.2(C)
Austria	13.7	13.6	15.0	1.3(C)	1.4(D)	4.3	3.7	3.6	-0.7(D)	-0.1(D)
Belgium	15.7	15.2	15.2	0.1(C)	0.3(C)	3.7	3.5	4.2	0.5(C)	0.7(D)
Canada	4.5	5.2	6.1	1.6(D)	0.9(D)	4.3	3.5	3.1	-1.2(D)	-0.4(D)
Denmark	1.9	1.5	1.6	-0.3(D)	0.1(D)	6.3	5.4	5.6	-0.7(C)	0.2(D)
Finland	7.1	9.9	12.1	5.0(C)	2.2(D)	5.7	5.3	5.7	0.0(D)	0.4(C)
France	19.3	19.3	19.1	-0.2(C)	-0.2(C)	3.9	3.8	4.0	0.1(C)	0.2(D)
Germany	13.9	13.7	15.4	1.5(C)	1.7(D)	3.3	3.4	3.7	0.4(C)	0.3(D)
Greece	12.5	11.7	14.7	2.2(D)	3.0(D)	7.3	5.8	7.2	-0.1(D)	1.4(D)
Iceland	0.7	1.0	2.5	1.8(C)	1.5(C)	7.5	5.4	4.5	-3.0(C)	-0.9(C)
Ireland	5.4	5.2	5.4	0.0(D)	0.2(D)	8.0	7.1	6.4	-1.6(C)	-0.7(C)
Italy	12.0	12.9	13.0	1.0(C)	0.1(C)	3.1	4.1	4.4	1.3(C)	0.3(D)
Japan	8.4	9.1	9.8	1.4(D)	0.7(C)	3.3	2.3	2.3	-1.0(D)	0.0(D)
Luxembourg	12.3	11.9	12.0	-0.2(C)	0.1(C)	5.3	4.7	6.1	0.8(D)	1.4(D)
Netherlands	19.5	16.7	19.3	-0.2(C)	2.6(D)	3.2	3.3	3.9	0.7(C)	0.6(C)
New Zealand	zero	zero	zero	0.0(D)	0.0(D)	3.9	3.4	3.3	-0.6(D)	-0.1(D)
Norway	9.8	11.0	9.9	0.1(C)	-1.1(C)	8.6	6.4	6.8	-1.8(C)	0.4(C)
Portugal	7.2	8.4	8.7	1.5(D)	0.3(D)	8.0	7.3	7.0	-1.0(C)	-0.3(C)
Spain	11.9	12.2	19.8	1.9(D)	1.6(D)	3.7	3.6	3.6	-0.1(D)	0.0(D)
Sweden	12.5	15.1	13.9	1.4(C)	-1.2(C)	5.8	5.1	4.8	-0.1(C)	-0.3(C)
Switzerland	10.3	10.4	12.4	2.1(D)	2.0(D)	2.6	2.2	2.4	-0.2(D)	0.2(D)
Turkey	2.2	3.9	3.5	1.3(D)	-0.2(D)	1.9	1.5	1.4	-0.5(D)	-1.0(D)
UK	6.8	6.2	6.1	-0.7(D)	-0.1(D)	5.2	4.6	4.7	-0.5(C)	0.1(D)
US	6.6	6.9	7.0	0.4(D)	0.1(D)	2.2	7.9	2.2	0.0(D)	0.3(D)
OECD unweighted average	8.6	8.9	10.2	1.6	1.3	5.0	4.3	4.8	-0.2	+0.5
Convergent				11	8				13	8
Divergent				13	16				11	16

If the alternative method of using total tax receipts instead of GDP as the denominator was used the number of convergent and divergent countries would have changed as follows:

Social Security Contributions

1985-94 13 convergent and 11 divergent instead of 11 convergent and 13 divergent
1990-94 12 convergent and 12 divergent instead of 8 convergent and 16 divergent

Excises etc.

1985-94 No change 13 convergent and 11 divergent in either case
1990-94 7 convergent and 17 divergent instead of 8 convergent and 16 divergent

Source: As table 1

1. Federal countries

In all seven countries except Australia there has been an increase in revenues allocated to the social security sector, and this has been fairly substantial except in the United States. This reflects the general increase in Social Security contributions shown in table 3 as these receipts are earmarked for the social security sector.

The share of federal government receipts in 1985 varied from 81 per cent in Australia to 29 per cent in Switzerland and between 1985 and 1994 declined in five countries, increased in Austria and remained more or less unchanged in Germany. The shift from federal government revenues was to the social sector, there being little increase in the share of state and local government except for a relatively large increase in the share of state government in Australia. In most federal countries there has been a slight decline over the last decade in both the state and local government share.

2. Unitary countries

In unitary countries the share of central government receipts in 1985 varied from 93 per cent in New Zealand to 44 per cent in Japan and the local government share from 30 per cent in Sweden to just over 1 per cent in Greece. Between 1985 and 1994, there have been mild shifts from central to local government in Denmark, Finland, France, Iceland, Nor-

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way, Portugal and a rather larger one in Sweden. The largest shift of all was in the United Kingdom and in the other direction, for central government's share rose from 71 to 77 per cent and the local government's share fell from 10 per cent to 4 per cent. There was also a slight move from local to central government in Luxembourg and New Zealand.

Unlike federal countries, there was little overall trend in the share of receipts of the social security sector, most countries increasing or decreasing this share very slightly. There were however large increases between 1985 and 1994 in Finland, Japan and Sweden and a large decrease in Italy and Spain. Finally the unweighted average of the social security share increased and that of both central and local government decreased over this period.

3. Fiscal federalism

The primary purpose of this section has been to see whether the limited data available, as reproduced in table 5, throw any light on the question whether over the last decade there has been any trend towards or away from giving a higher proportion of tax to subordinate levels of government. The above observations show that there has been hardly any trend in federal countries: only a move from federal to state government in Australia and from state to local (as well as federal) government in Austria. Among the unitary countries there was a move from central to local government in most countries (10 out of 17), but except in Sweden the move was slight. In contrast, in the United Kingdom the local government's share already below average was reduced by more than half and local government taxation powers have been further constrained by reduction in their grants if they raised their own taxes beyond a certain limit.

V. NOMINAL RATES OF TAX

A. Introductory remarks

Although nominal rates of tax may be a poor guide to tax actually paid, since this depends not only on the base to which the rates apply, but also upon the proportion of tax evaded, various questionnaires and enquiries have made it clear that it is nominal rates that predominate in political arguments on the incentive and equity effects of taxation. There are good reasons for this. Nominal rates are more transparent than effective rates, for calculating the personal and corporate income base is a very complicated operation,

Table 5

Attribution of tax revenues to subsectors of general government as percentage of total tax revenue

	Supranational		Central government		State		Local		Social security	
	1985	1994	1985	1994	1985	1994	1985	1994	1985	1994
Federal countries										
Australia			81.4	76.9	14.9	19.5	3.7	3.6	-	-
Austria			48.9	49.7	13.1	10.5	10.7	11.0	27.2	28.8
Belgium	1.6	1.2	61.6	59.1			5.2	5.2	31.6	34.5
Canada			41.2	39.2	36.0	33.8	9.3	10.1	13.5	16.9
Germany	1.0	0.6	31.6	31.5	22.0	21.1	8.9	7.6	36.5	39.1
Switzerland			28.7	26.7	22.6	20.7	16.7	15.9	32.0	36.6
United States			42.1	41.1	20.2	19.9	12.6	13.6	25.2	25.5
Unweighted Average	1.3	0.9	47.9	46.3	21.5	20.9	9.6	9.6	23.7	25.9
Unitary countries										
Denmark	0.7	0.4	68.5	65.5			28.3	30.8	2.5	3.2
Finland			55.8	48.8			22.4	22.6	21.8	28.6
France	0.6	0.4	47.2	45.9			8.7	10.1	43.5	43.6
Greece	0.8	0.6	62.5	64.7			1.3	1.3	35.3	33.3
Iceland			81.4	80.1			18.6	19.9	-	-
Ireland	2.0	1.3	82.1	83.4			2.3	2.3	13.6	12.9
Italy	0.6	0.4	62.3	63.6			2.3	4.8	34.7	31.2
Japan			43.7	40.5			26.0	24.4	30.3	35.1
Luxembourg	0.5	0.4	67.0	67.5			6.6	5.8	25.9	26.2
Netherlands	1.5	1.3	51.9	54.1			2.4	2.5	44.3	42.1
New Zealand			93.5	94.7			6.5	5.3	-	-
Norway			59.5	56.3			18.0	20.9	22.5	22.8
Portugal			70.6	68.3			3.5	5.4	25.9	26.3
Spain	-	0.5	47.8	48.6			11.2	12.7	41.0	38.2
Sweden			54.1	45.3			30.4	33.8	15.6	20.9
Turkey			75.5	75.1			10.2	9.1	14.3	15.8
United Kingdom	1.1	1.0	71.0	77.0			10.1	4.0	17.9	18.0
Unweigted average	0.9	0.7	64.4	62.6			12.3	11.8	22.9	24.9

Source: Revenue Statistics 1965-95 (OECD, Paris 1996) Table 134

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and the base will vary considerably between taxpayers. The base may be affected also by transfer pricing manipulation and the varying ability of taxpayers to qualify for, or to understand how to take advantage of base-related concessions.

It is too difficult to compare nominal rates of Social Security contributions and excises, but table 6 gives details of certain aspects of the nominal rates of the other main revenue raisers of central/federal government, the personal income tax, the corporate income tax and the value added tax. For the central government personal income tax the top marginal rate of tax is compared over recent years, but as in many countries less than 5 per cent of taxpayers are subject to the top rates, details are also given of the reduction in number of brackets or what is known as the flattening of the income tax schedule. Although there may be special rates for firms in certain sectors or with low profits, there is usually only one rate of central government corporation tax which is that shown in the table. Also, although a number of countries have lower rates of VAT, the standard rate of VAT given in the table usually accounts for 80 per cent to 100 per cent of total receipts.

Table 6 notes also that there are local income taxes in a number of countries not reproduced. These are particularly important compared to central/federal government income taxes in the Nordic countries and Switzerland. Unlike the central rates, the local rates have not generally been reduced.

B. Common trends

The three kinds of reform to the income tax summarized in table 6 occurred in most countries during the late 1980s. In contrast there was comparatively little change in the early 1990s, though a few countries introduced one or more of these earlier reforms (France, Germany, Luxembourg) and also in late 1996 the French government announced that over the next few years the top rate of the personal income tax would be gradually reduced from 56 per cent to 47 per cent. In nearly all cases the top marginal rate was *substantially* lower in 1995 than in 1986. Exceptions were Germany, Iceland, Switzerland where the decrease was slight and Turkey where there was an increase. In nearly all countries there was a substantial reduction in the number of personal income tax brackets between 1986 and 1996. Exceptions were usually due to there being very few brackets in 1986 (Australia, Denmark, Iceland, Ireland) but in Italy the decrease was only from 9 to 7, in Luxembourg only from 21 to 17, while in Turkey there was an increase from 6 to 7 brackets and in Switzerland from 6 to 13. The nominal standard rate of corporation tax was also much lower in 1995 than 1986 except in Italy, Spain and Switzerland, where it remained unchanged, in the United Kingdom where it decreased very slightly and in Austria where it increased.

Table 6 shows that 14 countries adopted VAT between 1968 and 1973, and a further 8 between 1986 and 1995 leaving only Australia and the United States without a VAT. Of the 14 first generation VAT countries the only change in rate between 1986 and 1990 was a decrease in the Netherlands from 19 per cent to 18.5 per cent. In contrast between 1990 and 1996 there were increases in VAT rates in 11 of the first generation VAT countries, exceptions being Austria, (no change), and Ireland and the Netherlands, where there were decreases. During the 1990s there was also an increase in the rates of most of the second generation VAT countries. Taking a longer view, there has been an increase, often quite considerable, in all the 22 countries since VAT was first introduced with the exception of Canada, Japan (see table 6) Portugal and Switzerland.

C. Convergence and divergence

Convergence of nominal rates of a particular tax between two years in a given country would occur if the rate were nearer to the OECD average rate of that tax in the second year than in the first, divergence if the rate was nearer to the OECD average in the first year. However, as the amount of revenue received from a given tax depends upon a number of factors other than the rate, the concepts of convergence and divergence of rates give little information of interest in examining tax trends. Consequently nothing more is said about convergence and divergence of tax rates.

VI. THE INFLUENCE OF THE EUROPEAN UNION ON TAX TRENDS IN THE 1990S

A. General considerations

The European Commission is empowered to make proposals on consumption taxes and corporate income taxes, which if approved by the European Parliament and unanimously by the Council of Ministers which represent Member Governments, will become Directives having the force of European Union Law which overrides national law. The European Union has no power with regard to other taxes, notably the personal income tax and social security contributions, where Member States of the European Union have complete sovereignty. (A complication is that the corporate tax system usually has implications for amounts of personal income tax paid on dividends).

An indirect influence of the European Union on its Member States' tax policy is the Maastricht requirement that deficits should not exceed 3 per cent of GDP if countries are to join the single Euro currency by 1999. Annex table 30 of the December 1996 *OECD Economic Outlook* predicted this will be achieved by 1998 in all EU countries except Austria, Greece and Italy. However, since then some doubts have been expressed as to whether this target will be met in certain other major countries such as France and Germany, in the absence of unpopular political decisions which may be unacceptable to the electorate in these countries. Whether the result will be the relaxation or manipulation of the criterion or postponement of the single currency is currently under discussion. It is also a Maastricht condition that the total (nominal value) of gross debt should not exceed 60 per cent of GDP. Annex table 61 of the December 1986 *OECD Economic Outlook* suggests

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Table 6
Nominal rates of personal and corporation income tax and VAT at federal/central level

	Top marginal rates of personal income tax and number of rates			Basic rates of corporation income tax to nearest percentage point			Standard rate of value added tax as (3)percentage of tax exclusive price				
	1986	1990	1995	1986	1990	1995	1986	1990	1996	starting rate	year introduced
Australia	57(5)	47(4)	47(4)	49	39	33	n/e	n/e	n/e	n/e	n/e
Austria	62(10)	50(5)	50(5)	30	30	34	20	20	20	16	1973
Belgium(4)(2)	72(12)	55(7)	55(7)	45	39	39	19	19	21	18	1971
Canada(1)(2)	34(10)	29(3)	31.3(4)	36	29	29	n/e	n/e	7	7	1991
Denmark(1)(2)	45(3)	40(3)	34.5(4)	50	38	34	22	22	25	10	1967
Finland(1)(2)	51(11)	43(6)	39(6)	33	23	25	19.05	19.05	22	12.4	1969
France	65(12)	57(12)	56.8(6)	45	34/42(4)	33	18.6	18.6	20.6	20	1968
Germany	56(n/a)	(n/a)53	53(n/a)	56/36(4)	50/36(4)	45/30(4)	14	14	15	10	1968
Greece	63(18)	50(9)	40(13)	49	46	35/40(4)	n/e	18	18	16	1987
Iceland(1)	38.5(3)	33(1)	38.15(2)	51	45	33	n/e	22	24.5	22	1989
Ireland	58(3)	53(7)	48(2)	50	43	50	23	23	21	16.4	1972
Italy(2)	62(9)	50(7)	51(7)	36	36	36	18	18	19	12	1973
Japan(1)(2)	70(15)	50(5)	50(5)	43	38	38	n/e	3	3	3	1989
Luxembourg	57(21)	56(24)	50(17)	40	33	33	12	12	15	8	1970
Netherlands	72(9)	60(3)	60(3)	42	35	35	19	18.5	17.5	12	1969
New Zealand	57(6)	33(2)	33(2)	45	33	33	10	10	12.5	10	1986
Norway(1)(2)	40(8)	20(2)	13.7(2)	28	27	19	20	20	23	20	1970
Portugal(1)(2)	60(n/a)	40(n/a)	40(n/a)	42/47(4)	36	36	17	16	17	17	1986
Spain(1)(2)	66(34)	56(16)	56(16)	35	35	35	10	12.5	16	12	1986
Sweden(1)	50(10)	20(1)	25(1)	52	30	28	23.5	23.5	25	11.1	1969
Switzerland(1)(2)	13(6)	13(6)	11.5(13)	4-10(5)	4-10(5)	4-10(3)	n/e	n/e	6.5	6.5	1995
Turkey(1)(2)	50(6)	50(6)	55(7)	46	49	25	12	12.5	15	12	1985
United Kingdom	60(6)	40(2)	40(3)	35	34	33	15	15	17.5	10	1973
United States(1)(2)	50(14)	28(2)	39.6(5)	46	34	35	n/e	n/e	n/e	n/e	n/e

1. Countries with sub central personal income taxes
2. Countries with sub central corporation income taxes
3. Some countries also have special rates for firms with lower profits and for particular sectors
4. Retained and distributed profits respectively
   n/a = not applicable
   n/e = non-existent
5. Tax is a progressive rate.
6. Currently there are proposals to increase Japan's rate to 5 per cent.

none of the EU Member Countries will achieve this target except France and the United Kingdom, but nobody seems to be worrying about that.

B. Corporate income tax

Although certain Directives have been adopted in the field of corporation taxation concerning the treatment of parents and subsidiaries, arbitration procedures and mergers, they do not relate to the matters referred to in this article, namely the tax system (classical, imputation, shareholder relief, split rate etc.) the tax base and nominal tax rates. Three proposals emanated from the Commission for a common system, in 1962 for a split-rate system, in 1970 for a classical system, and in 1975 for a partial imputation system. A number of countries in the then Common Market changed their system, but never in the direction recommended by the European Commission. In the late 1970s the European Parliament suggested that the system should be considered together with rates and base. In 1990 the Commission withdrew its 1975 proposals and in 1991 set up the Ruding Committee to enquire into the need and desirability of harmonizing Member States' systems, base and rates. Although the Ruding Committee made a number of priority recommendations to alleviate existing tax distortions against investment across borders of Member States, it made no recommendations for the adoption of any particular system.

The Ruding Committee made no important recommendation with respect to harmonizing the tax base. Some members of the Committee thought it desirable to narrow the base, so that European Union Countries would not be at a disadvantage compared to non-member countries, others thought it should be widened to reduce non-neutralities.

The Ruding Committee did recommend that in the short term the minimum nominal rate of corporation tax should be at least 30 per cent and in the longer term the rate should not exceed 40 per cent. I was never clear about the rationale for the maximum rate, which could have been left to tax competition. There was, however, evidence that certain EC States were imposing very low rates of corporate tax in certain circumstances in order to attract inward investment and that

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other countries could not afford the loss of revenue involved to match these concessions.

As far as I am aware, Member States have accepted none of the many recommendations of the Ruding Committee over the last six years and accordingly they seem unlikely to accept the recommendation on rates during what remains of the 20th century.

C. VAT

The most important tax influence of the European Commission has been to make adoption of VAT a condition of membership of the European Union, but of course all this happened before the 1990s and potential candidates for membership already have VAT in force.

The Sixth Directive has laid down a common base which includes goods and services that must be taxed and those (mostly financial services) that may be taxed or exempt. For the most part Member States conform to the Directive and during the 1990s Finland, and Sweden have widened their tax bases to include previously untaxed services and Portugal has abolished zero rating.

It was once hoped that a single standard rate of VAT could apply to all EU States. However, given the wide variation in the percentage of the total tax take represented by VAT (i.e. 13 per cent of the total tax receipts in Luxembourg to 23 per cent in Portugal) this clearly is not possible. In 1987 the Commission attempted to impose a standard rate of between 14 per cent to 20 per cent together with a reduced rate of 4 per cent to 9 per cent on strictly defined goods. For budgetary reasons this was unacceptable to some of the countries with a standard rate of over 20 per cent and no reduced rate. Later it was accepted that the minimum rate should be at least 15 per cent and countries were permitted rather than required to have up to two lower rates, provided that the lowest rate was at least 5 per cent. No higher rates than the standard rate were permitted. This has had some influence during the 1990s being one reason for the VAT increase in Germany, Luxembourg and Spain, all of which had previously a standard rate below 15 per cent. Also during the 1990s above-standard rates were abolished in Belgium, France, Greece, Italy, Portugal and Spain.

The main VAT rate problem remaining is the extensive zero rating in Ireland and the United Kingdom which is permitted for a so far unspecified transitional period. It is considered unlikely that during the rest of the 1990s the Commission will propose the end of the transition period.[11]

D. Excises

In 1987 the Commission unrealistically proposed complete harmonization of excises. In 1985 excise revenues represented 17 per cent of total tax receipts in some EU States and below 9 per cent in others. It is true that differences in excise rates create distortions and problems for high excise countries like Ireland, Denmark and the United Kingdom because their citizens buy in neighbouring countries (Northern Ireland, Germany and France respectively) but the high excise tax countries cannot afford the budgetary loss that lowering these excise rates would entail and raising the rate in the low excise countries would be politically unacceptable. However, in 1992 the Commission put forward revised proposals for minimum excise rates, which it seems have been largely observed. France, for example, increased its rate on cigarettes and beer to reach this minimum. I do not know if other countries have increased their excise rates during the 1990s to conform to the 1992 Rates Directive, but Greece, Italy and Spain were below the minimum for cigarettes and Luxembourg for all forms of hydrocarbon oil.[12] The minimum of zero for wine, which pertains in Germany (still wine only) Greece, Italy, Luxembourg (sparkling only), Portugal and Spain evidently poses no problem.

Finally the European Commission's decision to limit excises to alcoholic drinks, tobacco products and hydrocarbon oils has led to the phasing out in a number of countries of "nuisance" excises on products such as coffee, tea, salt and sugar, which bring in little revenue and have little rationale. Nevertheless there remains a proliferation of nuisance excises in Denmark, Finland, France and Italy and a few in Austria, Germany, Greece, Portugal, Spain and the United Kingdom.[13] There are also a few pollution excises, especially in the Netherlands, which do have some rationale.

E. Conclusions

To summarize this section, the European Commission has had during the 1990s a considerable influence on the VAT rates and base and also on the rates of the main excises on motoring, drinking and smoking as well as the coverage of goods subject to excises, but no influence at all on the systems, bases and rates of corporation tax or any other tax.

VII. QUESTIONS FOR THE REST OF THE 20TH CENTURY

A. Tax levels: up or down?

Whether tax levels (defined as TTR) will increase, decrease or remain roughly the same over the next few years depends on a variety of factors, only some of which will depend on governments' preferences. The rate of growth of economies, the levels of employment and the results of the eternal struggle between revenue officials and tax minimizers are among

11. The other main VAT problem, in which country and at what rate goods crossing frontiers of EU States should be taxed, is outside the scope of this article.
12. The information here is taken from my article for the December 1994 edition of the *Bulletin for International Fiscal Documentation* on "International Consumption Tax Rules" but I am out of touch with more recent developments in changes in excise rates.
13. This information is taken from the country tables in OECD Revenue Statistics which vary in the detail provided by countries, so this list should be taken as illustrative rather than exhaustive.

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the factors over which governments may have some but not total control. Where governments are more directly concerned is in the relative importance they attach to reducing fiscal deficits and increasing or decreasing or stabilizing the percentage of public expenditure to GDP, since it is their attitudes on these matters that will largely influence what happens to TTRs. There is also, of course, the possibility of privatization which to some extent can be a substitute for raising TTRs though the scope for (further) privatization varies between countries. As in the past, one may expect the TTR to move in different directions in different countries. This section is concerned with predicting what seems likely to be the general trend. It also tries to answer the question if TTRs are to be increased, what forms will the increases take?

In practice governments are unlikely to be neutral in their choice to raise or lower their TTRs. In favour of lowering tax levels is the desire of most voters in most countries for such lowering. Even if in reply to opinion polls a majority may express a preference for higher spending on health, education and social welfare at the cost of tax increases, such altruism tends to be forgotten when it comes to voting. Governments may also be constrained by their pre-election promises to lower taxes, though since the days of "read my lips" the promises may be qualified by "as soon as the economic situation or sound financial policy permits". Sound financial policy refers evidently to the fiscal deficit which thanks to the politicians, the media and the Maastricht criterion is generally recognized as something which governments have to address. Apart from increasing tax levels, the main way of reducing the deficit is to cut public expenditure, of which that on pensions, health, social welfare and education make up the greater part. Cutting public expenditure is particularly difficult when in most countries demographic trends entail a future increase in the ratio of pensioners to those in the work force and when in many countries unemployment levels remain very high.

The past provides some support for the view that increased taxation is necessary to reduce fiscal deficits. For example it is noted in an article in *OECD Economic Outlook* 59 [Paris: June 1996] commenting on the experience of 18 OECD countries between the years 1974 and 1996 "that significant fiscal consolidation, defined as positive change in the general government structural financial balance equivalent to at least 3 percentage points of GDP which takes place continuously over [at least two] consecutive years occurred on 15 occasions. In all but one of these 15 cases, fiscal consolidation included at least some increase in the proportion of total revenue to GDP".

A second reason for forecasting an increase rather than otherwise in tax levels is that as noted in Section IV A 1) there has been a consistent if slight increase in the average OECD TTR in each year between 1989 and 1994 and the TTR was higher in 1994 than in 1989 in 17 of the 24 countries covered in this article. In the longer term there have been annual increases in this average in 25 of the 30 years between 1965 and 1994, the exceptions being during the aftermath of the second oil shock in the late 1970s and in the late 1980s between 1987 and 1989.[14]

It is for these inductive reasons, together with a belief that generally governments will take seriously the need to reduce their deficits and will be unable to reduce by much their expenditures on health, pensions, education and social welfare that I believe that TTRs will continue to increase in most countries over the next few years. How will this be achieved? Increases in rates of personal or corporate income tax or capital gains are unlikely to occur, since this is the area where taxpayer resistance and politicians' pledges have focused. This leaves the income tax base where there is in many countries the possibility of abolishing or reducing tax reliefs related to certain expenditures or substituting tax credits for tax allowances, both of which can be defended on horizontal and vertical equity grounds. This applies in particular to tax relief for savings. Though there is a trend in a few countries to advocate relief for all savings (see Section III C above) the arguments for doing so seem flawed. In the first place the evidence suggests that such universal relief for savings is unlikely to increase their volume (e.g. see OECD 94); second, the terminological argument that savings should not be doubly taxed has little validity. It is true that taxpayers have already paid income tax on the income which they invest and then pay tax again on the dividends and interest from their savings, but equally if they choose to spend rather than save they will pay VAT on what they buy, yet nobody then talks of double taxation.[15] Also on the assumption that there is a need for an increase in tax levels there is also no reason why the 1990s trend under which nearly all countries with VAT have raised the standard rate by 1 or 2 percentage points should not continue at the appropriate stage in the cycle. Such modest rate increases bring in large sums of revenue without causing much pain to consumers and without contributing greatly to inflation. Past experience would suggest that governments may continue to take advantage of taxpayers' illusions about the shifting of their employers' contributions and the benefits they receive from their own contributions, by increasing the rates of both, however inappropriate such increases may be in countries with high unemployment levels. Finally, though the specifically environmental taxes may raise little money, there may be a case for increasing the traditional excises on environmental grounds. This applies especially to petrol and other taxes on motoring, where demand may be most inelastic.

B. Tax profiles : closer together or further apart?

"Tax profiles" is used in a wide sense to cover the system, base and rates of all the main taxes of the 24 countries covered in this article. As noted in the preliminary remarks, coming closer together or moving further apart is intended to cover separately the questions of are any of the recent common trends in tax profiles likely to continue or discontinue? and are TTRs and the ratio of particular tax receipts to GDP likely to converge or diverge?

14. In fact leaving aside the war years since the increase between 1937 and 1944 was matched by a similar increase between 1887 and 1937 (R.Bird 1988).
15. This is not to disagree with the view that the taxation of savings requires reform in most countries on the grounds that it is non-neutral between different forms of savings.

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Leaving aside the influence of the European Union, there is little evidence that other international factors such as economic globalization and international tax competition have had much influence on domestic tax profiles. There is perhaps one major exception to the fact that there is also little evidence that the actions of one country influence changes in the tax profiles of other countries. That is the rate-lowering and base-widening of the personal and corporate income tax in the 1986 US Tax Reform Act,[16] which it is alleged forced other countries to follow suit, because tax competition would have resulted in too much inward investment into the United States. It is for this reason that the terms "the imitation effect" or "fascination effect" of the US tax reform have frequently been employed. I use the qualifying "perhaps", because it may be that other countries thought all along that these reforms were desirable, but did not believe they could get away with such changes politically until the US success, which itself was in the balance only a few months before it was carried through. Also leaving aside Canada, which probably had no other choice, one may wonder how much effect the tax competition aspect had when such major countries as France, Italy and Japan did not follow the US example for some years. However, whether the US reform is regarded as a cause of or catalyst for similar reforms in other countries, it does appear the only major case over the last decade of one country's tax legislation influencing those of other countries. Nor do there seem many minor cases. One perhaps is New Zealand in 1988 following Australia in 1987 in adopting a full imputation system.

The main trends that began in most countries in the late 1980s but in some have continued or began in the early 1990s, the base widening and rate lowering of the two income taxes, along with the flattening of the personal tax schedule, may well continue over the next years; for there remain good theoretical arguments for such a move and in addition, as earlier remarked, the public, the media and politicians seem more concerned with nominal rates than the less transparent tax base. Continuation of this trend could be revenue neutral or be used either to increase or decrease the level of income or other taxes. Again, as argued in Section VI A, it would seem rational to continue the trend in the 1990s to raise VAT rates by 1 or 2 percentage points in countries other than those (e.g. Canada, Japan) where there remains hostility to VAT.

Most of the various current issues referred to in Section III are considered as likely candidates for change in only a few countries. Many of the authors of the country chapters of the book referred to in footnote 3 doubted that there would be major tax reforms in their country and no common trends other than those referred to in the last paragraph seem to have been identified. For example, though over the last decade there has been a move away from the split-rate system preferred in the 1960s and imputation systems preferred in the 1970s to a shareholder relief for residents investing in their own countries, within a classical type (non-integrated) structure during the 1980s, in the 1990s the only changes were Japan's abolition of a split rate in 1990 and Denmark's abandonment of a proposal for full imputation in favour of changing its form of shareholder relief in 1991.

On the convergence/divergence issue during the 1990s countries seem more or less equally divided into convergent and divergent camps as regards TTRs (see table 2). Future developments here probably depend mainly on the political choices discussed in Section VII A and it seems impossible to make rational forecasts on what the results will be by the end of the 20th century. However, the recent predominance of divergence of receipts from social security and excises to GDP (see table 4) is somewhat surprising. The arguments in favour of divergence discussed in Section IV B 2, seem to have more force when there was little taxpayer resistance between 1960 and 1975. Nowadays it would seem more rational to diversify revenue sources for governments in search of acceptable revenue increases.[17] However, rationality is rarely the predominant motive in governments' tax choices and again I would prefer not to forecast what the situation will be in a few years time.

In conclusion, it can be said that the few common trends that have been identified may well continue but otherwise there is no reason to believe countries' tax profiles will come closer together over the next few years, nor for that matter that they will move further apart. It may be expected that governments will continue to make most of their choices on tax matters on domestic grounds and without reference to the choices of other countries or international developments, including those in the European Union.

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16. Though the UK got there first with the corporate income tax in the 1984 Finance Act.

17. For example, it is for this reason that in ed. Messere (forthcoming, see *supra* note 3) the authors of the chapter on Canada suggest an increase in the social security tax receipts to GDP ratio, which in that country is well below the OECD average.

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AUSTRALIA

TINKERING AT THE EDGES: RECENT CHANGES TO THE FOREIGN SOURCE INCOME REGIME

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I. INTRODUCTION

In December 1996 the Australian Treasurer released an information paper entitled *Proposed Changes to the Taxation of Foreign Source Income* (the Information Paper).[1] It contained a number of proposals for changing the scope of the foreign source income measures (which includes the controlled foreign corporation (CFC) provisions)[2], the foreign income fund (FIF) measures,[3] and Australia's policy in respect of tax sparing. Following a period of consultation the Treasurer announced in his Budget Speech on 13 May 1997 the actual changes to be adopted in respect of the CFC measures, tax sparing and the FIF measures.[4] Other changes to the CFC measures were also announced.

The purpose of this paper is to outline the changes to the taxation of foreign source income adopted in the Budget and to indicate the likely impact of these changes.

II. THE CHANGES TO TAX SPARING

By way of background, "tax sparing" is the process where a foreign tax credit is given to an Australian resident deriving income from investing in a specific developing country despite the fact that no tax (or a lesser amount of tax) has been paid, due to the developing country offering tax holidays (or reductions in tax) for income derived from certain sorts of development investment.[5] The foreign tax credit given to the Australian resident is generally equal to the tax that has been foregone by that country. The rationale for tax sparing is that in the absence of such a concession any benefits received by Australian companies investing in developing countries (offering tax holidays or reductions in tax) would be lost. This occurs as the foreign income derived is assessed in full in Australia with the offsetting foreign tax credit limited to the actual tax paid in the foreign country.

A number of Australia's bilateral tax treaties provide for tax sparing relief.[6] The concession generally has a limited operation, usually for the period of ten years from enactment of the particular agreement. Despite the wide spread use of these concessions in recent bilateral tax agreements, the Treasurer adopted in the Budget the recommendations for change in policy (as foreshadowed in the Information Paper). The Government has decided against including tax sparing concessions in future bilateral tax agreements and will not renew such concessions.[7] The reasons, set out in the Information Paper, for the policy change are:

– tax sparing arrangements are redundant in respect of active income as many of the countries receiving tax sparing concession are listed or will be listed for the

1. *Proposed Changes to the Taxation of Foreign Source Income* (1996) AGPS, Canberra (the Information Paper).
2. Division 6AAA of Part III (the transferor trust measures) and Part X (the controlled foreign corporation (CFC) provisions of the Income Tax Assessment Act 1936 (hereinafter: the 1936 Act) were introduced by the Taxation Laws Amendment (Foreign Income) Act 1991 (Cth) (No. 5 of 1991). All section references following are to the 1936 Act, unless specified.
3. Part XI (the foreign income fund (FIF) measures) of the 1936 Act was introduced by the Income Tax Assessment Amendment (Foreign Investment) Act (Cth) 1992 (No. 190 of 1992). For a detailed examination of the scope of these measures, see Dirkis, M., "The Last Chapter? New Foreign Investment Fund Measures", 47 *Bulletin for International Fiscal Documentation* 12 (1993) at 687-697.
4. *1997-98 Budget Paper 2* (1997), AGPS, Canberra. The budget papers are available electronically on the Australian Treasury home page at http://www.treasury.gov.au/.
5. Sec. 6AB(5) and Reg. 152H of the Income Tax Regulations (the Regulations). All regulation references following are to the Regulations.
6. The Agreements that contain tax sparing concessions include:
China – Arts. 23(4) to 23(7) of the Agreement contained in Schedule 28 of the Income Tax and Fringe Benefits (International Tax Agreements) Act 1953 (formerly the Income Tax (International Agreements) Act 1953).
Fiji – Arts. 25(2) to 25(4) of the Agreement contained in Schedule 32;
India – Arts. 24(2) and 23(3) of the Agreement contained in Schedule 35;
Kiribati – Arts. 23(3) to 23(6) of the Agreement contained in Schedule 34;
Korea – Arts. 24(3) to 24(5) of the Agreement contained in Schedule 22;
Malaysia – Arts. 23(5) to 23(8) of the Agreement contained in Schedule 16;
Papua New Guinea – Arts. 23(3) to 23(5) of the Agreement contained in Schedule 29;
Singapore – Arts. 18(3) and 18(4) of the Agreement contained in Schedule 5A;
Sri Lanka – Arts. 23(2) to 23(4) of the Agreement contained in Schedule 31;
Thailand – Arts. 24(3) and 24(4) of the Agreement contained in Schedule 30; and
Vietnam – Arts. 23(4) to 23(6) of the Agreement contained in Schedule 38.
7. *Supra* note 1 at Ch. 6.

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exemptions in relation to non-portfolio dividends[8] and foreign branch profits;[9]
- tax sparing arrangements provide opportunities for tax avoidance where mobile assets or income are involved; and
- the change in policy is consistent with the approach adopted by the United States, New Zealand and several other OECD countries.

This change in policy was signalled by the exchange of notes between Australia and Vietnam on 22 November 1996, which sought to limit the tax sparing concession in the Australia–Vietnam treaty. Under these notes the tax sparing concession will now only be available to Australian residents if:
- the activity qualifies for a tax concession under a Vietnamese law specified in the notes;
- the incentive is for a specified activity (targeted to genuine economic development and active business income e.g. forest plantations, heavy industry projects and infrastructure construction); and
- the income does not arise from certain activities, including banking, insurance, accounting, auditing, the operation of ships or aircraft outside Vietnam or schemes entered into to use Vietnam as a conduit for income or as a location of property to avoid tax.[10]

Capito and Diskin argue that this complete rejection of tax sparing is an over reaction to the avoidance problems.[11] The issue should be addressed by targeting sparing arrangements in the manner adopted in the Vietnam notes.

III. THE FIF CHANGES

The changes to the FIF provisions proposed in the information paper are minor. They involve repealing the exemption for approved country funds and adding additional stock exchanges to the list of approved stock exchanges.

A. Approved country fund changes

The approved country funds[12] are trusts that are established in countries which, in 1993, prohibited or restricted direct investment on their stock exchanges (e.g. Chile, India, the Republic of Korea and Taiwan). These funds were exempted from the FIF measures to ensure that Australian investors were not hindered by the measures from investing in these emerging markets.[13]

The information paper argues that this exemption should no longer apply as its policy rationale is no longer relevant since these countries have freed up their markets permitting direct investment in active businesses.[14] Further, it is argued[15] that the continuation of the exemption is inconsistent with the policy underlying the FIF measures (to counter tax deferral) as many of these exempt funds were in fact being exploited to give taxpayers tax deferral advantages.[16]

The repeal of this exemption (specified in Section 513 of the 1936 Act and Schedule 11 of the Income Tax Regulations) is intended to have effect for notional accounting periods of FIFs commencing on or after 1 January 1997. It is argued that this will give affected taxpayers 12 months to reorganize their investments.

B. Approved stock exchanges

The information paper proposes to add to the list of approved stock exchanges the Bogota, Colombo, Zimbabwe and Bratislava stock exchanges. It is argued that this change, which is effective from 24 December 1996, will reduce compliance costs in respect of investments listed on these exchanges.[17]

The list of approved stock exchanges in Schedule 12 of the Income Tax Regulations is used in two ways under the FIF measures to reduce compliance costs.[18] Firstly, the list provides a simple method for determining whether a foreign company is principally engaged in active business. A company will be principally engaged in an "active business" under the stock exchange listing method if the activities of the company are classified by "approved stock exchanges" as belonging to a class of companies in a "designated activity" (i.e. an active business).[19] Secondly, stock exchanges on the list can also be used to provide a valuation (a market value[20]) for the purposes of the market value taxing method.[21]

IV. THE CFC CHANGES

The major changes foreshadowed in the Information Paper, and adopted in the Budget, relate to Australia's existing CFC and transferor trust regime. These changes, which include changes to countries that are designated as "listed countries" and the introduction of a repatriation list, are detailed below.

8. Under Sec. 23AJ non-portfolio dividends (i.e. where the resident taxpayer controls at least 10 per cent of the voting power) received by resident companies from related companies resident in "listed" countries are exempt from tax in Australia to the extent there is an "exempting receipt" (Sec. 380). That section also exempts from tax in Australia any part of a non-portfolio dividend paid by a company resident in an unlisted country out of profits that have been taxed by assessment in Australia or in a listed country (Sec. 377).
9. Under Sec. 23AH income derived by a foreign branch of a resident company (a permanent establishment) in a "listed" country is exempt from tax in Australia. A "listed" country is a country whose taxation system is broadly comparable to Australia's (see Reg. 152J).
10. The proposed amendments are contained in Arts. 23(5) to 23(7) and are contained in Schedule 38A, which was introduced into Parliament on 26 March 1997 by the International Tax Agreements Amendment Bill (1) 1997.
11. Alf Capito and Zorach Diskin "Proposed changes to Australia's taxation of foreign source income" (1997) *CCH Tax Week* 177, at 180.
12. Approved country funds were initially listed in Schedule 6 of the 1936 Act. With the making of Reg. 152M, the list of approved funds is now found at Schedule 11 of the Regulations (see Sec. 513).
13. *Supra* note 1 at para 7.2.
14. The validity of this exemption has been in doubt for some time – see Dirkis *supra* note 3 at 691.
15. *Supra* note 1 at para 7.2.
16. *Taxation of interests in Foreign Investment Funds: An Information Paper* (1992), AGPS, Canberra, at 5.
17. *Supra* note 1 at para 7.3.
18. Sec. 470
19. Sec. 499.
20. Sec. 539(2).
21. Secs. 537 to 542.

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A. Background to Australia's CFC regime

Under the CFC measures Australian residents are taxed on an accrual basis on their share of certain income earned by controlled foreign companies. The income subject to attribution is both the company's tainted income[22] and income which is not subjected to comparable taxation. Whether income has been comparably taxed is determined by two factors:

- the CFC is resident in a comparable tax jurisdiction (i.e. it is resident in a country designated to have a comparable tax system – a "listed country";[23] and
- the income is not subject to a tax concession in that listed country (i.e. it is not eligible designated concession income – income designated as not being taxed at comparable rates).[24]

This classification minimizes compliance costs, where a company operates in a country with a comparable taxation system (a listed country) by removing those interests from the CFC measures, unless they are subject to concessionary treatment in the listed country.

B. Changes to the CFC list

The Information Paper recommended, and the Government accepted, a new short list of seven truly comparable tax countries for the purposes of the CFC and transferor trust measures, called the "controlled foreign company list" (CFC list). The countries on the new CFC list are Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States. This list is the same as that adopted in New Zealand's grey list.

The reasons, set out in the Information Paper, for the change are:

- that many of the countries currently listed do not have comparable tax systems;
- the administration involved in maintaining a list of tax deferrals in listed countries is difficult given the large number of countries and as a result has had only limited success;
- the listing process only works when only genuinely comparable tax countries are included on the list. The opportunities for the derivation of tainted income in a foreign jurisdiction arises if a country is not consistently levying comparable tax;[25] and
- the change in policy is consistent with the approach adopted by Japan (which abandoned the designation approach in 1992) and the other 14 jurisdictions that have adopted CFC regimes (which generally apply a comparable test or subject all tainted income to accruals taxation).

These reasons are not universally accepted. Capito and Diskin argue that if the stated reason for the changes to the listing procedure was leakage caused by insufficient vigilance, then the problem could have been simply solved by ensuring that the designation process was kept up to date.[26] They argue that the proposed changes are an overreaction to the problem encountered in monitoring the current list, and a better balance between the number of countries listed and the monitoring could have been achieved.

Capito and Diskin also believe that there is an unstated policy reason for the changes, which should have been clearly set out in the Information Paper.[27] They point to the fact that even where a tax concession does not exist in a listed country, a CFC may derive tainted income which is subject to tax at a lower rate than applicable in Australia. If the tax arbitrage is positive (despite the loss of franking credits arising from paying foreign rather than domestic tax) taxpayers will seek to derive tainted income in that country. To try and distinguish between listed countries with arbitrage advantages is not administratively possible. If the changes adopted were intended to overcome this difficulty they are fundamentally flawed at a policy level as they will result in the taxation of tainted income which has already been fully taxed in a former listed country.[28]

The new list will generally take effect for the statutory accounting periods of CFCs commencing on or after 1 July 1997 and the income year of a transferor trust commencing on or after 1 July 1997. The new list will have little effect on the CFCs and transferor trusts resident in the listed countries as the income derived will generally continue to be exempt, except for eligible designated concession income.[29]

C. Introduction of a repatriation list

The Information Paper recommended, and the Government accepted, that the existing list of comparable tax countries[30] be retained, updated and expanded. This list (the repatriation list) will operate for the purpose of providing an exemption[31] for non-portfolio foreign dividends and foreign branch income (i.e. repatriated foreign profits). As these exemptions apply principally to active income that has been broadly comparably taxed, the revenue risks in maintaining the long list are considered small.[32] There is also a compliance saving by not subjecting the distributions to the foreign tax credit system.

22. Tainted income is passive income (such as dividends, interest and royalties), and certain related party income.
23. The "listed" countries are listed in Schedule 10 of the Regulations.
24. The designated concessions are listed in Schedule 9 of the Regulations.
25. A commonly cited example of such avoidance is the so called "double dutch" structure (see Mark Lawson, "Global tax plan 'sledgehammer'" *Australian Financial Review* 21 February 1997, 9, and Mark Lawson "New traps for tax trick" *Australian Financial Review* 7 May 1997, at 14). Under this structure a holding company is established in the Netherlands, with either a subsidiary in a European tax haven (such as Luxembourg), or the company establishes a branch in a tax haven. Under the Dutch grouping rules such a company or branch which carries on business in the tax haven is Dutch, resulting in the income having a Dutch source. The tax effect of this transaction is that if the income earned in the haven is paid as a royalty to the Dutch company it is only subjected to minimal withholding tax, while at the same time escaping Australia's CFC rules as the income is derived in a listed country, and as the income is not designated concession income.
26. *Supra* note 11 at 180.
27. Id.
28. Also see Hans van Leeuwen, "CFC changes threaten competitive edge" *Australian Financial Review* 15 May 1997, at 9.
29. *Supra* note 4.
30. In Schedule 10 of the Regulations.
31. Under Secs. 23AJ and 23AH and related sections.
32. *Supra* note 1 at 5.

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Despite assertions in the Information Paper that the repatriation list will reduce taxpayer's compliance costs and, thereby, assist active Australian businesses to compete equally with competitors in foreign jurisdictions,[33] the tax profession disagrees. They argue that the changes impose unjustifiable additional compliance burdens on the companies in the countries that have lost listing status that is well in excess of any administrative burden on the Australian Taxation Office and the Treasury.[34] They also argue that the changes indicate a failure by Government to recognize the growing investment in the Asian region and the need for Australian companies to be competitive[35] as well as failing to recognize the sensitivities aroused by labelling neighbouring countries as tax havens.[36] It is also seen as contradictory to the policies of promoting Australia as a place for a regional headquarters and will lead to companies moving elsewhere.[37]

The repatriation list will apply from 1 July 1997. The list will also be updated from 1 July 1997 to add the Czech Republic and Vietnam and to take account of changes in the political landscape such as the unification of Germany and the dissolution of the USSR, Czechoslovakia and Yugoslavia. The countries emerging from dissolution will be treated as unlisted, although transitional provisions will apply to treat CFCs resident in these countries as being resident in a listed country up to the release date of the Information Paper.[38] The law will also be amended to ensure that Hong Kong continues to be treated as an unlisted jurisdiction following the establishment of the Hong Kong Special Administrative Region of the People's Republic of China on 1 July 1997.[39]

The Treasurer also stated that bank branches operating in countries only on the repatriation list will be provided with an exclusion from tainted income, which is broadly consistent with the current exclusion for CFC banks operating in repatriation list countries.[40]

D. Other changes

The Treasurer also announced a number of changes that had to be made due to the creation of the repatriation list.

1. The consequential amendments

A number of consequential amendments where announced as a result of the changes.[41] Firstly, tainted income taxed normally (i.e. no concessions apply) in the country of residence will (as a result of the country of residence being placed on the repatriation list) be caught by accruals taxation. Secondly, to reduce compliance costs, the Government announced in the Budget that the active income test for CFCs in unlisted countries will now apply to CFCs in the repatriation listed countries. As most CFCs would satisfy the active income test (i.e. their proportion of tainted income to gross profits would be less than 5 per cent), they will generally escape the CFC measures.

Thirdly, the Government announced in the Budget that an active income test concession will be provided for branches of Australian companies operating in repatriation list countries. They will be able to derive up to 5 per cent of gross turnover as tainted income and still obtain full exemption for branch profits under Section 23AH. This will ensure a similar treatment for branches in repatriation list countries as applies to CFCs in repatriation list countries.

Finally, where a CFC changes residence from an unlisted to a listed country, Section 457 taxes the Australian controllers on any accumulated profits. The policy behind this was that the accumulated profits are likely to be lowly taxed and are then distributed as exempt dividends upon the CFC becoming resident in the listed country. However, the provision could act adversely where a country is included on the repatriation list. The Government will amend Section 457 such that it will not apply where the CFC has been resident in the newly listed country for three or more years. Where the CFC has been resident for a lessor period Section 457 will apply, but only to realized profits.[42]

2. Changes to the calculation provisions.

Firstly, to reduce the compliance costs of the CFC measures the Government announced some changes to the calculation provisions. The definitions of "tainted services income" and "tainted rental income" will be amended in response to concerns raised in submissions on the Information Paper.[43] The definitions will exclude services income derived from an associated CFC resident in the same country, provided that service income is subject to the normal rate of company tax in that country and does not reduce the attributable income of the associated CFC.

The transfer pricing rules will be amended such that they will not apply to transactions involving CFCs resident in the same CFC list country. Similarly, the requirement to apply thin capitalization rules and debt creation rules in calculating the attributable income of a CFC will be removed.[44]

Secondly, the Government announced changes to correct a deficiency in the current formulae used to determine the passive income of CFCs of Australian life and general insurance companies. Since the introduction of the CFC measures a concession existed under Section 446 that exempted from accruals taxation passive income (e.g. interest, royalties, dividends) derived by CFCs that carried on the business of life or general insurance, provided it arose from assets used to meet the calculated liabilities of policies issued by the CFC to non-resident non-associated policyholders. However, the formulae for calculating the amount of exempt passive income

33. Id.
34. For example see Capito and Diskin *supra* note 11 at 181; Lawson "Global tax plan 'sledgehammer'" *supra* note 25; Mark Lawson "Howard Government squeezes more juice from the tax lemon" *Australian Financial Review* 7 May 1997, at 14; and van Leeuwen *supra* note 28.
35. Id.
36. Lawson "Global tax plan 'sledgehammer'" *supra* note 25.
37. Lawson "Howard Government squeezes more juice from the tax lemon" *supra* note 34.
38. *Supra* note 1 at 6.
39. *Supra* note 4.
40. Id.
41. Id. and *supra* note 1 at Ch 5.
42. *Supra* note 4 and *supra* note 1 at 8.
43. *Supra* note 4.
44. Id.

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was flawed. It also treated as exempt amounts derived from assets which are in excess of the assets required to meet the liabilities of non-resident non-associated policy holders. This deficiency had the effect of sheltering from Australian tax passive income earned from the excess capital. The changes to the current formulae will apply to passive income derived by life and general insurance CFCs after 7.30 pm Australian Eastern Standard Time, 13 May 1997.[45]

3. Election provisions

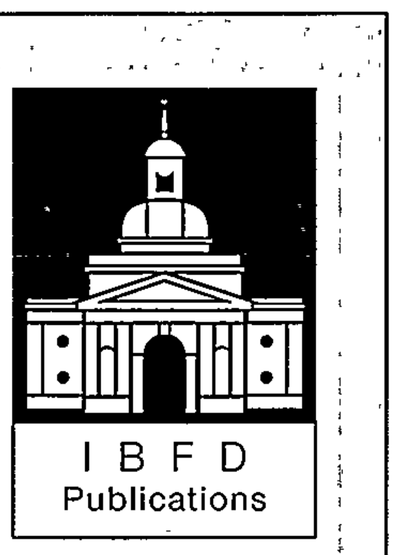
The Government announced changes to a number of the election provisions affecting CFCs. The election procedures in respect of a variation to the accounting period have changed. An election will now have immediate effect if made during the first period that a company becomes a CFC. Further, if the CFC is wholly owned by a taxpayer (either directly or indirectly through other entities) the taxpayer will be allowed to make elections on behalf of the CFC. Finally, the time for a CFC to make an election for capital gains tax roll-over relief will be extended to the time when an Australian controller lodges a tax return that is affected by the election.

V. CONCLUSION

The changes foreshadowed in the Information Paper, and adopted in the Budget to the scope of the Australia's CFC, transferor trust and FIF provisions and its policy in respect of tax sparing range from fundamental to minor changes that merely tinker with the edges of the system. What is clear is that they all will have the effect of raising more revenue[46] and will add to the compliance costs of resident controllers.

45. Id.

46. Id. Budget paper 2 estimates the revenue gain from implementing the Information Paper recommendations to be AUD 150 million and AUD 10 million for the change to the passive income concession for life and general insurance companies. The estimate AUD 150 million is seen in some quarters as somewhat optimistic (see van Leeuwen *supra* note 28).



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Tax Avoidance and the Rule of Law is based, in part, on discussions held at a conference in Sydney, in May 1995 on the topic: *The Rule of Law and Anti-Avoidance Rules - Tax Administration in a Constitutional Democracy*. The papers are reproduced in this publication, along with contributions from other eminent scholars.

This new volume of essays provides an excellent source of information which looks at the operation of the general anti-avoidance rules often enacted by governments in their tax statutes. Particularly examined in the essays is the extent to which there may be a conflict between GAARS, and the tradition of the rule of law.

Countries covered:
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THE NETHERLANDS

NEW DUTCH RULES ON THE TAXATION OF GAINS DERIVED FROM "SUBSTANTIAL PARTICIPATIONS"

Prof. Dr T. Blokland and Dr Irene J.J. Burgers

I. INTRODUCTION

In the Netherlands traditionally corporation tax and income tax were fully independent of each other. The unmodified classical system used to be applied. Profits derived by a "taxable body" (amongst others BVs and NVs) were subject to corporate income tax at the rate of 35 per cent,[1] irrespective of whether distributed or retained. Upon distribution a dividend withholding tax of 25 per cent was levied. The distribution was then aggregated in the shareholder's taxable income and subjected to tax in the normal progressive manner.

In a classical system as described above shareholders are tempted to let their NV or BV retain profits. The value of their shares will thus reflect this accumulation. A capital gain will be realized upon selling the shares. In the tax system of the Netherlands, generally, capital gains derived by individuals not being entrepreneurs are not taxed. However, to prevent retention of profits the Netherlands, as from 1941, levies income tax at a rate of 20 per cent on the capital gain (defined as transfer price minus acquisition price) derived upon the alienation of shares belonging to a "substantial participation". From 1 January 1997 the 1941 rules (modernized in 1964) have drastically changed. Not only has a modified classical system now been adopted, moreover amongst others the definition of "substantial participation" has also been amended, with the result that the amount of participation necessary for a participation to qualify as a substantial participation is reduced from 33⅓ per cent to 5 per cent. The substantial participation rules will therefore be applicable in far more cases than was the case before 1997. The new rules are explained below.

II. TOWARDS A MODIFIED CLASSICAL SYSTEM

As from 1 January 1997 "profit from a substantial participation" is no longer restricted to the capital gain arising upon the alienation of shares belonging to a "substantial participation". Article 20a(1)(b) Wet op de Inkomstenbelasting 1964 (Income tax Act, hereinafter: Wet IB), as amended now includes capital gains derived upon the alienation of profit-sharing notes or debt claims. Furthermore capital gains arising upon the alienation of option rights on such shares are included.[2] Besides these capital gains, regular gains derived from a substantial participation, such as dividends, are as from 1 January 1997 also treated as "profit from a substantial participation" (Article 20a(1)(a) Wet IB, as amended).[3] The interest on loans obtained for the purpose of financing the acquisition of the shares is usually treated as a negative component.

As from 1997 the rate applicable to profit from a substantial participation as defined above is 25 per cent, in as far as total income exceeds the higher amount of the first bracket. This implies that the 25 per cent also is applicable to dividends distributed. Thus a modified classical system has been introduced: by levying income tax at a lower rate, economic double taxation of profits is relieved.

III. DEFINITION OF "SUBSTANTIAL PARTICIPATION"

As from 1997 a shareholding qualifies as a substantial participation where the shareholder holds more than 5 per cent of issued capital. Corporate bodies may issue different sorts of shares e.g. common shares, preferential shares etc. Moreover rights on profit and reserves granted by the common shares can differ. Where a person, either alone or together with his or her spouse, owns 5 per cent or more of the number of shares of a certain class issued by the corporate body, all other shares the person holds in that corporate body will also qualify as shares belonging to a substantial participation. In addition where one of the parents of a person or his spouse, or one of his children owns a substantial participation in a corporate body, the shares owned by that person in the same corporate body will similarly qualify as a substantial participation.

The substantial participation rules not only apply to shares held in a corporate body incorporated in the Netherlands, but also to shares held in a corporate body incorporated by the law of any other country. Whether the rules are applicable depends on the state of residence of the shareholder, not on the state of residence of the corporation.

1. This rate applies as from 1 October 1988. For the first NLG 100,000 of the taxable amount a higher tax rate applies, which gradually has been reduced from 40 per cent (1988) to 36 per cent (1997). As from 1998 this special higher tax rate for the first NLG 100,000 of profits will be abolished.
2. Art. 20a(4) Wet IB, as amended.
3. Before 1997 these gains used to be treated as income from capital.

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IV. CAPITAL GAINS, REGULAR GAINS AND FINANCING INTEREST

A capital gain is defined as the difference between the transfer price and the price for which the shares, debt claims or options have been acquired. Where only a part of the shares, profit-sharing notes or debt claim is alienated the allowable deduction of the acquisition price is allocated on a pro rata basis. The capital gains will be taken into account at the time agreement was reached between the seller and buyer of the shares. Amounts not capable of precise determination e.g contingent consideration, balance guarantees, etc. will be estimated; differences between the amount estimated and the actual price realized will be taken into account at the time of realization as additional profit (or loss) from the alienation of a substantial participation.

Dividends are normally classified as "regular gains". They are included in the income at the moment of realization (cash basis).

Interest payable by the shareholder incurred to finance the acquisition usually forms a negative component of the profit/loss from a substantial participation.[4] However, this is not the case were a real transfer of a business occurs: in that case the interest is treated as *special expenses*, and is deductible from progressive taxed income. The cash method also applies to the interest expense.

The capital gain from the alienation of a substantial participation forms part of the taxable income. However, as mentioned earlier a special tax rate of 25 per cent applies in as far as the taxable income exceeds the basic tax-free allowance plus the amount of income taxed in the first bracket.

V. LOSSES FROM SUBSTANTIAL PARTICIPATIONS

Where the value received is lower than the acquisition price of the shares a loss results. This loss is not treated as a negative component of the income, but – on the basis of Article 60 Wet IB, as amended – gives rise to a tax credit of 25 per cent of the loss. Where the credit cannot be used in the tax year it arises, the article allows a carry back of the credit for a period of three years, and – if necessary – a carry forward for a maximum period of eight years.

VI. THE ALIENATION OF SHARES

In addition to a transfer of title, under the new rules the following are treated as deemed alienations:
- a purchase of own shares;
- a change of ownership due to marriage or inheritance;
- a diminishment of the participation to below 5 per cent;
- emigration of the Dutch resident shareholder;
- transfer of the seat of the corporate body from the Netherlands to another state.

VII. DEFERRAL AND PAYMENT SETTLEMENT RULES

In the case of an exchange of shares or a merger deferral of the capital gain is possible. The deferral ends when the acquired shares are alienated.

The Invorderingswet 1990 (Tax Collection Act) contains a special settlement rule: the *conserverende aanslag* (preservative assessment) for the following cases:
- shares inherited by a non-resident individual;
- emigration of a Dutch resident shareholder;
- a transfer of the statutory seat outside the Netherlands.

No interest is due. However, security should be lodged, for example by providing a bank guarantee or through hypothecating the shares.

The tax to be paid on the *conserverende aanslag* will be collected where the shares are alienated within 10 years. If alienation occurs after 10 years the tax will no longer be collected.

VIII. RESIDENCE AND TAX LIABILITY

A Dutch resident taxpayer is subject to tax on the profits from the alienation of a substantial shareholding irrespective of whether or not the corporate body is a resident of the Netherlands.

A non-resident shareholder is subject to tax in the Netherlands upon alienation of a substantial shareholding only where the corporate body is resident in the Netherlands (Article 49 Wet IB). For the application of this article a corporate body qualifies as resident if it has its central place of management in the Netherlands. In addition a corporate body having its statutory seat in the Netherlands falls within the scope of this article if the central place of management is outside the Netherlands, but had been in the Netherlands for a period of at least five years. In that case the corporate body is deemed to be resident in the Netherlands for a period of ten years after the transfer of the place of management outside the Netherlands.

IX. EMIGRATION OF THE SHAREHOLDER

Upon emigration of a Dutch resident shareholder a *conserverende aanslag* will be imposed on the difference between the market value of the shares at the time of emigration and the purchase price of the shares. The tax due is reduced by:
- Dutch withholding tax on dividends received after emigration;[5]
- a tax levied by the new country of residence of the shareholder on the capital gain realized upon alienation of the shares in as far as this capital gain was included in the tax

4. Art. 20b(3) Wet IB, as amended.
5. Art. 26(2)(a) and (b) Invorderingswet 1990, as amended.

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base applied in determining the amount of tax due under the *conserverende aanslag* rules.

Where the shares are held for a period of ten years after the end of the calender year of emigration the *conserverende aanslag* is remitted.[6] During the 1996 discussions of the Dutch Lower House of the parliament on Bill 24761 the Secretary of State for Finance indicated that in his view the *conserverende aanslag* is not in conflict with EC law as:

- Austria, Denmark and Germany also levy an exit charge in case of emigration of a resident shareholder;[7]
- the "freedoms" laid down in the EC-Treaty do not prohibit an exit charge upon emigration of the shareholder on gains that arose before the time of emigration;
- EC law is not harmonized in this field.[8]

In the literature questions have been raised as to whether the *conserverende aanslag* is in line with the rules laid down in the EC Treaty.[9]

X. ALIENATION OF SHARES AFTER EMIGRATION

Suppose upon emigration a shareholder's shares had a market value of NLG 100,000. Purchase price of the shares was NLG 60,000. A *conserverende aanslag* of 25 per cent of NLG 40,000 will result. After a period of four years the shareholder sells the shares for NLG 120,000. In that case the Netherlands will collect the tax due on the *conserverende aanslag*, i.e. NLG 10,000; however, the foreign tax on this capital gain may be deducted. In addition, the Netherlands will – in the absence of tax treaties or where the treaty applicable grants the Netherlands taxation rights on capital gains derived after emigration – also tax the additional capital gain of NLG 20,000, although this gain did not accumulate during the "Dutch" holding period.[10]

Although technically due, where the shares are sold more than ten years after the end of the calender year in which emigration took place the tax relating to the *conserverende aanslag* will be remitted. Tax treaties may limit Dutch taxation rights.

XI. TRANSFER OF THE CENTRAL PLACE OF MANAGEMENT

A transfer of the central place of management outside the Netherlands does not have any tax consequences as long as the shareholder remains a resident of the Netherlands. If, afterwards however, the shareholder decides to emigrate a *conserverende aanslag* will then be imposed.

Where the shareholder is a non-resident at the time of transfer of the central place of management, for purposes of Dutch individual income tax a capital gain arises. Though under tax treaties the right to tax capital gains usually is allocated to the other country, as concerns dual residence the tax treaties the Netherlands concluded amongst others with Australia, Canada, France, Norway, Sweden, the United Kingdom and the United States[11] under certain circumstances allocate the right to tax capital gains derived on the alienation of shares etc. to the Netherlands.[12]

XII. THE "PASSER-BY" RULES

Where an individual is a shareholder in a non-Dutch resident company a *conserverende aanslag* is not imposed if:

- the shareholder has resided in the Netherlands during the 25-year period prior to emigration for a period of no longer than ten years; and
- emigration takes place within eight years after (the latest) immigration to the Netherlands.[13]

XIII. REMIGRATION

A shareholder after emigration may decide to remigrate to the Netherlands. The *conserverende aanslag* is then remitted. The acquiring value of the shares is recalculated so as to cancel the capital gain on the shares. Where the other country

6. Art. 26(2)(c) Invorderingswet 1990, as amended.
7. This argument brings in mind the line of argument of the German Government in the *Denkavit*-case C-283/94: practically all other Member States interpreted Art. 5 of the Parent-Subsidiary Directive in the same way as did Germany. The Court, taking into consideration that many other Member States adopted the same reasoning as Germany and the fact that no case law was available on the matter, denied the plaintiffs the right to compensation for damages suffered.
8. This argument will not hold before the Court of Justice. In amongst others *Werner* (C-112/91), *Bachmann* (C-204/90) and *Schumacker* (C-279/93) the Court ruled that a difference in treatment can not be justified by the fact that harmonization did not take place.
9. M.J.W.M. Ellis, "Enkele internationale aspecten van het wetsvoorstel inzake aanmerkelijk belang", *MBB* 1996, at 294; M.G. de Jong, "Wetsvoorstel 24761: De emigratieheffing en de gevolgen van de mogelijke strijd met het Europese recht en het internationale recht", *WFR* 1996, at 1465. For a different opinion see J.W.J. de Kort, "De emigratieheffing in de voorgestelde aanmerkelijk belangregeling en de niet-strijdigheid met het Europese verdrag", *WFR* 1996, at 1594.
10. This not only is contrary to the basic idea underlying the exit charge to preserve the taxation rights on capital gains accumulated during the Dutch holding period, but also violates principles of international law.
11. Conditions vary. Under the treaty with Australia this is the case in respect of capital gains realized on the alienation of shares and profit-sharing notes. Capital gains on – under Dutch national law – deemed alienations as described above under Section V can not be taxed in the Netherlands. The treaties with Canada, Norway, Sweden and the United Kingdom limit the taxation rights of the Netherlands to capital gains derived by a non-resident who has been a resident of the Netherlands at any time no longer than six (Canada) resp. five (Norway, Sweden and the United Kingdom) years prior to the alienation. The treaty concluded with Sweden limits this taxation right to the capital gain derived upon the alienation of shares. The treaties with Canada and the United Kingdom do not contain such limitation. The Netherlands–US treaty requires the individual to have been a resident of the Netherlands no longer than five years prior to the alienation. Moreover at the time of alienation the individual (alone or with relatives) should possess at least 25 per cent of the shares. The treaty concluded with France allocates taxation rights on substantial interest holding capital gains to the country of emigration where the shareholder is a citizen of the Netherlands without being a citizen of France and has been a resident of the Netherlands at any time no longer than five years prior to the alienation.
12. The Netherlands–Belgium treaty, though on first sight containing rules that seem similar, does not fall under this category as this treaty allocates the capital gain to the Netherlands only in case shares are being alienated in a company that is "resident of the Netherlands as defined in the treaty." This implies the state where the place of central management is situated.
13. Art. 20a(8) Wet IB, as amended.

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upon emigration of the shareholder to the Netherlands taxes the capital gain the acquisition value of the shares will be adjusted to take this into account.

XIV. OTHER NEW RULES APPLYING TO A SHAREHOLDER HOLDING A SUBSTANTIAL INTEREST

New measures have been implemented to prevent a shareholder from evading Dutch income tax, social security premiums and property tax by waiving his right to income.

Where the shareholder gives up his right to receive a salary, he is deemed to receive a salary of NLG 78,000. Evidence to the contrary is possible, both from the taxpayer (lower salary) and the tax administration.

Where the shareholder waives his right to receive interest on loans he granted to his NV or BV, or to receive rent on property put at the disposal of the NV or BV the interest or rent will nevertheless be taken into account at arm's length value.

XV. CONCLUSIONS

As from 1997 the rules on the taxation of capital gains arising on the alienation of a substantial participation have changed drastically. The most important changes are the lowering of the minimum threshold necessary for the legislation to apply from 33⅓ per cent (alone or with relatives) to 5 per cent and the introduction of an exit charge upon emigration. This exit charge will however only be collected if the shares are alienated within ten years after the end of the calender year in which emigration took place (*conserverende aanslag*).

In addition to the changes mentioned above under domestic law additional tax is now due on the difference between the capital gain actually realized and the capital gain taken into account at the time of emigration.

Opinions vary on the question as to whether the new rules are in line with the EC Treaty, especially with respect to Article 8A.

Rules laid down in existing treaties apply also to the new Dutch rules (dynamic approach). Generally, where granted, the taxing right of the Netherlands is limited to five years after emigration. It is likely that the Netherlands will, on the basis of reciprocity, propose to their treaty partners a change of the capital gains article so that after emigration the other state retains taxation rights for a period of ten years.

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BELGIUM

FISCAL COMPETENCIES OF STATE, REGIONS, COMMUNITIES, PROVINCES AND MUNICIPALITIES IN BELGIUM

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I. INTRODUCTION[1]

A. State structure

According to Article 1 of the Belgian Coordinated Constitution, Belgium is a federal state, made up of three Communities and three Regions. The Communities are: the Flemish Community, the French Community and the German speaking Community. The Regions are: the Flemish Region, the Walloon Region and the Brussels Capital Region. Belgium is further subdivided into ten provinces and 596 municipalities.

B. Division of powers

At the federal level, the legislative power is vested in the House of Representatives, the Senate and the King, the executive power in the King, and the judicial power in the Tribunals and Courts (Tribunals of First Instance, Courts of Appeal, Court of Cassation).

At the level of the Regions and the Communities (to which legislative and executive powers were devolved by the constitutional reforms of 1970, 1980, 1988 and 1993), the legislative power is vested in the councils, and the executive power in the governments. In Flanders, the organs of the Flemish Community also exercise the jurisdiction of the Flemish Region, so that the powers are vested in one single Flemish Parliament and Flemish Government. The same does not apply for the French speaking part of the country, which has both a "Council of the French Community" and a "Walloon Regional Council". The Regions and the Communities do not have their own court systems.

At the level of the provinces, the legislative power is vested in the provincial councils, and the executive power in the permanent deputations.

Finally, at the level of the municipalities, the legislative power is vested in the municipality councils, and the executive power in the colleges of mayor and aldermen.

C. Legal acts

The Constitution is the supreme law. The federal legislator, who issues laws, is only competent for those matters which explicitly have been indicated by the Constitution as federal competencies. However, these exclusive federal competencies are not yet laid down. As long as this is the case, the residual competencies remain with the federal government. Decrees[2] and ordinances[3] issued by community and regional councils, in matters for which they are declared competent, also have force of law. The municipalities and the provinces have a general authority to issue rules and regulations for matters of exclusive municipal, and provincial interests respectively. However, the municipalities and the provinces can only exercise these competencies for matters which do not fall within the jurisdiction of higher authorities.

D. Fiscal competencies

Each of the Belgian authorities mentioned above has certain fiscal competencies. The legal basis for the exercise of these competencies can be found in different laws. The most important ones are: the Coordinated Constitution; the Special Law of 16 January 1989 concerning the financing of the Communities and the Regions; the law of 23 January 1989 concerning Article 11[7]0, paragraphs 1 and 2 of the Coordinated Constitution regarding tax competence; the Province Law and the New Municipality Law. Hereafter, each of these legal frameworks will be analysed.

1. Alen, A. (ed.), *Treatise on Belgian Constitutional Law*, Kluwer Law and Taxation Publishers, Deventer, 1992 (hereinafter referred to as *Alen Constitutional Law*), at 288; Alen, A., "Belgium", in *International Encyclopedia of Laws – Constitutional Law*, Kluwer Law and Taxation Publishers, Deventer, 1994, loose-leaf; Alen, A., *Handboek van het Belgisch Staatsrecht*, Kluwer Rechtswetenschappen, Deurne, 1995, (hereinafter referred to as *Alen Handboek*) at 889 ; Mast, A., Dujardin, J., van Damme, M. en Vande Lanotte, J., *Overzicht van het Belgisch administratief recht*, Kluwer Rechtswetenschappen, Deurne, 1996, at 345-506.
2. By the Flemish Parliament, the French (Community) Council, the Walloon (Regional) Council and the German speaking Community Council.
3. By the Brussels Capital (Regional) Council.

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II. COORDINATED CONSTITUTION (C.C.)[4]

A. Introduction

Chapter V (Articles 170-181) of the Coordinated Constitution deals with the "Finances". It contains provisions concerning:

- the principle of legality (Article 170);
- the principle of annual ratification (Article 171);
- the principle of equality (Article 172);
- the charges (Article 173);
- the spending power (Article 174);
- the financial systems of the Flemish and the French Communities (Article 175);
- the financial system of the German speaking Community (Article 176);
- the financial system of the Regions (Article 177);
- the specific situation of the Brussels Capital Region (Article 178).

Hereafter, each of these provisions will be briefly analysed.

B. Legality[5]

1. The State

(a) *Principles*

Article 170, paragraph 1 C.C. stipulates :

> No tax for the benefit of the State can be established other than by statute.

This provision implies that the (federal) State is a public authority with taxing powers. However, the State must establish taxes by law. No taxation without representation: taxes can only be levied with the approval of the elected representatives of the population, residing in the House of Representatives. This approval does not only concern the tax itself, but also the taxable base, the tax rate, the tax reductions and the tax exemptions. So, all these elements must be determined in the law itself.

(b) *Examples*

Obviously, the (federal) State has, during the past decades, made great use of this autonomous or general taxing power and has levied all kinds of taxes. For example:[6] individual income tax; corporate income tax; tax on legal entities; non-resident income tax; "précomptes"; taxation of dividends and remunerations of non-active directors; value added tax; motor vehicle tax; duty on betting and gambling; amusement machine tax; registration duties; mortgage duties; court duties; estate duties; stamp duties; customs duties; excise duties; etc.

2. The Communities and the Regions

(a) *Principles*

Article 170, paragraph 2, subsection 1 C.C. stipulates:

> No tax for the benefit of a Community or a Region can be established other than by a decree or by a rule referred to in Article 134.[7]

This provision indicates that the Communities and the Regions are also public authorities with taxing powers. Like the State, these Communities and Regions can only levy taxes with the approval of the elected representatives of the population, residing in the Parliament (Council) of the relevant Community or Region. Moreover, as with the State, this approval does not only concern the tax itself, but also the taxable base, the tax rate, the tax reductions and the tax exemptions. Therefore, all these elements must be determined in the decree or the ordinance in which the tax is enacted.

The taxing power of the Communities and Regions on the basis of Article 170, paragraph 2 C.C., is[8] an autonomous or general taxing power.[9] This autonomous taxing power was attributed to the Communities and the Regions in 1980, in response to their call for greater financial autonomy.[10]

The autonomous taxing power of the Communities and the Regions should not be confused with the additional taxing power of the Communities and the Regions and the transfers, to the Communities and the Regions, from national tax revenue. All three however, represent important sources of financial means for the financing of the budget (and policies) of the Communities and the Regions. The additional taxing powers of the Communities and the Regions and the transfers, to the Communities and the Regions, from national taxation revenue, will be analysed under Section III.

(b) *Remarks*

As mentioned above, Article 170, paragraph 2 C.C., speaks of the autonomous taxing power of the Communities and Regions. In this regard the following points are relevant:[11]

(1) the taxing power of the Communities and the Regions is an autonomous power: taxes provide the concerned authority with means to pursue a policy; however, they are not tied to the material competencies of the Communities and the Regions;

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4. The citations in English of the Coordinated Constitution are based upon: Craenen, J.G. and Craenen, G.J., *Constitution of the Kingdom Belgium – Coordinated text of February 17, 1994*, Acco, Leuven/Amersfoort, 1994, at 40.
5. *Alen Constitutional Law* at 251; *Alen Handboek* at 780-781.
6. Tiberghien, A., *Belgian taxation – An outline*, Kluwer, Deventer, 1987, at 93; Tiberghien, A., *Handboek voor fiscaal recht '96*, Kluwer Rechtswetenschappen, Antwerpen, 1996, at 1303.
7. Art. 134 C.C.: "The statutes made in pursuance of article 39 define the authority of the legal rules made by the organs which they establish in the matter indicated by them. They may attribute to these organs the power to draw up decrees having the force of law, within the scope and in the way defined by them."
8. Just as for the State, on the basis of Art. 170, para. 1 C.C.
9. Alen, A. and Suetin, B., "De fiscale bevoegdheden van de gemeenschappen en de gewesten", *T.B.P.*, 1989, at 271-288; van Orshoven, P., "Gemeenschaps- en gewestbelastingen", *A.F.T.*, 1990, at 123-129.
10. *Alen Constitutional Law* at 256; *Alen Handboek* at 792.
11. *Alen Constitutional Law*, at 257-258; *Alen Handboek*, at 796-799.

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(2) the taxing power granted is an integral concurrent power: taxes can only be introduced for matters which are not yet the subject of a federal tax; moreover, an earlier tax of a Community and/or a Region can be abolished by a normal federal law to make way for a federal tax on the same matter; in this way, the taxing power is unlike the other powers of the Communities and the Regions, which are exclusive powers;

(3) the taxing powers granted can be limited on the basis of Article 170, paragraph 2, subsection 2 C.C., which stipulates:

> A statute shall determine the exceptions which prove to be necessary with respect to the taxes referred to in the previous subparagraph.

Accordingly the federal legislator is able:
- to indicate, which taxes may not be imposed by the Communities and the Regions;
- to limit or to abolish, retrospectively, a tax of a Community or a Region, as far as the necessity of this is proven;

this competence of the federal legislator to reserve some fiscal matters, will be further analysed under Section IV.;

(4) the taxing power of the Communities and the Regions is limited by the territorial competence of the Communities and the Regions: Alen[12] states rightly that:

> This is a specific problem in relation to the application of community tax decrees in Brussels, as Flemish and French community decrees only apply to institutions in the bilingual region of Brussels-Capital, not to persons, there being no "subnationality";

(5) the taxing power is limited by the principles resulting from the fact that Belgium, as a federal state, is an economic and monetary union; as a consequence of this, taxes introduced by the Communities and/or the Regions, having the form of internal customs duties (or having an equivalent effect), are forbidden;

(6) the taxing power of the Communities and the Regions is limited by the proportionality principle: it is possible that a tax of a Community and/or a Region no longer has only a budgetary goal but also becomes a policy instrument and pursues in this way a non-fiscal goal; when this non-fiscal side-effect seems to be the primary goal of the fiscal measure, then the competence must not only be examined from the point of view of the fiscal competence rules, but also from the point of view of the material competence division between the State, the Communities and the Regions;

(7) the taxing power of the Communities and the Regions must not be in conflict with the taxing power of the provinces and the municipalities: taxes levied by Communities and/or Regions which limit the fiscal competencies of the provinces and the municipalities, are forbidden.

(c) *Examples*

(i) General[13]

During the past years, the three Belgian Regions[14] have used their autonomous taxing powers primarily to introduce environmental taxes and slum taxes. Here after, a brief survey is given of these taxes.

(ii) Environmental taxes[15]

As regards environmental taxes, the following categories can be distinguished:

– the removal of waste

In the *Flemish Region*, the tax on the removal of waste is laid down in the decree of the Flemish Parliament of 2 July 1981 concerning the prevention and the management of waste.[16] The Public Flemish Waste Company (OVAM) is responsible for the (quarterly) collection of the tax. The revenues of this tax are deposited in the Fund for Environment and Nature (the MINA-Fund).

In the *Brussels Capital Region*, there is still no regional tax on the removal of waste. There are however some local ("agglomeration") charges on waste.[17]

In the *Walloon Region*, the tax on the removal of waste is laid down in the decree of the Walloon Council of 25 July 1991 concerning the tax on waste in the Walloon Region.[18] The revenues of these taxes are deposited in a Walloon budget fund for the financing of the Walloon waste policy.

– the pollution of surface waters

In the *Flemish Region*, the tax on the pollution of surface waters is laid down in the law of 26 March 1971 concerning the protection of surface waters against pollution.[19] The Flemish Environmental Company (VMM) is responsible for the (annual) collection of the tax. The revenues of this tax are deposited in the MINA-Fund.

In the *Brussels Capital Region*, the tax on the pollution of surface waters is laid down in the ordinance of the Brussels Capital Council of 29 March 1996 which levies a tax on the discharge of waste water.[20]

In the *Walloon Region*, the tax on the pollution of surface waters is laid down in the decree of the Walloon Council of 30 April 1990 which levies a tax on the discharge of industrial and household waste water.[21] The revenues of these taxes are deposited in a Walloon budget fund for the protection of surface waters.

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12. *Alen Constitutional Law* at 257.
13. For a survey of regional taxes, see: van Orshoven, P., *Fiscolex 1996 – Regionale en provinciale belastingen*, Kluwer Rechtswetenschappen, Antwerpen, 1996, at 1048.
14. Because of the previously mentioned problems concerning the "competence ratione loci", no specific Community taxes have been introduced yet, although a few attempts have been made by the French Community (Peeters, B., "De fiscale bevoegdheidsverdeling na de vierde staatshervorming", *A.F.T.*, 1994, at 197-206).
15. De Jonckheere, M. and Spruyt, A., "Federal and regional environmental taxation in Belgium", *Intertax*, 1996, at 416-433; Deketelaere, K., "Environmental tax law in Belgium", in *Green taxes – Environmental protection by means of excises and contributions in the European Union*, Borgsmidt, K. (ed.), Bundesanzeiger Verlag, Cologne 1997; Deketelaere, K., "Milieufiscaliteit", in *NV/BVBA in de praktijk*, Kluwer Rechtswetenschappen, Antwerpen, loose-leaf.
16. *B.S.G.*, 25 July 1981 (as modified).
17. E.g.: the charge for the removal of waste through collection; the charge for direct disposals of waste in the installations of the Brussels Agglomeration; the charge for the collection of waste; the charge for the services rendered by the Regional Agency for Cleanness.
18. *B.S.G.*, 20 November 1991 (as modified).
19. *B.S.G.*, 1 May 1971 (as modified).
20. *B.S.G.*, 1 April 1996.
21. *B.S.G.*, 30 June 1990 (as modified).

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– intake of surface water

In the *Flemish Region*, the tax on permits for the intake of water is laid down in the Programme Decree 1991 of the Flemish Parliament of 21 December 1990.[22] The tax must be paid on the issue of a permit for the intake of water. The amount of the tax depends on the total volume of water taken.

No similar tax exists in either the *Brussels Capital Region* or the *Walloon Region.*

– extraction of groundwater

In the *Flemish Region*, the tax on the extraction of groundwater is laid down in the decree of the Flemish Parliament of 24 January 1984.[23] The Flemish Environmental Administration (AMINAL) is responsible for the (annual) collection of the tax. The revenues of this tax are deposited in the MINA-Fund.

In *the Walloon Region*, the tax on the extraction of groundwater is laid down in the decree of the Walloon Council of 30 April 1990 on the protection and the exploitation of groundwater and water that may be processed into drinking water.[24] The revenues of these taxes are deposited in a Walloon budget fund for the protection of both these categories of water.

No similar tax exists in the *Brussels Capital Region.*

– environmental permits

In the *Flemish Region*, the tax on environmental permits is laid down in the decree of the Flemish Parliament of 28 June 1985 concerning the environmental permit.[25] The revenues from this tax are deposited in the MINA-Fund.

In the *Brussels Capital Region*, the tax on environmental permits is laid down in the ordinance of the Brussels Capital Council of 30 July 1992 concerning the environmental permit.[26] The revenues of the tax are deposited in the Brussels fund for the protection of the environment.

No similar tax exists in the *Walloon Region.*

– surplus of manure

In the *Flemish Region*, the various taxes on the overproduction of manure are laid down in the decree of the Flemish Parliament of 23 January 1991 concerning the protection of the environment against pollution by manure.[27] The revenues from these taxes are retained in favour of the Manure Bank.

No similar taxes exist in either the *Brussels Capital Region* or the *Walloon Region.*

– gravel extraction

In the *Flemish Region*, the tax on gravel extraction is laid down in the decree of the Flemish Parliament of 14 July 1993 governing the foundation of the Gravel Fund and the regulation of gravel extraction.[28] The revenues from the gravel tax are deposited in the Gravel Fund.

No similar tax exists in either the *Brussels Capital Region* or the *Walloon Region.*

– others

Apart from the regional environmental taxes mentioned above, there are a few other, minor and essentially administrative, environmental taxes. For example: taxes on the issue of fishing permits (Flemish Region and Walloon Region), hunting permits (Flemish and Walloon Region), waste transport documents (Flemish Region), soil certificates (Flemish Region), etc.

(iii) Slum taxes[29]

– buildings and/or houses

In the *Flemish Region*, a slum tax on buildings and/or houses is laid down in the Programme Decree 1996 of the Flemish Parliament of 22 December 1995.[30]

In the *Brussels Capital Region*, there is no real slum tax on buildings and/or houses, but there is a tax which must be borne by those who occupy built-up properties and those who hold real rights in certain immovable property. This tax is laid down in the ordinance of the Brussels Regional Council of 23 July 1992.[31]

No similar tax exists in the *Walloon Region.*

– commercial spaces

In the *Flemish Region*, a slum tax on commercial spaces is laid down in the decree of the Flemish Parliament of 19 April 1995 containing measures to combat and to prevent the standing empty and the neglect of commercial spaces.[32]

In the *Brussels Capital Region*, a slum tax on commercial spaces is laid down in the ordinance of the Brussels Capital Council of 13 April 1995 concerning the re-arrangement of non-operated or abandoned commercial spaces.[33]

No similar tax exists in the *Walloon Region.*

3. The Provinces

Article 170, paragraph 3 C.C. stipulates:

> No imposition or tax can be established by a province other than by a decision of its council. A statute shall determine the exceptions which prove to be necessary with respect to the taxes referred to in the previous subparagraph.
> A statute may abolish, in total or in part, the taxes referred to in the first subparagraph.

Under this provision the provinces are therefore treated as public authorities with taxing powers. The taxing powers of the provinces will be further analysed under Section V.

22. *B.S.G.*, 29 December 1990 (as modified).
23. *B.S.G.*, 5 June 1984 (as modified).
24. *B.S.G.*, 30 June 1990 (as modified).
25. *B.S.G.*, 17 September 1985 (as modified).
26. *B.S.G.*, 29 August 1992 (as modified).
27. *B.S.G.*, 28 February 1991.
28. *B.S.G.*, 14 October 1993.
29. Deketelaere, K., "De Vlaamse heffingen inzake leegstaande, verwaarloosde en verkrotte gebouwen, woningen en bedrijfsruimten", in Deketelaere, K. (ed.), *Leegstand, verwaarlozing en verkrotting van gebouwen, woningen en bedrijfsruimten*, LeuVeM, nr. 8, Die Keure, Brugge, 1996, at 41-112; Robben, W., "Leegstand en verwaarlozing van bedrijfsruimten in het Vlaamse Gewest", *R.W.*, 1996, at 481-495.
30. *B.S.G.*, 30 December 1995 (as modified).
31. *B.S.G.*, 1 August 1992.
32. *B.S.G.*, 13 September 1995 (as modified).
33. *B.S.G.*, 13 June 1995.

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4. The Municipalities

Article 170, paragraph 4 C.C. stipulates:

> No imposition or tax can be established by an urban area, a federation of municipalities and a municipality other than by a decision of their council.
> A statute determines the exceptions which prove to be necessary with respect to the taxes referred to in the previous subparagraph.

This provision indicates that the municipalities are public authorities with taxing powers. The taxing powers of the municipalities will be further analysed under Section VI.

C. Annual ratification[34]

Article 171 C.C. stipulates:

> The taxes for the benefit of the State, the Community and the Region, are voted annually.
> The rules introducing them are valid for one year only if not renewed.

In order to ensure the supervisory role of the Parliament (State, Community, Region), this provision stipulates that tax laws (decrees or ordinances) remain in force until they are repealed (just like any other law (decree or ordinance)). However, the legislator (State, Community, Region) must annually renew the government's authority for collecting taxes. This authorization is normally given in the (State, Community, Region) Ways and Means Budget.

D. Equality[35]

Article 172 C.C. stipulates:

> No privileges may be established with respect to taxes.
> No exemptions or reductions of taxes may be established other than by law.

The first subsection is an application in fiscal law of the general equality principle (cf. Article 10 C.C.[36]) Alen describes the principle thus[37]:

> Legal equality in taxation entails that all citizens who find themselves in identical situations should be taxed identically on the basis of general, objective and impersonal tax laws [decrees, ordinances]. It also implies that the different contribution which is required of each citizen individually for sharing in the burdens of the State [Community, Region] should be based on objective and reasonable grounds. Thus, citizens should be taxed according to their ability to pay. It has been ruled that tax regulations are unconstitutional if the obligation to pay a tax depends on a condition that clearly bears no relation with either the nature of the tax or with its aim. The mere fact that only one taxpayer may be liable for the tax does not in itself make that tax illegal.

The second subsection of this article confirms (as stated previously) that: reductions and exemptions from a tax must be included in the law, decree or ordinance that enacts the tax.

E. Charges[38]

Article 173 C.C. stipulates :

> Save for the benefit of the provinces, the polders and the drained fens and in cases explicitly excepted by statute, decree or a rule referred to in Article 134, no retribution may be exacted from the citizens other than solely by way of taxation for the benefit of the State, the Community, the Region, the urban area, the federation of municipalities or the municipality.

Article 170 C.C., analysed above, expressly names all the public authorities which have the power to levy taxes in Belgium (be it at the level of the State, the Community, the Region, the Province or the Municipality). According to Article 173 C.C., these same public authorities, together with the polders and the drained fens and the authorities which are explicitly assigned by law, decree or ordinance, can also levy charges.

The following sets out the main characteristics which distinguish a tax from a charge:

(1) in general, a tax is an obligatory levy without immediate compensation, executed by the public force on the means of the citizens, in order to assure the payment of public expenditures;

(2) in general, a charge is a levy that is an immediate and reasonable compensation for a specific and individually provided government service, requested voluntarily from the relevant government;

(3) neither a tax nor a charge should be confused with the social security levies (e.g. the contributions by employers and employees), which are normally based on earnings, and for which other rules apply;

(4) the levying of a charge is bound to the material competencies of the concerned authority; as indicated above, this is not the case for a tax;

(5) the competent legislator which levies a charge can limit itself to the indication of the cases in which the charge is due and the persons who have to pay the charge; the other elements of the charge (exemptions, reductions) can be determined by the competent executing power. This is not the case for a tax as mentioned above: all essential elements of the tax must be expressly framed in legislation enacted by the legislator;

(6) the principle of annual ratification only applies to taxes.

F. Spending power[39]

Article 174 C.C. stipulates:

> Each year the House of Representatives settles the final accounts and votes on the budget. However, the House of Representatives and the Senate, each for itself, settle the endowment destined for their functioning.
> All receipts and expenditures of the State must be included in the budget and in the accounts.

34. *Alen Constitutional Law*, at 251-252; *Alen Handboek*, at 782.
35. *Alen Constitutional Law*, at 252; *Alen Handboek* at 782-783.
36. Art. 10 C.C.: "In the Kingdom there are no class distinctions. All Belgians are equal before the law; only they can be called to civil or military office, but for such exceptions as a statute may make in specific cases."
37. *Alen Constitutional Law* at 252.
38. *Alen Constitutional Law*, at 250-251; *Alen Handboek*, at 778-779; Peeters, B., "De begrippen belasting, last en retributie in de artikelen 110 en 113 van de Grondwet", *R.W.*, 1987-1988, at 241-250.
39. *Alen Constitutional Law*, at 252-256; *Alen Handboek*, at 782-792; Matthijs, H., *Overheidsbegrotingen*, Die Keure, Brugge, 1996, at 278.

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This provision contains the fundamental rules governing the spending power of the State.[40] These rules have been elaborated upon in the Budget and Accounting Acts of 1846 and 1963, as amended in 1989 and as coordinated by the royal decree of 17 July 1991.[41] The principle of legality, the principle of annual ratification, the principle of universality, the principle of specialization and the principle of the public nature of the budget and the accounts, apply to these rules.

G. Financial systems of the Flemish and French communities

Article 175 C.C. stipulates:

> A statute adopted with the majority indicated in the last paragraph of Article 4, establishes the financial system of the Flemish and the French Communities.
> The Councils of the Flemish and the French Communities decide by decree, each in their own spheres, the allocation of their revenue.

The special law establishing the financial systems of the Flemish and the French Communities will be analysed under Section III.

H. Financial system of the German speaking community

Article 176 C.C. stipulates:

> A statute establishes the financial system of the German speaking Community.
> The Council of the German speaking Community decides by decree the allocation of the revenue.

The normal law establishing the financial system of the German speaking Community is the law of 31 December 1983 which sets out reforms to the institutions of the German speaking Community.[42] This law will be analysed under Section III.

I. Financial system of the regions

Article 177 C.C. stipulates:

> A statute adopted with the majority indicated in the last paragraph of Article 4, establishes the system for the financing of the Regions.
> The Councils of the Regions determine by a rule referred to in Article 134, each as far as they are concerned, the allocation of the moneys received.

The special law establishing the financial system of the Regions will be analysed under Section III.

J. Brussels Capital region[43]

Article 178 C.C. stipulates:

> By the rule referred to in Article 134, the Council of the Region of Brussels-Capital transfers financial means to the Common Community Commission and to the French and the Flemish Community Commissions, under the conditions and in the manner which a statute adopted with the majority specified in the last paragraph of Article 4, determines.

This provision concerns the fact that the Flemish and the French Community Commission do not have their own fiscal competence. As a consequence of this, their expenditures are financed by donations from other authorities[44] (Flemish Community, French Community, Brussels Capital Region).

III. SPECIAL LAW OF 16 JANUARY 1989

A. Introduction

The Special Law of 16 January 1989 (Special Law) concerning the financing of the Communities and the Regions[45] deals with the financing of the Flemish Community, the French Community, the Flemish Region, the Walloon Region and the Brussels Capital Region. The system of financing[46] established by the Special Law, is based on two fundamental principles: the financial autonomy of and the solidarity between the federated entities. Hereafter, the main principles of this law will be analysed.

B. Financial means of the Flemish and French communities

1. General

According to Article 1, paragraph 1 of the Special Law, the budgets of the Flemish and the French Communities are[47] now[48] financed by:

- non-fiscal revenues;
- fiscal revenues;
- appropriated parts of the revenues of taxes and levies;
- loans.

40. These rules also apply to the federated entities (*Alen Handboek*, at 805-807).
41. *B.S.G.*, 21 August 1991.
42. *B.S.G.*, 18 January 1984.
43. *Alen Handboek*, at 810.
44. This financial system is laid down in the Special Law of 16 January 1989 concerning the financing of the communities and the regions (*B.S.G.*, 17 January 1989) and in the Special Law of 12 January 1989 concerning the Brussels institutions (*B.S.G.*, 14 January 1989, err. *B.S.G.*, 16 March 1989).
45. *B.S.G.*, 17 January 1989 (as modified).
46. There is a transition period which expires in the year 2000.
47. Besides the revenues of the community taxes levied on the basis of Art. 170, para. 2 of the C.C.
48. This has been different in the past (*Alen Handboek*, at 792-795; *Alen Constitutional Law*, at 146-148): (i) before 1980, the federated entities were financed by donations (federal budget credits), which were divided by reference to formulae fixed by law; the federated entities could spend this money at their own discretion for their own competencies; this system did not encourage the financial and fiscal responsibility of the federated entities; (ii) in 1980, the system of donations was supplemented with returns of premiums or revenues from some federal taxes, which were attributed to the federated entities. This allocation was not computed by reference to fixed formulae (cf. donations), but instead reflected the principle of localization or the criterion of the real revenues of the taxes in the relevant federated entity. All of this was replaced in 1989 by a completely new system of financing for the federated entities, laid down in the Special Law of 16 January 1989.

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2. Non-fiscal revenues[49]

Article 2 of the Special Law stipulates that non-fiscal revenues, connected to the exercise of the Communities attributed competencies, may be retained by the Communities. The Communities can also receive gifts and legacies.

3. Fiscal revenues[50]

According to Article 5bis of the Special Law, the television licence fee is a community tax. However, the term "community tax" is deceptive: as van Orshoven[51] states, the television licence fee is not a tax levied by the Flemish and/or French Community; it is a federal tax the revenues from which are attributed to the Communities; the federal legislator remains competent for the fixing of the tax rate, the tax base and the exemptions from the tax.[52] So it is better to speak of a quasi community tax,[53]) since the only community aspect of the tax is that the Communities get the revenues. In this way, it is also easier to underline the difference with the proper community taxes, being those levied by the Communities on the basis of their autonomous taxing power, laid down in Article 170, paragraph 2 of the C.C. As already indicated previously, problems concerning the competence *ratione loci*, have meant that no proper community taxes have yet been levied.

For the purpose of the application of Article 5bis of the Special Law, the television licence fee[54] is deemed to be localized to the place where the television is kept.[55] The French Community gets the part relating to the net (licence fee) revenues of the French linguistic area, augmented with 80 per cent of the part of the net-revenues from this tax derived from the bilingual area Brussels-Capital. The Flemish Community gets the net-revenues from the Flemish linguistic area increased with 20 per cent of the part of the net-revenues from the bilingual area Brussels-Capital.

The television licence fee was made a quasi community tax[56] in 1993,[57] because of the previously mentioned problems concerning the fiscal competence *ratione loci* of the Communities. Levying, among others, a quasi community tax in the form of the television licence fee (and in this way increase the financial means of the communities), avoided new and difficult discussions concerning the communities taxing powers.[58]

4. Appropriated parts of the revenues of taxes and levies[59]

Article 6, paragraph 1 of the Special Law stipulates that a shared tax is a federal tax which is raised in a uniform way across the whole territory of the country and of which the revenues totally or partly are attributed to the Communities. The shared taxes are the value added tax (of which the revenues are divided on the basis of the number of pupils) and the personal income tax[60] (which is deemed to be localized to the place where the taxpayer has settled his dwelling-place).

5. Loans[61]

The Communities may finance their budgets through loans subject to the conditions contained in Article 49 of the Special Law.

6. German speaking community[62]

The Special Law is not applicable to the financing of the German speaking Community. As already indicated before, the law of 31 December 1983 containing the reform of the institutions for the German speaking Community[63] is applicable to this Community. Besides the revenues of the community taxes levied on the basis of Article 170, paragraph 2 of the C.C., the law of 31 December 1983 foresees the following financial means: a credit chargeable to the federal budget; non-fiscal revenues; fiscal revenues (television licence fee); loans.

C. Financial means of the Flemish, Walloon and Brussels Capital regions

1. General

According to Article 1, paragraph 2 of the Special Law, the budgets of the Flemish, Walloon and Brussels Capital Regions are[64] now[65] financed by:

- non-fiscal revenues;
- fiscal revenues;
- appropriated parts of the revenues of taxes and levies;
- national solidarity mechanism;
- loans.

2. Non-fiscal revenues[66]

Article 2 of the Special Law stipulates that non-fiscal revenues, connected to the exercise of the Regions' attributed competencies, may be retained by the Regions. The Regions can also receive gifts and legacies.

49. *Alen Constitutional Law*, at 259; *Alen Handboek*, at 803.
50. *Alen Handboek*, at 799-801.
51. van Orshoven, P., "Gemeenschaps- en gewestbelastingen", *A.F.T.*, 1990, at 123-129.
52. However, the community governments must agree with a change in one (or more) of these elements.
53. Which however only concerns the revenues of the television licence fee.
54. The Regions are competent to levy surtaxes on the television licence fee, but they can not allow rebates (Arts. 5bis, paras. 3 and 11 of the Special Law of 16 January 1989).
55. As regards the sets in cars, the place where the holder of the set is settled is used.
56. Its purpose was to help meet the financial costs of providing for education in the French language.
57. Originally it was a shared tax.
58. *Alen Handboek*, at 798.
59. *Alen Constitutional Law*, at 259; *Alen Handboek*, at 801-803.
60. After the transition period (during which the calculation is very technical), these resources will increase in proportion to the nominal growth of GNP (*Alen Constitutional Law*, at 259; *Alen Handboek*, at 801-802).
61. *Alen Constitutional Law*, at 259; *Alen Handboek*, at 803-804.
62. *Alen Handboek*, at 793.
63. *B.S.G.*, 18 January 1984.
64. Besides the revenues of the regional taxes levied on the basis of Art. 170, para. 2 of the C.C.
65. See *supra* note 48.
66. *Alen Constitutional Law*, at 259; *Alen Handboek*, at 803.

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3. Fiscal revenues[67]

According to Article 3 of the Special Law, the following taxes are regional taxes:[68]
(1) duties on betting and gambling;
(2) slot machines tax;
(3) opening tax on off-licences;
(4) succession duties;
(5) assessed value tax on property;
(6) registration fees on transfers of real estate;
(7) motor vehicle tax;
(8) ecotaxes.

However, as was the case with the term "community tax" as applied to the television licence fee, in certain instances the description "regional taxes" is deceptive.[69] The taxes mentioned above are in essence federal taxes with regard to which the Regions have certain competencies (on the basis of the Special Law) and of which they get, either all or part of the revenues.[70] So it is better to speak of quasi regional taxes (and of the additional taxing powers of the Regions), since the only regional aspects of these taxes are that the Regions get, on the one hand, the revenues of the taxes and, on the other, some competencies regarding those (federal) taxes. In this way, it is also easier to distinguish these taxes from the proper regional taxes, i.e. those levied by the Regions on the basis of their autonomous taxing power, laid down in Article 170, paragraph 2 of the C.C. As previously indicated, the Regions have already levied numerous proper regional taxes.

As regards the competencies of the Regions concerning the eight categories of quasi regional taxes mentioned above,[71] the following elements are relevant (Article 4 of the Special Law):
(1) duties on betting and gambling: the Regions can change the tax base, the tax rate and the tax exemptions;
(2) slot machines tax: the Regions can change the tax base, the tax rate and the tax exemptions;
(3) opening tax on off-licences: the Regions can change the tax base, the tax rate and the tax exemptions;
(4) succession duties: the Regions can change the tax rate and the tax exemptions;[72]
(5) assessed value tax on property: the Regions can change the tax rate and the tax exemptions;
(6) registration fees on transfers of real estate: the Regions can change the tax rate and the tax exemptions, as soon as this tax is completely attributed to the Regions;
(7) motor vehicle tax;
(8) ecotaxes[73].

The federal legislator remains competent[74] for the fixation of the tax base of taxes (4) to (8) above, and also for the fixation of the tax rate and the tax exemptions for taxes (7) and (8) above.[75]

4. Appropriated parts of the revenues of taxes and levies[76]

Article 6, paragraph 2 of the Special Law stipulates that a joint tax is a federal tax (i) which is raised in a uniform way across the whole territory of the country, (ii) of which the revenues are partly attributed to the Regions, (iii) and on which the Regions, on the basis of the localization of those taxes, can levy surtaxes (since 1 January 1994) or can grant rebates (as far as these do not exceed the amount of the attributed revenue). The only joint tax is the personal income tax[77] (which is deemed to be localized to the place where the taxpayer resides).

5. National solidarity mechanisms[78]

According to Article 48 of the Special Law, a national solidarity contribution is paid to the Region or Regions, where the personal income tax revenue per capita is below the national average.

6. Loans[79]

The Regions may finance their budgets through loans subject to the conditions set out in Article 49 of the Special Law.

67. *Alen Constitutional Law*, at 258; *Alen Handboek*, at 799-801.
68. The (quasi) regional taxes only form a small part of total regional income (*Alen Handboek*, at 801).
69. van Orshoven, P., "Gemeenschaps- en gewestbelastingen", *A.F.T.*, 1990, at 123-129.
70. According to Art. 5 of the Special Law of 16 January 1989, the quasi regional taxes (with the exception of the ecotax) are attributed to the Regions in function of their localization. Those quasi regional taxes are deemed to be localized as follows:
(1) duties on betting and gambling: the place were the gambling takes place and the bets are made;
(2) slot machines tax: the place where the machine is placed;
(3) opening tax on off-licences: the place where the concerned room is situated;
(4) succession duties: the place where the estate falls open or the Region where the goods are situated;
(5) assessed value tax on property: the place where the immovable is situated;
(6) registration fees on transfers of real estate: the place where the immovable is situated;
(7) motor vehicle tax: the place where the taxpayer is settled.
71. Of which they have already made use, quite often (Tiberghien, A., *Handboek voor fiscaal recht '95*, Kluwer Rechtswetenschappen, Antwerpen, 1995, at 967-968).
72. This happened recently through enactment of the Arts. 14-22 of the Programme Decree of the Flemish Parliament of 20 December 1996 (*B.S.G.*, 31 December 1996).
73. The tax concerning products damaging the environment was introduced by the Special and Ordinary Law of 16 July 1993 (*B.S.G.*, 20 July 1993) concerning the completion of the federal state structure. According to the Special Law of 16 July 1993 (modifying the Special Law of 16 January 1989), the tax on products damaging the environment: (i) is a tax equated with excises and levied on products brought into consumption, because of the damage that they are deemed to cause the environment; (ii) is, as indicated above, a quasi regional tax, whereby the federal government has the competence to change the base, the rate and the exemptions from the tax (although only with the consent of the regional governments); (iii) is a tax of which the total net-revenues are assigned to the regions; (iv) is a tax of which the total net-revenues are divided between the regions according to the number of inhabitants of each region. A cooperation-agreement between the three regions stipulates that the regions must use the revenues of the tax for supplementary expenditures in the sector of the environment. The different products on which the tax is levied, the rates, the exemptions and the reductions can be found in the Ordinary Law of 16 July 1993 (as modified).
74. Contained in Art. 4 of the Special Law of 16 January 1989.
75. However, the regional governments must agree with a change in one (or more) of these elements.
76. *Alen Constitutional Law*, at 259; *Alen Handboek*, at 801-803.
77. See *supra* note 60.
78. *Alen Constitutional Law*, at 259-260; *Alen Handboek*, at 804-805.
79. *Alen Constitutional Law*, at 259; *Alen Handboek*, at 803-804.

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IV. LAW OF 23 JANUARY 1989[80]

As indicated above the autonomous taxing powers of the Communities and the Regions can be limited on the basis of Article 170, paragraph 2, subsection 2 C.C.[81] According to this provision, the federal legislator[82] is able (i) to indicate, which taxes may not be imposed by the Communities and the Regions, and (ii) to limit or to abolish, retrospectively, a tax of a Community or a Region, as far as the necessity of this is proven. The federal legislator has used this competence to reserve some fiscal matters in the law of 23 January 1989 concerning the definition in Article 11[7]0, paragraphs 1 and 2 of the C.C. of tax competence.[83]

Article 1 of the law of 23 January 1989 stipulates that the Communities and the Regions are not endorsed to levy taxes, to levy surtaxes or to grant rebates, on the matters which are already subjected to a federal tax (with exception however for the cases foreseen in Article 11 of the Special Law).

Article 2 of the law of 23 January 1989 stipulates that the Communities and the (federal) State are not authorized to levy taxes, to levy surtaxes or to grant rebates, on the matters concerning water and waste (as defined in Article 6 of the Special Law of 8 August 1980).

V. PROVINCE LAW

As indicated above according to Article 170, paragraph 3 C.C., [84] the provinces are public authorities with taxing powers.

However, the in principal general fiscal autonomy of the provinces is limited in different ways:[85]

(1) the ten[86] provinces exercise their taxing powers in their own territories; the link between the province and the tax base can take various forms;
(2) the taxing powers of the provinces are limited by different legal dispositions which, on the one hand, exempt different persons and/or institutions from the provincial taxes, and, on the other, forbid the provinces to levy taxes on certain matters;
(3) the tax regulations of the provinces are subjected to the administrative supervision of the regional governments;
(4) the provinces are, in the exercise of their taxing power, obligated to respect the C.C., the laws, the international treaties and the general principles of law.

The adoption, the settlement, the collection and the prosecution of provincial taxes are regulated by the Province Law and the law of 24 December 1996 concerning the settlement and the collection of provincial and municipal taxes[87] (which from 1 January 1997 replaced the law of 23 December 1986 concerning the collection and the differences concerning provincial and municipal taxes.[88])

VI. NEW MUNICIPALITY LAW

As indicated above according to Article 170, paragraph 4 C.C.,[89] the municipalities are public authorities with taxing powers.

However, the in principal general fiscal autonomy of the municipalities is, just as in the case of the provinces, limited in different ways:[90]

(1) the municipalities exercise their taxing powers in their own territory; the link between the municipality and the tax base can take various forms;
(2) the taxing power of the municipalities is limited by different legal dispositions which, on the one hand, exempt different persons and/or institutions from the municipality taxes, and, on the other, forbid the municipalities to levy taxes on certain matters;
(3) the tax regulations of the municipalities are subjected to the administrative supervision of the provincial governor;
(4) the municipalities are, in the exercise of their taxing power, obligated to respect the C.C., the laws, the international treaties and the general principles of law.

The adoption, the settlement, the collection and the prosecution of municipal taxes are regulated by the New Municipality Law and the law of 24 December 1996[91] concerning the settlement and the collection of provincial and municipal taxes.[92]

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80. *Alen Constitutional Law*, at 257; *Alen Handboek*, at 797-798.
81. "A statute shall determine the exceptions which prove to be necessary with respect to the taxes referred to in the previous subparagraph."
82. According to Tiberghien (Tiberghien, A., *Handboek voor fiscaal recht '95*, Kluwer Rechtswetenschappen, Antwerpen, 1995, at 971), this rule creates the priority of the Fiscal Law over the Fiscal Decree or over the Fiscal Ordinance, and this notwithstanding the fact that the law, the decree and the ordinance are rules of law with an equal value.
83. *B.S.G.*, 24 January 1989 (as modified).
84. "No imposition or tax can be established by the province other than by a decision of its council. A statute shall determine the exceptions which prove to be necessary with respect to the taxes referred to in the previous subparagraph. A statute may abolish, in total or in part, the taxes referred to in the first subparagraph."
85. Tiberghien, A., *Handboek voor fiscaal recht '95*, Kluwer Rechtswetenschappen, Antwerpen, 1995, at 957-960.
86. Since the division of the former province "Brabant" into the present provinces "Vlaams-Brabant" and "Waals-Brabant" (1 January 1995), there are no longer provincial taxes in the district of Brussels-Capital, since it is no longer part of a province. These former provincial taxes in that area have been taken over by the Brussels Capital Region by the ordinance of 22 December 1994 (*B.S.G.*, 11 February 1995). As concerns the Brussels conurbation, it only has a well defined and limited taxing power.
87. *B.S.G.*, 31 December 1996.
88. *B.S.G.*, 12 February 1987.
89. "No imposition or tax can be established by an urban area, a federation of municipalities and a municipality other than by a decision of their council. A statute determines the exceptions which prove to be necessary with respect to the taxes referred to in the previous subparagraph."
90. Tiberghien, A., *Handboek voor fiscaal recht '95*, Kluwer Rechtswetenschappen, Antwerpen, 1995, at 937-956.
91. As from 1 January 1997 this law replaces the law of 23 December 1986 concerning the collection and the differences concerning provincial and municipal taxes. *B.S.G.*, 12 February 1987.
92. *B.S.G.*, 31 December 1996.

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VII. CONCLUSIONS

The principal rules concerning the division of fiscal competencies in Belgium have been set out above. Apart from the problem of the fiscal competence *ratione loci* of the Communities, experience has shown, that the quite complex division of fiscal powers functions quite well. However, from a more general perspective, one must say that the financing of the Communities and the Regions is a continuous point of discussion between the Dutch speaking part and the French speaking part of this country.[93] This is true despite the fact that the financial means, and as a consequence the spending autonomy, of the federated entities has over the years shown a substantial growth.[94] The earning autonomy of the federated entities also remains limited.[95] The greatest part of their financial means are appropriated parts of the revenues of taxes and levies (value added tax and personal income tax).[96] This means that the federated entities have now considerable financial means available to facilitate the exercise of their attributed competencies.

According to Alen,[97] the financial situation of the Belgian federated entities is quite comparable with those of the federated entities in the United States, Australia, Germany, Canada or Switzerland: in modern federal financial systems, the federal government remains competent regarding the most important income sources while the most important expenditures relate to the level of the federated entities.

However, not everybody shares this last point of view. For example: on 29 February 1996, the Flemish Government approved a working paper for a further reform of the state;[98] in that working paper, increased financial and fiscal autonomy is a very important point. This same idea is present in the draft of a constitution for Flanders,[99] which was presented in 1996. So, it is to be expected that the following phase in the reform of the Belgian state (due to commence in 1999) will bring about changes in the field of the fiscal competencies of the Communities and the Regions. The saga no doubt will be continued ...

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ITALY

1997 BUDGET LAW

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Studio Capaccioli, Florence

I. INTRODUCTION

The 1997 Budget Law grants the Government the authority to issue delegated laws on fiscal matters. In this article I examine the main implications of the proposed changes to the corporate and individual income tax regimes.

II. CORPORATE INCOME

The taxation of corporate income will be modified by a new tax *imposta regionale sulle attività produttive* (IRAP) – and by a reduction of the corporate tax rates due by companies which increase their paid in capital – dual income tax (DIT). The two taxes will presumably come into force in 1998.

A. RAP

The new tax (IRAP) stands for "tax on the value of production".
The value of production, subject to IRAP, is the value produced in Italy, by an Italian company or by the Italian permanent establishment of a foreign company.

The value of the production is calculated according to the type of business:

- for an industrial or commercial business, the taxable base will be the gross value of the production (sales, increases in inventories and other revenues) less the production costs (purchases, depreciations, reductions in inventories and other costs);
- for a financial business, the taxable base will be the interest on loans plus other financial revenues less the interest on deposits, other production costs and depreciations;
- for an insurance business, the taxable base will be the insurance premiums net of commissions less the indemnities and provisions for compulsory technical reserves.

For all types of business, the tax base will be calculated without deduction of labour costs. Furthermore, for businesses other than financial, the tax base will not take into account interest paid or accrued.

The new definition of the tax base is likely to mean that industries with substantial labour costs and companies that are thinly capitalized will be taxed more heavily than industries with low labour costs and companies with low net borrowings.

1. Restructuring of business activities

The effect of the new regime is likely to lead to the modification of business structures, since companies are likely to attempt to shift non-deductible costs into deductible costs. This might be achieved through:

(i) the outsourcing of non-deductible labour costs into deductible costs related to the purchase of labour intensive services; or
(ii) leasing or renting material assets rather than purchasing them through borrowings.[1]

2. Royalties

According to the Italian jurisdiction, the current local income tax (ILOR) is due on the royalties paid to non-residents which have been subject to a withholding tax. This treatment applies in the majority of Italian tax treaties.

Furthermore the Italian jurisdiction applies ILOR even where a tax treaty provides an exemption from withholding tax.[2] This circumstance implies an ILOR taxation of 16.2 per cent on the royalties paid in Italy.

On the contrary, the base of the tax liability in respect of IRAP is the "value of the production" produced in Italy. IRAP will bear upon the production value produced in Italy irrespective of net income and withholding taxes. Therefore, (subject to the legislation to be enacted) the royalties paid to non-residents by residents in Italy will probably be exempt from IRAP because the value of the production (i.e. the royalties) will be considered not to be produced in Italy.

The tax rate of IRAP is expected to fall in the range of between 3.5 and 4.5 per cent[3] of the value of the production as calculated above. IRAP will replace ILOR and therefore royalties paid to non-residents will be subject only to withholding tax, unless otherwise provided for in an applicable treaty.

3. Tax on capital

IRAP will also replace the tax on capital (the so called *imposta patrimoniale*) which is currently levied at a rate of 7.5 per thousand on the company's net worth.

1. I.e. the interest on money borrowed to acquire the asset would not be deductible.
2. See for example the treaties with Cyprus and Israel.
3. Regions may impose a further tax of up to 1 per cent.

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The reason for the proposed adoption of IRAP is that it offers the prospect of greater neutrality in the field of corporate taxation. It may be argued that the future IRAP is a production tax, whereas the current ILOR (16.2 per cent tax rate) is an income tax. Given the low rate suggested for IRAP there is an expectation of a reduction in the overall corporate tax burden.

B. DIT

The new tax rate which is to be set within a range of between 12.5 and 27 per cent will apply to the (portion of) net income calculated by reference to the financial return on the increase in the amount of money invested in a company as paid in capital and non-distributable reserves. The return on such investment is assumed equal to the return on the same amount of money invested in treasury bonds and bond securities marketed on the Italian Stock Exchange. The beneficial tax rate applies to increases in the capital and non-distributable reserves occurring after 30 September 1996. The current corporate tax rate is 37 per cent; therefore the reduction in the rate is expected to be at least 10 per cent (37 per cent less 27 per cent).

The following example illustrates a hypothetical tax computation under the proposed regime:

	Corp X.
(a) Income before taxes:	USD 500,000
(b) Net capital and reserves as of 30/09/1996:	USD 5,000,000
(c) Net capital and reserves as of 31/12/1997:	USD 10,000,000
(d) Current return on treasury bonds:	7 per cent per annum

Therefore the capital increase is 5,000,000 (10,000,000 – 5,000,000).
An amount of USD 350,000 (5,000,000 x 7 per cent = 350,000) is entitled to be subject to the lower rate.

The total income will therefore be taxed as follows:
– 350,000 at 27 per cent;
– 150,000 at 37 per cent.
The tax saving will be, USD 35,000 (10 per cent of 350,000). Of course, the amount of the tax saving will depend on the tax rate finally chosen.[4] If we assume, for instance, a rate of 12.5 per cent, the tax computation will be as follows:
– 350,000 at 12.5 per cent;
– 150,000 at 37 per cent.
Upon this assumption, the total tax saving will be USD 85,750 (37 – 12.5 = 24.5 per cent. 350,000 x 24.5 per cent = 85,750).

The new tax rate – DIT – will shift the attention of corporate managers on to the capitalization of their companies rather than on the assignment of the net income to the reserves. On the other hand private investors, as shareholders, will presumably be willing to invest their money in the corporate sector, provided that the return of alternative investments in the financial markets does not exceed the expected return of their investments in that sector.[5]

The new tax rate – DIT – in conjunction with the introduction of IRAP (see above) is in line with the expected suppression of the tax on capital, currently 7.5 per thousand.

C. Tax harmonization

The expected provisions (IRAP and DIT) will reduce the Italian corporate tax burden and cause an approach to the EU average corporate tax rate. Currently, the Italian corporate tax rate is 53.2 per cent, whereas competing EU countries have lower rates: e.g. 34.5 per cent in Germany; 33.3 per cent in France; 35 per cent in the Netherlands and so forth.

D. Other benefits

The 1997 Budget Law also provides for:
(i) the introduction of an additional tax incentive to companies coming on to the Italian Stock Exchange for the first time. A reduced rate of corporate tax on income of between 12.5 per cent and 27 per cent will apply to these companies for the three business years following the first quotation on the Italian Stock Exchange;
(ii) a tax exemption for a group reorganization taking place in Italy through an exchange of shares or contribution of an enterprise.

E. Consequences

A consequence of the expected provisions anticipated by the Budget Law as shown above, will presumably be:
(i) tax motivated increases in corporate share capital and non-distributable reserves;
(ii) the intercompany financing of Italian subsidiaries by their offshore parent companies will be by way of capital increases rather than debt-financing;
(iii) the reorganization of Italian business groups will be enhanced by taking advantage of a tax exemption scenario.

III. INCOME OF INDIVIDUALS

The top tax rate on the income of individuals will be reduced to a rate of at most 46 per cent: currently, the top rate is 51 per cent. The intermediate current tax rates will be maintained:

4. In the range of between 12.5 per cent and 27 per cent.
5. The following example illustrates this:
(i) current net return of investments in the Italian financial markets: 5.8 per cent per annum;
(ii) expected (dividend) return on equity, at par-value: 7 per cent. Upon these assumptions, private investors may be willing to invest in corporations rather than in the Italian financial markets, because the expected net dividend of 6.12 per cent (7 per cent less 12.5 per cent as flat withholding tax) and the expected capital gains of the investments may offset the higher risks of investing in the corporate sector.

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Net income (Lira)	Tax rate
30,000,000 – 60,000,000;	34%
60,000,000 – 150,000,000;	41%
Over 150,000,000	46%

The taxation of capital gains will be reintroduced: currently capital gains related to sales made on the Italian Stock Exchange are not subject to tax, provided that the negotiated participation does not exceed 2 per cent of the capital of the company. Presumably the capital gains tax rate of 12.5 per cent will apply. The tax will apply on all investments of capital. Currently, gains on several types of capital investment are tax free: for instance, the capital gains on the purchase and sale of credits.

Finally the current (optional) final withholding tax on dividends applied at a flat rate of 12.5 per cent will be maintained. This rate will also apply to income from treasury bonds and similar income.

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France

Devereux, Michael P.
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(B. 116.290)

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- Legislation
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- Rulings and guidelines
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Nederlandse regelingen van internationaal belastingrecht
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Personenassociaties
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- Algemene deel
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London, Butterworths.

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New York, RIA Research Institute of America.

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Boston, Warren, Gorham & Lamont.

Conference diary

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

JULY 1997

The 1997 Summer Leasing School, The Berystede, Ascot, Berkshire, UK, 7-9 July 1997 (English):

Samantha Roper, Asset Finance International Seminars, Nestor house, Playhouse Yard, London EC4V5EX, UK, Tel.: 44-171-779 8793, Fax: 44-171-779 8603, E-mail: qm8o@dial.pipex.com

Successfully Managing VAT Disputes, The Berners Hotel, Berners Street, London W1A, 10 July 1997 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

VAT Planning, The Berners Hotel, Berners Street, London W1A, 11 July 1997 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

AUGUST 1997

Summer Course Principles of International Taxation, Amsterdam, The Netherlands, 18-29 August 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

SEPTEMBER 1997

Transfer Pricing Policy, Libertel Terminus Nord, Paris, France, 22-23 September 1997 (English):

Vision in Business, 41 Whitcomb Street, London, United Kingdom,

Tel.: 44-171-839 8391, Fax: 44-171-839 3777, E-mail: postmaster@visibis1.demon.co.uk

International Tax Avoidance and Anti-Avoidance, Amsterdam, The Netherlands, 25-26 September 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

OCTOBER 1997

International Tax Aspects of Electronic Commerce, Amsterdam, The Netherlands, 3 October 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

51st Congress of the International Fiscal Association, New Delhi, 19-24 October 1997 (simultaneous translations into French, English, German and Spanish):

IFA General Secretariat, World Trade Center, Beursplein 37, 3011 AA Rotterdam, The Netherlands, Tel.: 31-10-405 2990, Fax: 31-10-405 5031.

Non-Discrimination, Amsterdam, The Netherlands, 30-31 October 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

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UNITED KINGDOM

RECENT UNITED KINGDOM DEVELOPMENTS IN TRANSFER PRICING

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I. INTRODUCTION

Transfer pricing law and practice in the United Kingdom has for many years been a shadowy activity. Although the requirement for arm's length pricing for related party transactions has been on the statute book[1] for some 50 years, the absence of decided cases and the silence of the Inland Revenue on transfer pricing policy have conspired to make it something of a black art. It has however received a significantly higher profile in recent times and several issues have now been aired in public. This higher profile has manifested itself in several ways:

- new Inland Revenue announcements, particularly on procedural issues;
- the proposed incorporation of transfer pricing into self-assessment for companies which may now come into effect in 1998;
- higher government priority given to investigative work including transfer pricing as announced in the November Budget spend to save initiative;
- litigation. Two recent cases, one in the High Court and the other in the Special Commissioners may indicate an increased willingness of taxpayers to seek recourse to the courts in the face of tougher transfer pricing examinations.

The United Kingdom has not acted in isolation in this respect. These developments must be seen in the context of the OECD rewrite of its transfer pricing guidelines and an increasing awareness of the issue worldwide. Governments are not only seeking to protect themselves from aggressive international shifting of profits by multinational groups but are also trying to generate a source of new revenue. Transfer pricing, as the Clinton election campaign statements in 1992 showed,[2] is viewed as a source of revenue that can be increased by focusing administrative resources on it, without the need for politically unpopular tax increases. The United Kingdom "spend to save" initiative announced in the November 1996 Budget is in the same category.

The Inland Revenue Annual Report published on 19 October 1995 referred to additional tax resulting from adjustments including transfer pricing at GBP 4,047,000. This included one unusually large adjustment which produced GBP 1,638,000 in additional corporation tax. Although they were not at liberty to disclose the name of the party, there was considerable speculation that the pharmaceutical giant Glaxo plc was the company involved. This was denied by the company.

The report also indicates that transfer pricing is the most cost effective method of collecting tax in the anti-avoidance area. The ratio of tax to costs in transfer pricing for 1994/95 was 240 to 1, compared with 75 to 1 on technical avoidance, 29 to 1 on tax investigation and 24 to 1 on tax fraud.

II. INLAND REVENUE ANNOUNCEMENTS

A. The OECD guidelines

In October 1996, the Inland Revenue issued their first public comment on the revised OECD transfer pricing guidelines since the guidelines were released in the middle of 1995.[3] It confirms that the Inland Revenue are guided by the OECD principles. Unlike some other OECD countries, the United Kingdom has not published separate transfer pricing guidelines. The last statement of this kind was in a press release on 26 January 1981.[4]

Semi-annual meetings held between the Inland Revenue International Division and representatives of four professional bodies (The Chartered Institute of Taxation, The Institute of Chartered Accountants in Scotland, the Institute of Chartered Accountants in England and Wales and the Chartered Association of Certified Accountants) have been the major venue for public statements by the Inland Revenue on the subject in recent years.

1. The principal provision is in the Income and Corporation Taxes Act 1988, ("Taxes Act 1988") Sec. 770. The arm's length rule in respect of capital gains is found in the Taxation of Chargeable Gains Act 1992 Sec. 17.
2. See for example *FT World Tax Report* July 1992 at 128.
3. *Inland Revenue Tax Bulletin*, Issue 25, October 1996 at 345.
4. Guidance Notes: The Transfer Pricing of Multinational Enterprises (Inland Revenue Press Release 26 January 1981).

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The issues raised at those meetings usually reflect concerns of taxpayers and their advisors, rather than those that the Inland Revenue wish to raise.

B. Cost contribution royalties

The Inland Revenue have recently indicated at such a meeting, for example, that they would view a payment under a cost contribution arrangement as a royalty where the payment related almost entirely to obtaining rights to use already developed intangibles rather than constituting a contribution to the costs of developing a new intangible.

III. MUTUAL AGREEMENT PROCEDURE

The Inland Revenue set out detailed guidelines in October 1996 for the first time on the mutual agreement procedure under United Kingdom bilateral tax treaties particularly in respect of transfer pricing.[5] As a general matter all mutual agreement procedures in respect of transfer pricing are dealt with by the International Division except those relating to oil companies which are handled by the Oil Taxation Office. The guidelines emphasize that mutual agreement is a process of consultation between the two competent authorities to which the taxpayer is not a party as such. The Inland Revenue may at their discretion invite the taxpayer to participate informally in the process.

The procedure remains informal. There is no set form of claim although UK taxpayers should set out claims in writing specifying the years concerned, the nature of the action giving rise to taxation not in accordance with the applicable treaty and the full names and addresses of the parties to which the procedure relates including the UK company's tax district and reference number.

A. Time limits

One of the difficult issues in relation to invoking the mutual agreement procedure relates to time limits. The Inland Revenue statement notes that the six-year time limit for making claims generally applies to recourse under the mutual agreement procedure. Protective claims may be made in recognition of the fact that transfer pricing investigations may take many years to resolve. One of the difficult questions facing a company in this context is the relationship between administrative remedies and appeals procedures. The guideline states that where the transfer pricing issue is settled by an appeal to the Special Commissioners or on to the courts it may not be varied under the mutual adjustment procedure. In such circumstances however the Inland Revenue would be prepared to take the matter up with the relevant treaty partner with a view to obtaining a corresponding adjustment in that jurisdiction.

The Inland Revenue warn that the competent authorities are under no obligation to guarantee relief from double taxation but are merely required to consult and endeavour to resolve the case. Notwithstanding this, they claim however that the procedure has been effective in providing relief. The United Kingdom is not under an obligation to grant relief if the other contracting party for example does not accept that taxation has been levied other than in accordance with the treaty.

Where there is adequate evidence to satisfy the United Kingdom that an adjustment imposed by a treaty partner is in accordance with the treaty and pursuant to the arm's length principle there will normally be no difficulty in granting a corresponding adjustment.

The Inland Revenue encourage the early invoking of the mutual agreement procedure in transfer pricing investigations. They state that their experience shows that this is advantageous to companies and that early action can help to ensure that unrelievable double taxation does not arise from the actions of one authority.

B. Methods of giving relief

The manner in which relief is granted by the United Kingdom depends on the facts and circumstances of the particular case, it may be either by deduction against UK profits or by tax credit. Following agreement between the competent authorities the UK company will normally be invited to submit revised tax computations reflecting the agreed relief.

The United Kingdom does not accept that a taxpayer may make unilateral adjustments through its accounts in order to obtain corresponding relief for an adjustment imposed by another jurisdiction. The only avenue is to claim relief under the mutual agreement procedure.

C. Secondary adjustments

Secondary adjustments are those which are intended to restore the financial situation of associated companies whose transactions have given rise to a transfer pricing adjustment. This recognizes that while the primary adjustment will adjust taxable profits of the enterprises, it will not rectify the situation that one enterprise actually retains funds that it would not have retained had the transactions in question been undertaken at arm's length.

The secondary adjustment seeks to rectify this situation. This is commonly by assuming that a constructive dividend, equity contribution or interest-bearing loan has been made in an amount equal to the transfer pricing adjustment.

Secondary adjustments may themselves give rise to double taxation unless some form of relief is provided. The guidelines state that the United Kingdom will consider the merits of claims to deduct interest relating to the deeming of a constructive loan by a treaty partner following a transfer pricing adjustment. The claim would however be subject to the arm's length principle and would be considered in the light of any relevant provisions relating to the payment of interest. Where

5. *Inland Revenue Tax Bulletin*, *supra* note 3 at 346.

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a treaty partner applies a secondary adjustment by deeming a distribution to have been made, the United Kingdom neither taxes the distribution nor grants relief for tax suffered on the distribution in the other jurisdiction.

Similarly the repatriation of funds to restore the cash position of the associated company may in some cases remove the need for secondary adjustments. Some jurisdictions encourage repatriation and have specific rules on this. The Inland Revenue state that repatriation of profits to the United Kingdom can be made without further tax consequences providing the amount does not exceed the amount of profits reallocated under the transfer pricing adjustment. There is no opposition in principle to the repatriation of profits by an UK enterprise to an overseas enterprise following a transfer pricing adjustment. However, if under the mutual agreement procedure the amount of the transfer pricing adjustment is modified, then the amounts repatriated in excess of the modified adjusted price may in certain circumstances be regarded as a distribution.

To avoid such a result the Inland Revenue recommend that any repatriation from the United Kingdom be made following agreement of the reallocation as part of the mutual agreement procedure.

D. Advance Pricing Agreements (APAs)

The United Kingdom has no formal mechanism for entering into advance pricing agreements. UK companies often seek participation of the UK competent authority in APAs which their affiliates enter into with other jurisdictions. This may be done under the mutual agreement procedure.

The United Kingdom considers each case on its merits. The Revenue note that the extent to which they will participate is limited by the terms of the mutual agreement procedures in the relevant treaty.

Following the October 1996 *Tax Bulletin* article, discussions were held between the Inland Revenue and professional bodies on the recent Revenue announcement on transfer pricing. In particular clarification was sought on the interaction between seeking competent authority proceedings and appeals settled by agreement under Section 54 Taxes Management Act 1970. This section authorizes appeals to the Commissioners to be settled by agreement. However, such agreements are treated as decisions of the Commissioners. The effect of the section is thus that the issue is deemed settled by appeal and competent authority proceedings are thereby excluded. The principal result of the discussions are:

- the Inland Revenue may be willing to discuss the scope for entering into competent authority discussions before an assessment is settled;
- early notification to the Revenue of disputes with overseas authorities is welcome;
- the UK competent authority does not have the power to modify transfer pricing adjustments on settled years but will assist the group of which the taxpayer is a member in securing corresponding relief;
- a claim for a corresponding adjustment in respect of action by an overseas authority must be made within six years although in appropriate cases a protective claim may be accepted, and a claim may be made within six years even if an appeal has been settled by agreement under Section 54 or earlier;
- the means to ensure relief from international double taxation on transfer pricing is an evolving issue and the Revenue are open to representations.

E. EU Transfer Pricing Arbitration Convention

The Inland Revenue have responded recently to questions on the Arbitration Convention[6] at the regular meetings with professional bodies.

The Revenue noted some time ago that they were not aware of any Member State having established any detailed procedures in relation to the Convention. On the question as to which event triggers "the first notification of the action" in Article 6(1) of the Convention, the Revenue stated that a case cannot be made before 1 January 1995 although after that date a case may be made relating to an event in the preceding three years. The Revenue seek to interpret Article 6(1) in a manner favourable to the taxpayer. The question arose as to whether the taxpayer should initiate proceedings at the earliest possible stage. The Revenue's view is that this should not be before crystallization of a double tax liability. They propose to seek clarification about the trigger mechanism with other EU Member States.

The Inland Revenue have stated frequently that they plan to publish guidance on the application of the Arbitration Convention in the future, although this has not yet been forthcoming. The Inland Revenue have mentioned in the most recent discussions with professional bodies that the Arbitration Convention will soon be due for renegotiation and that they view it unlikely to continue in its present form.

IV. SELF-ASSESSMENT

As part of the November 1996 Budget, the Inland Revenue announced that legislation will be introduced to bring transfer pricing within the new self-assessment framework.[7]

It would commence on the date when self-assessment starts applying to companies, estimated to be 1998 at the earliest. This proposal was first floated as part of the November 1995 Budget. A consultative document will accompany the legislation setting out in detail how the new procedures are intended to work. Under current rules transfer pricing adjustments may only be made if a direction is issued by the Board of Inland Revenue. The Inland Revenue recently indicated in the May 1997 Budget Papers that the consultative document

6. Convention 90/436 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (23 July 1990, OJ 1990 L 225/10).
7. Inland Revenue Press Release 26 November 1968 Rev 32.

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would be issued in 1997. The Revenue have not issued the discussion paper to date, but have consulted privately on this subject. While some taxpayers and professional advisers have resisted this move, it seems clear that transfer pricing in some form will be incorporated into self-assessment.

Self-assessment of transfer pricing in those countries where it is already applied, such as the United States and Canada, has resulted in a heavy compliance burden for multinational groups. In particular, the need for documentation and the imposition of penalties have been extremely controversial. Since the Inland Revenue have given no clues on these difficult topics, the debate on them has yet to begin.

V. SPEND TO SAVE

In the November 1996 Budget Papers, a press release from the Treasury restated the position of the Chancellor that "Fraud and abuse are unfair and unacceptable. So is avoidance which makes large inroads into tax yields".[8] The Inland Revenue were to have an additional GBP 187 million which was budgeted to produce revenue of GBP 1.95 billion. No details as to how those funds will be spent within the Inland Revenue were given. The press release however gave some clear indications. It stated that

> the Inland Revenue will be able to undertake additional corporate tax enquiries and investigations into international transactions, speed up the settlement of outstanding liabilities, take further action to counter the shadow economy, and redeploy 1000 staff onto collection and enquiry work after the introduction of self-assessment is complete."

Given the exceptional return on costs invested in transfer pricing referred to above, and the priority given to "international transactions" in the Budget statement it is clear that a fair amount of the extra resources were to be devoted to transfer pricing.

The Inland Revenue's own press release was in similar terms.[9]

VI. LITIGATION

The United Kingdom has almost no decided cases on transfer pricing as most matters have inevitably been resolved by negotiation. In *Glaxo Group Limited v. IRC*,[10] the High Court has considered a highly technical issue in relation to the manner in which transfer pricing adjustments may be made. The question was whether the Inland Revenue could exercise their powers to make adjustments by adjusting existing open assessments as opposed to being obliged to issue new assessments subject to the normal six-year limitation.

The company had been in correspondence with the Inland Revenue on transfer pricing issues intermittently since 1976. Normally, group companies receive notices of assessment to corporation tax against which they appealed. Some appeals had not been resolved either by a hearing, withdrawal of the appeal or by consent. As a result, group companies had open assessments going back for many years.

The Inland Revenue argued that the combination of an open assessment resulting from an unresolved appeal and subsequent direction under the transfer pricing provisions was sufficient to enable the direction to be considered and taken into account on an appeal.

The company claimed that a direction under the transfer pricing provision (Income and Corporation Taxes Act 1970 Section 485)[11] was ineffective unless followed by an assessment. This would normally be a further assessment under Taxes Management Act 1970 Section 29(3) made within the appropriate statutory time limit, normally of six years.

Mr Justice Robert Walker considered that the case turned on the interpretation of the procedural provisions of what is now Taxes Act 1988 Section 770(3). This provides that no adjustments to prices are to be made unless the Board of Inland Revenue so direct and in such a case all such adjustments shall be made "whether by assessment, repayment of tax or otherwise as are necessary to give effect to the direction". He held that these should be construed not only in the context of the section as a whole but in the context of the whole statutory machinery for assessment, determination and collection of tax.

The Court rejected the argument that the requirement in Taxes Management Act 1970 Section 50(3)(b) "to give reasons in support of the assessment" impliedly prohibited an inspector from giving grounds for increasing an assessment especially on a new ground.

The taxpayer argued that the adjustment mechanism could only be invoked in relation to something that was there already and that a new assessment therefore had to be made since the circumstances causing the adjustment related to new matters. The Court however felt that the adjustment mechanisms were necessary in indicating the practical consequences of applying the statutory fiction which arose in relation to a transfer pricing adjustment. Consequently, the Court rejected the claim by Glaxo that a direction had to be followed by an assessment which could only be made within the appropriate statutory time limit.

Against the background of the *Glaxo* case, the Government announced that they intended to introduce legislation in the next Finance Bill to remove any argument about the Inland Revenue's ability to make adjustments to taxpayers "open" tax assessments in order to give effect to a direction that a taxpayer's profits should be adjusted following a transfer pricing enquiry. In view of the Revenue's victory, the proposed clause was dropped.

Entitlement to adjust prices between related parties by the Inland Revenue exists by virtue of Taxes Act 1988 Section 770. The transactions that are potentially subject to adjustment are described in a most curious way in that section. The main provisions refer to property sold between parties under common control. An associated provision extends this princi-

8. HM Treasury Press Release 26 November 1996 HMT3.
9. Inland Revenue Press Release 26 November 1996 Rev 9.
10. [1996] STC 191 CA.
11. Now Taxes Act 1988 Sec. 770.

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ple with necessary adaption to "lettings and hiring of property, grants and transfers of rights, interests or licences and the giving of business facilities of whatever kind". The Inland Revenue have long held the view that these provisions apply to interest payments although this view has not been shared universally by practitioners.

The issue has recently come before the Special Commissioners in *Ametalco v. IRC*.[12] In that case a UK subsidiary of a US company made interest-free loans to another non-UK resident subsidiary of the US parent company. The Inland Revenue issued directions and assessments that the profits of the UK company should include notional interest on the interest-free loans as if they had been made at arm's length.

The taxpayer argued that the "giving of business facilities" did not include advances of money and that the expanded category of transactions only referred to a "seller" in the course of his trade. On this basis, advances could only be included if the seller was a money lender who advanced the money in the course of that business.

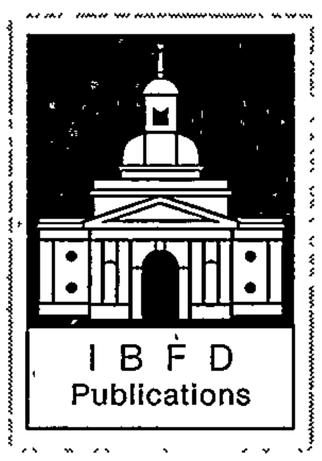
The Special Commissioners accepted that the statutory provisions are ambiguous and that it seems impossible to give them an entirely satisfactory and consistent *modus operandi*. Notwithstanding this, it was held that business facilities means or includes facilities for the purposes of the company's business and that therefore the interest on the loans fell within the scope of the transfer pricing provision.

The decision may however not represent total victory as far as the Inland Revenue is concerned. The Commissioners appeared to draw a distinction between fixed loans and ad hoc credits. Since the case involved ad hoc credit, the position in relation to fixed loans appears therefore to be unresolved. Furthermore, with the ambiguity of the section being aired in the courts, taxpayers may seek to argue that other kinds of transactions are not subject to adjustment.

VII. NEW GOVERNMENT

The election of a new government on 1 May 1997 has meant that the policies on the move to self-assessment and the "spend to save" initiative will likely be evaluated again. The Inland Revenue press release issued as part of the Budget Papers on 2 July 1997 does not give any indication either way. While there may be technical changes, the general approach is almost certain to continue.

12. [1996] STC (SCD) 399.



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CANADA

TREATY CAPITAL GAINS EXEMPTION – MAYBE NOT IN CANADA

Jack Bernstein & Barbara Worndl

Aird & Berlis

I. INTRODUCTION

It is a basic tenet of tax law that a taxpayer should be able to legally structure his affairs so as to minimize tax or at least so as to not maximize his tax. A taxpayer should therefore have the right to choose whether to sell shares or assets. A non-resident of Canada residing in a treaty country would generally be exempt from Canadian tax on gains realized on the disposition of shares. A sale of assets and a liquidation of the Canadian company could result in double tax. As the company would not be Canadian controlled, it would be subject to Canadian tax on income at the combined federal and provincial rate of approximately 45 per cent[1] or approximately 33 per cent on capital gains. In addition, deemed[2] or actual dividends on the distribution of the after tax corporate proceeds would be subject to Canadian withholding tax at the rate of 25 per cent, unless modified by treaty.[3] A capital dividend paid to a non-resident would also be subject to Canadian withholding tax. Based on the foregoing, a share sale is more attractive when a treaty exemption is available.

Section 212(1) of the Income Tax Act (of Canada) (the "Act") provides for a deemed dividend rather than a capital gain on a non-arm's length sale of shares of a Canadian corporation by a non-resident to a corporate purchaser. However, this rule does not apply to an arm's length sale.

II. GAAR

Effective for transactions entered into after 13 September 1988, Canada introduced a general anti-avoidance rule (commonly referred to as GAAR) which is set out in Section 245(2) of the Act. It applies generally to a tax motivated transaction (defined as an avoidance transaction) which results in an abuse or misuse of the provisions of the Income Tax Act. Where applicable, Revenue Canada has a number of remedies, including the right to recharacterize the transaction.

Specifically, it provides that when a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result directly or indirectly from the transaction or from a series of transactions that includes that transaction. An avoidance transaction is defined as a single transaction or a transaction that is part of a series of transactions where the result is a tax benefit unless the transaction is carried out primarily for bona fide purposes other than to obtain the tax benefit. GAAR should therefore not apply to a transaction which is motivated by bona fide business, investment or family purposes.

A tax benefit is defined to mean a reduction, avoidance or deferral of a tax or other amount payable or an increase in a refund of tax or other amount under the Income Tax Act.

GAAR does not apply if the transaction may reasonably be considered not to result in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Income Tax Act read as a whole. A transaction which relies on a specific provision and which is consistent with the object and spirit of the Act will not be affected.

III. *RMM ENTERPRISES* AND *McNICHOL*

In 1997, the first two cases on GAAR were heard. The taxpayer lost in both cases on similar facts although in *McNichol* the taxpayer was Canadian and in *RMM Enterprises* the taxpayer was a non-resident. In both cases a Canadian company was wound down prior to the share sale to the point of having only cash and/or near cash. The shares were then sold to arm's length parties rather than causing the liquidation of the companies. The resulting capital gain was not taxable in either case while a dividend would have been taxable. There was no business motive for the transaction. The sole objective was to trigger a capital gain which would not be taxable. *RMM Enterprises* is especially interesting as it involves an analysis of whether an international tax convention which came into force before the enactment of GAAR should prevail.

In *RMM Enterprises Inc. v. Canada*,[4] Itel Corporation, a large US public corporation acquired all the issued and outstanding shares of Equilease Corporation ("EC"), a US corporation, in 1988. EC had a Canadian subsidiary Equilease Limited ("EL") which in turn had a Canadian subsidiary Equilease Canada, Limited ("ECL"). Together EL and ECL had cash of about CAD 3,000,000 and an entitlement to receive a refund

1. The tax relief afforded a Canadian controlled company including the small business deduction and refundable dividend tax would not be available to a non-resident.
2. E.g. which may arise on a redemption or purchase for cancellation of shares.
3. A Canadian shareholder can receive one quarter of capital gains realized by the corporation as a tax free capital dividend.
4. [1997] C.T.J. No. 302 (TCC), a decision of Mr Justice Bowman released 10 April 1997.

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of income tax of about CAD 1,500,000. EL and ECL also owned a portfolio of leases. However, the leasing businesses had been wound down and the sole activity carried on by EL and ECL was collecting the rental payments under the leases and winding down their portfolios. EC was aware of the tax consequences of winding up a Canadian corporation and therefore decided that it would sell the shares of EL in order to access the cash and income tax refund in ECL and EL.

A friend of the general counsel of Itel and two associates formed RMM Canadian Enterprises Inc. ("RMM"). RMM purchased the shares of EL from EC for an amount equal to the cash and income tax refund in ECL and EL. EC and Itel guaranteed the amount to be recovered under the leases at USD 140,000 (as part of that negotiation it was agreed that the purchase price would be reduced by USD 10,000 to cover part of RMM's legal costs). The transaction was completed on 27 June 1989. RMM borrowed the purchase price from a bank, secured on the assets of EL. Following the purchase of the shares, and on that same date, EL commenced winding up into RMM and ECL was amalgamated with RMM. Three or four days after the date of the purchase, RMM paid off its loan to the bank using the cash that had been in EL and ECL.

The Minister assessed non-resident withholding tax of 10 per cent against EC in 1989 and 1990 on the net amount received by it on the transaction, less the paid-up capital of EL's shares of CAD 205, 100. The assessments were based on a combination of Sections 245, 84 and 212. He also assessed RMM as the Canadian resident that made the payment of the amounts to EC under Section 227(10) of the Act.

Mr Justice Bowman held that the transaction represented a distribution or appropriation of property or funds of EL to or for the benefit of EC on the winding up, discontinuance or reorganization of EL's business within the meaning of Section 84(2). As a result, the Court held that the transaction gave rise to a deemed dividend which was subject to withholding tax under Section 212(2). According to Mr Justice Bowman "there was no need to call in the heavy artillery of GAAR".

With respect to Section 84(2) the Court concluded that RMM was interested only in earning what was in essence a fee for acting as a facilitator in the transaction the purpose of which was to enable EC to obtain the cash and near cash of EL and ECL without paying withholding tax. It was significant to the Court that before any call was made on the guarantee or there was any necessity to make the guarantee payment, EC paid the guaranteed amount and RMM ceased to have any function other than to endorse the subsequent tax refund cheques.

Mr Justice Bowman acknowledged that there was in fact a sale of the shares and that the transaction was not a sham. He also rejected the notion that he had relied on the doctrine of substance over form. However, he concluded that the sale of EL's shares and the winding up or discontinuance of its business were not mutually exclusive events. He regarded the sale as one aspect of the transaction described in Section 84(2) that gave rise to the deemed dividend. He rejected the notion that the amounts received must be characterized either as proceeds of the disposition of the shares of EL or as a distribution or appropriation of the funds of the property of EL on the winding up and concluded that both characterizations applied. He stated "I do not think that the brief detour of the funds through RMM stamps them with a different character from that which they had as funds of EL distributed or appropriated to or for the benefit of EC".

It is somewhat ironic that almost the same issue was raised in *McNichol et al. v. The Queen*, 97 D.T.C. 111 (T.C.C.), the first GAAR case. In that particular case, Mr Justice Bonner held that Section 84(2) did not apply. In *McNichol* four shareholders owned all the shares of a corporation which had sold a building and, after payment of tax and distribution of the capital dividend account, had as its sole remaining asset CAD 318,000 in cash. Instead of winding up the corporation and realizing a dividend under Section 84(2) the taxpayers sold their shares to a third party and claimed the benefit of a capital gains exemption on the sale of the shares. Mr Justice Bonner concluded that in order for Section 84(2) to apply the transaction must be converted from that which in fact took place into something else. In the Court's view, it was impossible to conclude that the monies received by the selling shareholders came from the target corporation since the evidence demonstrated that the purchase price was funded with monies borrowed from the bank and the target corporation's funds remained in its bank account until some time following the sale transaction.

In *RMM Enterprises* Mr Justice Bowman distinguishes the decision in *McNichol* on the application of Section 84(2) on the basis that there was no finding in that case that the purchaser corporation was instrumental in the overall transaction. A greater period of time elapsed before the bank was repaid and there was no payment of the purchaser's legal fees by the shareholders. The purchaser corporation was an existing corporation and was not, as in this case, created solely to facilitate the transaction which had as its only purpose the distribution of EL's funds to EC. Mr Justice Bowman held that the words in Section 84(2) "'distributed or otherwise appropriated in any manner whatever on the winding-up, discontinuance or reorganization of its business' are words of the widest possible import and cover a large variety of ways in which the corporate funds can end up in a shareholder's hands". As a result, the amount represented a deemed dividend to EC.

The Court further held that RMM was liable for failure to withhold under a combination of Sections 215(1) and 215(6). Counsel had argued that the Minister should have assessed EL as opposed to RMM. The Court concluded that, one way or another, if EC was subject to withholding tax on the amounts paid to it by RMM, then RMM was liable for an amount equal to that tax under either Section 215(6), or as agent under Section 215(3) or, on the basis of EL's liability under 215(6), as a responsible representative under Section 159.

The Minister also argued that EC and RMM were not at arm's length and that accordingly Section 212(1) applied. Section 212(1) deems a non-resident corporation which disposes of shares of a Canadian corporation (the "subject corporation") to another Canadian corporation with which it does not deal

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at arm's length to have received a dividend equal to the amount by which the non-share consideration exceeds the paid-up capital of the subject shares, provided that after the transaction the purchaser and subject corporations are connected. In order for 212.1 to apply there must be non-arm's length payment. As in the *McNichol* case, the Court reviewed the definition of arm's length and concluded that RMM did not deal at arm's length with EC. The Court admits that there was an arm's length bargaining relationship between the parties with respect to the amount that RMM would realize on the transaction. However, following the negotiation of the fee, the Court held that RMM virtually disappeared from the scene and had no independent role. RMM and EC were directed by a common mind and were acting in concert. As a result, 212.1 also applied.

Finally, in an *obiter dicta*, the Court reviewed the application of GAAR to this transaction and held that it would apply. The Court conducted an analysis of the application of GAAR first considering whether the transaction constituted an avoidance transaction within the meaning of Section 245. For it to be an avoidance transaction, the transaction must result in a tax benefit. The Court held that it was obvious that there was a tax benefit in these circumstances. The object of the exercise was for EC to extract EL's surplus without paying Canadian withholding tax. The more interesting question was whether there was a reduction, avoidance or deferral of tax or other amount paid under the Act given that the benefit sought depended on the application of the Canada–US Income Tax Convention (the "Convention") to the transaction. The Court held that the fact that the reduction of tax "under [the] Act" was expected to result from the application of the Convention did not remove the benefit sought from the application of Section 245. Mr Justice Bowman reasoned that it was the Act, not the Convention, that imposes the tax.

The second question the Court reviewed was whether the transaction was undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit. The argument advanced by the appellant was that by selling the shares of EL, there was more tax saved in the United States than in Canada. As a result, the primary purpose was not to obtain a tax benefit in Canada but to save US taxes. The Court was not prepared to conclude that because the US tax saving was greater than the Canadian tax saving that this would remove the transaction from the ambit of Section 245.

The third question posed by the Court was whether the transaction resulted directly or indirectly in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act as a whole. Mr Justice Bowman concluded that it did result in an abuse or misuse of the provisions of the Act. However, he did provide examples of tax benefits that would not be caught by Section 245(2): incentives such as accelerated capital cost allowance, investment tax credits and tax incentives given to industries to encourage the establishment of businesses in particular regions.

In determining whether the transaction constituted an abuse or a misuse of the Act the Court made reference to a decision of the Supreme Court of Canada in *Harris v. M.N.R.*, 66 D.T.C. 5189. That case was decided under the predecessor to the old Section 245(1) which was Section 137(1). Many tax practitioners believed that the repeal of old Section 245(1) and the introduction of the GAAR rules was designed to sever the tie between the old anti-avoidance legislation and the new rule. In referring to the old case law, Mr Justice Bowman may have opened Pandora's box in this regard.

Mr Justice Bowman went on to adopt the remarks of Mr Justice Bonner in *McNichol* at pages 120 to 122 in which he reviewed at length whether Section 245(4) prevented the application of Section 245(2) in that case. Mr Justice Bowman further stated as follows:

> ... the *Income Tax Act*, read as a whole, envisages that a distribution of corporate surplus to shareholders is to be taxed as a payment of dividends. A form of transaction that is otherwise devoid of any commercial objective, and that has as its real purpose the extraction of corporate surplus and the avoidance of ordinary consequences of such a distribution, is an abuse of the Act as a whole.

As a result he concludes that the general anti-avoidance rule would apply in these circumstances.

Finally, he considered whether the fact that GAAR was added to Canadian law after the entry into force of the Convention means that the Convention could restrict the operation of Section 245 of the Act. The appellant had contended that, notwithstanding the application of Sections 84 and 212 of the Act, the transaction was a sale giving rise to a capital gain and that as such, recharacterization of the payment as a dividend under Section 245 is inconsistent with the Convention. Accordingly, the Convention must prevail and the sale must be treated as giving rise to a capital gain which is taxable only in the United States. Mr Justice Bowman rejected this argument and held that "...a tax avoidance scheme that has as its predominant, indeed sole, object the extraction of corporate surplus under the umbrella of a transaction that is ostensibly an alienation to which Article XIII applies" cannot prevail.

The Court also considered the application of the Income Tax Conventions Interpretation Act. This provides in Section 3, that notwithstanding the provisions of a convention or the act giving the convention the force of law in Canada, to the extent that a term is not defined in the convention or is not fully defined, that term has the meaning it has for purposes of the Act from time to time. The appellant had argued that Section 245 did not modify the definition of dividends. Rather it permitted the recharacterization of certain transactions giving rise to deemed dividends. However, the Court concluded that this was an unduly restrictive reading of Section 3 of the Income Tax Conventions Interpretation Act. It is submitted that the Court's analysis is superficial. The Court also reviewed Article XXIXA of the Convention which was added by the 1995 Protocol, effective 1 January 1996 and the US Technical Explanation to this paragraph. As the US Technical Interpretation is not part of Canadian law it should have no authority. Mr Justice Bowman concludes that, although the provision was adopted a number of years after the payments in question were made, it indicates that there is an inherent right in the Convention for Canada and the United States to apply their own anti-abuse provisions. As a result, the appeal was dismissed.

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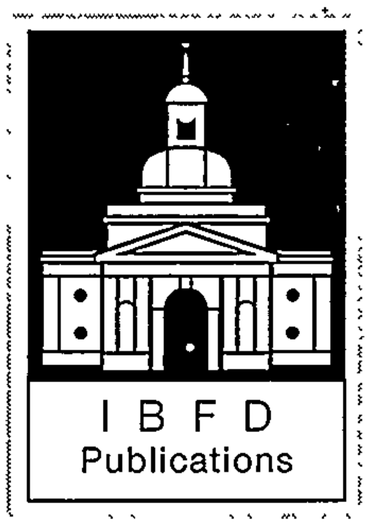
IV. COMMENT

This case, combined with the *McNichol* case is an unfortunate precedent for the use of GAAR. In both cases the Court viewed a sale of shares of a corporation which had an undistributed surplus as abusive. In *McNichol* the taxpayers relied on a specific provision in the Act available to shelter up to CAD 500,000 of capital gains arising on the sale of shares of a qualifying small business corporation. There is little or no analysis in that case as to how the transaction could be an abuse or a misuse of the provisions of the Act given that the tax benefit was a direct result of the application of a provision in the Act which provided an exemption from taxation. Moreover, there is no discussion of the provisions of Section 110(6) which are designed to restrict the availability of the capital gains exemption in certain circumstances such as Section 110(6)(7) which prohibits the use of the capital gains exemption to a series of transactions involving a butterfly or Section 110(6)(8) which prohibits the use of the exemption where it is reasonable to conclude that a significant part of the gain is attributable to the fact that dividends were not paid on the shares. The Court simply held that it is the scheme of the Act that corporate surplus be distributed by way of dividends.

In *RMM Enterprises*, the Court held that it is an abuse of the provisions of the Act to structure a transaction as a sale of shares instead of a dividend. This analysis seems to ignore the tax consequences that arise under the Act since but for the application of the relief from taxation provided for in the Convention the tax on the capital gain arising on the sale of shares would likely have exceeded the withholding tax on the deemed dividend. The Court glossed over the fact that the exemption from tax arose under the Convention and not under the Act.

Mr Justice Bowman should have refused to apply GAAR in circumstances where the Act contains specific anti-avoidance rules (Sections 84 and 212(1)) which are designed to apply to surplus stripping. Indeed, he acknowledges that he need not apply GAAR where the transaction is caught by another provision of the Act. He nevertheless proceeded to apply GAAR even though he had found that the transaction was caught by Section 84(2) and Section 212(1).

Fortunately, the *McNichol* case has been appealed and we anticipate that *RMM* will also be appealed. We hope that the higher courts will clarify that GAAR is not applicable where a specific anti-avoidance rule exists but is inapplicable to a particular circumstance. Until the higher courts have clarified the application of GAAR, taxpayers and their advisers must proceed with the utmost caution.



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HONG KONG

HONG KONG'S HANDOVER: THE PRIVY COUNCIL'S LAST (UNHELPFUL) WORD ON THE SOURCE OF PROFITS

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I. ONE COUNTRY, TWO TAX SYSTEMS

As all the world knows, Hong Kong became a Special Administrative Region (HKSAR) of the People's Republic of China (PRC) on 1 July 1997. As such, it will maintain its legal and tax systems separate from those of the PRC for at least 50 years, according to the agreement between Britain and the PRC. The Basic Law for the HKSAR, which is effectively Hong Kong's new constitution, provides that the HKSAR "shall, taking the low tax policy previously pursued in Hong Kong as a reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation" (Article 108).

So much for the formalities. What is likely to happen in practice? In the short term – say, the next five years – it is highly likely, in the authors' view, that no significant changes will be made to the Hong Kong tax system. Despite the relatively low rates (16.5 per cent for corporations) and the narrow scope of Hong Kong tax (only Hong Kong sourced trading profits, rents and salaries are taxable), the system has raised sufficient revenue over the past decade and a half to produce a large surplus for the Hong Kong Government. Any significant change in the system involving higher taxes would be illogical and self-destructive, as it would send a negative signal to the international business community on which Hong Kong depends.

II. THE FAREWELL GIFT

For over a decade, international businesses have had to accept that there is an element of uncertainty about Hong Kong taxation, due to the approach of the Inland Revenue Department and the courts to the question of the source of profits. A decision of the Privy Council in London just before the handover has added to that uncertainty. The decision, *Commissioner of Inland Revenue v. Orion Caribbean Limited* (23 June 1997), departed from one of the few rules of source that were thought to be settled, the "provision of credit" test for the source of interest income. This can only be viewed by Hong Kong taxpayers as an unwelcome farewell gift from the Privy Council, which will no longer be the court of last resort for Hong Kong cases.

Before discussing the facts and the decision, we will briefly discuss the background to the case.

III. THE SOURCE QUESTION

Hong Kong tax applies only to profits arising in Hong Kong. The Inland Revenue Ordinance contains very few source rules. Therefore it has been left to the Commissioner and the courts to articulate guidelines for determining the source of profits for tax purposes.

Predictably, the guidelines that have been articulated in particular cases are difficult to apply in other cases. The general principle is that the source of a profit is a "hard, practical matter of fact". Given that we are talking about legal and accounting concepts that do not exist in nature, the "hard, practical matter of fact" test is not very helpful in deciding cases. Slightly more meaningful is the "operations test" of source, which states that a profit arises at the place where the operations occur which in substance produce the profit. This is easy to apply in cases where everyone can agree which operations produced the profit and those operations all occurred in the same place. Of course, this is not often the case in tax disputes concerning source.

The source of interest income has been determined, in practice by the Commissioner and in law by the courts, on the basis of where the lender made the funds available to the borrower. This is known as the "provision of credit test". The only exception to this has been in respect of financial institutions (as defined in the Inland Revenue Ordinance). Their interest income is considered to arise in Hong Kong if it arises "through or from the carrying on of business in Hong Kong", under a particular provision of the Ordinance (Section 15(1)(i)). The correctness of the provision of credit test as a general matter was affirmed by a dictum of Lord Bridge in the Privy Council's decision in *Commissioner of Inland Revenue v. Hang Seng Bank Limited* (1990) 3 HKTC 351, where it was said that profits from lending money would arise where the money was lent.

IV. THE *ORION* CASE

The *Orion* case involved a Cayman Islands company, Orion Caribbean Limited (the taxpayer), which earned interest income by lending to unrelated parties as a participant in syndicated loans. It was not a financial institution as defined in the Ordinance. It was wholly owned by a Hong Kong finan-

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cial institution, Orion Royal Pacific Limited (ORPL), which provided various services to the taxpayer in Hong Kong for a fee. ORPL also entered into syndicated loan agreements in Hong Kong on behalf of the taxpayer from time to time. About 40 per cent of the taxpayer's loan agreements were concluded in Hong Kong in this way.

The taxpayer's directors met in the Cayman Islands and approved all of its loans there. In all cases the taxpayer, acting through ORPL, made the loan funds available to the borrower outside Hong Kong. The taxpayer relied on ORPL and another related bank in Singapore to lend it the funds with which it made its loans. ORPL handled virtually all aspects of the taxpayer's business except for the decision making by the directors.

The Commissioner's assessment of profits tax was upheld by the Inland Revenue Board of Review on the ground that the taxpayer was a financial institution carrying on business in Hong Kong and so its interest income was sourced in Hong Kong under the expansive source test of Section 15(1)(i) of the Ordinance. On appeal, the Court of Appeal reversed the Board's decision, holding that the taxpayer was not a financial institution within the meaning of the statutory definition. Therefore the expansive source test of Section 15(1)(i) was not applicable; rather, the "provision of credit test" was applicable. Since the taxpayer had provided the credit to the borrowers outside Hong Kong, its interest did not arise in Hong Kong and was not taxable.

V. THE PRIVY COUNCIL'S DECISION

The Commissioner appealed to the Privy Council. It is not clear what the ground of appeal was, but the Privy Council was clearly of the view that the taxpayer was simply a mechanism by which ORPL had avoided Hong Kong tax on interest from syndicated loans to borrowers outside Hong Kong. The court did not even reach the Section 15(1)(i) issue, but chose to reverse the Court of Appeal's holding that the source of the taxpayer's interest income must be determined under the "provision of credit test".

The joint judgment of the bench delivered by Lord Nolan listed three reasons as to why the taxpayer's interest was sourced in Hong Kong under the "operations test" rather than outside Hong Kong under the "provision of credit test".

1. A distinction must be drawn between the situation where the taxpayer lends out its own funds and where the taxpayer must borrow before it may lend. In the first situation the source of the interest will be the place the money was lent. However, the latter case is more akin to a trading transaction involving commodities and both the place of lending and the place of borrowing should be looked at.

2. The established authorities, including Lord Bridge's dictum in the *Hang Seng* case, do not stand for "the proposition that Lord Bridge was laying down a rule of law to the effect that, in the case of a loan of money, the source of income was always located in the place that the money was lent". There is no simple single legal test – it is a practical hard matter of fact.

3. The present case was far removed from the simple type of loan transaction contemplated by Lord Bridge. The business of the taxpayer was the borrowing and on-lending of money with a view to a profit. The taxpayer allowed itself to be interposed between its Hong Kong parent and the ultimate borrowers as a channel for the loans. In all ways the parent acted as an agent for the taxpayer. The loan agreements were negotiated, concluded (in some cases at least) and serviced by the parent from funds raised or provided by the parent in Hong Kong.

The judgment did not consider whether the taxpayer was a financial institution for the purposes of Section 15(1)(i).

VI. COMMENTARY

Lord Nolan reiterated the Board of Review's finding that the taxpayer "served as a vehicle for a tax avoidance scheme" and established this as the foundation for the decision. It was not found, however, that the taxpayer was not a genuine company or that the arrangements could be disregarded under either general principles or anti-avoidance legislation.

The provision of credit test has long been accepted by the Inland Revenue Department and its use of the test for non-financial institutions is stated in Departmental Interpretation and Practice Notes No. 13. In the *Hang Seng Bank* case, Lord Bridge stated that interest arises where the money was lent in order to demonstrate that the source of profit from the exploitation of property depends on where the property was situated. The test does not rely on determining where the original funds used to make the loan were acquired.

Lord Nolan has altered the test to determine the source of interest for an entity which is not a financial institution as defined in the Ordinance. If Lord Nolan's reasoning is correct, the provision of credit test is limited to the situation where the money lent is the entity's own money. If the taxpayer has had to borrow funds in order to lend, then it appears that both the place where the borrowing took place and the place of lending should be looked at in determining the source of the interest.

It may be wondered why the Privy Council did not distinguish between the loans that were concluded outside Hong Kong and those concluded in Hong Kong. In the *Hang Seng Bank* case, the court stressed the importance of determining the source of particular profits from particular transactions. In other cases, such as in *Commissioner of Inland Revenue v. HK-TVB International Limited* [1992] 2 AC 397, the Privy Council has seemed to look at the taxpayer's business as a whole in determining the source of the taxpayer's profits, rather than at particular transactions. Unfortunately, the *Orion* case takes a similar approach.

VII. CONCLUSION

The Privy Council's refusal to apply the provision of credit test in the *Orion* case is a most unwelcome handover gift to the taxpayers of the Hong Kong Special Administrative Region. The determination of the source of profits for Hong Kong tax purposes was already problematic. The *Orion* decision will only make it more so.

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JAPAN

JAPANESE TAX TREATIES WITH MEXICO AND SOUTH AFRICA[1]

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I. INTRODUCTION

On 9 April 1996, the "Convention between Japan and the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income" was signed in Mexico City. The Convention was approved by the National Diet in Japan on 17 May 1996 and came into force as from 6 November of the same year. On 9 March 1997, the "Convention between the Government of Japan and the Government of the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income" was signed in Cape Town. The Convention was approved by the National Diet in Japan on 30 May 1997.

II. ECONOMIC BACKGROUND

A. Mexico

Japan is an important trade partner of Mexico.[2] According to the IMF, *Direction of Trade Statistics*, 1996, in 1995 Japan as an exporter ranked second only behind the United States. Furthermore in that year Japan was the third largest importer[3] of Mexican goods.[4] The major import item of Japan from Mexico is crude oil and the major export items are automobile parts and machinery. The foreign direct investment of Japan in Mexico was JPY 65.1 billion, JPY 20.2 billion, and JPY 12.8 billion during the fiscal years 1994, 1995 and 1996 respectively, according to the statistics of the Japanese Ministry of Finance.[5]

B. South Africa

Japan is the fourth most important trade partner of South Africa.[6] According to the IMF, *Direction of Trade Statistics*, 1996, in 1995 Japan as an importer of South African goods ranked second only to Italy while it ranked fourth as an exporter behind Germany, the United Kingdom and the United States. In the same year, the Japanese Ministry of Finance statistics show Japan's exports to South Africa were valued at JPY 230 million and imports at JPY 238 million, representing an annual increase of 10.9 per cent and 6.1 per cent, respectively. Japan's major imports from South Africa are metals and metal products and its major exports are automobiles and their parts and machinery. Japan's direct investment in South Africa was JPY 5.5 billion in fiscal year 1995 and JPY 25.0 billion in fiscal year 1996. In 1996, a car manufacturing company made a USD 100 million investment[7] and in the near future another car maker will reportedly make a USD 82 million investment.[8]

The tax treaties with Mexico and South Africa are indicative of current Japanese treaty policy. Therefore, both conventions are discussed together in this article.

III. THE TREATIES

A. Scope

1. Personal scope

Both the Mexican and South African treaties make a person who is a resident of one of the contracting states of the agreement primarily liable in his country of residence. For the purposes of the tax treaties, the term "person" includes both an individual and a company and any other body corporate. Under the treaty with Mexico the resident to which the treaty is applicable is determined, in the case of an individual, by

1. The author is much indebted to the Staff of the International Tax Affairs Division, Tax Bureau, Ministry of Finance of Japan.
2. The North American Free Trade Agreement (NAFTA), between the United States, Canada and Mexico was signed in October 1992 and entered into force in January 1994. Mexico joined the Organisation for Economic Co-operation and Development (OECD) in April 1994.
3. I.e. following the United States and Canada.
4. The statistics of the Japanese Ministry of Finance show that in 1995 Japan exported JPY 335 billion to and imported JPY 140 billion from Mexico.
5. The statistics of the Japan External Trade Organization (JETRO) show that the accumulated total of Japanese foreign direct investment in Mexico from fiscal year 1951 to 1995 is USD 2,999 million, which includes transport machinery 1,509, mining 505, iron and non-ferrous metals 238, commerce 184, and the service industry 182 (in millions of US dollars). Japan has been increasing its stakes in the *maquiladora* (in-bond industry) plants.
6. The Republic of South Africa is the only African country that is not classified as a developing country by any definition. Japan opened a Consulate General in 1952 and an Embassy in 1992, both in Pretoria. South Africa established a Consulate General in 1962 and an Embassy in 1992, both in Tokyo.
7. According to the statistics of JETRO, the accumulated total of the Japanese foreign direct investment in South Africa from fiscal years 1951 to 1995 is USD 76 million, which mainly consists of 31.4 for car manufacturing, 17.7 for iron and non-ferrous metals, 5.7 for the chemical industry and 20.3 for mining (in millions of US dollars)
8. In addition two Japanese banks have established representative offices in South Africa. In April 1997, a twice-weekly direct flight between Kansai International Airport and Johannesburg was inaugurated on the basis of the Bilateral Air Service Agreement signed in 1994 between the two countries.

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his domicile or residence and, in the case of a company, by its head or main office, place of management or any other criterion of a similar nature. These criteria also apply to determine Japanese residence under the treaty with South Africa. However, an individual who is a resident under South African laws is a resident of South Africa for the purposes of the Japan–South Africa treaty. In the case of corporations if the company has its place of effective management in South Africa it is treated as a resident of South Africa.

Under both treaties, the status of those who are residents of both contracting states will be determined by: (1) in the case of an individual, the criteria set forth in the OECD Model Tax Convention and (2) in other cases, through the mutual agreement of the competent authorities of both contracting states.

2. Taxes covered

By their very nature, both conventions only apply to taxes on income and these taxes are enumerated individually for each contracting state. In the case of Japan, they are (i) (individual) income tax, (ii) corporation tax and (iii) local inhabitant taxes (on both individuals and corporations) while for Mexico, income tax (*impuesto sobre la renta*) and for South Africa, (i) normal tax (personal and corporation taxes) and (ii) secondary tax on companies (tax on distributed earnings).

It is to be noted that the conventions will also apply to any identical or similar taxes, whether national or local, which are imposed after the signature of the conventions in addition to the above-mentioned taxes.

B. 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[9] is taxable.

The tax treaty with South Africa generally follows the PE provisions of the OECD Model. However, the treaty with Mexico modifies its related provisions by reference to the United Nations Model Double Taxation Convention between Developed and Developing Countries of 1979 (UN Model) as follows: (1) a building site, a construction, assembly or installation project or supervisory activities thereof which lasts more than six months constitutes a PE. This treatment should be compared with that applying under the OECD Model where only when a building site or a construction or installation project lasts more than 12 months, does it constitute a PE. The treaty with South Africa includes "assembly project or supervisory activities" while retaining the 12-month requirement. (2) In both treaties 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. However, like the OECD Model, the treaties provide that an independent agent who acts in the ordinary course of business on behalf of an enterprise resident in the other country is not deemed to be a PE.

2. International transport

Profits from international transport business are taxed only in the country of residence of the enterprise as provided for in the OECD Model. Both treaties follow the provisions of the OECD Model. To ensure the thorough application of the mutual exemption of taxation in the source country Japan exempts a local enterprise. In turn, Mexico and South Africa are expected to exempt Japanese enterprises from any similar tax if introduced in the future although as of now neither country has a tax of this kind.

3. Associated enterprises

Like the OECD Model, both conventions provide 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.

C. Income from capital

1. Dividends

Under the OECD Model, the maximum tax rate on dividends imposed by the source country is 5 per cent between parent and subsidiary companies, the ownership requirement being 25 per cent or more. In all other cases the maximum rate of 15 per cent applies. When Japan joined the OECD in 1964, Japan used a split rate system for corporate tax under which distributed earnings were taxed at a lower rate than retained ones. Consequently, Japan reserved the application of this provision so as to make the maximum rate between parent and subsidiary companies 10 per cent. However, the radical tax reform of 1988 led to the complete phasing out by 1990 of the split tax rate system for corporations. Therefore, ever since the tax treaty with Luxembourg of 1992, the above-mentioned rate has been changed from 10 per cent to 5 per cent.

Both treaties set the maximum rates on dividends at 5 per cent and 15 per cent in line with the OECD Model. However there is a requirement that 25 per cent of the subsidiary's shares should be owned by parent companies for at least six months in order to qualify for the rate of 5 per cent. To prevent the favourable tax treatment being abused by residents of a third country, the treaty with Mexico applies the favourable rate for dividends from subsidiaries to parent companies only if they satisfy the following conditions:

9. I.e. a place of management, branch, office or a factory.

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- the shares of the parent company are traded regularly on a recognized stock exchange of its residence country;
- more than 50 per cent of the total shares are owned by:
  (i) the government, local governments or other political subdivisions of the country;
  (ii) one or more individuals of the country of the parent company;
  (iii) one or more companies of the residence country of the parent company whose shares are regularly traded on a recognized stock exchange or more than 50 per cent of the total issued shares are owned by one or more individuals resident of the residence country of the parent company; or
  (iv) a combination of shareholders from (i) to (iii) together meet the test.

Other provisions, including the definitions, the treatment of dividends attributable to a PE or a fixed base and prohibition of taxation on dividends from profits derived from a source in another contracting state by an enterprise operating without a PE there (subject to certain conditions), follow those of the OECD Model for both treaties.

2. Interest

The OECD Model and most of the tax treaties to which Japan is a party set the maximum rate of taxation on interest in the source country to 10 per cent. The treaty with South Africa is no exception. But under the treaty with Mexico, the 10 per cent maximum rate is only applicable to interest received by banks or insurance companies derived from bonds and securities traded on a recognized stock exchange, paid by banks, or paid in respect of the sale on credit of equipment or machinery. All other kinds of interest are subject to the maximum rate of 15 per cent.

Interest received by the governments, both national and local, local authorities, the central banks, and financial institutions wholly owned by the governments and the interest from the credit or insurance guaranteed by the governments or financial institutions wholly owned by the governments is exempt from taxation in the country of source.[10] By the Protocol, interest derived from the granting of credit for a period of less than three years guaranteed by the governments or government-owned financial institution is not tax exempt.[11]

Other provisions follow those of the OECD Model.

3. Royalties

The OECD Model limits the taxation on royalties in the source country. In contrast the UN Model gives full taxing power on royalties to the source country, leaving the percentage of the maximum rate of tax at source to negotiation between the contracting states. Japan's policy is to set the maximum tax rate at 10 per cent at source, since Japan reserved the right to tax royalties in such a way when it joined the OECD in 1964. In accordance with this Japanese policy both treaties set the maximum rate on royalties in the source country at 10 per cent. However, most other provisions in principle follow the OECD Model.

It is to be noted that the 10 per cent maximum rate is also applicable to proceeds from the alienation of any copyright, patent, or the like except when the provisions of capital gains are applied. In this connection, the Protocol of the treaty with Mexico clarifies that the provisions of royalties are not applicable to a "genuine alienation" which will be subject to the provisions of capital gains and that "any alienation shall be considered genuine if it does not leave the alienator any right on such property".

D. Capital gains

In principle, both treaties' 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 treaty with Mexico:

- 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. This is in accordance with Japanese domestic tax legislation.[12] The UN Model also has the same provision, although it leaves the relevant percentages to bilateral negotiations; and
- gains from the alienation of shares of a company whose property primarily consists of immovable property may be taxed in the country where such immovable property is situated. This is intended to prevent the evasion of tax and is incorporated into the UN Model.[13]

E. Income from personal services

1. Dependent and independent services

Both treaties follow the provisions of the OECD Model regarding dependent and independent services. In particular, 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 (where they offer the services) unless the length of the person's stay

10. As eligible institutions, the treaty with Mexico names the Bank of Japan, the Export-Import Bank of Japan, and the Overseas Economic Cooperation Fund and their Mexican counterparts in existence.
11. The treaty with South Africa names, as qualified institutions, the Japan International Cooperation Agency while on the part of South Africa as of now only the South African Reserve Bank is named and other wholly government-owned institutions may be added in the future as may be agreed upon between the two countries.
12. The Japanese treaties with the United Kingdom, Australia, Singapore, Denmark, France and Vietnam have a similar provision.
13. The Japanese treaties with the Philippines, Singapore, France and Vietnam contain a similar provision.

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in that country exceeds in 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 to perform 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 performed. 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. Both treaties grant a tax exemption on income derived by these persons under the cultural exchange programme agreed upon between the two governments.

2. Others

Like the OECD Model, both the treaty with Mexico and South Africa provide that pensions in consideration of past employment are taxable only in the country of the recipient.[14] Likewise, those engaged in government service are exempt from taxation by the host country on their remuneration and pension unless they are nationals of that host country. They are subject to taxation by their own country for such remuneration and pension. Also like the OECD Model, both treaties provide that payments which students or business apprentices receive from abroad solely for the purpose of their education or training are exempt from tax in the country of residence. It is worth mentioning that like the OECD Model neither of the two treaties provides for tax exemption for professors and researchers. In the past Japanese tax treaties normally granted such tax exemption for a limited period of two years (for China three years).

F. Elimination of double taxation

1. Credit method

Both the OECD and the UN Model set forth two alternatives: (a) the exemption method; and (b) the credit method, in order to eliminate international double taxation on income. In the case of the treaties with Mexico and South Africa, both contracting parties employ the credit method.

Under the credit method, any taxpayer may deduct the amount of tax paid to foreign countries from the tax payable to the country of residence to which he owes an unlimited tax liability according to that country's tax laws. Moreover, a Japanese corporation which owns not less than 25 per cent of the shares of Mexican or South African companies is entitled to an indirect foreign tax credit. Under the treaty with Mexico, when a Mexican company receives a dividend from a Japanese company of which it owns at least 10 per cent of the total shares, that Mexican company may credit against the Mexican tax the Japanese tax paid by that Japanese company with respect to the profits out of which the dividends are paid.

2. Tax sparing credit

Tax sparing credit is a device to extend foreign tax credit relief to taxes that are "spared" by the source country, i.e. that are forgiven or reduced under legislation providing incentives for foreign investment. The tax sparing credit was one of the most controversial issues during the discussion of the draft of the UN Model. While all the developing nations were naturally anxious for the tax sparing credit clause, some developed nations were adamantly opposed to it. The US Congress has been critical of this provision. Japan's policy has been to grant the tax sparing to support the efforts for economic development of developing countries, whenever necessary and appropriate.

However, recently, the necessity and usefulness of the tax sparing credit are being reassessed not only in Japan but also at the OECD. Japan is now taking a more cautious and restrictive attitude. One of the new policies is to put a time limit on such tax sparing credit.[15]

The tax treaty with Mexico grants the following tax sparing credit:

(i) For those for which the provision of royalties of this convention is applicable, the tax is deemed to have been paid at the rate of 15 per cent for foreign tax credit purposes.

(ii) The Mexican Income Tax Law of 1 January 1981 provides the following tax incentives:
   - Under Article 13, the total tax amount payable of enterprises engaged in agriculture, stock farming and other specified industries will be reduced by 25 per cent or 50 per cent, depending on the kind of industry.
   - Under Articles 51 and 51-A, when new investments are made in fixed assets, enterprises may immediately deduct as an expense 74-97 per cent (depending on the type of asset), of the total cost of the investment.

By virtue of the tax sparing credit provision, a Japanese business would be deemed to have paid the Mexican tax amount in full without enjoying the above-mentioned tax incentives for the purposes of foreign tax credit in Japan.

It should be noted that the tax sparing credit is not applicable to the business activities in the financial sector nor to the case in which more than 25 per cent of the business profits, dividends or royalties are derived from a source in a third country. In line with the recent Japanese policy, the tax sparing credit for Mexico is to expire by the year 2005.

14. Incidentally, the UN Model 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.

15. See for example the treaties with Singapore, Turkey and Vietnam under which the tax sparing credit will terminate in 2000, 2003 and 2010, respectively.

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G. Miscellaneous

1. Non-discrimination

Like the OECD Model, both the treaty with Mexico and South Africa establish the principle of non-discrimination in taxation with regards to nationality, PE, payees of income and capital. The non-discrimination clause is applicable not only to the taxes covered by the conventions but also to all other taxes such as inheritance tax and consumption tax.

2. Mutual agreement procedure and exchange of information

Also following the OECD Model, both treaties provide that any person may present a case to the competent authority of his resident country within three years from the first notification of the action. The competent authorities of both contracting states should endeavour to resolve the problem by mutual agreement. They may communicate with each other directly for the purpose of reaching an agreement.

By the same token, the competent authorities of both contracting states may exchange information necessary to carrying out the provisions of this convention and the domestic laws of their countries and also to prevent fiscal evasion under certain conditions. Any information thus provided will be treated as secret in the same manner as information obtained under the domestic laws of the recipient country. In these days of growing globalization of economic activities, the exchange of information between taxation authorities has a greater role to play.

3. Mutual assistance for collection of taxes

For the sake of the proper and fair enforcement of the convention, each of the contracting states should endeavour to collect the tax which any taxpayer in the other state evaded by claiming a tax reduction or exemption (e.g. the maximum tax rate on interest, dividends and royalties) which he was not entitled to under the convention. In collecting such taxes, however, the country is not obliged to take any measure at variance with its laws and administrative practice or contrary to the public policy. This article is included in the Japanese tax treaties with the United States, Pakistan, Norway, Singapore, France, the Netherlands, the Republic of Korea, Finland, Luxembourg, Turkey and Vietnam,[16] although neither the OECD Model nor the UN Model has such a provision.

16. Most of these treaties are relatively new.

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NEW ZEALAND

DIVIDEND IMPUTATION IN THE CONTEXT OF GLOBALIZATION
EXTENSION OF THE NEW ZEALAND FOREIGN INVESTOR TAX CREDIT REGIME TO NON-RESIDENT DIRECT INVESTORS

Brett Wilkinson

I. INTRODUCTION

Recent world history has seen dramatic changes in the way in which cross-national business is conducted. Barriers to trade have been progressively dismantled and economies exposed to international competition. Multinational corporations have become increasingly important in terms of world trade and investment, and technological change has introduced new dimensions to the conduct of international business.

The changes which have been observed have widespread implications for various aspects of government policy, not the least of which is taxation policy. More than ever before, national taxation policy may have a significant bearing on the level of investment into and out of individual countries. Ironically perhaps, the consequence of this may be that the ability of sovereign states to determine their own taxing arrangements is constrained. That is to say, the cost of pursuing tax objectives and policies which are incompatible with those of other economies is likely to outweigh substantially any possible benefit.

It is in this context that the operation of dividend imputation systems needs to be assessed. Imputation systems cause problems both in terms of foreign income received by domestic companies and foreign shareholdings in domestic corporations. The problems arising in the latter context are the focus of this paper. Dividend imputation frequently results in a discrimination against foreign investment with foreign investors being denied access to the benefits of the imputation system. Authors such as Head (1993) have correctly noted that this ability to tax foreign investment is a benefit of the imputation system. However, the question arises as to whether such discrimination is sustainable within the context of increasing globalization.

In essence, New Zealand's foreign investor tax credit [FITC] regime, which has recently been broadened to include non-resident direct investors, represents an attempt to reduce the bias against foreign investment. As noted by Smith (1994) it is, in effect, a partial extension of the imputation system to non-residents. The mechanism by which foreign investors are given access to the imputation system is highly effective, since it ensures that the benefit of the tax reduction flows to foreign investors and not to foreign treasuries (Shewan & Heffernan, 1993; Smith, 1994). It reflects, nonetheless, a movement toward modification of domestic tax arrangements to accommodate international changes.

To the extent that existing imputation systems do create problems in the context of growing internationalization, there may be grounds for pursuing some harmonization between countries. Potentially, such harmonization could be achieved within the context of the CER agreement between Australia and New Zealand, or within the broader APEC context. Although harmonization is inherently difficult, as evidenced by the developments in the European Union, it would appear that the returns to harmonization are potentially very high.

This paper discusses the recent extension of the FITC regime to foreign direct investors in the context of the imperative for national tax policies to address adequately international tax issues. Section II of the paper reflects on the trend toward globalization and the implications for national tax policy. Section III discusses the operation of imputation systems generally and the tendency for there to be a bias against inward foreign investment. The basis for taxing foreign investment is considered in Section IV, while Section V outlines some generally accepted international tax principles. Section VI considers the issue of whether the benefits of imputation can be denied to foreign investors over the long run, and Section VII provides an overview of the FITC regime. The possibility of tax co-ordination within the Asia Pacific region is raised in Section VIII with concluding comments in Section IX.

II. TAX IMPLICATIONS OF GLOBALIZATION

In recent decades there has been a pronounced trend toward internationalization of world economies. The progressive openness of economies through removal of trade barriers and changes in technology have no doubt facilitated this process of globalization.

The Bureau of Industry Economics (BIE)(1996) has noted that multinational corporations have played a key role in the globalization process. According to the BIE such corporations:

> not only respond to emerging global opportunities (such as those created by inter-government trade liberalization), but they also create new opportunities for others (through technological and organizational innovation, etc.). By linking economies, [multinational enterprises] increase the interdependence of world economies. (p. 4)

In 1993, the OECD reflected on the trend toward globalization stating:

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> Over the last decades there has been an increasing economic interdependence between the 24 Member countries of the Organisation for Economic Co-operation and Development. Barriers to cross-border trade have progressively been removed and the volume of such trade and foreign direct investment has substantially increased. Over the same period, multinational enterprises have come to play a dominant role in the international trade arena, accounting for more than 50 per cent of international transactions. This globalization of economic activity is widely recognized and has been accomplished by an increased fiscal interdependence between Member countries. (p. 1)

In the Asia Pacific region, the establishment of the APEC group reflects both an increased awareness of the growing interdependence of economies within the region, and a commitment to continue with a range of strategies likely to reinforce such interdependence (APEC Leader's Declaration of Common Resolve, Bogor Declaration, 1994, paragraph 2).

It is apparent, then, that there has been substantial change in the operation of the international economy. The trend toward globalization is profound and introduces new challenges for policy-makers. In terms of tax policy implications, Frenkel, Razin and Sadka (1991) have suggested that:

> The removal of economic borders among independent tax jurisdictions ... has immense implications for both the structure and the overall burden of the tax system in each of these jurisdictions. When capital, labour, goods, and services can move freely from one tax jurisdiction to another, the tax base becomes global, and its distribution among the various tax jurisdictions becomes endogenous to all the various tax systems. (p. 3)

In essence, the suggestion is that it is becoming progressively difficult for individual nations to pursue tax strategies without due reference to the implications of such policies in an international context. This is not to say that anything like an appropriate level of attention has been paid to international tax issues in the past. On the contrary, as pointed out by Ault and Bradford (1990) in respect of the US situation, all too frequently: "International tax policy has been something of a stepchild in the tax legislative process. The international aspects of domestic tax changes are often considered only late in the day and without full examination" (p. 11).

Even beyond the need for countries to pay appropriate attention to the international implications of their tax policies is the fact that globalization is progressively curtailing national fiscal sovereignty. Choice over tax policy alternatives is essentially being eroded. A discussion of tax reform issues at a symposium of OECD and non-OECD countries on tax reform was reported by Anderson (1990) as indicating that:

> While many of the recent reforms can be explained by domestic considerations, participants generally attached considerable importance to international factors. Tax distortions can be tolerated for much longer periods in a purely domestic context, perhaps because governments find the costs acceptable compared with the costs and disruption associated with reforms. However, with increasing internationalization of economies and greater capital mobility, countries have also become more fiscally interdependent. (p. 28)

In a similar vein, Bird (1989) has stated: "the existence of important capital flows, and their apparent sensitivity to national budgetary policy, inevitably constrains to some extent the freedom of national policy-makers to decide their own tax system" (p. 161).

Bird (1989) went on to note that this outcome was particularly relevant to the Australian context, where foreign direct investment accounted for a significant proportion of non-residential fixed private investment. The same situation could be said to apply in New Zealand, where, according to the New Zealand Government: "Foreign direct investment into New Zealand in the year to March 1994 alone was NZD 4.7 billion ... From 1988 to 1992, the [Overseas Investment] Commission declined only three out of more than 4,000 applications" (Birch & Creech, 1995, p. 2).

It would seem, therefore, that New Zealand, like the majority of countries, is now facing the fiscal policy pressures brought about by globalization. In particular, the challenge faced by governments, is one of trying to "balance, on the one hand, their desire to preserve their national revenues and, on the other hand, their unwillingness to harm the international competitiveness of their domestic business interests" (Razin & Slemrod, 1990, p. 2).

The recent extension of the FITC to non-resident direct investors appears to reflect a shifting of the balance in New Zealand toward ensuring international competitiveness. In essence, the change represents a further extension of the imputation system to non-residents, beyond that noted by Smith (1994) in respect of the initial introduction of the FITC regime for portfolio investors. The fact that the New Zealand Government has seen fit to allow foreigners access to the imputation system, albeit in a limited and predominantly nominal sense, is in itself quite significant and warrants further review. Before turning to a detailed assessment of the FITC regime and consideration of its implications, it is first necessary to pause and reflect upon the consequences of dividend imputation systems for inward foreign investment.

III. DIVIDEND IMPUTATION, GLOBALIZATION AND INWARD FOREIGN INVESTMENT

Under a classical system of company taxation, such as existed in New Zealand prior to 1988, the income earned by companies is taxed twice – once in the hands of the company and then again on receipt of dividends by shareholders. Such a system leads to very high effective rates of taxation on equity earnings, violating the principles of both equity and efficiency.

Full integration would redress this problem. As noted by Head (1993) "under a full integration strategy, the policy goal is to ensure that any and all effects on domestic tax policy objectives of the separate corporate level tax are completely eliminated, leaving the personal income tax as the effective single-level tax" (p. 21).

A distinct trend toward integration has become evident in world economies over the last decade. As a result "the pure classical system is now rare in developed tax systems in Western nations and it is more common to see in practice a wide variety of idiosyncratic mechanisms for integrating the

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corporate and individual tax" (Deutsch & Cooper, 1993, p. 209).

Discussion of the different systems of company tax integration is outside the scope of this paper: interested readers are referred to the available literature for more detailed discussion and analysis (Benge & Robinson, 1986; Deutsch & Cooper, 1993; McLure, 1983). It is sufficient to say here that dividend imputation is but one means of achieving at least partial integration. The key point to note is that imputation credits can be denied to foreign shareholders.

In discussing the various types of integration options available, McLure (1983) points out that:

> the various alternative approaches to dividend relief would be equivalent if all shareholders were resident individuals and no shareholders held shares in foreign firms. If tax-exempt organizations or foreigners owned shares in domestic firms the two basic approaches need not be equivalent. . . . the benefits of the imputation credit could be denied either to tax-exempt organizations or foreign shareholders. (pp. 235-236)

Where the imputation credits are denied to foreign investors, essentially these investors bear the full impact of the New Zealand tax system. If the country of residence will not recognize the imputation credits arising in New Zealand, then to the extent that the dividends paid to foreign investors are taxed in the country of residence, the foreign investor bears a second tax on what is effectively the same corporate income.[1] It is clear that this represents an additional impost: while a domestic investor is able to take advantage of the imputation system and thus receive corporate income which is taxed only once, the income paid to the foreign investor is subjected to two layers of tax, one in each jurisdiction. Effectively the foreign investor remains in the classical tax system. This problem compounds where the foreign investor is a company located in a non-imputation country. In that case, a further layer of tax may be imposed.

The operation of the imputation system as it applied prior to the extension of the FITC regime to foreign direct investors is shown in Table 1. For the sake of simplicity the figures in the Table are completed under the assumption that the dividend is paid directly to an individual foreign shareholder who is resident in a treaty country.

Table 1: Total taxes paid by foreign and domestic shareholders under imputation

	NZD	
Net profit before tax	100	
NZ company tax	33	
Net profit after tax	67	
	Domestic investor	**Foreign investor**
Grossed-up dividend	100	67.00
Non-resident withholding tax (NRWT) (at 15%)	0	(10.05)
Grossed-up dividend	100	67
Personal tax payable (at 33%)	(33)	(22.11)
Foreign tax credits	0	10.05
Imputation credits	33	0.00
Net foreign country tax liability	0	12.06
Total tax paid	33	55.11 (= 33 + 10.05 + 12.06)

Source: IRD, 1996, p. 25

Whilst imputation is logistically an effective means of taxing foreign investment, the question as to whether this explicit bias against foreign investment is sustainable over the longer term is not so clear. As noted above, increasingly globalization is impacting upon national fiscal policy: existing systems need to be continually re-evaluated within the context of the changing international climate. Ault (1992) made the general comment that:

"there seems to be increasing recognition that the solutions developed in the past are not adequate for an increasingly interdependent world of international trade and investment". (p. 566)

This comment may well apply to the use of dividend imputation systems for taxing foreign investment. The New Zealand FITC regime appears to be a direct response to an observed need to redress some of the bias against foreign investment. It is a highly appropriate regime, since as mentioned above it extends the imputation regime to foreign investors in a manner which ensures the benefits are not diverted to foreign treasuries (Shewan & Heffernan, 1993; Smith, 1994).

Before reflecting further on the merits of the New Zealand FITC regime, it is appropriate to give space to two more issues:

- the basis for taxing foreign investment at all; and
- the broad principles by which international tax systems can be evaluated.

IV. WHY TAX FOREIGN INVESTMENT?

That New Zealand is a small, capital-importing country, begs the question as to why foreign investment should be taxed at all. Potentially, taxation will discourage foreign investment and/or raise the cost of funds in New Zealand (Birch & Creech, 1995). To answer this question, let us first consider the bases on which tax is applied and how this influences taxing decisions in an international context.

There are two fundamental principles on which taxes are applied: the source principle and the residence principle. Ault (1992) notes that the tax treaty system was "developed explicitly to allocate taxing claims with respect to international income" (p. 571). He also points out that: "the legal and political analysis has in large part assumed the existence

1. Note that if the foreign jurisdiction when assessing an individual's tax liability recognizes the tax paid in New Zealand at the company level, no problem emerges.

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of the primacy of source jurisdiction and the resulting tax share to the country of source" (p. 572).

This is consistent with inter-nation equity which "requires that nations of source take a 'fair' share of income accruing to non-residents" (Musgrave, 1983, p. 282). This can be justified economically because the foreign investor benefits from services provided by the government and the general economic environment in place in the host nation (Musgrave, 1983). The OECD (1991) notes that foreign investors benefit from the host nation's services and may also derive economic rents from its operations through activities such as the exploitation of natural resources. According to Head (1993) "the revenue obtained from the taxation of foreign direct investment is arguably the most important benefit that most countries can expect to derive from such investment" (p. 15).

Regardless of the philosophical and economic logic, this primacy of the source base provides the principal reason for taxing foreign investment income since failure to do so will generally result in a net gain to foreign treasuries and not to foreign investors. Muten (1983) suggests that: "Countries offering tax concessions to foreign investors are certainly unhappy when they find that the tax they abstained from is only reducing the foreign tax credit in the investor's country, rather than benefiting the investor himself" (p. 333). He points out that the problem is eliminated if the residence country exempts this income. Where the residence country still applies a tax the net tax paid by the foreign investor remains the same; only the jurisdiction of payment has changed. It is therefore:

> in a country's interests to impose tax on domestic source income earned by non-residents to the extent that the tax can be credited against residence country tax on that income. If imputation credits were extended to non-residents the result might be simply to transfer revenue from the source country to the residence country. (Rigby, 1991, p. 378)

However, while it maybe appropriate for the source country to derive some return from foreign investment income, the use of the company tax regime and dividend imputation system to achieve this end is not necessarily the best means. A less costly means of deriving such a return may be available. Bird (1989) has argued that for capital importing countries:

> Perhaps the best of all strategies ... in principle would be not to adopt an imputation system at all but rather to have a relatively low corporate tax rate and high withholding taxes on payments abroad, with the total just equal to the rate in the capital-exporting country, assuming that country has a credit-with-deferral system. (p. 172)

The FITC regime would appear to be consistent with this sentiment – it is in effect a lowering of the tax paid by foreign investors by reducing the income tax paid at the company level rather than the withholding tax rate. This maximizes the potential tax credit available in the residence country. This is addressed further in a later section. In order to more adequately assess the FITC regime, it is first necessary to review some broad international tax principles. These are discussed below.

V. INTERNATIONAL TAX PRINCIPLES

Musgrave (1987) has identified the three most relevant and broadly accepted principles for the evaluation of international taxation systems as being:

- interjurisdictional equity;
- locational neutrality; and
- taxpayer equity.

These three points are discussed below.

A. Interjurisdictional equity

Interjurisdictional equity is concerned with the appropriate division of the returns to taxation between jurisdictions. This is largely the source versus residence debate. As noted earlier, there is widespread acceptance of the dominance of the source country's right to taxation. As Musgrave (1987) has noted:

> It is clear that all jurisdictions, be they nation states acting independently or within common markets, or lower-level political units within a federal system, assert and accept the entitlement to tax all income arising within their boundaries, that is, their rights to tax as jurisdictions of source. (p. 204)

A lengthy treatise on the philosophical and economic arguments for and against the alternative tax bases of source and residence is not possible here. Consequently, it is accepted that the source base, as the most widely accepted base, is the most appropriate. In any event, worldwide acceptance of this principle is likely to constrain any alternative New Zealand policy responses.

B. Locational neutrality

Musgrave (1987) refers to locational neutrality as requiring that: "the tax system should not influence the choice of jurisdiction in which to invest on the part of investors resident in any one jurisdiction" (p. 205).

Viewed from the perspective of worldwide welfare maximization, tax systems should not interfere with the allocation of capital. That is to say, capital should flow to the areas of highest pre-tax return. Where tax systems distort the rank ordering of project returns, then global economic welfare will be reduced. This possibility was considered in the New Zealand Government's discussion document on international tax. It was noted that:

> If the international tax regime is to play its part in encouraging the efficient use of New Zealand's resources, the Government must aim for a regime that does not distort the relative rates of return from alternative investments both in New Zealand and offshore. When relative rates of return are not distorted by tax, investors will concentrate on those activities that make the most efficient use of New Zealand's resources, rather than those investments that take advantage of the deficiencies in the tax system. (Birch & Creech, 1995, p. 8)

The concept of locational neutrality is broadly embodied in the notion of capital export neutrality [CEN], which is achieved where "an investor in country A [is] not affected by tax considerations when choosing whether to invest in A, B

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or C" (Musgrave, 1987, p. 205). In other words, "worldwide efficiency in the allocation of resources would be achieved since the location of investments would be determined by the pre-tax rates of return, thus maximizing worldwide welfare" (Ault, 1992, p. 572).

Capital import neutrality [CIN] is sometimes suggested as being an appropriate alternative basis for evaluating the efficiency of international tax arrangements. CIN occurs where "within a given taxing jurisdiction, domestic and foreign investors face the same tax rate" (Rollinson 1993, p. 314).

The difference is subtle, but nonetheless significant, since both CEN and CIN have different policy solutions. Unfortunately, "economic analysis cannot provide definitive answers to resolve this debate" (Anderson, 1988, p. 402). As a general rule, however, CEN is held to be more appropriate than CIN (Musgrave, 1987; Rollinson, 1993). It is perhaps somewhat ironic then, that the tendency toward use of source-based tax systems means that CIN is achieved considerably more widely in practice than is CEN, at least in European Community countries (Federal Trust for Education and Research & Ernst & Young, 1991). The same is likely to apply in other countries also.

An important point to note in respect of locational neutrality is that while it leads to an enhancement of global welfare, the practical outworking of national tax policy all too frequently reflects the sentiments of authors such as McIntyre (1993) who pointed out that:

> Although a free flow of investment capital to its most productive use may tend to enhance worldwide welfare, it does not necessarily enhance national welfare... Worldwide welfare is desirable, but national welfare is the more appropriate goal of a national tax policy. (p. 320)

Thus, the concept of locational neutrality, or colloquially speaking, the level playing field, is frequently sacrificed in favour of the pursuit of national self-interest. Whether this will continue to be a viable long-term strategy for countries in light of increasing internationalization is considered in Section VI.

C. Taxpayer equity

The third tax principle to be considered is that of taxpayer equity. Taxpayers should be treated equally irrespective of the sources from which they derive their income. Musgrave (1987) suggests that: "Taxpayer equity requires that income taxes apply to global income and only the country of residence/citizenship of the income recipient is in a position to tax this comprehensive measure of economic pursuit" (p. 207). Specific perceptions of equity will vary from country to country, and thus: "Different jurisdictions may be expected to have different notions regarding the requirements for taxpayer equity and wish to apply those standards to their own residents" (p. 207).

VI. CAN THE BENEFITS OF DIVIDEND IMPUTATION BE DENIED TO FOREIGN INVESTORS OVER THE LONGER TERM?

From the foregoing discussion it is clear that there are benefits associated with taxing foreign investment, and dividend imputation systems serve as one means of achieving this end. However, it has also been noted that there is a clear trend toward globalization and that this trend has implications for the conduct of national fiscal policy. The question that inevitably arises is one as to how long dividend imputation systems can be maintained in the face of growing globalization. Clearly, current systems do not promote CEN and thus are unlikely to be welfare-maximising from a global perspective. In essence, the question is really one as to how long other countries will tolerate the apparent discrimination associated with denial of imputation credits to foreigners.

Prior to the introduction of imputation in New Zealand, Vann (1986) foreshadowed the likely pressure which would be applied to countries with imputation systems, suggesting that:

> because of the pressure that will be exerted by countries with major investments in Australia and New Zealand for extension of imputation credits to their residents, it is necessary to consider what are the appropriate fall back positions which will most successfully protect the revenue base. (p. 54)

With growing globalization, this pressure has indeed been realized. Harris (1994) has observed that:

> There is a steady ground swell, pressuring countries with imputation systems to integrate foreign taxes into their imputation systems. Once a number of major countries make the move, others will be pressured to follow or face handicap in the international investment market. (p. 230)

Whilst Harris's point is not so much related to the extension of imputation benefits to non-residents, it still reflects the point that other countries are likely to continue to pressure imputation countries to modify their systems to suit foreign interests. Bird (1987) noted the following in respect of Canada's situation:

> Canada's general approach to the international aspects of integration may be illustrated by the recently concluded treaty with the United States. The United States constantly criticized Canada throughout the extended negotiations for discriminating by failing to extend its dividend tax credit to non-resident shareholders. In the end, Canada won the day, albeit only at the price of reducing the withholding tax on dividends from its preferred 15 per cent rate to 10 per cent. (p. 13)

Already, the United Kingdom has moved to extend in part its imputation system to foreigners by refunding some portion of advance corporation tax [ACT] to certain non-resident investors (Smith, 1994). The likelihood that smaller economies such as New Zealand will be forced to follow this lead is high. Indeed, Smith (1994) described the initial FITC regime, which was restricted to portfolio investors, as extending "dividend imputation to certain non-resident investors" (1994, p. 247).

The recent extension of that regime to non-resident direct investors may represent yet another step toward allowing foreigners access to the imputation system. The Inland Revenue (1996) notes, in respect of the FITC regime, "a portion of the

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underlying company tax is effectively refunded to non-resident investors" (p. 23). This is much the same as the way the imputation system treats domestic shareholders; that is, the underlying company tax is refunded to resident shareholders.

The change appears to have come about in recognition of the need to be internationally competitive in the investment market. The Government's international taxation discussion document stated that:

> The FITC mechanism also recognizes that New Zealand is a small open economy, drawing on and investing in, a global economy. Any distortions the tax system introduces into interactions between New Zealand and the global economy can significantly affect New Zealand's overall economic performance (Birch & Creech, 1995, p. 42).

While it is unlikely that New Zealand would, or even should, unilaterally adopt a policy of allowing foreign investors full access to the imputation system, the potential benefits from achieving a multilateral solution to this issue are becoming more apparent. The possibility of mutual recognition of imputation credits between Australia and New Zealand has once again become a topic for consideration with the change of government in Australia in 1996. The previous Australian government had demonstrated a reluctance to follow through on this possibility (Shewan & Heffernan, 1993). The potential also exists for some form of multilateral arrangement between members of APEC. Further attention is given to this topic in Section VIII but first a review of details of the FITC regime is warranted.

VII. THE FITC REGIME: AN OVERVIEW

The foreign investor tax credit regime (FITC) came into effect in 1993. Initially, the regime was restricted to non-resident portfolio investors – that is, those holding less than a 10 per cent voting interest in a New Zealand resident company, but as of 1996, the government has extended the regime to all non-resident shareholders in New Zealand companies. The new regime is expected to ensure that the maximum New Zealand tax borne by non-residents in respect of income derived through a New Zealand company will be 33 per cent, the same rate as that which applies to New Zealand domestic investors (Inland Revenue, 1996). But more than this, the regime is designed to ensure that the benefit of this effective tax reduction flows predominantly to the foreign investor, and not simply to the government of the home country of the foreign investor (Shewan & Heffernan, 1993; Smith, 1994).

The FITC regime achieves this through a somewhat complex process called a supplementary dividend. As outlined by the Inland Revenue (1996):

> The FITC regime allows a company an income tax credit (the FITC credit), which is calculated as a portion of the imputation credits attached to dividends paid to non-resident shareholders. The company is entitled to this credit when it pays a supplementary dividend of the same amount to its non-resident shareholders. Because it is based on the amount of imputation credit attached to a dividend, the FITC regime only applies to the extent that company tax has actually been paid (p. 23).

Mathematically, the FITC credit available to a company is equal to 67/187 multiplied by the level of imputation credits which would be paid to non-resident shareholders. Table 2 demonstrates the operation of the FITC regime. As can be seen from the Table, the net result is that total tax paid in new Zealand reverts to 33 per cent.

Table 2: New Zealand tax paid under the FITC regime

		NZD
Net profit before tax		100
Company tax (at 33%)	(33)	
FITC credit	11.82	(21.18)
		78.82
Dividends paid		78.82
NRWT (at 15%)		(11.82)
		67.00
Total tax paid in New Zealand		33.00

(Source: IRD, 1996, p. 25)

An obvious question is one as to why such a complex mechanism was selected to essentially eliminate the non-resident withholding tax [NRWT] payable by non-residents on dividends which are fully imputed. Why not simply remove the tax altogether, as is the situation applying in Australia where dividends paid from profits that have borne full company tax are not subject to withholding tax?

This question has been touched upon earlier in this paper and was dealt with by Shewan and Heffernan (1993) in relation to the FITC as it applied to non-resident portfolio investors. They correctly pointed out that:

> The reason is that in many countries dividends received from New Zealand are fully taxable with a credit for NRWT paid in New Zealand. If New Zealand had simply repealed the NRWT, then there would be no credit available in the foreign jurisdiction and the foreign portfolio investor's foreign tax liability would increase by the same amount as his/her New Zealand tax liability reduced. The effect of this would be that the benefits of repealing NRWT on franked dividends would simply be passed on to foreign tax jurisdictions (p. 280).

Smith (1994) similarly points to the manner in which the FITC regime ensures the flow of benefits to the foreign investor.

Thus it can be seen that the FITC mechanism, ensures that the benefit of the effective tax reduction is passed on to the investor and hence the incentive effects of the tax cut are maximized. This is preferable to the course of action adopted by other countries. Australia, for example, exempts from withholding tax any dividends which have been fully imputed. However, "in circumstances where the withholding tax would have been fully creditable, this approach would simply result in a transfer of revenue from Australia to that other country" (Rigby, 1995, p. 179).

It is also important to point out that the regime is entirely consistent with the principles outlined in Section V. The inter-jurisdictional equity issue is satisfied by ensuring that New Zealand, as the country of source, receives a return from the foreign investment. The return has been reduced, but the majority of the reduction flows to the foreign investor. In terms of locational neutrality, removal of the additional layer

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of taxation on foreign investment is a step in the direction of capital export neutrality. That is to say, the tax induced bias against investing in New Zealand has been lowered and there is thus a greater likelihood of investment being made on a basis consistent with worldwide wealth maximization. Taxpayer equity within New Zealand is generally not relevant in this instance since the concern lies with non-resident investors. However, individual taxpayer equity between countries may be enhanced.

It is not possible to comment on this issue in any detail without reference to the taxing regimes existing in the countries of residence of individual foreign investors. Fundamentally, these international tax principles are satisfied not only by virtue of the effective tax reduction, but also by way of the mechanism for reducing the tax. This mechanism ensures the benefit flows to the foreign investor and not the foreign jurisdiction. To that extent, it should be noted that both the reduction per se and the process of delivery of the reduction are strongly positive changes and should benefit both New Zealand and the global economy.

VIII. ASIA PACIFIC TAX HARMONIZATION: AN IMPOSSIBLE DREAM?

As has been noted earlier, there are increasing pressures on countries to extend imputation systems to accommodate the interests of both inward and outward foreign investment. The FITC regime represents a partial extension of the imputation system in New Zealand to inward foreigner investors. This is a unilateral response to the problem. There may, however, be substantial benefits from pursuing multilateral solutions, possibly through a regional trade grouping such as APEC.

In essence, APEC is about removing trade and investment barriers, opening economies and promoting competition within the region. Paragraph 2 of the APEC's Leader Declaration of Common Resolve, Bogor Declaration, 1994) states that:

> A year ago on Blake Island in Seattle, USA, we recognized that our diverse economies are becoming more interdependent and are moving toward a community of Asia-Pacific economies. We have issued a vision statement in which we pledged:
> - to find co-operative solutions to the challenges of our rapidly changing regional and global economy;
> - to support an expanding world economy and an open multilateral trading system;
> - to continue to reduce barriers to trade and investment to enable goods, services and capital to flow freely among our economies;
> - to ensure that our people share the benefits of economic growth, improve education and training, link our economies through advances in telecommunication and transportation, and use our resources sustainably.

However, it seems that the full gains from trade liberalization will not be achieved in the absence of some reform of taxing arrangements within the region. Deutsch and Cooper (1993) have suggested that:

> Not only do the various kinds of imputation systems fail to "mesh" appropriately, at a more fundamental level, it is our argument that there is as yet no common international understanding about the proper division of taxes (both corporate tax and personal income tax) on corporate profits. Until each problem is addressed, tax will remain an impediment to international trade within the region (p. 208).

Even within the context of CER between Australia and New Zealand, tax problems remain of concern. Shewan and Heffernan (1993) suggest that: "the absence of reciprocal imputation crediting between Australia and New Zealand is the single greatest obstacle to the achievement of a single market" (1993, p. 274). Deutsch and Cooper (1993) note that:

> given its physical and cultural proximity, the similarity of the corporate tax structures and rates and the degree of mutual investment, the most logical place for the mutual recognition of imputation credits to occur would be between Australia and New Zealand (p. 230-231).

They went on to note the difficulties which have been encountered in attempting to reach any such agreement, noting that: "nothing has occurred for reasons which may well lie in the trade imbalance between the two countries and in the inability of the two countries to agree how to remit double tax in the absence of a model" (p. 231).

It would appear then that there is a strong case within the APEC context to pursue some form of tax harmonization within the region and thus foster the growth of inter-regional trade and economic development. Whether or not such harmonization is in fact realistic is another issue. The evidence from the European Union debate on tax harmonization would seem to indicate that achieving tax harmonization is in reality extremely difficult. The Ruding Committee noted that:

> Cooperation among Member States with regard to direct tax matters is currently confined to an extensive network of bilateral tax treaties, designed to alleviate double taxation of cross-border income flows and transactions, together with some exchange of information. Any attempt to achieve a more comprehensive tax harmonization at the Community level would encounter a number of major obstacles (Commission of the European Communities, 1992, p. 45).

Whether or not tax harmonization can be achieved within the APEC region is thus open to considerable debate. This should not, in any event, rule out further consideration of the topic. Whilst the path to harmonization may prove to be somewhat difficult, the benefits may be equally rewarding. Anderson (1990), summarizing the discussion on tax reform at a symposium of OECD and non-OECD countries, stated in regard to policy co-ordination that:

> The interest in this topic has emerged because of the possibility that there may be efficiency gains at the international level from policy coordination rather than policy competition which could lead to policy induced distortions. Competition may lead to policies which place greater emphasis on national rather than international welfare objectives (p. 29).

This same issue should be considered by the APEC economies in determining the merits of choosing to cooperate on tax policy. It is not appropriate to discuss here the details of how such harmonization could be achieved. There are a broad range of alternatives which may be pursued – some possible options can be found in Deutsch and Cooper (1993). At this stage, emphasis should be placed in raising the awareness of the need for, and benefits which may flow from, regional cooperation on tax policy.

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IX. CONCLUSIONS

There has been a marked trend toward internationalization of economies over recent decades. This globalization process has substantial implications for the conduct of international tax policy. Increased capital mobility between nations raises issues as to the impact of tax policies that discriminate against foreign investment. Questions have been raised about the role of imputation systems in this context.

The initial introduction of the FITC regime and its recent extension to non-resident direct investors appears to be a direct response to the increased need to ensure that tax policies do not impact adversely upon foreign investment. As observed by Smith (1994), the regime effectively amounts to a partial extension of the imputation system to non-residents. Whether this extension represents a first step toward wholesale change in the way the imputation system deals with foreign residents and foreign taxes cannot be determined at this stage. In any event it reflects the pressures that globalization is bringing to bear on national taxing systems.

To the extent that the FITC regime changes reflect a need to ensure that domestic tax regimes are compatible in an international context, it raises some questions as to the possibility of inter-regional tax harmonization. Whilst the European experience would suggest harmonization cannot be achieved easily or costlessly, there remains nonetheless some possible benefits from pursuing harmonization within an APEC context. The APEC economies have committed themselves to the progressive removal of international trade barriers in order to facilitate long term economic growth. It would seem that tax policy, as well as being influenced by this process, has a key role to play in progressing development toward free and open trade on a regional basis.

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BELGIUM

THE BELGIAN RDT[1] SYSTEM CONFRONTS COMMUNITY LAW

THE TIME FOR A RETHINK HAS COME

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I. INTRODUCTION

The amendments made by the Royal Decree of 20 December 1996[2] (hereinafter: the Royal Decree) to the Belgian RDT system marks the high point of a legislative policy which has heightened the conflicts between this system and the European Parent-Subsidiary Directive of 23 July 1990[3] (hereinafter: the Directive).[4]

It is not proposed to examine in detail here the provisions of the Royal Decree which have once again amended the RDT system. This exercise has already been undertaken several times in the last few months.

It is intended, rather, to draw the attention of readers to the many difficulties that have arisen at this point in time between the Belgian RDT system and the requirements imposed by Community law.

The concern of this analysis is not strictly academic. Belgian taxpayers, i.e. natural persons and companies can directly invoke provisions of Community law against conflicting provisions of Belgian law, and experience has shown that such efforts can meet with success. Can anyone really believe that it was in a spirit of magnanimity that the VAT authorities not so long ago amended the applicable rules concerning benefits in kind? Are we to believe that the recent amendments made as to the taxing of non-resident companies, (the abolition of the discriminatory taxation rate; the abolition of the non-allocation of withholding tax on income from movable assets/dividends), not only for the future but also for current legal proceedings, are due to a benevolent and spontaneous initiative coming from the Belgian legislator?

II. A REMINDER: THE DIRECTIVE

All Member States, were required to put their domestic law in alignment with the Directive as of 1 January 1992.

From the same date onwards, Belgian taxpayers can rely, not only in their national courts but also before their national tax authorities, on those provisions of the Directive which lay down obligations on Belgium that are "... clear and sufficiently precise to be directly applied by a court" against national provisions that conflict with those of the Directive.

They can also lodge a complaint with the Commission, directly or via a professional organization, directed against a possible conflict between national legislation and obligations laid down by the Directive.

We propose to examine hereafter some of the conflicts which exist between the obligations laid down by the Directive and the Belgian RDT system, as modified and set out by the Royal Decree. The following list is not exhaustive.

The attention of the reader is drawn to the fact that the critical analysis which follows always assumes a situation where a Belgian company either pays dividends to, or receives dividends from, a non-Belgian company which is both resident for tax purposes *and* legally incorporated under the laws of another Member State.[5]

III. DEDUCTING RDT FROM THE TAXABLE PROFIT IS NOT THE SAME AS "REFRAINING FROM TAXING IT"

In the Belgian system, the RDT is not excluded from the (taxable) profit of the accounting period.

Instead, it forms part of the said profit (as the same is determined *before* deduction of possible recoverable tax losses arising from previous accounting periods).[6]

Thereafter, 95 per cent of the RDT will be deducted from the taxable profit.

1. RDT: "Revenus définitivement taxés" (already taxed dividend income). This is an abridged version of an article originally published in French and in Dutch in the Belgian Chartered Accountants Bulletin ("*L'Expert Comptable Belge – Revue de l'Institut des Experts Comptables*"), July 1997, p. 24. The author gratefully acknowledges the assistance of Mr André E. Bywater, Barrister, Middle Temple, in the translation of the same into English.
2. *Moniteur Belge* of 31 December 1996, 4th ed., at 32,635 with the Rapport au Roi.
3. European Parent-Subsidiary Directive of 23 July 1990 "on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States"
4. Council Directive no.90/435/EC, OJ 225/6 of 20 August 1990.
5. The attention of the reader is drawn to the interesting *Survey of the Implementation of the EC Corporate Tax Directives* published in 1995 by the International Bureau of Fiscal Documentation in Amsterdam.
6. See Art. 202 CIR: "From the profits of the accounting period, are deducted ..."

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As a result, no deduction of the RDT is possible if there is no taxable profit for the relevant accounting period. In other words, deduction of the RDT from the profit of the accounting period can never lead to the creation of a recoverable tax loss.

The disadvantages of the system of "first include, then deduct" have worsened since the 1993 accounting period. Article 205, paragraph 2 of the "Code des impôts sur les revenus" (the Belgian Income Tax Code, hereinafter: the CIR), specifies that the deduction for RDT cannot be applied against taxable profit arising from non-deductible expenses, except taxes, losses in value and reductions in value on shares.[7]

This system appears to be incompatible with the Directive.

Indeed, Article 4 of the Directive specifies that the Member State of the parent company must:

- either refrain from taxing (the) profits (distributed by the subsidiary); or,
- tax such profits while authorizing the parent company to deduct from the amount of tax due that fraction of the corporation tax paid by the subsidiary which relates to those profits ... up to the limit of the corresponding domestic tax [payable by the parent company in respect of the profits distributed by the subsidiary and included in the taxable base of the parent company].

When the Directive was implemented by Belgium, the first option was chosen.

Yet, in conflict with this chosen option, the Belgian system results in directly taxing RDT up to the total amount of non-deductible expenses referred to in Article 205(2) CIR.

Additionally, in the situation where the activity of the company for the accounting period concerned results in a loss (*before* inclusion of RDT in the taxable profit and before deduction of recoverable prior tax losses), the result is the taxation of the RDT received during the accounting period up to the amount of the losses incurred by the company during the said accounting period.

IV. CAPPING OF THE DEDUCTION AT 95 PER CENT

Under the terms of Article 4(2) of the Directive:

> ... each Member State retains the option of specifying that any charges relating to the holding [which has generated the dividends] ... may not be deducted from the taxable profits of the parent company. Where the management costs relating to the holding in such a case are fixed as a flat rate, the fixed amount may not exceed 5 per cent of the profits distributed by the subsidiary.

The CIR, however, limits the deduction of RDT from the taxable profit (inclusive of said RDT) to 95 per cent of the gross amount received (that is, before deduction of any applicable Belgian withholding tax.[8] This capping at 95 per cent applies *in all cases*, irrespective of whether or not the parent company has incurred any "charges relating to [its] holding [in the subsidiary]".

On the other hand, there is nothing in the CIR to prevent the parent company from deducting without limit (in principle) the true costs relating to its holding in the subsidiary.

The capping of the RDT deduction at 95 per cent cannot therefore be justified by reference to Article 4(2) of the Directive. Indeed, Belgium has not availed itself of that Article in order to exclude the deduction by the parent company of "charges relating to [its] holding [in the subsidiary] ...".

V. DISALLOWANCE OF THE DEDUCTION OF INTEREST EXPENSES UP TO THE AMOUNT OF RDT GENERATED BY CERTAIN HOLDINGS HELD FOR LESS THAN A YEAR

In order to combat " ... the inappropriate use of the RDT system ... ", the tax legislator sought to prevent certain operations whereby the deduction of interest expenses permitted under the provisions of Articles 52(2) CIR and 183 CIR, were combined with the exemption of RDT. To do this, the tax legislation specifies that henceforth interest borne by a resident company is not a deductible professional expense up to an amount equal to that of the dividends received which qualify as deductible RDT. This is insofar as these dividends relate to "... shares ... not held ... during an uninterrupted period of at least one year at the time of their transfer".[9]

It is not required, however, for the deduction of interest to be disallowed that the said interest arise from loans "... relating to the holding ..." which has generated the RDT.

On the contrary, the Government made it clear during the parliamentary proceedings regarding the law of 20 December 1995 which introduced this "anti-abuse" measure in the CIR, that it was not intended to establish *any connection* between the acquisition of holdings giving rise to the payment of deductible RDT on the one hand, and of the purpose of the loans the interest of which is disallowed on the other hand. The justification that was put forward for this refusal was the practical difficulty that would exist for the taxpayer to prove the existence of a causal link and for the authorities to be able to check such proof.[10]

The European Court of Justice has however repeatedly ruled that contingent administrative difficulties cannot in any situation justify a policy which conflicts with a Directive, nor indeed general principles of Community law.[11]

The conclusion is that, here too, the Belgian RDT system conflicts with the Directive.

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7. For specific examples of the disadvantages of this situation, see Dassesse and Minne, "Précis de droit fiscal", *Bruylant*, 4th ed., at 686 and 687.
8. See Art. 204 CIR.
9. Art. 198, 10° CIR This limitation is nevertheless not applicable in as far as the RDTs are generated by holdings held in associated companies (whether or not they are booked as fixed financial assets), or by shares booked as fixed financial assets.
10. See Doc. Chambre, 1995-1996, no. 208/8, at 8 and 20.
11. See in particular, as regards tax, case C-204/90, *Bachmann*, of 28 January 1992, para. 17. Also, cases C-80/94, Wielockx, of 11 August 1995 and C-279/93, *Schumacker*, of 14 February 1995.

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True, the Directive clearly allows Member States to disallow the deductibility of "charges *relating* to the holding" of the parent company.

On the other hand, the Directive does not allow a Member State which has opted for the exclusion from taxation of profits received by the parent from its subsidiary to undo the benefit of that exemption by engaging in a "communicating vases" exercise: increasing concomitantly the taxable profit of the parent by an amount of disallowed expenses equal to the exempted profit, but *unrelated* to the holding which has generated such profit.

The Belgian system is also open to further criticism in that it quite simply denies the taxpayer the right to adduce evidence that the interest paid does not constitute "charges relating to the holding".

VI. THE MINIMUM HOLDING PERIOD REQUIRED FOR THE EXEMPTION OF WITHHOLDING TAX ON DISTRIBUTED PROFITS CONFLICTS WITH THE DIRECTIVE

According to Article 5(1) of the Directive, "profits which a subsidiary distributed to its parent company shall, at least where the latter holds a minimum of 25 per cent of the capital of the subsidiary, be exempt from withholding tax."

This text should be read together with Article 3(2)(2), of the Directive. Under the terms of this latter provision, "... Member States shall have the option of ... not applying this Directive to companies of that Member State which do not maintain for an uninterrupted period of at least two years holdings qualifying them as parent companies or to those of their companies in which a [parent] company [established in] another Member State does not maintain such a holding for an uninterrupted period of at least two years."

On 17 October 1996 the Court expressly considered this in the case of *Denkavit*.[12]

In this case, which concerned German legislation but which is equally applicable to Belgium,[13] the Court ruled as follows:

> A Member State may not make grant of [the exemption from withholding tax provided for in] Article 5(1) of ... the Directive ... subject to the condition that, at the moment when profits are distributed, the parent company must have held a minimum of 25 per cent of the capital of the subsidiary *for a period at least equal to that set by that Member State pursuant to Article 3(2) of the Directive*. It is for the Member States to draw up rules for ensuring compliance with this minimum period, in accordance with the procedures laid down in their domestic law. In no case are those States obliged under the Directive to grant the advantage immediately on the basis of a unilateral undertaking by the parent company to observe the minimum holding period [determined by that Member State under Article 3, paragraph 2 of the Directive].

In other words:

- a Member State may not make the exemption from withholding tax subject to the condition that the minimum period it may specify (but not exceeding two years) has been satisfied at the time when the dividends are paid; *but*
- the commitment of the parent company that it will maintain its holding in the subsidiary for the full period specified by the Member State of the subsidiary does not, as such, oblige that Member State, in terms of the Directive, to grant the benefit of the exemption before the minimum holding period it has specified has been accomplished.

As a result, the Member State of the subsidiary may, at its own discretion:

- either grant the exemption immediately, provided it receives adequate guarantees, as specified by its domestic law, that it will be able to recover the withholding tax initially waived, should the holding not be held for the full, minimum, specified period; or
- wait until the full, minimum, specified period has been accomplished before *retroactively* granting the benefit of the withholding tax exemption, with effect from the date of acquisition of the holding.[14]

Belgian legislation refrains from applying the Directive on this point too.

VII. SOME OF THE ANTI-ABUSE PROVISIONS OF THE RDT SYSTEM DO NOT COMPLY WITH THE DIRECTIVE

A. Preliminary remark

As Professor Guy Kleynen has masterly demonstrated in a recent article,[15] the degree of tinkering, pointless complexity and legal uncertainty introduced by the Royal Decree into the RDT system in terms of anti-abuse provisions has reached a level rarely equalled in Belgian tax law.

Having regard to the scope of the present article, we will limit ourselves here to the analysis of the compatibility of only one of the anti-abuse provisions of the Belgian RDT system with both the Directive and the general principles of Community law. For a more detailed analysis, we refer the reader to the unabridged version of this article published in Dutch and in French in the Belgian Chartered Accountants Bulletin (see note 1).

B. Scope of the Directive's anti-abuse clause

According to Article 1(2), "this Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse."

12. Joined cases C-283/94, C-291/94 and C-292/94.
13. Belgium, and a number of other Member States, made submissions to the Court in support of the position of the German tax authorities and the German Government.
14. On this question, see our commentary on the *Denkavit* case in the 20 November 1996 edition of the journal "*L'Echo*": "Participation mère-filiale et précompte mobilier sur dividendes."
15. "La complexification à outrance des revenus définitivement taxés", *L'Echo* of 21 January 1997.

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However, the interpretation of the "anti-abuse" clause referred to in Article 1(2) is not left to the discretion of the Member States.

In order to ensure its uniform application throughout the Community, the interpretation of this clause must be the same in all Member States. Therefore, in the final analysis, it is for the European Court of Justice to determine what constitutes "... domestic or agreement-based provisions required for the prevention of fraud or abuse" *and* what constitutes "fraud or abuse" within the meaning of the Directive.

In this respect it should be noted that the term "necessary" referred to in Article 1(2) is the reflection of the general principle in Community law of proportionality. A Member State is certainly permitted to take necessary measures to prevent "fraud and abuse" within the limits placed on these terms by the European Court of Justice. It couldn't possibly be otherwise. However, the means put into place to combat such fraud and abuse, even in tax matters, must be in proportion to the objective pursued so as to not unjustifiably undermine the freedoms guaranteed by the Treaty, and, in this particular instance, the objectives pursued by the Directive.

Recent case law of the European Court of Justice has applied this principle in tax matters.

In the judgment in the *Bordessa case* of 23 February 1995[16] the Court ruled that, a provision of Spanish legislation which made the exportation of pesetas in the form of bank notes subject to prior authorization from the Spanish authorities, was prohibited by Community law because such a requirement was disproportionate in relation to what the combat against "fraud and abuse" required. The objective pursued could easily have been achieved by making the exportation subject only to a compulsory declaration to the Spanish authorities.[17]

The Court reiterated its position some months later in the *Lucas de Lera case*,[18] which concerned the exportation of bank notes to a non-Member State, namely Switzerland.[19]

In its above mentioned judgment in the *Denkavit* case, the Court also applied the principle of proportionality, this time in determining the scope of the anti-abuse clause of the Directive.

Indeed, the submission made in the *Denkavit* case by "... the Bundesamt and the German Government that [their] interpretation [of Article 3(2) of the Directive as allowing the withholding tax exemption to be made subject to a completed period of minimum holding] was supported by [the anti-abuse provision] of Article 1(2)"[20] was rejected by the Court as follows:[21]

> ... it is to be noted that Article 1(2) of the Directive is a provision of principle, *the content of which is explained in detail in Article 3(2) thereof*. Thus, Article 3(2) ... is aimed in particular at counteracting abuse whereby holdings are taken in the capital of companies for the sole purpose of benefiting from the tax advantages available and which are not intended to be lasting. *In those circumstances it is not appropriate to resort to Article 1(2) of the Directive to interpret Article 3(2).*

In other words, according to the Court, Article 3(2) "... rendered in more explicit detail" the content of the anti-abuse clause referred to in Article 1(2).

It can therefore be inferred that the anti-abuse clause referred to in Article 1(2) does not amount to a "master-key" which can be used here, there and everywhere in support of domestic or agreement-based measures excluding certain holdings from the scope of the Directive.

This is of paramount importance when assessing the question of the compatibility with the Directive of anti-abuse provisions of the Belgian CIR denying the benefit of the RDT system to dividends received by a Belgian parent company from certain subsidiaries, including subsidiaries established in other Member States.

Such a refusal may *not* be justified by relying on the anti-abuse provision of Article 1(2) of the Directive whenever the holding in the foreign, EC subsidiary has been held by the Belgian parent for two years, being the maximum period provided for by Article 3(2) of the Directive, which article, as held by the Court in the *Denkavit* judgment, explicates the general anti-abuse provision of Article 1(2).[22]

The refusal to grant the benefit of the RDT system to the Belgian parent in such circumstances can therefore only be justified, in the absence of any abuse, if one of the conditions laying down the scope of the Directive is not met. These conditions are listed in Article 2 of the Directive which reads as follows:

> For the purposes of this Directive "company of a Member State" shall mean any company which:
> (a) takes one of the forms listed in the Annex hereto;
> (b) according to the tax laws of a Member State is considered to be resident in that State for tax purposes, and under the terms of a double taxation agreement concluded with a third State, is not considered to be resident for tax purposes outside the Community;
> (c) moreover, is subject to one of the following taxes, without the possibility of an option or of being exempt:
> – *impôt des sociétés/venootschapsbelasting* in Belgium...
> – or to any other tax which may be substituted for any of the above taxes."

16. Joined cases C-358/93 and C-416/93.
17. For a more detailed analysis of the case, see our commentary published in the *Journal de Droit Fiscal*, 1995, at 240.
18. Judgment of 14 December 1995, joined cases C-163/94, C-165/94 and C250/94.
19. For a detailed analysis of the *Lucas de Lera* judgment see our commentary in the *Journal de Droit Fiscal*, 1996, at 286.
20. See para. 30 of the judgment.
21. See para. 31 of the judgment.
22. Without however suggesting that a holding held for less than two years necessarily comes within the scope of application of the "anti-abuse" provision.

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C. Exclusion of dividends received from companies subject to an "... appreciably more advantageous tax regime"

Article 203(1) CIR (as amended by Article 26 of the Royal Decree) excludes from the benefit of the RDT system dividends received from foreign subsidiaries which are subject in their Member State of origin to a tax regime which is "... appreciably more advantageous" than the Belgian system.

To state that the collection of dividends by a Belgian parent from a company established in another Member State amounts to an abuse justifying refusal of the application of the Directive, on the sole ground that this company benefits from a tax regime which is "... appreciably more advantageous" than the Belgian regime, means that the Directive may only apply between Belgium and Member States whose corporation tax system is the same as, or more onerous than, the Belgian system.

If this interpretation was also applied by the other Member States, the result would be that the Directive could only apply between Member States having essentially similar corporation tax regimes.[23] Such an interpretation is clearly untenable since the very *raison d'être* of the Directive is to permit, subject to the conditions laid down by the Directive, the free transfer of dividends between related companies throughout the Community, notwithstanding the widely different tax regimes which apply in the various Member States.

Therefore, even if it is accepted that Belgium can deny the benefit of the Directive for dividends distributed to Belgian companies by European Community subsidiaries subject to corporation tax in another Member State on the sole ground that they benefit from "an appreciably more advantageous tax system" than the Belgian tax system, it should, in any event, permit the Belgian parent company "... to deduct from the amount of [Belgian corporation] tax due that fraction of the corporation tax paid by the subsidiary which relates to those profits".

VIII. REFUSAL OF TAX CREDIT FOR FOREIGN DIVIDENDS EXCLUDED FROM THE RDT SYSTEM

As was stated at the outset of this article, Article 4(1) of the Directive specifies that the Member State of the parent company must:

- either refrain from taxing dividends received by the parent company;
- or tax such profits while authorizing the parent company to deduct from the amount of tax due that fraction of the corporation tax paid by the subsidiary in its own Member State, concerning profits distributed to the parent company.

IX. CONCLUSION: A NEW MANIFESTATION OF THE ENDEMIC INSTABILITY OF BELGIAN TAX LAW

The instability of the Belgian tax system remains a major source of concern.[24] It is already "written in the stars" that the latest rehash of the RDT system as a result of the Royal Decree of 20 December 1996 will soon have to be amended once again on a number of points. Moreover, the endemic instability of the Belgian tax system is becoming a significant handicap: as a result, any Belgian initiative in the tax field designed to attract foreign investors becomes less and less credible for foreign observers.

Yet, Belgium is not an island and the Single Currency which it aspires to join will further reduce its already very small room for manoeuvre.

23. Indeed, if the corporation tax regime of Member State "A" is viewed by the Belgian tax authorities as being "more onerous" than the Belgian tax regime (and hence outside the scope of application of the Belgian anti-abuse provision), it follows that, for its part, Member State "A" may view the Belgian tax regime as being significantly less onerous than its own tax regime, and hence apply its own anti-abuse provision to dividends received by parent companies based in Member State "A" from subsidiaries based in Belgium.

24. See, on this subject, our article "La perte de crédibilité du législateur fiscal et financier: raison du déclin de la place financière belge?" ("The loss of credibility of the tax and financial legislator: reason for the decline of Belgium as a financial centre?"), Mélanges Jean Pardon, *Bruylant*, Brussels, 1996, at 197.

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HUNGARY

THE TAXATION OF FINANCIAL DERIVATIVES IN EMERGING FINANCIAL MARKETS: THE HUNGARIAN EXPERIENCE

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I. INTRODUCTION

A. Methodology

This paper seeks to clarify how transactions in financial derivative instruments (hereinafter: FDIs) are to be treated for commercial and tax accounting purposes in an emerging market economy, namely in Hungary. In consideration of the early stage of development of the Hungarian capital markets as well as the state of flux as experienced in the worldwide business in FDIs, the question of derivatives seems to be quite esoteric.[1] A market of derivative products has nevertheless been created in Hungary and, most importantly, it is expected to develop rapidly.

The paper commences with some introductory remarks on the Hungarian financial and legal environment.[2] The examination of the accounting and tax rules concerning FDIs is divided into three major parts. First comes an explanation of the commercial and tax accounting treatment of capital gains in Hungary. As explained below, Hungary follows the fiscal disparity principle. According to it, potential capital losses must be recognized while unrealized capital gains need not be. Secondly, the accounting and tax rules concerning FDIs will be dealt with in detail. This is the centrepiece of the analysis. It will be based on an overview of the relevant accounting guidelines. The third major section of the paper sets forth examples of the Hungarian accounting and taxation treatment of FDIs. Finally, the article concludes with recommendations aimed at facilitating the future development of an improved tax and accounting regime for FDIs.

B. Financial and legal environment

1. Background

Financial derivative products first emerged in the markets of highly developed countries where huge concentrations of capital have accumulated, and where it is necessary to introduce various means of hedging the risks arising mainly from the volatility of securities markets.[3]

In spite of difficulties,[4] the Budapest Stock Exchange, which was established in 1990, has developed significantly. An example of its growing international reputation is that in 1996 it was registered as a recognized exchange by the London Stock Exchange.[5]

2. Legal structure

a. *Hungarian banking law in transformation*

Despite the inadequacies of Hungary's capital markets, the relevant legal infrastructure has developed quickly in Hungary. In 1987 Hungary was the first country in Central and Eastern Europe to start to create the legal framework necessary for modern Western style financial markets to function

1. Since even in highly developed markets the various contractual forms that constitute financial derivative products are constantly evolving, it is not surprising that, in addition to the legal treatment, the accounting and tax considerations of FDIs also constitute topics that are widely discussed in recent years.
See *Taxation of new financial instruments*, Paris: OECD, 1994; and Ch.T. Plambeck, H.D. Rosenbloom, D.M. Ring, "Tax aspects of derivative financial instruments," *Cahiers de droit fiscal international, Vol. LXXXb*, 1985.
For the background, see: Organisation for Economic Co-operation and Development, *Taxation of global trading of financial instruments: A discussion draft*, 14 *TNI* 7 (17 February 1997). For a recent discussion of the topic regarding the USA, see R.S. Avi-Yonah, L.Z. Swartz, „U.S. International tax treatment of financial derivatives", 14 *TNI* 9 (3 March 1997). The Hungarian legal problems of financial derivatives have not yet appeared in the literature. The only exception is a paper on swaps: Z. Lengyel, W.A. Paardekooper, C. Young, „Swap transactions in Hungary", *Baker and McKenzie Central European and CIS Legal Update* (Winter 1996/97) at 13-15.

2. The term "financial enterprise" is taken directly from the relevant Hungarian law, which has been drafted on the model of the EC Directive No. 93/22 on investment services. Financial enterprises as regulated in Hungarian law can be compared to investment firms as regulated by the said EC directive on investment services.

3. Financial derivative instruments can be defined as the composite of contractual rights and obligations that are established in relation to the transfer or exchange of cash flows that is to be implemented at stipulated future points in time. It is also crucial that the quantity of these cash flows is determined by reference to foreign exchange, securities, commodities or financial indices such as combined stock exchange rates or publicly offered interest rates. In the following, nothing but the basic forms of derivative instruments (forward, futures, option and swap contracts) will be discussed. Original issue discount bonds (or zero coupon bonds) are also dealt with here for practical considerations, although these instruments cannot be treated strictly speaking as FDIs.

4. In the Central European region, including Hungary, capital markets are relatively small and in their infancy. To the extent that the volume of trade is small, it is easy to exercise influence on market prices by disposing of minor contract values.

5. The total market value of the shares traded on the Budapest Stock Exchange increased in 1996 by about 160 per cent (in current terms of Hungarian forints). The combined Budapest Stock Exchange index, called BUX, showed an annual increase of approximately 170 per cent (in current terms of Hungarian forints). The trade in derivatives which commenced in 1995 increased at a rate of approximately 2,000 per cent in 1996.

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properly.[6] The first of January 1997 is an important date in the further development of the legal regulation of Hungary's financial markets. As of that date, the earlier law on credit and financial institutions has been replaced by Act CXII on Credit Institutions and Financial Enterprises (following the official Hungarian abbreviation, hereinafter: HPT). Also, the old law on capital markets has been superseded by Act CXI of 1996 on the Admission of Securities, on Investment Services and the Stock Exchange (hereinafter: EPT).

The introduction of the new laws are significant because:
- they create a system based on the idea of universal banking, in particular, a uniform public body (called the State Supervisory Agency of Money and Capital Markets) has been established to supervise both financial and capital markets;
- the Hungarian terminology of financial law has further been approximated to the language of the First and Second Banking Law Directives (EEC 77/780 and EEC 89/646); and
- clarification has been made in the field of investment banking.

b. *Transactions in financial derivatives and trade in securities*

In order to comply with EC Directive 93/22 on investment services, the Hungarian legislation has for 1997 significantly developed the existing legal framework governing transactions carried out on financial markets. In particular:
- the civil law concept of commercial paper (including negotiable instruments and securities) has been modernized;[7]
- a wider range of investment services[8] is now covered by regulations.[9]
- the position of "nominee" has been recognized; and
- the legal regulation of the securities deposit services has been clarified.

Transactions in FDIs, such as forward and futures contracts, swaps and options are regulated both by the law on the stock exchange and the law on the commodities exchange.[10] The legal definitions of these transactions are basically identical in both laws. Futures as such are not regulated, but it is possible on the Budapest Stock Exchange to enter into agreements in standardized terms regarding treasury bills, currencies and the stock exchange index. These agreements are to be implemented through the central clearing house called KELER. The scope of standardized transactions is expected soon to be extended to the local inter-banking offered rate, called BUBOR, the combined Central European Stock Exchange Index, named CESI, and options.

A sign that Hungarian financial markets are getting more sophisticated is that the first foreign securities (the shares of Cofinec SA) were introduced in 1996 in terms of depositary receipts. Another step that has brought Hungary closer to achieving developed capital markets is the introduction of the institution of nominees.[11]

In the field of the trade in securities, there are certain restrictions for the purposes of foreign exchange control. Adopting the new law on foreign exchange control (Act XCV of 1995) that took effect on 1 January 1996, Hungary has undertaken to honour Article VIII of the IMF Treaty of 1944 (as amended) by declaring that the national currency, called "forint", is to be freely available for use in current account payments.[12] Under the effective law, the admission of foreign securities in Hungary is subject to licensing. Also, to engage in a trade in foreign securities, Hungarian investors must be licensed. However, there is an ever growing number of qualifying foreign securities, the trade in which is free for Hungarian investors, provided that they approach Hungarian securities traders. Any trade in financial derivative products with foreigners is subject to licensing although this is expected to be liberalized in the near future. Even at present foreigners are allowed to directly enter the Budapest Stock Exchange in respect of a wide range of derivatives without being subject to individual foreign exchange licensing. This is because the Exchange may run businesses with derivatives based on a block permit issued by the National Bank of Hungary.[13]

II. THE COMMERCIAL AND TAX ACCOUNTING OF CAPITAL GAINS DERIVED FROM THE DISPOSAL OF SECURITIES

In Hungary, the accounting treatment of transactions in FDIs follows the general accounting principles. Before discussing FDIs, the Hungarian accounting and taxation treatment of trading in securities will be examined in broad terms. In general, the corporate tax base of a Hungarian resident business organization is based on accounting profits. Therefore in the following the basic accounting rules are first described prior to the analysis of the main tax rules.

A. Commercial accounting

The prerequisite for the accounting of capital gains is to make a distinction between active and passive income. In addition,

6. I.e. by abandoning the monolithic banking system.
7. As a result, it is no longer obligatory to physically show an individual document to enforce the rights embodied by the document.
8. Investment services relate to financial instruments. They are listed as follows:
   - securities, whether publicly traded or not, and treasury bills or bonds, provided that they are publicly traded;
   - foreign exchange;
   - option contracts;
   - products of the stock exchange, i.e. derived by reference to the foreign exchange rate, interest rate and stock exchange index.
9. E.g. the underwriting and portfolio asset management activities are now subjects of independent regulation.
10. For the latter, see: Act XLIX of 1994, as amended, on the Commodities Exchange and the Transactions on the Commodities Exchange.
11. A nominee is authorized to exercise shareholder rights in his or her own name but on behalf of the securities owner. The position of nominee is therefore similar to that of a trustee in common law.
12. With regard to the OECD recommendations, some restrictions on capital payments have remained (see §§ 35-36 of Foreign Exchange Act), but they are being removed step by step.
13. For example, a block permit was issued by the National Bank of Hungary on 2 October 1996 to the Budapest Stock Exchange for the trade in BUX for an indefinite period.

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business organizations subject to commercial accounting, and corporate tax, must consider the distinction between operating and capital income. In commercial accounting (see Act XVIII of 1991, as amended, on Accounting), businesses show in their income statement operating profits and financial profits. For tax purposes, it does not matter whether profits are derived from business operations or investment activities. This is because uniform corporate tax rules are applicable both to operating and financial profits. In contrast to business organizations, Hungarian individuals are as a rule subject to a system of schedular taxation. Capital income, including interest, dividends and capital gains, is (with minor exceptions) not subject to progressive taxation. Instead, taxes at a flat rate, usually withholding taxes, are payable on capital income.

Business organizations subject to commercial accounting have to honour the principle of prudence as regulated in accounting law.[14] According to this principle profits must not be accounted for until it is certain that receipts will be realized, while unrealized losses should be recognized immediately. Therefore, businesses have to make provisions for various purposes,[15] or are obliged to review the historical value of financial assets – comprising debt or equity securities, or business stakes in private liability companies – or the trading stock held by way of depreciating the original value of assets.[16] In addition to assets, liabilities can also be reviewed and revised. For example, the value of liabilities must be increased during the life of a contract when a business organization has taken up a loan determined in terms of foreign currency, provided that the functional currency has been devalued. The revision of historical costs includes the possibility not only to depreciate but also appreciate assets. Business organizations may depreciate or appreciate their capital assets with the exception of debt securities and loans specified in national currency.[17] Notably, securities, whether equity or debt securities, must in the appropriate circumstances be depreciated, but may never be appreciated.

As mentioned earlier following the tradition of the European continent, Hungary relies on the principle of fiscal disparity. This means that the depreciation of capital assets or trading stock affects profits while the appreciation of the same assets has no impact on profits. The depreciation can be accounted for as expenses but the appreciation does not have an influence on profits because the increase in the value of capital assets is offset on the liability side of the balance sheet by an increase in the revaluation reserves. Being similar to capital reserves, these reserves are part of equity, but do not represent profits. The decrease in the value of capital assets must, of course, be accounted for against the positive revaluation reserves. However, so far as the decrease in value exceeds the value of these reserves, the balance reduces equity by reducing profits. This policy can be seen as a sign of prudence, which is justifiable in the eyes of creditors, but may be detrimental to government revenues. The reason for this is that a business' tax liability can be reduced dramatically by accounting for the expenses stemming from accounting for capital losses.[18]

There are some special accounting rules on capital gains and expenses that are applicable to credit institutions and financial enterprises which are authorized to conduct a trade in securities.[19] These business organizations are professional traders in securities. Credit institutions must not depreciate securities held as capital assets. Nor can their trading stock be depreciated. As an alternative, credit institutions may make provisions.[20] Financial enterprises are subject to provision making in respect of the securities held in their trading stock.[21] Furthermore, it is explicitly regulated by § 7(3) of the quoted decree on financial enterprises that these business organizations are allowed to account for the depreciation in capital value of securities, whether publicly traded or not. For commercial accounting purposes, it matters little whether profits are reduced by way of depreciation or the making of provisions. However this distinction is important for tax purposes. As will be seen below, deductions for provision-making are drastically restricted for tax purposes. The only exception to this is that there is no fiscal restriction on bad debt provisions in the case of credit institutions. Furthermore, for tax purposes, business organizations are only under certain conditions allowed relief for capital losses. This fiscal restriction is nevertheless not as strict as the restrictions applying to provisions.

B. Tax rules

The loss in value of capital assets or trading stock by way of reviewing historical costs can only be recognized for tax purposes after the revaluation. Thus the previous year's loss in value is only allowable as a current year deduction, and only in proportion to the current year use of the relevant assets.

14. § 15(9) of Accounting Act.
15. Id. § 27.
16. Id. § 39.
17. See: § 41A(1) Accounting Act; in fact, tangible and intangible assets, and loans denominated in foreign currency may be depreciated or appreciated.
18. It would be wise in Hungary to introduce fiscal restriction on the above way of accounting for capital depreciation. Undoubtedly, it can be accepted that the expenses made because of the depreciation of capital assets are recognized up to the extent of the appreciation of capital assets, possibly up to the extent of capital gains whether realized or not. However, following this logic, combined profits should not be reduced by the expenses made in books because of the accounting for capital losses.
19. Credit institutions are not yet allowed in Hungary to deal in publicly traded securities.
20. Credit institutions are widely allowed to make provisions. For the general authorization of credit institutions to make provisions, see, § 87 HPT. For the general rules on provisions made by financial enterprises, see § 108 EPT. For the particular rules on the provisions made by credit institutions, see Government Decree No. 198/1996 (XII. 22.) on the annual accounts and book-keeping of credit institutions and financial enterprises, §§ 5(6), 6(9), 9(9), 9(11), 13(3)-(4). Under § 87 HPT, a credit institution is obliged to make, in addition to provisions made for particular purposes, a general provision to the extent of 1.25 per cent of the adjusted turnover (there are special rules on how to calculate the adjusted turnover). In other words, 1.25 per cent of total risk assets should be general loan loss reserves. This a is requirement brought in accordance with the Basle Standards of 1987. See: W.A. Lovett, *Banking and financial institutions law in a nutshell*, St. Paul, MINN: West, 1992 at 127.
21. See Government Decree No. 197/1996 (XII. 22.) on the annual accounts and bookkeeping of financial enterprises, § 8(1). With regard to the abbreviation in Hungarian, in the following, the quoted government decree on financial institutions will be marked as HPTR, the government decree on financial enterprises as EPTR.

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There are complex rules on the tax accounting of expenses constituting "loss in value" of capital assets or trading stock.[22] However, there is considerable room left by the tax rules for the accounting of the expenses arising from capital losses. In contrast to these tax rules, the tax law on provisions is very restrictive. The essence of these rules[23] is that it is only possible to recognize as an expense the annual increase in the provisions made because of bad and doubtful debts as follows:

- 2 per cent of debts that are overdue for more than 90 days;
- 5 per cent of debts that are overdue for more than 180 days; and
- 25 per cent of debts that are overdue for more than 360 days.

For tax purposes, bad debts may not normally be written off unless they have been overdue for more than 5 years. The tax restrictions on provisions do not apply to credit institutions and financial enterprises. These institutions may make provisions under the rules on commercial accounting,[24] and these provisions are not overridden by tax law. As mentioned, under accounting law credit institutions enjoy much freedom in provision-making. Financial enterprises are also entitled to treat their provisions as tax deductible without limitation. However, in contrast to the case with credit institutions, their opportunity to make provisions is restricted under commercial accounting as regulated by the quoted government decree.

In contrast to business organizations subject to commercial accounting, individual taxpayers are only allowed to recognize capital losses in one specific case which concerns the disposal of publicly traded shares in Hungarian resident companies.[25]

III. THE COMMERCIAL AND TAX ACCOUNTING TREATMENT OF TRANSACTIONS IN FINANCIAL DERIVATIVES

A. Commercial accounting

In Hungary the accounting treatment of transactions in FDIs is based on the following principles:

- transactions with contingent assets and liabilities must not be accounted for on the balance sheet;
- gains or losses arising from finalized transactions with financial derivatives can only be accounted for where the gains or losses in question have been realized through the disposal of the underlying assets; gains or losses arising from a notional contract are to be recognized as the difference between the contractual and the striking price as soon as the life of the contract expires;
- hedging (except in the case of swaps) is based on the separate accounting method;
- credit institutions and financial enterprises may recognize the non-realized gains stemming from certain forward contracts; in addition, gains derived by any business organization from bonds that have been issued or acquired below par value are subject to the mark-to-market principle.

It can be seen that the Hungarian accounting treatment of FDIs is based on conservative rules. Depending on the development of capital markets, they are expected to be relaxed, but the outcome of the changes to be made is not yet predictable. The current rules will now be discussed in detail.

1. Contingent assets and liabilities, the realization of gains or losses, hedging transactions

Transactions with contingent assets and liabilities must not be accounted for on the balance sheet. Items stemming from these claims and liabilities will only be accounted for on the balance sheet when all rights and obligations have been determined. This is a rule that applies to all business organizations, although it is not based on statutory law provisions. There are, however, special legal provisions on the accounting for pending items that are applicable to traders (that is, to credit institutions and financial enterprises). Forward contracts, futures, options and swaps, whether traded publicly or not, will therefore only enter the balance sheet at the time when their outcome has been determined through expiry, offsetting or the disposal of the contract.[26] It can further occur that traders act as nominees for third parties in respect of pending items. In such a case, a trader holds the status of a commission agent.[27]

In comparison to highly developed countries, in particular to common law countries, the Hungarian practice regarding pending items seems to be very rigid. Indeed, in a modern market economy, rights and obligations must be accounted for because they have certain current financial value even when they have not fully matured. Since it is difficult to estimate the present financial value of rights and obligations whose ultimate value may depend on the outcome of future events the possibility of later adjustments must be preserved. The Hungarian Institute of Chartered Accountants urgently needs to find techniques, which may be used to assess the early impact of contingent assets and liabilities on businesses. Similar to the procedures followed in accounting for

22. See §§ 7(1)(f), 7(2) and 8(1) of Act LXXXI of 1996 on Corporation Tax and Dividend Tax.
23. §§ 7(1)(b), 8(1)(a) and 8(2) of Corporate Tax Act.
24. § 27(3)-(4) Accounting Act.
25. Under § 67(6) of the law on individual income tax (see Act CXVII of 1995, as amended, on Personal Income Tax), 20 per cent of the loss suffered on the disposal of publicly traded shares in Hungarian resident companies may be credited against the 20 per cent schedular tax on the capital gains derived from the disposal of any securities. In other words, these capital losses may be used to reduce the tax payable on capital gains derived from the disposal of securities. For the purposes of this tax credit, the trade in shares must be effectuated through an authorized securities trader. Losses that are not utilized in the current year cannot be carried forward. Under Hungarian individual income tax law, there are some tax reliefs relating to the trade in securities. An example being that the capital gains derived from the transactions managed via capital accounts are tax exempt. The capital accounts are special accounts kept with authorized dealers.
26. § 21(1) HPTR, § 13(1) EPTR.
27. In addition to a commission agent's business, some other instruments can be highlighted as particular pending items applicable to credit institutions as well. They are as follows: suretyship, guarantee, standby letter of credit, contractual promises and like obligations assumed by credit institutions.

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contingent assets and liabilities, businesses have to follow conservatism in the accounting of gains or losses as well. Accordingly, gains or losses arising from transactions in derivatives, whether publicly traded or not, will only be accounted for at the time when the underlying assets are disposed of. In contrast to the transactions based on underlying assets, gains or losses arising from notional contracts will be recognized as soon as when the difference between the contractual and the striking price has duly been paid. For example, gains derived from a contract relating to BUX will be recognized at the time of settlement.[28] This rule applies to all business organizations.

Traders are obliged separately to account for hedging and hedged transactions.[29] As a consequence, these transactions cannot be off set against each other. Due to the lack of any explicit regulation applicable to business organizations (other than financial institutions and financial enterprises), business organizations have to follow the separate accounting method. The accounting for swap transactions is an exception to the above rule. In regard to the nature of a swap, its outcome can only be determined as the result of a comparison between two transactions.[30] This is a rule that can be applied to any business organization.

2. Mark to market

The principle of mark to market is applicable to the gains as shown on the last day of the financial year in the books. In Hungarian practice, this principle is of relevance in two major fields. First, it must be followed by professional traders in the case of certain forward contracts. Secondly, it implies an obligation for any business to annually recognize part of the non-realized gains on discount bonds that have been issued or acquired below their face value.

Credit institutions and financial enterprises may account for those gains or losses that are shown on the last day of the financial year, and arise from forward contracts operating as hedging transactions that relate to the current year. This applies irrespective of whether the forward contracts appear on the stock exchange or not.[31] Financial enterprises must recognize unrealized losses, arising on stock exchange forward contracts where these are not hedging transactions. Furthermore, a financial enterprise although not obliged to, may recognize the unrealized gains that relate to the current year which arise from non-hedging forward transactions carried out on the exchange.[32] The recognition of non-realized gains or losses is to be calculated by following the principle of "time delimitation".[33] According to this principle, the financial outcome of economic events lasting for more than one year must be accounted for in the current year as a fraction of the total value, which is in proportion to the current year value that relates to the financial value of the whole period of the contract. Notably, while the recognition of unrealized losses is an obligation, there is no such obligation to recognize unrealized gains, merely a right. This means that the practice of mark to market applies to traders engaged in certain forward contracts, but that it is not obligatory for them to recognize unrealized gains. It is nevertheless important to consider the possibility of traders recognizing non-realized gains relating to a trade in securities in certain conditions. This is because, as mentioned, businesses may otherwise only review the historical costs of securities through revaluation.

Futures first appeared on the Budapest Stock Exchange in 1995. They are liquidated each day by the exchange's central clearing house. Therefore investors show gains or losses resulting from the contract that has been offset with the clearing house by increasing or decreasing the variation margin call.[34] However, these gains or losses will not be recognized as realized gains or losses for accounting purposes. Instead, the gains or losses arising from a contract will only be accounted for at the time of expiry, disposal or offsetting. This rule applies to both the commercial and tax accounting treatment as well as to traders and non-traders.[35]

While special accounting rules only apply to financial enterprises in respect of interest rate swaps, credit institutions are obliged to follow special rules for both currency and interest rate swaps. Gains or losses, whether arising from currency or interest rate swaps, cannot be recognized unless they have been realized. In the case of interest rate swaps, the gains or losses that have not yet been realized are not to be recognized at the year end.[36] In the case of currency swaps, non-realized gains or losses may be recognized. However, it is not the difference between the currency flows which is subject to prompt recognition. Instead, the change in currency rates as expressed in terms of Hungarian forints may be subject to revaluation. In the case of swaps between the domestic and a foreign currency, the gains or losses are calculable as the difference between the contractual currency rate and the fair market rate as expressed in Hungarian forints by the National Bank of Hungary on the last day of the year.[37] In the case of swaps stipulated in foreign currencies, the gains or losses are calculated as the difference between the relevant currency market rate effective on the day of the conclusion of the contract and the contractual currency rate; both values must be expressed in Hungarian forints at the rate determined by the National Bank of Hungary on the last day of the year.[38]

In comparison to the contractual value, the fair market value in various cases can be defined as follows:

- in the case of stock exchange transactions, the closing prices of the exchange, or the prices determined by the clearing house;
- in the case of transactions carried out with foreign currency, the currency rates as set by the National Bank of Hungary on the last day of the financial year;

28. § 21(2) HPTR, § 13(2) EPTR.
29. § 22(1) HPTR, § 14(1) EPTR.
30. § 23(7) HPTR, § 15(4) EPTR.
31. § 22(3) HPTR, § 14(3) EPTR.
32. § 15(2) EPTR.
33. § 15(12) Accounting Act.
34. In Hungary it is called a variation deposit.
35. For the commercial accounting applicable to traders, see: § 24(3) HPTR, § 16(3) EPTR.
36. § 23(7) HPTR, § 15(4) EPTR.
37. § 23(5) of the above decree on financial institutions.
38. § 23(6) of the same decree.

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– in the case of interest rate transactions that are carried out outside the stock exchange, the inter-banking offered rate, that is, BUBOR, as published at the end of the financial year; in the case of other transactions that are carried out outside the stock exchange, fair market prices as fixed on recognized negotiated markets.[39]

Gains or losses relating to options, whether they are used as hedging transactions or not, are not subject to current year recognition.[40] As can be seen, the early recognition of gains is only open to traders. In addition, the gains arising from this recognition can be offset by provisions. Credit institutions are widely allowed to make provisions on pending transactions.[41] In addition, financial enterprises are entitled[42] to make provisions in respect of forward contracts implemented on the stock exchange as non-hedging transactions. Furthermore, financial enterprises may account for capital depreciation if necessary.

Deep discount bonds as such are not in general regulated. Neither are there special original issue discount rules or independent provisions governing zero coupon bonds. Since deep discount bonds are not legally determined, there is no threshold defined by reference to a public index. Discount bonds are only subject to special legal regulation in one specific respect. In commercial accounting law, in respect of debt securities that have been acquired by an accrual-basis business organization at the time of issue or later at a value, which is lower than the nominal value, such a business organization is obliged to recognize as receipts part of the positive difference between the nominal value and the value of issue or purchase price at which the debt securities in question have been acquired. This treatment applies whether or not these securities are publicly traded. The fraction of receipts to be recognized from year to year is based on time apportionment of the return on capital over the life of the contract.[43] In other words, in accordance with international practice, capital gains will actually be converted into interest, and the result of this conversion is the implementation of the mark-to-market rule.[44] It can be seen that the above accounting rule is in principle of relevance to original discount bonds or market discount bonds. However, in normal circumstances, it is hard to imagine that bonds other than original issue discount bonds can be acquired below the face value.

B. Tax rules

Due to the lack of explicit legal regulation, the tax consequences of transactions in FDIs may not be determined with certainty. In the case of corporate taxpayers, there are no independent tax law provisions. That is also true for accounting rules except in the case of the early recognition of gains on the acquisition of discount bonds. However, the special provisions concerning the accounting for transactions in FDIs that are applicable to traders can be authoritative to other business organizations as well. As mentioned, in Hungary the corporate tax liability is based on accounting profits. There are specific tax rules applying to the gains derived by individuals from the discount value of publicly issued and traded debt securities. These gains are qualified as tax exempt interest for individual income tax purposes.[45] Another explicit legal regulation in Hungarian individual income tax law is that the income arising from swaps must be regarded as the final result of the synthetic transaction in terms of a difference between two capital flows comprised of individual transactions.[46] This means that the interest amount, the calculation of which is based on the separate transactions constituting the swap, is not directly targeted by tax law. It is noteworthy as well that the gains derived from the conversion of foreign currency into Hungarian forints, or vice versa, is in Hungary tax exempt, provided that the conversion is implemented by authorized dealers.[47] This means that currency swap transactions may (subject to fulfilling certain conditions) be exempted from income tax.

There are no detailed Hungarian international tax law provisions regarding FDIs. The income derived from forward or futures contracts, or options or swaps by foreign resident corporate or individual taxpayers is not taxable in Hungary unless its source is in Hungary. In corporate tax law, as a rule of thumb, the income derived by a foreign resident corporate taxpayer is not located in Hungary. However, the law contains a list of income items that are located, and so taxed, in Hungary. This list is short. It only contains interest, royalties and dividends.[48] Since 1 January 1997, capital gains are no longer sourced in Hungary. Any type of income not listed is

39. See § 22(5) HPTR and § 14(5) EPTR.
40. See § 24(4) HPTR and § 16(4) EPTR.
41. See §§ 7(9) and 13(5) HPTR.
42. § 8 (2) EPTR.
43. § 24(2) Accounting Act.
44. For example, in the case where company B obtains a five-year bond for HUF 8 million at the very beginning of 1997 from company A and sells it a year later for HUF 9 million to company C, and the bond was originally issued at the very beginning of 1996 for HUF 7 million at a par value of HUF 10 million, then company B must recognize HUF 500,000 interest (one fourth of HUF 2 million), which is due for 1997, in 1997 and HUF 1 million capital gain in 1998 (in the year of disposal). Company A was obliged to recognize HUF 600,000 interest (one fifth of HUF 3 million) in 1996 and is required to show HUF 1 million capital gain in 1997. Company C will only recognize HUF 333,000 interest (one third of HUF 1 million) from 1998-2000 until the expiry. In this case, the interest allocation is based on the straight-line method, so the time-value of money remains out of consideration. Given the early stage of development in Hungarian capital markets, there are not yet bonds issued for 10 or 15 years or more. In this case, it is not crucial to replace the straight-line calculation of interest by the economic accrual method to reflect the time value of money. The structure of the total return on capital can be illustrated as follows:

	Company A		Company B		Company C	
	(Return in thousands of HUF)					
	Interest	Cap. gain	Interest	Cap. gain	Interest	Cap. gain
1996	600					
1997			500			
1998		1,000			333	
1999				1,000	333	
2000					333	

45. § 65(1)(b) of Act on Personal Income Tax.
46. See § 67A(2) of Personal Income Tax Act.
47. Annex 1(7)(4) to Personal Income Tax Act.
48. § 4(22) of Corporate Tax Act.

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deemed to be derived outside Hungary.[49] This is the case with financial derivatives unless the interest element of a transaction can be identified. In individual income tax law, many categories of income are deemed to have a Hungarian source. Among other things, any income derived from Hungarian located property, whether movable or immovable, is taxable in Hungary.[50] The gains derived from FDIs are determined in Hungarian law as an independent category of gains subject to a 20 per cent schedular tax.[51] Under tax law, these gains might thus not be the same as capital gains. However, it is more likely that, as usually the case is, this type of gain will be considered to be capital gains. The characteristics of the gains derived from FDIs can be of relevance to the Hungarian interpretation of treaty law. As in other bilateral income tax treaties, it may occur in Hungarian treaties that interest is normally taxable in the source country while capital gains are rarely so taxable.

It is not likely that foreign parties to the transactions in FDIs will be subject to Hungarian tax, provided that they derive capital gains since as mentioned above, the capital gains derived by foreign corporations are exempt from tax under Hungarian corporate tax law. Although this is not the case in individual income tax law, Hungarian bilateral income tax treaties can be used by individuals to avoid paying Hungarian tax on capital gains.

In the case of original issue discount bonds, the rule on the current year gain recognition is not applicable to foreigners who are not subject to Hungarian accounting rules. This raises the problem of mismatching. This occurs where the Hungarian debtor is an accrual-basis business organization, and so able to accelerate the recognition of the expenses of the loan taken up, and, simultaneously, the creditor remains outside the scope of Hungarian commercial accounting for any reason. In Hungarian tax law there are not yet special provisions combating this sort of mismatching. Another problem is with the qualification of swaps. To the extent that swaps must be accounted for in Hungary based on the linked approach, there is no interest element of the return on capital that could be carved out. As a consequence, irrespective of whether the parties to the transaction are foreign or domestic taxpayers, it is only the gains derived from the exchange of capital flows that may trigger the obligation to pay tax.

IV. THE TAXATION OF FDIs

A. Forward contracts and financial futures

1. Forward contracts

Example: Party A contracts with Party B on 30 June 1997 to purchase 1,000 shares of C corporation in exchange for HUF 100 per share on 30 September. Assume the market price of one share is on 30 September either HUF 105, or HUF 95.

Party A disposes of the shares on 30 October at a price of
(i) HUF 105, or
(ii) HUF 95, respectively.

The parties are not engaged professionally in a trade of dealing in securities. It is also assumed that the financial year coincides with the calendar year.

The basic commercial and tax accounting consequences of the above are as follows: As mentioned, a pending transaction must not be accounted for on the balance sheet. There is thus nothing to do in the period from 30 June-29 September. This solution is not quite satisfactory because the expectation of future economic events can be of real present financial value, but the Hungarian practice is very conservative in this respect. The transaction will thus be accounted for not earlier than on 30 September. On that date, Party A will put the purchased shares in its portfolio by recording them at the contractual price, which is HUF 100 per share. This is because Party A is obliged to treat the acquisition of shares as if it had obtained the shares through a spot contract. Gains (or losses) are not recognized earlier than on 30 October. This is the date of disposal. That day, Party A will recognize a gain (or loss) of HUF 5 per share because it could sell the shares on the open market for HUF 105 (or 95) per share.

Party A followed the above procedure because the forward contract was based on the underlying shares. Where there is no underlying asset, it would only be necessary to account for the difference between the stipulated price and the fair market value, as at 30 September. This is because the gains or losses arising from a notional contract must be accounted for on the day when the forward transaction expires. In the specific case, Party A would have recognized a gain (or loss) of 5 HUF per share on 30 September if it had entered into a notional contract with Party B. It is the same whether or not the forward contract is executed as:
- a transaction on the exchange; or
- a hedging transaction.

A hedging transaction may take place where Party A agrees on 30 June to sell 500 shares in corporation X to Party B on 30 September for HUF 100 per share while Party A already holds a stock of 500 shares in corporation X. Assuming again that the market price is HUF 105 per share on 30 September, and that Party A has originally obtained the shares for HUF 100 per share, it will show no gain or loss on the hedging transaction. Had Party A obtained the shares at the market price on 30 September, that is, for HUF 105 per share, it would have suffered a loss of HUF 5 per share. Simultaneously, party B can realize HUF 5 gain on the shares provided that it sells them on the open market on 30 September. Party A is not obliged to combine the two transactions. It is thus not subject to the netting of gains or losses, if any, derived from a hedging and a hedged transaction.

49. In a specific case, it was decided by a joint ruling of the Finance Ministry and the Office of Tax and Fiscal Audit [PM 57605/1995 – APEH 9250382034/95; in 8 Ado es Ellenorzesi Ertesito 2 (1996) at 59] that a foreign corporate taxpayer was not liable for the tax payable on the return on investment certificates. Investment certificates are shares held in an investment fund as regulated by a special law. This fund is designed to manage collective transferable securities. Because the return paid on investment certificates does not appear on the list of Hungarian sourced income, it is not taxable in Hungary, the revenue said.
50. § 3(3) of Personal Income Tax Act.
51. § 67A of Personal Income Tax Act.

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To continue the example suppose the shares purchased on the above terms on 30 September are sold on 30 January in the following year. Since the forward contract has expired, it will be accounted for. However, there are not yet realized gains on the last day of the financial year. Gains or losses will only be realized in the following year when the assets are sold. Non-traders are not subject to the mark-to-market rule. Traders are subject to it in the case of certain forward contracts but, as mentioned, they are not obliged, but merely allowed to recognize non-realized gains. Even if gains are shown as realized, traders are given fairly wide scope to offset the gain recognized by making provisions.

Of course, the gains or losses stemming from a forward contract affect the profit position of a corporate taxpayer. Under Hungarian law, the capital gains realized by foreign corporations or partnerships are not located in Hungary, so they are not taxable in this country. The capital gains derived by individuals are subject to a 20 per cent withholding tax in Hungary. Foreign individuals are also subject to this Hungarian tax unless they are able to benefit from treaty shelter.

2. Futures

Example: There is a trade of 10 futures contracts of government bonds with a face value of HUF 5 million for each bond. The contracts are executed on 28 December 1996 at the agreed price of 98.45 per cent. Clearly, each change of 1/100 per cent is worth HUF 500. It is assumed that the fiscal year is equal to the calendar year and that the buyer and seller are not engaged in a trade in securities. The following fact pattern occurs:

	Buyer	Seller
28 December		
Buy and sell at 98.45		
Close at 98.55		
Initial margin call	(1,500,000)	(1,500,000)
Variation margin call	50,000	(50,000)
29 December		
Close at 98.60		
Variation margin call	25,000	(25,000)
30 December		
Close at 98.50		
Variation margin call	(50,000)	50,000
31 December		
Close at 98.35		
Variation margin call	(75,000)	75,000
3 January		
Close at 98.15		
Variation margin call	(100,000)	100,000
4 January		
Close at 98.30		
Variation margin call	75,000	(75,000)
Initial margin refund	1,500,000	1,500,000
Net trade profit or loss	(75,000)	75,000

As can be seen from the example, in aggregate, the buyer has on 4 January 1997 lost HUF 750,000 while the seller has gained an identical amount. This is because the market price on 4 January is lower than the agreed price. Therefore the buyer had to buy the bonds for a high value and could only sell them on the open market at a low value. In contrast the seller was able to buy bonds at a low value while he could under the agreement sell them at a high value. In reality, each day the buyer buys bonds at the stipulated price (which is actually the closing price on the previous day) and sells them immediately at the fair market value. Similarly, the seller sells at the agreed price (which is actually the closing price on the previous day) the bonds, which he buys from the clearing house at a market price each day prior to sale. As mentioned, this daily accounting does not have tax consequences. This is because gains and losses are not deemed for tax purposes to be realized before the expiry date or the date when someone disposes of the contract by transfer or offsetting. Apparently, the Hungarian practice of treating "gains" as capital gains rather than ordinary income is not in line with international practice. The reason for the Hungarian approach may be that the FDI market is only in its infancy in this country. In contrast to the capital-oriented practice applicable to non-traders, traders are subject to the mark-to-market requirement. However, they are not obliged but merely allowed to recognize non-realized gains (against which they may make provisions). Premium expenses paid to traders are recognized not earlier than the date the contract is terminated because of expiry, or by offsetting or disposal.

The tax treatment of the gains or losses arising from futures is basically the same as that applying to gains derived from simple forward contracts. Hence, individuals, whether domestic or foreign resident persons, suffer from withholding tax. Some uncertainty remains regarding the futures contracts based on the stock exchange index. In this case, because of the lack of real capital, one can argue that the gains cannot be qualified as capital gains. Instead, gains or losses fall under the authority of a special tax regime. Hence, under treaty law, the other income article (Article 21 of the OECD Model Treaty) can be relevant to the income derived from futures. Under Hungarian income tax treaties, the application of this article in practice implies tax exemption in the source country.

B. Options

Standardized options have not yet been introduced to the Budapest Stock Exchange. The accounting rules are the same whether options are implemented on the exchange or not, or whether they are used as instruments of hedging or not. In Hungary the mark-to-market principle does not apply to options. So the year-end gain is not to be recognized in any way.[52]

Three examples are presented concerning accounting for options. It is assumed that the fiscal year coincides with the calendar year and that neither the issuers nor the holders are traders.

52. Interest-rate guarantee agreements can be made on the over-the-counter market. This way, a borrower or a lender can be protected by cap or floor agreements (or by collars) in return for the payment of a fee. These transactions are modelled on options.

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In the first case, on 30 September 1997, A issues an option to B to buy his stock of shares in corporation X for HUF 150 per share before 31 March 1998. B pays an option premium of HUF 20 per share. On 31 December, the fair market value is HUF 160 per share. On 31 March, the option lapses without being exercised.

B will not exercise his right to buy shares in corporation X if the share price falls below HUF 150 per share. At the time of expiry, the option premium of HUF 20 will be accounted for as an expense. At the same time, A will recognize the option premium as part of his receipts.

In the second case, on 30 September 1997, C issues an option to D to buy his stock of shares in corporation Y for HUF 150 per share before 31 March 1998. D pays an option premium of HUF 20 per share. On 31 December, the market value is HUF 220 per share. On 15 February, D exercises the option. The current market value is at that time HUF 200 per share.

D will record the shares purchased in his books at a value of HUF 150 per share on 15 February 1998. He will record a value of HUF 150 per share because this is the acquisition price he will have paid. He will not show gains or losses unless he disposes of the shares acquired. If he sells the shares on 15 February, he will realize a gain of HUF 50 per share because the market price per share is HUF 200 at that time. The premium of HUF 20 per share is an expense D will account for on 15 February while C as an option writer will recognize the receipts derived from the option premium at the same time. It may occur that D will only dispose of his shares later. However, he is allowed to account for the expense of the option premium at the time of acquisition, so he does not have to wait until the time of disposal.

In the third case, on 30 September 1997 E issues an option to F to buy his stock of shares in corporation Z for HUF 150 per share before 31 March 1998. F pays an option premium of HUF 20 per share. On 15 December, F sells the option to G. Its price is HUF 80 per share. On 31 December, the market value is HUF 220 per share. On 31 March, G exercises the option. The current market value is at that time HUF 210 per share.

F will recognize a gain of HUF 60 per share on 15 December, at the time when the option is sold, by accounting for the receipts of HUF 80 per share and expenses of HUF 20 per share. On 31 March, G, the new owner, will obtain the shares at a value of HUF 150 per share as stipulated in the contract. Provided that he immediately sells the shares, he will realize a gain of HUF 60 per share on the same day because the market price is at that date HUF 210 per share. At the time of acquisition, that is, on 31 March, G will get relief for the cost of the option he purchased. This is also the time for E, who is the option writer, to recognize the receipts derived from the option premium. Since G will have paid HUF 80 per share, which exceeds the gain of HUF 60 per share that is derived from the option, G will eventually show a loss.

In all three cases the tax consequences follow the accounting rules.

C. Swaps

Example: The accounting treatment of currency swaps is simpler, so there is no independent sample calculation of currency swaps. A Hungarian resident company, which is not engaged in a regular trade in derivatives, borrows short term, say in US dollars, at a fixed interest rate of 8.5 per cent and, relying on its strong financial position and a boom on the financial markets, swaps with a Hungarian commercial bank for LIBOR, so the bank:

- pays 8.5 per cent to the company; and
- receives LIBOR from the company.

At the time of payment it turns out that the LIBOR rate is 8 per cent. The bank therefore suffers a loss reflecting the difference of 0.5 per cent in the rate while the company gains from the same difference. In Hungary the transaction must be accounted for by relying on the linked approach method. Then it is only the difference between the receipts and expenses relating to the two transactions, which is accounted for. Assuming that the above company has fiscal residence in a country other than in the country of the bank, then this company may be subject to withholding tax in the source country. So far as the said company is not-Hungarian tax resident while its party to a swap is Hungarian resident, there is no Hungarian tax payable because capital gains derived by foreign corporations are exempt from Hungarian corporate tax. In the case where the principal borrowed by the company is USD 1 million, it accounts for the annual interest amount of USD 85,000 less USD 5,000, that is USD 80,000. This is because the interest payable by this company may be reduced by the differential gained from the swap of interest flows.

For foreign corporate investors, it would not be beneficial if the income derived from swaps was qualified as interest because interest income under Hungarian corporate tax law is subject to an 18 per cent withholding tax[53] while capital gains are tax exempt. However, to the extent that the separate transactions constituting the swap shall not be treated in Hungary separately, there is no interest income that would be taxable. As mentioned, foreign individual investors deriving gains from swap transactions carried out on the stock exchange are subject to a 20 per cent withholding tax unless they benefit from treaties.

D. Original issue discount bonds

In the examples below, it is assumed that there are Hungarian resident corporations operating as accrual-basis businesses. It is also assumed that they are not traders, and that the fiscal year coincides with the calendar year. In the first case, on 1 January 1996, Company A issues a zero-coupon bond which matures on 31 December 2005. The redemption value is HUF 10 million. The annual yield to Investor X is 10 per cent. Investor X acquires the bond on its issue for HUF 3,855,000. On 31 December 2005, X redeems the bond for HUF 10 million. As an accrual-basis business organization subject to the

53. § 15(2) Corporate Tax Act.

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Hungarian accounting law, X is obliged in 1997 to recognize the fraction of non-realized receipts that relate to 1997. This is because Company X is subject to mark to market each year until the expiry. Of course, Company A as an accrual-basis issuer is allowed to recognize the interest expense that relates to the current year. In the second case, on 1 January 1996 Company B issues a bond carrying 2.5 per cent interest which matures on 31 December 2005. The redemption value is HUF 10 million. The annual yield promised is 10 per cent. Investor Y acquires the bond on its issue for HUF 4,852,000. On 31 December 2005, Y redeems the bond for HUF 10 million. In this case, the original issue discount is subject to the same accounting regime, provided that both the issuer and the investor are accrual-basis business organizations subject to the Hungarian accounting law.

In the third case, on 1 January 1996, Company C issues a bond carrying zero per cent interest which matures on 31 December 2005. Again, the redemption value is HUF 10 million. The annual yield promised is 10 per cent. Investor P acquires the bond on its issue for HUF 3,855,000. On 31 December 1998, P sells the bond to Q for HUF 5,800,000. On 30 June 2002, Q sells the bond to R for HUF 6,900,000. On 31 December 2005, R redeems the bond for HUF 10 million. As was discussed above, accrual-basis business organizations subject to Hungarian accounting law continue to be subject to mark to market as long as the acquisition price is below the par value. Hence, in the period 1996-1998, P recognizes the interest fractions that relate to the relevant years. In addition, in 1998 P also recognizes a capital gain calculable as the difference between HUF 5,800,00 and HUF 3,855,000. Again, Q will recognize the interest fractions relating to the period 1 January 1999-30 June 2002. In 2002, Q will also recognize a gain calculable as the difference between HUF 6,900,000 and HUF 5,800,000. Each year R will recognize the interest fractions relating to its ownership period (30 June 2002-31 December 2005) on the basis of the difference between the redemption value and the acquisition value of HUF 6,900,000.

The tax consequences of the above transactions follow the accounting treatment. As mentioned, for a Hungarian resident corporate taxpayer, it does not matter whether the income is held to be interest or capital gains because both elements of income are part of taxable income calculable according to the normal tax rules. It is however worth discussing the tax liability to be assumed by foreign beneficiaries in more detail. To the extent that foreign corporations are not subject to the Hungarian accounting law, there are no accounting profits to be shown. Therefore in the absence of the source being located in Hungary no Hungarian tax liability exists. I.e. to the extent that the income derived by foreign corporations from the discount is to be qualified as capital gains, foreign corporations enjoy tax exemption in Hungary. Capital gains derived by foreign individuals may be taxable under Hungarian law, but the 20 per cent withholding tax can be avoided by treaty.

V. RECOMMENDATIONS

It is important to create a fiscal environment for transactions in FDIs, which does not impede innovation and is transparent enough for national tax authorities to tackle abuse. To this end, the following guidelines may be considered helpful in the case of Hungary:

- the laws on foreign exchange control should be liberalized to facilitate the Hungarian market in FDIs;
- in the long run, the application of the principle of fiscal disparity must be reviewed; in the short run, the accounting for capital losses must be restricted in a way that they should only be recognized to the extent that they reduce capital gains, but they do not affect operating income;
- the accounting for pending transactions must be developed to promptly reflect the real financial expectations and, simultaneously, maintain the possibility of later adjustments;
- parties to futures should be authorized to recognize the gains or losses as reflected in variation deposits from day to day;
- the separate accounting method should be substituted in particular cases for the linked approach by providing that professional traders may opt for integration;
- credit institutions and financial enterprises should be subject to a greater degree to the mark-to-market principle;
- financial enterprises active in the trade in FDIs should get access to tax deductible provisions, in a similar manner to credit institutions;
- anti-avoidance legislation should be introduced to combat mismatching in the case of discount bonds with regard to an accrual-basis debtor and a cash-basis creditor;
- detailed tax rules should be introduced on how to interpret the income derived from swaps and original issue discount bonds for fiscal purposes; and
- uncertainty should be removed for fiscal purposes about the nature of the income derived by individuals from transactions in FDIs so that this type of taxable income should uniformly and unambiguously be treated as capital gains.

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RUSSIA

TAX PENALTIES AND THEIR APPEAL IN RUSSIA

THE CURRENT SITUATION AND LIKELY DEVELOPMENTS

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I. INTRODUCTION

Russia is currently undergoing one of the most critical stages in its history. A number of recent political and legal developments give cause for optimism for both the international and Russian business communities. However, there is a major obstacle in the way of any potential investor seeking to enter the emerging and highly promising Russian market. This obstacle is the Russian tax system.

Certainly, problems in the local tax system do not appear at random. Rather, they reflect a country's social and political situation. The Russian tax system was effectively born only at the end of 1991, when a number of federal laws establishing the major Russian federal taxes were enacted. Since then, these laws have been regularly and chaotically amended. The constantly changing and erratic Russian tax rules make it virtually impossible for foreign and domestic investors in Russia to engage in long-term manufacturing and construction projects in Russia.

Unfortunately, in most cases these tax law amendments pursue exclusively fiscal purposes. Traditionally in Russia the tax laws have not had any business policy objectives, or any regard for the underlying business concepts, which makes the financial effect of the tax laws on many business transactions almost unpredictable. As a result, the current Russian tax framework is erratic, complicated and unfair. Ultimately, it does not provide incentives for business development.

One of the major tax evils in Russia is the tax penalty system. For the most part, it is extremely severe and badly regulated. Basically, it does not matter whether a taxpayer has committed a tax violation intentionally or erroneously. In almost all cases, the tax penalties are the same. As a result, honest corporate citizens are treated in the same manner as inveterate tax evaders.

Fortunately, the draft Russian Federation Tax Code (the "Tax Code"), which was recently approved in its first reading by the Russian State Duma,[1] the lower chamber of the Russian Parliament, gives some hope that this negative trend will change for the better in the foreseeable future.

II. TAX PENALTIES AND THE APPEAL PROCEDURE UNDER CURRENT LAW

A. Tax penalties

At present, Russian law imposes penalties for tax violations on the basis of the following two laws: Russian Federation Law No. 2118-1 "On the Tax System in the Russian Federation" of 27 December 1991, as amended (the "Tax System Law"), and Russian Federation Law No. 943-I "On the State Tax Service of the RSFSR" of 21 March 1991 (the "State Tax Service Law").

Under these two laws, there are four groups of tax violations:

a. If a taxpayer conceals or decreases the amount of the taxable income for profits tax purposes or the tax basis for any other tax (e.g. VAT), the taxpayer is subject, respectively, to the confiscation of the entire concealed or decreased amount of taxable income or the amount of the tax due. In addition, the taxpayer is subject to a fine of an equal amount.

b. If a taxpayer does not account for all of its taxable items, the taxpayer is subject to a fine in the amount of 10 per cent of any taxes due from such omitted taxable items, which the tax authorities have discovered. The taxpayer is subject to the same fine if it fails to account properly for all of its taxable items.

c. If a taxpayer fails to present to the tax authorities any documents necessary for calculating and paying taxes (e.g. tax returns), the taxpayer is subject to a fine in the amount of 10 per cent of the tax due from it. The same fine applies if such documents are presented late.

d. If a taxpayer fails to pay a tax on the date when the tax is due, the taxpayer is subject to a daily fine of 0.3 per cent of the amount of the tax due.

1. The Tax Code was drafted over a period of nearly four years by a special group of the Russian Government. In early May 1997, the Government finally submitted the Draft Tax Code for the consideration of the State Duma. In June 1997, the Duma unexpectedly approved the Draft Tax Code in its first reading. (Under Russian constitutional law, every federal law must be approved in three readings by the State Duma, then ratified by the Federal Council, the higher chamber of the Russian parliament, and thereafter approved and signed by the President.) Despite such surprisingly quick initial approval by the State Duma, most experts believe that the Tax Code is still unlikely to be finally approved this year and, consequently, it is unlikely to come into force even in 1998.

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Russian law does not currently distinguish between intentional violations and those made by negligence. As an exception to this rule, Presidential Decree No. 685 of 8 May 1995, provides that, if a taxpayer makes a technical error in preparing its tax calculations, which results in the underpayment of taxes, it should not be subject to any tax penalties other than fines for late payment. However, the applicability of this relief is somewhat limited. First, the taxpayer must reveal this error and disclose it to the tax authorities, before the tax authorities discover it in the course of their audit. Second, the concept of a "technical error" is not clearly defined in the tax legislation and is subject to a narrow interpretation by the tax authorities.

Hence, the actions of nearly every taxpayer will almost inevitably result in the levying of tax penalties and fines, if, in the opinion of the tax authorities, they resulted in the underpayment of taxes. Under current law, the tax authorities may impose penalties on corporate taxpayers without recourse to any court.[2] The Russian Constitutional Court has recently issued a ruling generally prohibiting the tax police (i.e. the law enforcement branch of the fiscal authorities, who investigate cases involving tax evasion and ensure the safety of the tax authorities) to impose penalties on taxpayers without prior recourse to a court. In contrast to the tax police, the tax inspectorates, who are generally responsible for the collection of taxes, are not forbidden by this ruling from imposing tax penalties on taxpayers without a court procedure.[3]

Thus, if the tax inspectorate concludes, in the course of a tax audit, that a taxpayer has underpaid certain taxes or has otherwise violated the tax law, the tax inspectorate needs to simply file a debit notice against the funds deposited in the taxpayer's bank account and withdraw the funds equal to the amount of the tax arrears and penalties.

Article 12 of the Tax System Law generally states that a taxpayer is entitled to challenge the actions of the tax authorities and the tax officials in the manner provided by law. In reality, a taxpayer may follow one of two tactics to appeal an adverse decision of the tax authorities, namely: an administrative appeal to the superior tax bodies, or an appeal to the arbitration court.

B. Administrative appeal with the superior tax bodies

Under the administrative appeal procedure, a taxpayer may challenge a decision of a particular tax inspectorate or tax official before a superior tax authority.[4]

At the present time, the administrative appeal procedure is very poorly regulated. In fact, Article 14 of the State Tax Service Law provides only that a superior tax inspectorate must consider a taxpayer's complaint within 30 days after it is filed. No other federal law further specifies the procedure in detail. Moreover, to date the State Tax Service has not issued any binding instruction regulating the administrative appeal procedure. Under Article 25 of the Tax System Law, the State Tax Service may issue instructions implementing the tax legislation. The Higher Arbitration Court ruled several years ago that no other letters, rulings or other regulations issued by the State Tax Service have binding force.[5] However, even the internal regulations which have been issued by the State Tax Service do not shed much light on the issue and, in fact, are contradictory and inconsistent.[6]

In brief, the administrative appeal procedure is as follows. Within ten days after its receipt of the report drafted by the tax inspectorate alleging tax violations, a taxpayer may present to the tax inspectorate an *act of disagreement* contesting the conclusions contained in the report. Russian law does not establish any special form for such a document. Rather, a taxpayer may simply lay out in this act the reasons for its disagreement with the conclusions of the tax inspectorate. Subject to its review of this act, the tax inspectorate issues a decision imposing tax fines on the taxpayer after the above-mentioned ten-day term elapses. Then, within five days of its receipt of the decision, the taxpayer may voluntarily pay the amount of the penalties. If it does not do so, then the tax inspectorate may issue a debit notice against the taxpayer's bank account and withdraw the funds from that account without recourse to a court. Within 30 days of its receipt of the report, the taxpayer may still file a complaint with the superior tax inspectorate. Within 30 days after its receipt of this complaint, the superior tax inspectorate must issue a decision confirming or repealing (wholly or partially) the decision of the lower tax inspectorate. If the taxpayer is dissatisfied with the decision of the superior tax inspectorate, it may file a complaint with the State Tax Service in Moscow, which must consider the complaint within 30 days (in practice, this usually takes several months). Finally, the State Tax Service must issue a decision confirming or repealing (wholly or partially) the decision of the lower tax inspectorate or the decision of the superior tax inspectorate.

As discussed above, this entire administrative procedure is governed by several rulings of the State Tax Service. All of the legal steps and terms specified above are, therefore, subject to interpretation by the tax authorities. In practice, the chances of obtaining a positive decision from an administra-

2. Art. 13 of the Tax System Law.

3. Resolution No. 20-P of the Constitutional Court of the Russian Federation of 17 December 1996. By this Resolution, the Constitutional Court ruled that the provisions of the Russian Federation Law "On Federal Bodies of Tax Police", which allegedly permit the tax police to withdraw the amount of tax penalties from taxpayers' bank accounts without recourse to a court, contradict Art. 35 of the Constitution of the Russian Federation. This Article provides that no person may be deprived of his/her property otherwise than by a court decision. The Constitutional Court ruled that the tax police may not withdraw the amounts of tax penalties from taxpayers' bank accounts, unless there is a valid court decision to this effect. For equivocal reasons, the Constitutional Court held, however, that the tax police still may withdraw amounts of tax arrears and fines for late payments from taxpayers without recourse to the courts. Certainly, this conclusion is highly debatable. In any event, this Resolution is, at a minimum, a highly positive move forward toward a more civilized tax environment.

4. There are three levels of tax authorities in Russia: the municipal tax inspectorates, the regional tax inspectorates (i.e. the tax inspectorates of those administrative units which are considered subjects of the Russian Federation, e.g. the Cities of Moscow and St. Petersburg), and the Russian Federation State Tax Service.

5. Letter No. S1-7/OP-373 of the Higher Arbitration Court of 31 May 1994.

6. See, for example, Recommendations on the Application of Penalties for Tax Violations by the State Tax Inspectorates approved by Letter No. VG-6-14/344 of the State Tax Service dated 6 October 1993.

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tive appeal are fairly limited. Most importantly, the filing of a complaint does not entitle the taxpayer to obtain an injunction against the tax inspectorate's implementation of its decision (e.g. debiting the taxpayer's bank account). Sometimes, the superior tax inspectorate may instruct its lower branch to suspend the imposition of penalties until the complaint has been considered. Such cases, however, are rather the exception than the rule. Besides, the lower tax inspectorate is not even legally bound by such an instruction from its superior body.

In summary, the administrative appeal process is overwhelmingly bureaucratic and is unlikely to result in the repeal of the initial claims brought by the tax authorities. In fact, this is hardly a surprise, because the local tax inspectorates take most of their decisions on the basis of the implementing regulations issued by the superior tax authorities. Therefore, when a taxpayer brings its claim to a regional or federal tax authority, it is requesting the tax bureaucrats basically to reverse their own directives. They are of course most unlikely to do so. Lastly and most discouragingly, even if a taxpayer initiates an appeal of its case through the tax authorities, they may still at any moment come after the taxpayer's assets. Accordingly, most taxpayers prefer, immediately after the first administrative appeal is rejected, to file a lawsuit rather than to continue the predictably unfruitful administrative appeal process.

C. Appeal in the arbitration court

The procedure for an appeal in the arbitration court is governed by the Russian Federation Arbitration Procedural Code (the "Arbitration Code").[7]

Under the Arbitration Code, a taxpayer may file two major types of lawsuits against the tax authorities: (i) a taxpayer may challenge the legality of a decision of the tax authorities imposing penalties; and (ii) a taxpayer may challenge the illegitimate withdrawal of funds from its bank account by the tax authorities.[8] In practice, in most cases the taxpayers prefer to contest the validity of the decisions by the tax authorities, rather than to fight for the repayment of already withdrawn funds. Indeed the first approach has a number of advantages. First, when filing such a lawsuit, a taxpayer does not bring any property claims against the tax authorities and, hence, may pay a nominal state duty of only ten times the minimum monthly wage (i.e. approximately USD 140). Whereas, when a taxpayer files a lawsuit containing property claims, the stamp duty is calculated as a percentage of the amount in dispute (but not more than 1,000 times the minimum monthly wage).[9] Second, such lawsuits may be filed regardless of whether any funds have already been withdrawn from the taxpayer's account. The taxpayer may also apply for an injunction order prohibiting the tax inspectorate from imposing any fines before the arbitration court procedure is completed, which, of course, is not an option if the funds have already been taken from the taxpayer. Third, but not the least important, statistically the judges appear to be more willing to satisfy the first type of lawsuit, primarily because they do not have to confront the issue of whether the state budget will be obliged to return any funds which have already been used for some "socially meaningful" purpose.

If a taxpayer decides to bring a lawsuit against the tax inspectorate, it must apply to the local arbitration court where the tax inspectorate is located. If the taxpayer decides to challenge in court a decision of the State Tax Service, it must file a suit directly with the Higher Arbitration Court, which, in this case, will act as the court of "first instance". Importantly, the taxpayer may initiate the arbitration court appeal procedure regardless of whether it has been involved in the administrative appeal process. Under the general limitation rules, the taxpayer may file a lawsuit within three years after the tax authorities have adopted a relevant decision (or have withdrawn funds from the taxpayer's bank account).

In practice, before a taxpayer decides to file a lawsuit, it should carefully examine whether any similar cases have ever been heard by the Higher Arbitration Court. Although prior decisions of the Higher Arbitration Court are not automatically binding on the lower courts, in practice a lower arbitration court will inevitably be persuaded by a decision of the Higher Arbitration Court when considering any substantially similar dispute. Therefore, a taxpayer may reasonably expect a favourable outcome for its dispute if there has already been a positive decision on a similar case heard by the Higher Arbitration Court.

Theoretically, through the appeal procedure, a taxpayer may take its dispute all the way to the Higher Arbitration Court in the hope that the latter will reverse its prior decision. In practice, however, it is quite difficult to convince the Higher Arbitration Court to reverse its own prior decision. Indeed to date it has not done so.

In summary, the arbitration court appeal procedure is as follows. After the tax inspectorate issues a decision imposing tax penalties on the taxpayer, the taxpayer may immediately file a lawsuit with the arbitration court where the tax inspectorate is located. The taxpayer may also submit a substantiated petition for an injunction order prohibiting the tax inspectorate from imposing any fines before the arbitration court procedure is completed. The court must consider an application for an injunction order within one day after it is filed.[10] The court is not required to grant the injunction, but, in practice, it normally does so, particularly where it is obvious that the decision in dispute is incorrect.

7. The system of arbitration courts in Russia is separate from the system of common courts. The arbitration courts hear cases involving economic disputes between legal entities, as well as disputes between legal entities and governmental agencies, e.g. the tax authorities. Generally, they may not hear cases involving individuals. In contrast, the common courts primarily hear cases involving individuals. The Arbitration Code regulates the structure of the arbitration courts, as well as the trial and appeal procedures in the arbitration courts. The system of arbitration courts consists of four major elements: (i) the lower local arbitration courts; (ii) the appeal panels of the local arbitration courts; (iii) the Federal Circuit Appeal Courts; and (iv) the Higher Arbitration Court.
8. Art. 22 of the Arbitration Code.
9. Art. 2 of Russian Federal Law No. 226-FZ "On State Duty" of 31 December 1995, as amended.
10. Art. 75(2) of the Arbitration Code.

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Within 30 days after the lawsuit is received, the arbitration court must try the case. As a general matter, the court may either reject the claims or satisfy them wholly or partially. If the taxpayer or the tax authorities are not satisfied with the court's ruling, then either of them may file an appeal to the appeal panel of the arbitration court within 30 days after the issuance of the lower court's decision. In turn, the appeal panel must hear the case within 30 days after it receives the appeal. The appeal panel may either (i) confirm the initial decision of the arbitration court; (ii) repeal it wholly or partially and return the case to the arbitration court for retrial; or (iii) issue its own decision in the case. The decision of the appeal panel becomes effective immediately. The injunction order ceases to be effective upon the issuance of the decision by the appeal panel. Thereafter, within 30 days after the decision is issued by the appeal panel, it may be challenged in a Federal Appeal Court of the relevant circuit. (Notably, the initial decision of the arbitration court may be directly appealed to the relevant Federal Appeal Court without first passing it through the appeal panel). The Federal Appeal Court must try the case within 30 days after it receives the appeal. The decision of the Federal Appeal Court becomes effective immediately and may not be appealed by either the taxpayer or the tax authorities.

As a final resort, however, the Chairman of the Higher Arbitration Court and the State Prosecutor may initiate their own judicial review of a decision of any arbitration court, including the Higher Arbitration Court, on the ground that it contradicts the law or is not properly substantiated. The Presidium of the Higher Arbitration Court tries such an appeal. The Deputies of the Chairman of the Higher Arbitration Court or the State Prosecutor may bring an appeal against a decision of any arbitration court, other than the Higher Arbitration Court.

Although, at first glance, the arbitration court appeal process appears to be rather ponderous, in reality it is often surprisingly quick and effective. Normally, it does not take more than three to four months to go through all of the stages up to the Federal Appeal Court. Although, generally, the judges in Russia do not have a strong tax academic background, they are not under the same political pressure as the tax officials are under. Also, they more readily refer to the tax legislation, rather than to the internal regulations issued by the tax authorities. Since most of the disputes arise from different constructions of the tax laws by the taxpayers and the tax authorities, the judges are often at least willing to interpret the tax laws themselves, in order to find the most reasonable and rational interpretation. Moreover, the Russian Constitution and the Arbitration Code lay out an important principle, under which the courts must disregard the provisions of any normative act or letter issued by a governmental agency, if such provisions contradict the federal laws.[11]

On the other hand, in many instances, the taxpayers are still to a large degree "rolling the dice" when bringing an appeal in the arbitration court, because the Russian courts, particularly the Federal Appeal Courts, are frequently "pro-tax-inspectorate" in tax cases. This is partially because the judges themselves have no expertise or even competence in tax matters, which they generally consider to be a complicated and highly technical field. This leads them to defer to the expertise of the tax authorities. Furthermore, in many instances, they also tend to favour the tax authorities because they recognize the Russian Government's extreme need to increase tax revenues and to enforce tax collections.

It is worth mentioning that corporate taxpayers may also bring some of their disputes in the tax area to the common courts or even to the Russian Federation Constitutional Court. In particular, any taxpayer may challenge in the common courts the validity of a normative act issued by any governmental agency.[12] Furthermore, a taxpayer may, theoretically, even apply to the Russian Federation Constitutional Court if it is seeking to oppose the validity of a federal law as being in conflict with the Constitution.

Hopefully, with the enactment of the Tax Code, Russian taxpayers will enjoy a more certain and favourable tax regime and, most critically, receive the additional tools needed to protect their legal rights.

III. TAX PENALTIES AND THE APPEAL PROCEDURE UNDER THE TAX CODE

A. General trends

The Tax Code consists of four parts: (i) the General Part, (ii) Federal Taxes, (iii) Regional Taxes, and (iv) Local Taxes. The General Part lays down the major principles of the future Russian tax system. More than a quarter of the General Part (i.e. 112 articles) deals with tax violations, their investigation and their appeal.

In general, the Tax Code attempts to create a distinct and consistent terminological and definitional base for Russian tax legislation, as well as to establish a clearer legal relationship between the tax authorities and the taxpayers.

Although, undoubtedly, the Tax Code represents a radical move towards a more civilized tax community, many of its provisions on tax violations still pursue, to a high degree, almost exclusively the fiscal interests of the state. Some of its provisions are internally inconsistent, contradictory and confusing. Therefore, to ensure that the Tax Code will truly improve the business environment, certain of its provisions should be further examined and modified to exclude potential controversies and infringements of taxpayers' basic constitutional rights.

11. Art. 122 of the Constitution of the Russian Federation and Art. 11 of the Arbitration Code.

12. A normative act is any regulation issued by an authorized governmental agency, which regulates a certain legal relationship and applies to an indefinite number of persons. For example, only instructions issued by the State Tax Service have this status and, therefore, are binding for taxpayers. Recently, taxpayers have become proactive in challenging the validity of the State Tax Service Instructions themselves with the Supreme Court of the Russian Federation (a higher common court in Russia).

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B. Tax penalties

Remarkably, the Tax Code finally distinguishes between deliberate and negligent tax violations.[13] As a result, the severity of the tax sanctions will depend on whether a taxpayer has committed a tax violation intentionally or by negligence. Regretfully, if read narrowly, the Tax Code presumes that a taxpayer has deliberately violated the tax laws, and puts the burden to prove the opposite on the taxpayer.[14] In a certain sense, this provision contradicts Article 49 of the Russian Constitution, which presumes that a person accused of a law infringement is innocent unless proven otherwise.

As a very positive development, the Tax Code exempts a taxpayer from liability for tax violations (i) if the taxpayer has committed a non-intentional tax violation because of *force majeure*, or (ii) in the event that a taxpayer was relying on an official ruling or normative act issued by the appropriate authorities, which was later held to be unlawful by an appropriate court.[15] It is important to note that the Tax Code also provides that, if any tax violation results in criminal liability or liability under the customs legislation, then no tax penalties may be applied.[16]

Further, the Tax Code introduces the concept of "tax amnesty", pursuant to which the tax authorities may exempt from tax liability a taxpayer which has negligently violated a tax law. To enjoy a tax amnesty, the taxpayer must inform the tax authorities of the negligent tax violation before the tax authorities have revealed such violation and before they have notified the taxpayer about an upcoming tax audit. Logically, however, such a regime should to some extent be available to a taxpayer regardless of whether it was notified of the tax audit. Otherwise, the taxpayer is essentially stimulated not to cooperate with the tax authorities in the course of a tax audit.

Positively, the Tax Code establishes a 5-year limitation term, within which the tax authorities may bring claims against a taxpayer which has violated the tax law. On the other hand, such a limitation term is deemed negated if the taxpayer commits another tax violation before the initial limitation term elapses. The Tax Code does not specify whether such a violation must be the same as the initial one or just any violation. Undoubtedly, such broad wording makes the limitation concept almost meaningless.[17]

The Tax Code further empowers the tax authorities to decrease or increase the amount of the basic tax penalties, under certain extenuating or, to the contrary, aggravating circumstances. It generally appears that the tax authorities, as an interested party, should not be entitled to change at their discretion the amount of the tax liability. Rather, this authority should vest with the courts.[18]

Chapter 20 of the Tax Code provides for 25 types of tax violations, including, *inter alia*, evasion of tax registration, non-filing of tax returns, violation of bookkeeping procedures, tax evasion, exerting unlawful influence on tax authorities, etc. For most minor tax violations, the Tax Code establishes penalties calculated as a certain multiple of the minimum monthly wage. Whereas for major tax violations, the tax penalties are calculated as a percentage of the underpaid taxes or taxes due.

On one hand, such diversity in classifying tax violations is an obvious improvement, because it allows the authorities to treat more equitably the various actions of taxpayers. Also, in many cases the Tax Code shifts liability from the taxpayers to their banks, if the latter fail to properly fulfil the instructions of the taxpayers to pay their tax obligations.[19] Importantly, the tax penalties are dependent on whether the tax violations are intentional or negligent.

On the other hand, such diversity raises a lot of questions. First, the tax officials may simply lack sufficient academic background and legal skills to reasonably interpret the factual circumstances which have resulted in a particular tax violation. Second, the general wording of this Chapter makes a frontier between certain violations almost elusive, although the applicable tax penalties may differ dramatically.[20] Third, in several instances, the Tax Code does not clearly define the scope of the relevant violations.[21]

Chapters 21 through 27 of the Tax Code thoroughly regulate the various aspects of the proceedings on tax violations from the discovery of a tax violation by the authorities through to the issuance of a decision imposing penalties on the taxpayer or, in certain instances, closing the case. Generally, in this part the Tax Code closely follows the pattern set forth in a number of other Russian Codes regulating other branches of Russian administrative law (e.g. the Russian Federation Customs Code and the Russian Federation Code on Administrative Offences).

C. Administrative appeal

Surprisingly, only seven articles of the Tax Code are directly devoted to the appeal procedure. As a basic rule, a taxpayer

13. Art. 254 of the Tax Code.
14. Art. 254(2) of the Tax Code.
15. Art. 256 of the Tax Code.
16. Art. 252(3) of the Tax Code.
17. Art. 260 of the Tax Code.
18. Arts. 257, 258 and 261 of the Tax Code.
19. Currently, a tax obligation is deemed to be fulfilled when the necessary funds physically come to the appropriate budget account. Under the Tax Code, a taxpayer will be deemed to have performed its tax obligation, after it has instructed its bank to make a tax payment, provided that there are sufficient funds in its bank account. Accordingly, in such cases, the tax authorities will apply tax penalties to the bank and not to the taxpayer.
20. For example, Arts. 276 and 277 provide for two different types of tax violations: (i) violations in the procedure for the keeping of records and (ii) evasion of the keeping of records, respectively. Under the current draft of the Tax Code, the difference between these two violations is fairly subtle. The penalties, however, differ dramatically. In the first case, the penalty is equal to 30 minimum wages (approximately USD 430 at the current exchange rate), whereas, in the second case, the penalty may be as high as 80 per cent of the taxes due for the period in question, but no less than 600 minimum wages (approximately USD 8,600).
21. For example, Art. 293 subjects a taxpayer to a fine equal to 50 minimum wages for exerting illegal influence on a tax body. When defining what "illegal influence" means, the Tax Code refers to a "commitment by a person toward unlawful actions in order to affect a decision taken by the tax body..." The Tax Code, however, does not specify what may constitute "unlawful actions". Undoubtedly, this Article should be further amended to ensure that it does not leave any room for interpretation.

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may challenge a decision of the tax authorities imposing tax penalties only within 20 days after it is issued. As is currently the case the taxpayer may file a complaint either with the superior tax body or with the arbitration court.[22] However, in contrast with the current procedure, the taxpayer may contest a decision of the superior tax body only at the arbitration court.[23] The taxpayer must file this second appeal within ten days of its receipt of a decision from the superior tax body. Apparently, by introducing such a short term for appeal, the legislature intends to accelerate tax proceedings and to make them more efficient. It is evident, however, that such time periods may simply be inadequate, particularly in complicated multi-issue tax disputes. To be fair to the drafters of the Tax Code, it should be noted that the Tax Code permits the superior tax body or the court hearing an appeal to restore the limitation term if they deem that a taxpayer has missed this term for good reasons.[24]

As a rule, the superior tax body must consider a complaint within 30 days after its receipt (or 15 days if the review of the complaint does not require any additional examination or audit).[25]

Most importantly, if the taxpayer files a complaint challenging the imposition of tax penalties, such penalties may not be levied until after the appeal procedure is completed.[26] In contrast, the taxpayer's filing of a complaint against any other decision of the tax authorities does not suspend the decision.[27]

D. Appeal in the arbitration court

Basically, the Tax Code does not change the arbitration court appeal process. Thus, this process will essentially remain the same and will be governed by the Arbitration Code. The Tax Code envisages that every arbitration court will have a tax board, i.e. a separate department of the court dealing exclusively with tax disputes. Such novelty should certainly be hailed, because, at least in the long term, it should improve the quality of the tax litigation and make it more professional and efficient. At the same time, the sharp limitation of the appeal terms cannot but cause some astonishment.

IV. CONCLUSION

Of course, it is almost impossible to cover in one short article all of the problems and trends associated with tax disputes in Russia. We hope, however, that this overview will provide our readers with a fair idea of the perplexity and the multiformity of tax proceedings in Russia.

The only way by which Russia can overcome the existing chaos in its tax system is to reform the tax law and to consolidate it under the "umbrella" of a new formal tax code. At the same time, by introducing a tax code, Russia should not make its tax system oversophisticated. Subject to its legal, political and economic peculiarities, Russia should prudently utilize the tax concepts and mechanisms which have proved to be efficient over many years in other jurisdictions. Provided that such concepts are carefully applied to Russia's present legal framework, Russia may be able to defuse its existing tax crisis much more quickly and smoothly, and, consequently, accelerate its new positive economic and social developments.

22. Art. 404 of the Tax Code.
23. Thus, the administrative appeal process under the Tax Code is effectively limited to a one-stage appeal.
24. Art. 404(4) of the Tax Code. Evidently, the Tax Code should further explain what reasons should be deemed "good" for the purposes of this Article.
25. Art. 408 of the Tax Code. As in many other instances, this Article does not define in which cases a complaint does not "require additional examination or audit", thereby providing the possibility for various abuses. Notably, this Article allows the head of the respective tax body or his/her deputy to extend this term up to three months, if he/she considers this necessary. Again, such wording is scarcely clear. Finally, if a decision of the tax authorities is contested by a public prosecutor, the tax authorities must consider his/her objection within 10 days.
26. Art. 409 of the Tax Code. The same rule applies if a public prosecutor files an objection.
27. E.g. a decision of the tax authorities obligating a taxpayer to present certain documents to the tax authorities or a decision to initiate a criminal investigation against the taxpayer.

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CENTRAL AND EASTERN EUROPE

PRESUMPTIVE TAXES IN CENTRAL AND EASTERN EUROPE

Steve Harrison*

I. INTRODUCTION

A presumptive tax may be defined as one which is levied on income which a taxpayer is presumed to have received, rather than on his or her actual income.[1] The justification for a presumptive tax is essentially pragmatic: it is used instead of a tax on actual income (hereinafter "an income tax") because an income tax cannot be effectively or efficiently administered in the prevailing circumstances.

Although presumptive taxes have a long history and are in use in a number of developed countries, in recent years they have become associated with the process of tax reform in developing countries, where they are seen as offering particular advantages in dealing with "hard to tax" groups such as individual entrepreneurs.[2]

This article is intended to give an overview of the types of presumptive tax currently in use in Central and Eastern Europe (hereinafter "CEE"), a comparatively neglected area in studies of this subject, and to consider some of the issues relating to the compliance effect of such taxes.

II. TYPES OF PRESUMPTIVE TAX

A. Methods of classification

Presumptive taxes can be classified in a variety of ways.[3] Perhaps the most obvious method (and that which is followed in this article) is by reference to the way in which the presumed income is calculated. However, taxes can also be classified according to certain structural or administrative features, and in this respect there are two key criteria which relate to presumptive taxes.

The first criterion is whether a presumption is rebuttable or not (i.e. whether the taxpayer can prove his income was lower than the presumption): a rebuttable tax is perceived as being fairer, but inevitably imposes greater administrative burdens than a non-rebuttable tax.

The second criterion is whether presumptions of income are applied generally to certain groups of taxpayers (or perhaps at the election of the taxpayer) or are applied only to specific taxpayers in specific situations. This last category usually covers situations where the taxpayer has understated his taxable income or has failed to maintain adequate records,[4] and in these circumstances the tax administration will invariably be permitted to make a presumption of income. However, although CEE countries have a variety of approaches to these situations, the use of such presumptions can be seen as a necessary part of income tax administration rather than an application of presumptive taxation *per se*, and so will not be considered further.

Rather, this article will concentrate on presumptive taxes which are applied to particular groups of taxpayers *in place of* income taxes.[5] Such a substitution implies that presumptive taxes are seen as offering particular compliance or administrative advantages over income taxes, and their effects in these areas will also be considered.

B. Presumptions based on capital

Although a tax on income, a presumptive tax can be estimated by reference to both income and capital. Presumptions based on capital are not particulary common in CEE, and are generally confined to those based on the value of agricultural land.

An example of such a tax, based on the cadastral value of agricultural land, is found in Macedonia.[6] Individuals who own, lease or use land are assessed on the cadastral income for each unit of land which is capable of being used for agriculture or forestry, regardless of whether or not the land is used for productive purposes. In Macedonia the presumption is (to some extent at least) rebuttable, in that it may be reduced if yields are reduced due to natural disaster or other exceptional circumstances.

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1. In theory the presumed income is based on the "average" income which the taxpayer could be expected to derive from his or her labour or property: in practice presumptions can often give the appearance of being more arbitrary than scientific.
2. See Kenan Bulutoglu, "Presumptive Taxation", in Parthasarathi Shome (Ed), *Tax Policy Handbook*, IMF 1995, at 258-262; Vito Tanzi and Milka Casanegra de Jantscher, "The Use of Presumptive Income in Modern Tax Systems", in *Changes in Revenue Structures*, Proceedings of the 42nd Congress of the International Institute of Public Finance, Athens 1986, at 32-51.
3. See, for example, Tanzi and Casanegra de Jantscher, *supra* note 2.
4. Presumptions of income are also commonly used where the permanent establishment of a foreign company has not determined its host country-source income in a manner acceptable to the tax administration.
5. It will also concentrate on individual, as opposed to corporate taxes. Although presumptive taxes are more commonly applied to individuals, a number of CEE countries have special regimes for small companies which include an element of presumption. However, a purposive distinction can be drawn because such special regimes for companies tend to be introduced to encourage small companies by reducing their administrative burden (and thus are often linked to simplified accounting requirements etc.) rather than as a response to poor compliance or weak administration.
6. Arts. 18-27 Personal Income Tax Law. A similar tax exists in several other of the former Yugoslav republics.

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This tax on cadastral income is generally applied to all individuals with agricultural income, unless they elect, before the start of the year of assessment, to be assessed on their actual income. However, the tax administration can insist that actual income is taxed if it considers that income from certain non-arable agricultural activities "substantially exceeds" the cadastral value.

Although the valuation involved in such a system is a major undertaking (especially in an inflationary situation), presumptions based on cadastral income have the merit of being applied to a well-defined group of taxpayers and of being comparatively hard to avoid if the land register is complete and up to date.

C. Presumptions based on gross receipts

Presumptions based on gross receipts are more common than those based on capital. Using this method, taxpayers are presumed to have a net income which is determined as a percentage of their turnover, and on which tax is then due.

A distinction can be drawn between a true presumptive system based on gross receipts and one where a flat rate of tax is applied directly to turnover, without an explicit presumption of taxable income. However, it has to be admitted that the distinction can be a fine one, especially where the rate of tax applied is sufficiently low to suggest that an implicit presumption of income can be inferred. Thus, for example, in Albania, the Law on Small Business Tax[7] applies a variety of flat-rate taxes to individual traders, craftsmen and professionals, at rates which are significantly lower than those applied to other forms of earned income: in general these taxes take the form of fixed rate taxes,[8] ranging from 3 per cent for craftsmen to 8 per cent for lawyers and doctors, which are levied on the gross receipts of the activity in question – the comparable rate of tax on wage income would be 20 per cent.

True presumptive taxes based on gross receipts are found in CEE, where they tend to take a rather specific form, namely that of a presumptive deduction, i.e. a deduction given for tax purposes regardless of (and in lieu of) the actual expenses incurred. Since the deduction is given against gross income, the effect is the same as making a presumption of taxable profit.[9] An example of such a system is found in Hungary, which recently introduced an optional taxation regime for small-scale entrepreneurs engaged in agriculture, manufacturing, processing, repair activities and retailing (the so-called "flat-rate taxation".[10]) This regime, which taxpayers must opt for at the start of the tax year, applies to individuals engaged in qualifying trades whose turnover in the previous year did not exceed HUF 15 million (approx. USD 81,000) for retailers and HUF 3 million (approx. USD 16,200) for other activities. Taxable income is calculated by deducting a fixed "presumptive cost ratio" from gross receipts. The basic deduction is a seemingly rather generous 80 per cent of turnover, and this is increased to 87 per cent or 93 per cent for certain retail activities and 92 per cent for a limited range of agricultural producers. The resulting presumed income is taxed at flat rates of between 12.5 per cent and 35 per cent, depending on the level of the presumption.

It is notable that although the "flat-rate" taxation system may be chosen instead of the normal income tax, it does not confer a general exemption from the requirements of the income tax relating to the keeping of records and issuing of invoices. The significance of this point will be discussed below.

Presumptive deductions are also used in Bulgaria, the Czech Republic, the Slovak Republic and Slovenia,[11] but as part of the system of income tax, not as an alternative to it. Such deductions are generally confined to individuals engaged in agriculture and professional or entrepreneurial activities.

However structured, presumptions based on gross receipts share a number of problems. Perhaps most significantly, unless the presumption is rebuttable or the option to apply the system is retroactive, businesses with high expenditure may suffer a proportionately higher tax burden and businesses with losses will receive no relief. Moreover, the compliance controls required for such a system are not significantly lower than those required for a system based on actual profits: the most difficult task, the auditing of gross receipts, is common to both.

D. Presumptions based on estimated income

Also found in CEE are presumptions based on estimated income. Estimates are based on a variety of factors, but nowhere do they approach the relative complexity or sophistication of the *forfait* system in France or the *tahshiv* system in Israel.

An example of a CEE presumptive tax based on estimated income is the Fiscal Duty (or "tax card"[12]) in Poland. This applies to individuals performing business activities defined in the law, which include any of 95 listed services and manufacturing activities (e.g. engraving, smithing, clock-making, glaziery, cosmetic treatment), food retailing and catering, small-scale transportation services, independent professional activities and child-care and education. A further requirement is that the individual does not employ more than a specified number of employees (the threshold varies according to the profession or industry but cannot exceed five employees).

7. Law 7679/93 of 3 March 1993. This law replaced the earlier, but similar, Law 7545 on the Income Tax of Individuals in the Private Sector of 6 January 1992.
8. Subject to a minimum tax of ALL 20,000 (approx. USD 110) for retailers and ALL 55,000 (approx. USD 300) for wholesalers.
9. . For example, allowing a 60 per cent deduction for expenses achieves the same end as presuming a taxable profit of 40 per cent.
10. Act CXVII of 1995 on Personal Income Tax (as amended), Secs. 50-57. The author is indebted to Mária Véghelyi of the IBFD for clarification of a number of points relating to these provisions.
11. Slovenia uses a minimum deduction for certain types of income (i.e. a rebuttable presumption). The amount of the presumed deduction varies according to the activities of the taxpayers, but is generally somewhat less generous than that available in Hungary.
12. Karta podatkowa. Decree of the Minister of Finance 17 December 1996 (*Official Journal* 1996, No. 151, item 171). The author is grateful to Aleksandra Ostaszewska of the IBFD for details of this tax.

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In most cases the tax payable is determined using a scale which takes into account three variables: the profession or activity being carried on, the number of employees and the number of inhabitants in the village or town where the activity is performed.[13] By way of example, the monthly tax scale for smithing services is as follows (USD 1 = approx. PLN 3.2):

Number of employees	Number of inhabitants: up to 5,000	5,000-50,000	over 50,000
0	PLN 106	PLN 118	PLN 126
1	PLN 201	PLN 233	PLN 254
2	PLN 275	PLN 308	PLN 338
3	PLN 318	PLN 359	PLN 401

In certain cases other methods of presumption are used. For example, the tax due from nurses, midwives and certain other professions is based simply on the number of hours worked (PLN 1.70 per hour for nurses and midwives), while the charge for amusement services is calculated by reference to the number of machines, etc. being used. Taxpayers falling within the Fiscal Duty regime are not required to keep books, submit tax returns or make advance payments of tax.

Although a number of CIS countries use presumptive taxation in the form of licences for individual entrepreneurs (see below), the system is, in some cases, developed enough to merit comparison with the Polish Fiscal Duty. In Azerbaijan, for example, a licence may be paid annually or monthly by individual entrepreneurs whose average monthly income does not exceed 12 times the minimum wage of AZM 5,500 (approx. USD 1).[14] The licence fee is determined according to a 4-point scale which is intended to reflect the potential income which an individual business can generate: factors taken into account include the type of business, its location, the number of employees and the income tax treatment of the activity.[15] The monthly rate for a licence is:

Level 1: 24% of the monthly minimum wage.
Level 2: 60% of the monthly minimum wage.
Level 3: 105% of the monthly minimum wage.
Level 4: 150% of the monthly minimum wage.

These systems are simple enough to avoid many of the administrative problems associated with more sophisticated estimated income schemes,[16] and at the same time may be flexible enough to overcome some of the problems associated with fixed-sum licences. However, in their use of turnover thresholds and their exemption from the normal record-keeping requirements they create new opportunities for evasion and abuse (see below).

E. Lump-sum fees

Perhaps the most widely used method of presumption in CEE is the fixed lump-sum payment or licence fee. This normally applies to specific (small-scale) entrepreneurial or agricultural activities, and often replaces both income tax and VAT.

Licences which both confer the right to trade and serve as a presumptive tax on the proceeds are used in a number of CEE countries, particularly those which are members of the CIS. Sometimes they make an attempt to take individual circumstances into account (as in the case of the Azerbaijani system mentioned above), but more often this is not the case.

There are also various forms of lump-sum taxation. In Albania, for example, individuals carrying on ambulant business activities are taxed in fixed amounts[17] according to their activities. These amounts range from ALL 2,000 (approx. USD 11) per annum for a shoeshiner to ALL 110,000 (approx. USD 600) for an individual operating a goods vehicle with a carrying capacity in excess of 16 tonnes. In all there are eight main categories of service and retail activity (with various sub-categories), but in general there is no provision for taking the taxpayer's individual circumstances into account. Similarly, Hungary has a so-called "itemized flat-rate" taxation system for hairdressers, cosmeticians and passenger transport vehicle operators (private taxi drivers) who are sole traders.[18] The scheme is optional and imposes a lump-sum payment of HUF 100,000 (approx. USD 540) for hairdressers and cosmeticians and HUF 120,000 (approx. USD 650) for taxi drivers.

Simple licence fees or fixed payments are the most administratively convenient method of presumptive taxation, but they often seem to bear little or no direct relationship to the profits or potential profits of the individual taxpayer. Moreover, if the fees or payments required are not regularly updated, the real value of the charges can soon amount to little more than a nominal form of taxation.

F. Minimum taxes

In some cases, as in Albania, presumptive taxes are associated with a minimum tax. A minimum tax can also be used as a separate device, which addresses some of the same problems as a presumptive tax[19] and can (but need not) be broadly equivalent in its effect.[20] In its simplest form, a minimum tax requires all taxpayers to pay at least a predetermined amount of tax. In effect, this is equivalent to a tax based on the presumption of a minimum level of taxable income: the important difference is that if actual income is higher this is taxed

13. In general three categories are used: I – up to 5,000 inhabitants; II – from 5,000 to 50,000; and III – over 50,000. For transport services four categories are used: I – up to 25,000 inhabitants; II – from 25,000 to 100,000; III – from 100,000 to 500,000; and IV – over 500,000.
14. Art. 13 of the Personal Income Tax Law.
15. For example, whether an activity is beneficially taxed under the normal income tax regime.
16. These disadvantages include the extensive technical resources required to make detailed studies of profitability by type of activity and/or the need for sufficient staff to verify information which taxpayers give about their businesses.
17. An exception is an individual providing passenger transport, who is liable to a tax of 5 per cent on his gross income, subject to a minimum tax which depends on the size of the vehicle.
18. Act CXVII of 1995 on Personal Income Tax (as amended), Secs. 57/A-57/C. These provisions also apply to income from certain forms of rented accommodation.
19. For a discussion of some of the practical issues relating to minimum taxes see Janet Stotsky, "Minimum Taxes" in Parthasarathi Shome (ed), *Tax Policy Handbook*, IMF 1995, at 263-266.
20. See Tanzi and Casanegra de Jantscher, *supra* note 2, at 45-46.

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in full, with the minimum tax generally being credited against the final tax liability.

An interesting variation occurs in Macedonia, where the taxable base for individuals must generally exceed the average net salary,[21] but a presumption of income can be made by the tax administration, independently or on request, to allow individuals to pay *less* than this minimum.[22] The amount of the presumption depends on such factors as the size and location of the business, and is determined *before* the commencement of the year of assessment.

III. PRACTICAL PROBLEMS

Presumptive taxation is widely promoted as a way of improving overall levels of compliance by broadening the tax base, and/or collecting tax at a lower administrative cost than is possible under a tax on actual income. Paradoxically, if not adequately controlled, presumptive taxes can actually undermine both of these objectives by creating new administrative requirements and adding to the scope for tax evasion.[23]

A. Administering turnover-based systems

As noted above, presumptive treatment is often available only to individuals whose turnover does not exceed a certain threshold. In addition, several forms of presumptive taxation in CEE use gross receipts as the basis of the presumption.

The existence of a turnover threshold reflects the fact that such systems are often (though by no means always) intended to apply to *small* entrepreneurs, as a first step towards their full integration with the income tax regime. However, it also creates opportunities for evasion, most obviously by making it advantageous to artificially split a larger business into separate units, each of which falls below the turnover threshold.[24]

If such evasion is to be countered, the tax administration will need to introduce control systems to identify sub-divisions of a larger business, in addition to those required to check actual turnover for the purposes of ensuring that only qualifying taxpayers are making use of the presumptive regime, and/or verifying the gross taxable base.

In practice, the tax administration may consider that it has more serious problems to worry about than relatively minor tax evasion by various groups of small traders. There is anecdotal evidence that tax administrations in a number of CEE countries, perhaps understandably, have tended to concentrate their scarce resources almost exclusively on larger taxpayers, with the result that presumptive taxes are poorly controlled or audited.[25]

B. Exemption from record keeping requirements

Presumptive taxes are frequently applied to sectors of the economy where record keeping and accounting literacy are low. It may therefore seem logical to accompany a presumptive tax with an exemption from or relaxing of the normal requirements relating to the maintenance of business records, and this is the situation in most CEE countries which make use of presumptive taxation.

However, this can, in the longer term, lead to serious compliance problems. Most income tax systems require taxpayers to keep certain minimum business records and to issue invoices to their customers; since deductible expenditure must usually also be verified by invoices from suppliers, there is both a degree of self-enforcement inherent within the system and an opportunity for tax auditors to use the records of one business as a stepping stone to the control of others. Thus, if a presumptive taxation regime exempts certain taxpayers from key record-keeping requirements, opportunities to control evasion amongst the taxpaying population as a whole are reduced. The same is true of presumptive deductions, which, if non-rebuttable or set at too high a level, also reduce taxpayers' incentives to obtain an invoice for all purchases.

The problem is not just one of controlling existing evasion – a presumptive system can actually encourage evasion by larger taxpayers. For example, if the issuing of an invoice is of no consequence for a presumptive taxpayer, entrepreneurs and enterprises who are subject to the normal income tax or corporate tax regime have a ready source of false invoices with which they can reduce their taxable profits.

IV. CONCLUSIONS

Although a wide range of presumptive taxes are in use in CEE, some generalizations concerning them can be made. They are primarily applied to certain well-defined groups of individuals, generally those within what conventional wisdom holds to be the "hard to tax" sectors. They tend to be collective, applied to a group or sub-group of taxpayers as a whole rather than being specific to individual circumstances. They also tend to be non-rebuttable (or must be elected for in advance, which has the same effect). These last two features simplify their administration, but in a number of cases any efficiency gains risk being offset by the need to establish an accurate measure of gross income on which to base the presumption or to ensure compliance with qualification thresholds. The impact which these factors have on the effectiveness of the presumptive tax in question is often compounded by an absence of record-keeping requirements.

The overall impression is that the presumptive taxes applied in CEE often (but perhaps not intentionally) create a

21. Art. 30 Personal Income Tax Law.
22. Art. 31 Personal Income Tax Law.
23. It could be added that presumptive systems which give tax officials discretion over the level of the presumption can lead to collusion or corruption.
24. The same device could also be used to circumvent other limits, e.g. on the number of employees.
25. CEE tax officials sometimes express the view that presumptive taxes serve the purpose of getting at least some tax from people who would otherwise pay none – whether these taxpayers are paying less than they should is a secondary concern. Moreover, it is apparent that in some countries taxpayers who should strictly be paying income tax are allowed to remain in the (easier to administer) presumptive system with the tacit approval of the tax administration.

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favourable tax environment, either because they apply a presumption of income which is unrealistically low, or because in practice the tax administration makes little effort to control them. It is possible to argue that, nonetheless, they serve the purpose of broadening the tax base or allowing scarce administrative resources to be focused in more productive areas, but the fact remains that a presumptive system which is too favourable in its design or implementation can undermine the wider system of income tax, by providing a disincentive for taxpayers to move up to the declarative system, or by providing opportunities for evasion which can be exploited by larger taxpayers. In the longer term these issues will need to be addressed if the use of presumptive taxes is not to cause more problems than it solves.

Conference diary

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

SEPTEMBER 1997

Tax Provisions in International Takeover Agreements, The Tulip Inn Tropen, Amsterdam, the Netherlands, 4-5 September 1997 (English):

IBA and IBFD, 271 Regent Street, London W1R 7PA, the United Kingdom, Tel.: 44-171-629 1206, Fax: 44-171-491 4470, E-mail: confs@int-bar.org

Successfully Minimising Tax Liability in Central and Eastern Europe, Hotel Holiday Inn Crowne Plaza, Vienna, Austria, 15-16 September 1997 (English):

Vision in Business Ltd, 41 Whitcomb Street, London WC2H 7BT, Tel.: 44-171-839 8391, Fax: 44-171-839 3777, E-mail: postmaster@visibis1.demon.co.uk

Tax Planning using Derivatives and Structured Products, London, 15-16 September (English):

Risk Publications, 104-112 Marylebone Lane, London, WIM 5FU, United Kingdom, Tel.: 44-171-487 5326, Fax: 44-171-486 0879, E-mail: 100726.60@compuserve.com

Transfer Pricing Policy, Libertel Terminus Nord, Paris, France, 22-23 September 1997 (English):

Vision in Business, 41 Whitcomb Street, London, United Kingdom, Tel.: 44-171-839 8391, Fax: 44-171-839 3777, E-mail: postmaster@visibis1.demon.co.uk

Anti-Avoidance Case Law and Legislation, St. James Court Hotel, London, the United Kingdom, 23 September 1997 (English):

AIC Conferences Limited, 2nd Floor, 100 Hatton Garden, London EC1N 8NX, Tel.: 44-171-242 2324, Fax: 44-171-242 2320.

New Opportunities for International Tax Planning, San Georg Corinthia Hotel, St. George's Bay, St. Julians, Malta, 24-26 September 1997 (English):

Ms Fiona Captur, the Conference Co-Ordinator, Tel.: 356-419 690, Fax: 356-410 426, E-mail: unconventional@dream.vol.net.mt

International Tax Avoidance and Anti-Avoidance, Amsterdam, The Netherlands, 25-26 September 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

Performers' Tax and Finance, Hyde Park Hotel, London, the United Kingdom, 29 September 1997 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-673 4383, E-mail: juliet.neckar@ibcuk.co.uk

OCTOBER 1997

International Tax Aspects of Electronic Commerce, Amsterdam, The Netherlands, 3 October 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

51st Congress of the International Fiscal Association, New Delhi, 19-24 October 1997 (simultaneous translations into French, English, German and Spanish):

IFA General Secretariat, World Trade Center, Beursplein 37, 3011 AA Rotterdam, The Netherlands, Tel.: 31-10-405 2990, Fax: 31-10-405 5031.

Taxation for International Companies in Russia and the CIS, The Marriott Hotel, Vienna, 22-23 October 1997 (English):

Business Seminars International Ltd, Sussex House, High Street, Battle East Sussex, TN33 OAL, United Kingdom, Tel.: 44-171-490 3774, Fax: 44-1424-77 3334, E-mail: 1004513120@compuserve.com reference number XBA03

E-ATI 20th Annual Congress, Carlton Inter-Continental Hotel, 58, La croisette, BP 155, 06406 Cannes Cedex, France, 27-29 October 1997 (English):

The European-American Tax Institute, Falmer Court, London Road Uckfield, East Sussex TN22 1HN, United Kingdom, Tel.: 44-1825-760 901, Fax: 44-1825-760 903

Expatriate Management Conference, Hyatt Regency Scottsdale at Gainey Ranch, Scottsdale, Arizona United States, 27-29 October 1997 (English):

Mr Michael J. Bisshko, Ernst & Young, 787 Seventh Avenue New York, NY 10019, United States, Tel.: 1-212-773 2595, Fax: 1-212-773 2550.

Non-Discrimination, Amsterdam, The Netherlands, 30-31 October 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

NOVEMBER

Transfer Pricing Audits, Amsterdam, The Netherlands, 20-21 November 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

DECEMBER

Double Taxation Relief, Amsterdam, The Netherlands, 11-12 December 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

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The publications listed in this bibliography have recently been acquired by the Bureau's library which will gladly supply further information upon request (please quote the reference numbers). They should, however, be ordered through a bookseller or direct from the publisher indicated, and not through the Bureau.

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 71-72 of the January 1997 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

ASIA & THE PACIFIC

Asia Pacific taxation.
Melbourne, KPMG Asia Pacific Tax Committee, KPMG House, 161 Collins Street, Melbourne Vic 3000, Australia. 1996, pp. 381.
ISBN: 90 5522 007 8.
An outline of the tax systems and other relevant information for twenty seven countries in Asia and the Pacific.
(B. 58.225)

Australia

Arnold, B.J.; Li, J.; Sandler, D.
Comparison and assessment of tax treatment of foreign-source income in Canada, Australia, France, Germany and the United States.
Ottawa, Ministry of Finance. 1996.
Working Paper 96-1, pp. 50.
The report deals with selected aspects of the tax treatment of foreign-source income in Canada, Australia, France, Germany and the United States. It emphasizes the structural features of each country's tax system with respect to the taxation of foreign-source income derived by resident corporations. In particular, the report focuses on the taxation of dividends from foreign corporations, controlled foreign corporation (CFC) rules, foreign investment funds rules, and source of income and expense rules.
(B. 116.262)

India

Doing business in India.
Amsterdam, Price Waterhouse. 1996, pp. 233.
Information guide on doing business in India including taxation aspects of individuals and corporations, auditing, accounting and foreign investment, based on material assembled as of September 1996.
(B. 58.293)

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New Delhi, Bharat Law House Pvt. Ltd., 222, Tarun Enclave, Pitampura, New Delhi 110 034, India. 1997, pp. 144.
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(B. 58.291)

Nepal

Khadka, Rup Bahadur.
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ISBN: 3 927489 25 5.
The author, a senior tax officer of the Nepalese government, traces the development of the tax system in Nepal and assesses proposals for reform of the system in the light of current economic conditions. Focussing principally on the proposed introduction of VAT and the reform of income and property taxes, the author describes the problems of raising revenue and improving tax administration in an agriculture-based economy.
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Belgium

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ISBN: 90 5334 769 0.
Annual updated pocket handbook (now accompanied by diskettes) providing practical information on civil, tax and accounting laws regarding companies.
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Droit fiscal. Principes généraux et impôts sur les revenus. 4th Edition.
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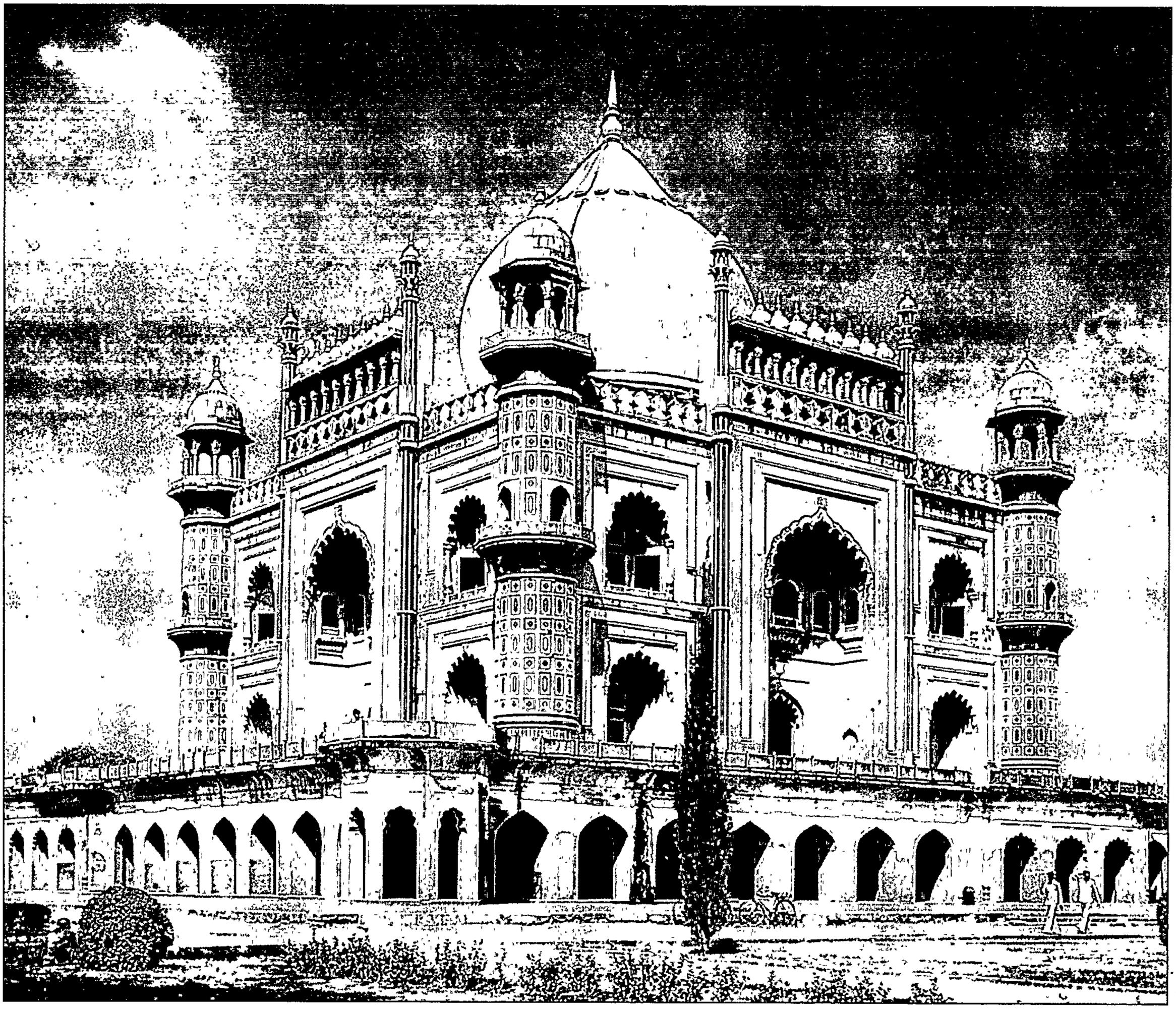
INTRODUCTION

THE 51ST IFA CONGRESS – NEW DELHI 1997

Prof. Avv. Pietro Adonnino



1997 is a unique year in IFA's history. Immediately after the jubilee celebrated last year in Geneva, for the first time ever IFA is holding its congress in a country in a Southern Asia region: India.

So far the congresses have been held in Europe and America, two continents which have been left only for the congresses held in Australia and Israel. Furthermore, up until now the IFA Congresses have been held in countries which are mostly concerned with issues connected to international investments and taxation.

Now the situation has evolved. The globalization of markets, the new rules in international trading, the delicate international political balances, the creation of regional economic and institutional organizations and the development of new communication, information and transmission technologies have rapidly changed the investment and international trade scenario. There is, therefore, the trend to involve ever more countries and ever more areas in international taxation problems.

India is undoubtedly on the front line as far as this trend is concerned. It is a federal republic consisting of 25 states and

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has from her independence pursued a democratic legal system. India has more than 900 million inhabitants and in the last few years its economy has been showing a considerable development effort and it therefore needs a rapid adjustment of its domestic tax laws, particularly as far as they affect international transactions.

The effort made to relaunch the economy has required the introduction of rules encouraging foreign investments and the liberalization and deregulation of the markets. This also requires the framework of a more competitive taxation system.

Apart from its interesting fiscal developments, India has much to offer delegates.

This is a territory where different cultures, life styles and religions have met, thus giving rise to traditions and experiences which are considerably far, in some fundamental aspects, from those of the Western countries but which deserve attention and further study especially at a time when there is a wide and fast exchange of points of view among the various parts of the world. This may lead to new scenarios where each one gives the contribution of its own culture and experience and may receive the contribution of others' cultures and experiences.

These considerations led us to accept the Indian Branch's invitation to organize the 1997 Congress in New Delhi. Furthermore, the Indian Branch has been an IFA member for many years and a very active one, too; its representatives have regularly taken part in our congresses and have also been members of the Association's bodies.

New Delhi, in particular, is a great city, the capital of this great state, which has all the hotel and business facilities needed to host a great international event such as an IFA Congress. This is evidenced by the fact that many other big international congresses have been very well organized in India and in New Delhi in particular.

I am aware of the substantial efforts made by the Indian Branch to organize this congress. In close cooperation with the Secretary General, some changes to the traditional organizing scheme of IFA Congresses have been accepted in order to guarantee a perfect result. I am very grateful for this to the managers in charge of the Indian Branch.

New Delhi and India possess many natural beauties, from the coasts facing the Indian Ocean to the wide plains and the imposing mountains rising out of the inner part of the country towards the Himalayas. This beautiful land has thousands of artistic treasures, especially temples and religious art, but also exquisite palaces and gardens which remind us of the long and intense history of this country.

Indian art is surely very different from Western art and this is why it not only deserves to be seen but also to be known and understood.

I believe it important to underline that a congress held in a country with such ancient civilizations and traditions will deal, among others, with a very topical issue, i.e. the taxation of income deriving from the supply of technologies.

Also in this case I believe that this meeting between traditions and the future represents very well one of the present major features of India; the expression of its own culture and its own tradition and a look at the needs of today and those of the near future which require a great effort in acquiring new technologies.

The second fundamental issue of this congress is also highly topical: the taxation of investment funds which are an unsurpassable instrument used to supply the necessary financial means to the high-technology companies, emerging markets and privatization programmes which are under way in many countries.

The seminars will also focus on topical issues. Tax aspects will be discussed with respect to cross border valuation for income tax, VAT and customs duties (transfer pricing), taxation of expatriates; a very important aspect will be examined with reference to the instruments to assess the taxable base in situations where it is difficult or even impossible to proceed on a documentary basis: taxation based on presumption will therefore be dealt with. I wish to underline that this is a highly topical issue because it is connected to the complexity of assessing the taxable base and is being considered more and more by developing countries.

In New Delhi it will be possible to listen to useful suggestions on how to do business in India and, obviously, there will be the now traditional seminar organized under the joint responsibility of IFA and OECD on the Model Convention, which this year will focus in particular on some problems concerning the permanent establishment such as those relating to the identification of the conditions under which the performance of services may be considered as constituting a permanent establishment and those aspects relating to the impact that the revolution in the world of communications may have on the permanent establishment concept.

The scientific, professional, business, cultural and tourist reasons are so many that I believe that the congress in New Delhi, from 19 through 24 October 1997, represents a unique opportunity.

The spouse programme and the possibility to extend the visit to India after the congress are further aspects which should be taken into consideration.

I am therefore certain that many IFA members will attend the congress, thus showing that they agree with the decision made to host the congress in India.

So, see you in New Delhi in October.

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The taxation of income derived from the supply of technology
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SUBJECT II
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Discussion Leader: Y. Prussen (Luxembourg)

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Cross border valuation for income tax, VAT and customs duties (transfer pricing)
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Prof. F. Vanistendael (Belgium)

SEMINAR C
Taxation of expatriates
Chairman: Prof. R. Krever (Australia)

SEMINAR D
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THE INDIAN SYSTEM OF ADVANCE RULINGS

Justice S. Ranganathan

I. INTRODUCTION

Lessons in income tax, like lessons in life, have to be learnt the hard way. One has to take a plunge into the turbulent waters not knowing whether one will sink or swim. Or, to use a better known metaphor, one has to get caught in the truly perplexing maze, often helpless but sometimes guided by the ingenuity of professional advisers (which did not commend itself to Lord Simon[1]) and take a chance of coming out least hurt. At the end of his experience, all that the terrified victim can do is to let out an anguished cry: Oh! Had I known all this before! The system of advance rulings provides some protection against such trauma. It sounds a note of caution to the entrant in the battle of manoeuvre that has waged for centuries between the tax gatherer and the taxpayer,[2] warns him of the lurking dangers and sometimes also helps him to avoid pitfalls.

Uncertainty of the tax effects of one's transactions can prove fatal to a business enterprise, particularly when the area of one's business operations begins extending beyond the frontiers of one's own country. In this era of globalization, international boundaries are fast disappearing and distances between capitals and cities are shrinking. Gone are the days when the competition between sellers and buyers of commodities is confined to the domestic market; now we see that countries have become market places and that there is competition among countries in the matter of attraction of more and more investments from the entrepreneurs of other countries. This opening up of the boundaries and liberalization of laws has resulted in the emergence of a number of international tax problems such as: the application of Double Tax Avoidance Agreements (DTAAs); their use and misuse in tax planning; conflicts between DTAAs and domestic legislation; taxation of international partnerships; transfer of assets into and out of tax jurisdictions; taxation of international acquisitions, business combinations, mergers and demergers; taxation of services, pensions, royalties, technical fees and income from supply of labour, equipment; transfer pricing; thin capitalization; etc.[3]

India, after its independence in 1947 had opted for a planned economic development. Initially, foreign capital, goods, services and technology came to India in some areas only and under conditions of strict regulation. But, thanks to the metamorphosis in world trading patterns, the rapid scientific and technological advancement of the developed nations and the emergence of competitive tendencies among the developing nations to attract foreign investments, India has also opened up its doors to foreign investments during this last decade of the 20th century in almost all areas by liberalizing the rules and regulations governing such investments. With a view to ensuring the flow of foreign investments into India, particularly in infrastructural areas, the government has been initiating measures calculated to attract such capital and allay possible apprehensions of investors from abroad in venturing on to Indian soil. One such important measure, the first of its kind in South Asia, was announced by the Finance Minister of India in his budget speech for the financial year 1992-93. He said:

> Having regard to the complexities in tax laws, I have been receiving representations that the Government should give advance rulings whenever a taxpayer has doubts about the tax liability in respect of his intended transactions. This practice obtains in a number of countries. There are certain practical difficulties in implementing such a suggestion. However, in the interest of avoiding needless litigation and promoting better taxpayer relations, a scheme for giving advance rulings in respect of transactions involving non-residents is being worked out and will be put into operation soon.

This proposal has been given effect by the introduction in the Income Tax Act, 1961 (hereinafter: the Act) of a special facility to non-residents, Indians and foreigners alike, to obtain a ruling from an Authority for Advance Rulings (AAR) in respect of their transactions in India and know their precise tax liabilities in advance.[4] The Authority provides guidance in the correct interpretation of the Indian tax law which they may not, otherwise, be familiar with and helps them in taking investment decisions under an environment of certainty and in avoiding tensions and conflicts. The purpose of this article is to provide a broad summary of this newly introduced system.

II. CONCEPT OF ADVANCE RULING

An advance ruling may be strictly defined as an authoritative determination regarding the tax consequences of a proposed future transaction arrived at through an interpretation of the provisions of the tax law and other laws relevant to such a transaction. Such determinations are issued in many countries by their tax authorities in response to requests by taxpayers who wish to be certain of the tax consequences of a proposed transaction prior to entering into the transaction.[5]

1. *Latilla v. I.R.* (1943) 25 Tax Cases 107 at 117 (H.L).
2. Lord Greene, M.R. in *Lord Howard De Walden v. I.R.* (1942) 25 T.C 121 at 134 (C.A).
3. Other problems include: taxation of income arising from international seabed, sea water and space; taxation of shareholders on distributed and undistributed income of domestic and foreign companies; taxation of broadcasts through satellites; taxation of offshore companies, offshore trusts, offshore funds, cross border leasing etc.; the determination of liability for tax withholding (or tax deduction at source) in international transactions and questions regarding the determination of permanent establishments of foreign enterprises.
4. Chapter XIX-B (Sec. 245N to Sec. 245V) inserted w.e.f. 1 June 1993. This is supplemented by the Income Tax Rules (44 E and F) and the AAR (Procedure) Rules).
5. E.g. Canada, the United States, Sweden, France and Germany.

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The Indian definition[6] is, however, wider in that it covers not only a proposed transaction but also a transaction which has already been undertaken by the applicant. This safeguards the interests of the taxpayer in two ways. After tentatively drawing up the broad outlines of a transaction which he proposes to enter into, he may seek the ruling of the Authority before he actually puts the transaction through, perhaps even modifying the transaction in the light of the points raised at the hearing. If the ruling is favourable, he can go ahead; but, if the ruling is adverse, he can reformulate his strategies and reframe his transaction in the light of the ruling given by the Authority and protect himself against the adverse tax consequences of the transaction originally proposed. Alternatively, if he has already undertaken the transaction he can, instead of waiting to be assessed in the normal course, seek an authoritative decision from the Authority regarding his tax obligations once and for all thus avoiding costly and prolonged litigation by way of assessment, appeals and further proceedings which may go right up to the Supreme Court. The ruling of the Authority imparts an element of certainty in respect of his tax obligations and saves avoidable delay and expense in their finalization. It has often been said "In many cases, it is almost true to say that the spin of a coin would decide [an issue] almost as satisfactorily as an attempt to find reasons"[7]. One cannot be always too sure of how a final authority would ultimately decide the same issue. If one keeps this in mind, it would not be wrong to say that a taxpayer will be acting more prudently and saving time, money and energy by getting an early ruling in advance rather than in opting for a course of successive litigation.

III. CONSTITUTION OF THE AUTHORITY

The Authority is headed by a former Judge of the Supreme Court of India, who is entitled to such allowances and other benefits as are admissible to a sitting Judge of the Court. It also includes two more members, one from the Indian Revenue Service, who is qualified to be a member of the Central Board of Direct Taxes and another, an officer of the Indian Legal Service, who is, or is qualified to be, an additional secretary to the Government of India. The Authority thus constituted is not part of the revenue administration but is an independent quasi-judicial tribunal. Its constitution is specially structured to give it a high status to combine in itself judicial, revenue and legal expertise, to function totally independent of the tax administration[8] and thus to command the confidence of the taxpayers. The Authority at present has jurisdiction only in matters relating to income tax[9] and can be approached for ruling only by non-residents.

The expression "non-resident" means a person[10] who is not a "resident" as defined in Section 6 of the Act. Under this section, an individual would be a resident in any financial year if he has been in India during that year for 182 days or more; or 60 days or more if he has also been in India for 365 days or more within the preceding four years. If the individual is a citizen of India or a person of Indian origin who has come to visit India in that year or is an Indian citizen who has left India in that year for employment outside India or as a member of the crew of an Indian ship, the period of 60 days mentioned above would be increased to 182 days. An Indian company is always resident but any other company is treated as resident only if the control and management of its affairs is wholly situated in India. A firm, Hindu undivided family (hereinafter: HUF), an association of persons and every other person will always be considered resident except where the management and control of its affairs during the year is situated wholly outside India. It has been clarified by the Authority that the residential status, for the purposes of deciding the admissibility of the application, has to be determined with reference to the financial year immediately preceding the financial year in which the application is made.

IV. LIMITATIONS ON THE JURISDICTION

The Authority's sole function is to pronounce "advance rulings" which means "the determination of a question of law or fact, specified in the application made to it by a non-resident, in relation to a transaction which has been undertaken or is proposed to be undertaken by it".[11] It will be noticed that the statute does not place any limitations on the nature of questions that can be referred to the Authority for its determination. But, having regard to the context, it can be taken that the questions posed should pertain to the income tax liability of the applicant qua a past or proposed transaction and should not be "naked" questions of statutory interpretation, unclothed in the habiliments of a past or proposed transaction. The questions posed should not relate to purely hypothetical, or vaguely contemplated, transactions or be in the nature of a prayer for a "comfort ruling" merely seeking an affirmation of self-evident propositions or be one that is of real interest to a third person and not the applicant. The questions raised may be questions of law or even of fact. The number of questions raised may be one or many, depending upon the nature of the transactions proposed and the nature of the doubts, ambiguities and difficulties encountered in a proper appraisal of the tax obligations.

The statute, however, excludes three types of questions from the purview of the Authority's jurisdiction.[12] These are the situations where the question raised in the application

(a) is already pending in the applicant's case before any income tax authority, the Appellate Tribunal or any court;

6. Sec. 245N(a).
7. Greene, M.R in *I.R. v. British Salmson Aero Engines Ltd.* (1939) 22 I.T.C. 29 at 43 (C.A).
8. The Service rules confer on the Chairman the same terms of service as a sitting judge of the Supreme Court and the Members are required to seek retirement from their previous office.
9. Not purely as a consequence of the income tax legislation being separate from those dealing with other direct taxes but because they mainly involve problems of valuation of various kinds of property, a field which is sought to be kept out of the purview of advance rulings as explained later.
10. This expression connotes a legal entity and is classified for purposes of income tax into the following categories: individual, Hindu undivided family, company, firm, association of persons, body of individuals and other artificial juridical persons.
11. Secs. 245N(a), (b) and (c).
12. The proviso to Sec. 245R(2).

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(b) involves determination of the fair market value of any property;
(c) relates to a transaction which is designed prima facie for the avoidance of income tax.

The objects of these exclusions are clear. The first is to deter taxpayers from having two strings to their bow and trying simultaneously two different remedies which are intended to be alternative. The second is to prevent the Authority getting entangled in intricate problems of valuation which are generally the field of experts and are imprecise and time consuming. The third is to eschew the possibility of a stamp of official sanction being affixed to a transaction that may be a tax avoidance device. Though simply stated, the full implications of these restrictions raise difficult issues[13] for the consideration of the Authority.

V. APPLICATIONS TO THE AUTHORITY

To help in the precise drafting of the issues posed to the Authority, the statute requires the application to be filed in quadruplicate in a particular format.[14] A nominal fee has to accompany the application[15]. The application should:
(a) set out fully and truly all relevant details of the transaction in relation to which questions are raised;
(b) enunciate the questions on which the advance rulings are sought; and
(c) also set out the applicant's own view as to the nature of the ruling expected, supported by reference to the facts and relevant judicial decisions, if any, bearing on the issue.

The application is required to be verified in a manner prescribed *vide* Rule 44E(2) of the Income Tax Rules.[16] As per this rule, in the case of an individual, HUF, company and firm, it should be verified respectively by the individual himself, the karta or any other adult member of the HUF, Managing Director/Director of the company and the Managing Partner/Partner of the firm. In the case of an individual or a company, it can also be verified by a person who holds a valid power of attorney provided the application is accompanied by an affidavit setting out the unavoidable reasons for which it has not been possible for the applicant to sign it.[17] The application also requires the applicant to nominate an authorized representative as defined in Section 288 of the Act to represent him in the proceedings and also furnish an authorization for such person to act and plead on his behalf.[18] The applicant is at liberty to withdraw the application within 30 days.[19]

VI. PROCEDURE OF THE AUTHORITY

When an application is received in the office of the Authority, the concerned Commissioner of income tax is requested to send the records of the applicant, if any, and also his views on the questions raised in the application and the answers suggested by the applicant and if he wishes to be heard, to nominate a person to represent him.[20] If the Authority, on perusing the application or after considering it in the light of the Commissioner's report, is satisfied that the application has to be rejected, it may do so after giving the applicant or his authorized representative an opportunity of being heard. It should also set out its reasons for the rejection.[21] If, on the other hand, it is of the opinion that the application should be dealt with on merit, it may do so straightaway or after conducting an oral hearing at which both parties are represented. The Authority has also the powers of a civil court to obtain such further information as it may consider necessary. It will then pronounce its rulings on the questions raised.

The statute requires that the ruling should be in writing but does not, unlike in the case of an order of rejection, require it to be a reasoned one, apparently because the ruling is final and no appeal therefrom is provided for. However, in view of the fact that the scheme has been recently introduced and with a view to setting up a healthy precedent, the orders of the Authority at present are elaborate and comprehensive. They set out the full facts of the case on the basis of which the ruling is given,[22] the arguments of both parties, the legal position in the light of relevant judicial decisions and other details which are necessary for the decision making process.

One other important statutory requirement is that the ruling has to be given within a period of six months from the date of the application.[23] This ensures speedy disposal of the applications under this procedure.

VII. BINDING EFFECT OF THE RULING

The ruling pronounced by the Authority is binding only:
(a) on the applicant who had sought it;
(b) in respect of the transaction in relation to which it had been sought; and
(c) on the Commissioner and the income tax authorities subordinate to him in respect of the applicant and the said transaction.

A ruling, being one given on the basis of certain facts relating to a particular taxpayer, is, understandably, no precedent for other cases. However, it can be stated with some assurance

13. More detailed discussion is avoided here as it will be totally outside the purpose and scope of the present article.
14. Rule 44E read with Form 34C. The application should be sent by post or fax to: The Authority for Advance Ruling, 5th Floor, NDMC Building, Yashwant Place, Satya Marg, Chanakya Puri, New Delhi-110021 (Fax: +91-11-6113407).
15. Sec. 245Q(2): Indian Rupees 2,500 in the form of a crossed draft on a New Delhi bank made out in favour of The Authority for Advance Ruling.
16. The verification is in the nature of a solemn affirmation by the applicant of the truth of the contents of the application.
17. Rule 14 of the Procedure Rules. The Procedure Rules framed by the Authority require such an affidavit in order to ensure that the conditions of the rule are fulfilled.
18. Sec. 245R(1) and rule 13 of the Procedure Rules.
19. Sec. 245Q(3).
20. Sec. 288 of the Act prescribes the qualifications of the person representing a taxpayer before the income tax authorities. A regular employee, a lawyer, a chartered accountant and certain other categories of persons are comprehended in the definition.
21. Sec. 245R(2) – Second & third provisos.
22. This is also necessary for another reason discussed later.
23. Sec. 245R(6).

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that, where the question on which the ruling has been given decides a general question of law or principle, it will, as a matter of convention and judicial propriety be followed in other cases too, provided the material facts are similar.

Another consequence of the ruling being based on a set of stated facts and the interpretation of the statute as it stands at a particular point in time is that it will cease to be binding even on the above parties if there is a change in law or if the actual facts of the transaction, as put through, are materially different from those on the basis of which the ruling has been obtained. This is, indeed, the position in all the countries where this system prevails. However, even otherwise, in some countries, the validity or binding nature of the ruling is limited to a specified period. But this additional limitation does not prevail in India where the ruling given will be effective without any limitation of time so long as the material facts of the transaction and law continue to be the same.

A third consequence of the ruling being based on the facts placed before it by the applicant without deep scrutiny or detailed investigation is that the ruling should be treated as *void and non-est* if it is found that it has been obtained by misstatement of relevant facts or fraud. In such an event, the Revenue can move the Authority and the Authority, after providing a reasonable opportunity to the applicant of being heard, may by order, declare the ruling to be *void ab initio*.[24] The resultant position will be as if no such advance ruling had ever been made.

VIII. THE UNIQUE FEATURES OF THE INDIAN SYSTEM

The system of advance rulings is well established in some of the developed countries like the United States, France, Germany, Australia, the Netherlands, etc. but the system adopted by India is unique in many ways. It is binding both on the Revenue and the applicant in respect of the transaction with reference to which it is issued unlike other countries where the taxpayer and/or the Revenue could ignore it. Secondly, in many of the countries, the advance ruling is issued by the officers of the Revenue Authority whereas, here, a high level quasi-judicial and autonomous body headed by a former judge of the Supreme Court of India has been set up to pronounce such rulings. To avoid indefinite litigation, no further appeal has been provided here, whereas in most other countries, since rulings are issued by the Revenue themselves, if a ruling is considered to be adverse, an appeal can be filed which means that litigation and concomitant delay and uncertainties are not avoided. The Indian system of advance rulings is very helpful in one more respect i.e. that all the matters under the income tax law, except valuation of property, are covered under the jurisdiction of the Authority; therefore, an applicant does not have to look to any other authority in matters relating to taxation of his income. In other countries, however, there are only select areas in which advance rulings can be given. In countries like the United States rulings are classified as private and published rulings. Private rulings do not apply to any other case, whereas published rulings are intended to be a supplement to the existing case law and their principal goal is nation-wide uniformity among the taxpayers and also the officers of the Revenue Service. There is no such bifurcation of the rulings under the Indian law. In India, many of the questions coming up before the Authority are interesting ones on which, generally speaking, decisions of the High Courts or the Supreme Court are not available. Therefore, the rules of the Authority provide that such rulings may be published[25] in the public interest even though the rulings are binding only in the case of the particular applicant. Where an applicant has any objection to the publication on account of the confidentiality of his transactions, the Authority allows publication only after abridging the ruling by taking out the confidential portions of the transactions which are not relevant for the decision making process. Publication of rulings was decided upon because, although the rulings are binding only in the case of the applicant, coming from a high powered authority, the ruling has a persuasive value, and its applicability in any other case on the same or similar facts and the position of law by the same or any other authority or tribunal cannot be denied. This also helps in achieving uniformity in application of the legal provisions and ensuring equality before the law. Owing to the uniqueness of these features, the setting up of the Authority for Advance Rulings in India has been welcomed as a step in the right direction and there is a demand that this facility be made available to residents as well.

IX. INSTANCES OF RULINGS

The Authority has, so far, pronounced rulings on several important issues, many of them involving an interpretation of the provisions of Double Tax Avoidance Agreements (DTAA) entered into between India and other countries, such as the United Arab Emirates, the United States, Mauritius, France and Sweden. A few of these may be referred to here. The definition of the expression "resident", commonly used in DTAAs, had to be considered in the context of an agreement between two countries, one of which did not levy income tax at all, and it had to be interpreted so as to prevent the treaty becoming a dead letter altogether.[26] The difficult concept of "permanent establishment" has come up for consideration in the context of a number of contracts entered into by sub-contractors dividing up the work of one principal contractor into sections of short duration so as to overcome one of the clauses of the definition which gives importance to the duration of the place of work in India.[27] The concept of "permanent establishment" in other contexts has also been ruled upon.[28] The consequence of the provision in DTAAs which directs treatment of fees for technical services earned in the course of business activities as business profits and their assessment, as such, in accordance with the local legislation

24. Sec. 245T read with rule 23.
25. Rule 25.
26. Mohsinally Md. Rafik 1995 – 213 I.T.R. 317.
27. Many unreported cases exist on this issue.
28. Advance Ruling No. P-10 of 1995 (1997-224 ITR 473); Tekniskil (Sendirian) Berhard 1996-222 I.T.R. 55; Advance Ruling No. P-8 of 1995 (1997-223 I.T.R. 416).

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of the taxing State came up for consideration in the Ericsson case.[29] Recently, a question has been raised by a television company floated in Mauritius as to whether charges collected by it from Indian parties for advertisements on its television channels would be liable to be charged to income tax at all. This issue had been considered at a conference of similarly placed organizations and the Central Board of Direct Taxes had issued a circular stating that the profits embedded in the charges collected by such companies in India would be taxed at 10 per cent. The applicant, however, desired the Authority to give a considered ruling. This issue is awaiting decision.

The Authority had to consider objections to an application on the ground that the question related to a transaction which was prima facie designed for avoidance of tax in two cases. In one,[30] the Authority refused to entertain the application upholding the objection. The applicant companies had invested huge funds in Indian companies and claimed that, as they were companies incorporated and resident in Mauritius, they were entitled to concessional rates of tax on the interest and dividend income earned by them from Indian sources and to nil taxation on the capital gains derived by them on sale of their Indian holdings of movable property.[31] The Authority found that the applicants were companies with only one shareholder which was a British Bank and it prima facie appeared to the Authority that the transaction was put through in the form of investments by the Mauritian companies in order to take advantage of the exemption/concession clauses in the DTAA between India and Mauritius. The Authority, therefore, rejected the application *in limine*. But, in another case,[32] where material had been placed on record adducing the reasons for the location of the applicant in Mauritius, the application was held maintainable.

Many other issues involving interpretation of the provisions of the Act concerning foreigners such as the meaning of the expressions "technician", "manufacturing process" and "business carried on",[33] the tax reliefs available to non-residents in respect of India Development Bonds and other Indian securities and investments,[34] the availability of exemption to a foreign educational institution in India,[35] the liability to pay interest on delayed payments of advance tax[36] and the mode of assessment of income from house properties[37] have been resolved by the Authority. In another case,[38] the Authority had to consider the tax liability of a company in Mauritius which, along with other organizations in India and elsewhere, formed an Indian Trust to handle its investments in infrastructural projects in India. The question was whether each of the settlors-beneficiaries of the Trust was liable to be individually assessed on an aliquot portion of the income of the Trust at the concessional rate available under the DTAA with Mauritius or whether the entire income of the Trust should be aggregated and assessed at the maximum marginal rates in the hands of the Trust. The Authority pronounced its ruling after considering the relevant provisions of the Act.

It is unnecessary to elaborate further. Suffice it to say that the rulings of the AAR have been of great help not only to Indians residing abroad and having investments in India but also to foreign enterprises entering into business arrangements and collaborations in India. The setting up of the AAR in India has demonstrated the advantages of the scheme of advance rulings as an integral part of the system of taxation.

X. THE INDIAN SYSTEM COMPARED TO OTHERS

Before concluding, it may be useful to provide a comparison of the procedure for advance rulings prevalent in India with that in vogue in some other countries of the world. One of the seminars at the 46th IFA Congress held in Mexico in 1992 was on "Advance Ruling Practice and Legality". The proceedings at the seminar have been published in the form of a booklet. Pages 53-56 of this booklet features a synoptical table setting out the perspectives of France, Germany, the Netherlands, Sweden and the United States on this topic. In order to provide a comparative review of the Indian system, that table is made an appendix to this article with one additional column pertaining to India. This brings out in relief the salient features of the Indian system.

29. 1997-224 I.T.R. 203. Tekniskil (Sendirian) Berhard 1996-222 I.T.R. 551.
30. Advance Ruling No. P-9 of 1995: 1996-220 I.T.R. 377.
31. Arts. 10, 11 and 13 of the DTAA.
32. Advance Ruling No. P-10 of 1995: 1997 - 224 ITR 473.
33. Robert W. Smith 1995-212 I.T.R. 275; Monte Harris 1996-218 I.T.R. 413; Arthur Newell 1997-223 I.T.R. 776.
34. Advance Ruling No. P-5 of 1995: 1997-223 I.T.R. 379.
35. Educational Institute of American Hotel & Motel Association 1996-219 I.T.R. 183.
36. Advance Ruling No. P-2 of 1994: 1996-221 I.T.R. 172.
37. Jagtar Singh Purewal 1995-213 I.T.R. 512.
38. *Supra* note 32.

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COMPARATIVE TABLE* RE: SCHEME OF ADVANCE RULINGS IN INDIA AND CERTAIN OTHER COUNTRIES

	United States	France	Netherlands	Germany	Sweden	India
I. Definition of advance ruling						
A decision regarding the tax consequences of a proposed transaction, given by the competent authority and binding upon that authority	The decision must be in writing	The advance ruling should be in writing, although there is one case of non-written agreement	The decision must be in writing	Decision may be written or verbal	The decision must be in writing	The decision must be in writing and generally gives detailed facts and reasons
Which authority takes the decision?	IRS	Local department or central administration, depending on the case	Tax inspector (Rotterdam)	Competent authority	Council for Advance Rulings	The Authority for Advance Rulings, quasi judicial in nature independent of the Revenue department
II. Does the taxpayer have the right to obtain an advance ruling?	No. Advance Rulings can only be given in certain fields	Generally not. There is a case of non-written agreement re abuse of law	No. Advance Rulings can only be given in certain fields	Only in cases prescribed by law particularly after a tax investigation	Only in certain cases	Yes, except in three excluded cases (i) alternative remedy pursued (ii) question of valuation (iii) tax avoidance design
III. Does the taxpayer have a right of appeal against an Advance Ruling or against refusal to provide one?	No	None to date	No	Yes, in principle	Yes	No. Question of refusal does not arise
IV. The tax authorities are bound by Advance Ruling on legal questions	Yes, until it is revoked	Yes. The Ruling can change only with regard to future case	Yes, for four years of imposition	Yes	Yes	Yes, on legal as well as factual issues
V. Are the authorities bound by an Advance Ruling if the facts change?	No	No	No	No	No	No, but otherwise they are bound
VI. Are Advance Rulings binding upon the court?	Open question	Yes. In France advance rulings have a legal base	Not if it contradicts the law	Yes	Yes	Binding on the Revenue, not the courts
VII. Can the taxpayer renounce the right to rely on an Advance Ruling?	Yes	Yes	Yes	Yes	Yes	No. Neither party can ignore the ruling
VIII. Fields in which Advance rulings are given						
A. Taxation: income tax, inheritance tax Indirect taxation: especially VAT Customs duties	Yes, in the case of federal tax	Yes	Tax on company profits only	Yes, except in certain cases (customs duties indirect taxes tax audit)	Yes, except tax on gifts and inheritance	Only in income tax matters
B. Advance Rulings concern only interpretation of the law?	Yes	Originally yes. Since 1987, it can also be given on facts of a case	No, but Advance Ruling can be given in five specific cases	No, they also concern the facts of the case, application of the law to the said facts, and matters of judging the facts of the case and the law	Yes	No. They also concern the facts of the case, application of the law to the said facts, and matters of judging the facts of the case and the law
C. Are Advance Rulings limited to precise fields?	Yes, Advance Rulings cannot be obtained in areas where there is an established administrative practice. There also exists a list of areas in which Advance Rulings cannot be given	The Advance ruling on an abuse of law only covers a draft contract. The other types of advance rulings are more general, but they serve to stop only tax increases	Yes, they cover only: – holding companies – finance companies – financing of fixed establishments – licence contract conducted by Dutch companies – application of cost price method for transfer pricing	There are a number of exclusions. The main reason for refusal of an Advance Ruling is where the claimant is only attempting to gain a fiscal advantage	No	It can cover any area relating to income tax liability whether pertaining to the statute or double tax treaties
D. Can Advance Rulings cover matters of international taxation?	Yes, but a list of exclusions exists	This is not forbidden in law	Yes, but only in those areas where Advance Rulings may be obtained	Yes, but the income in question must be subject to German tax	Yes, on the same conditions as a domestic matter	There is no prohibition so long as the issue affects liability to Indian income tax
IX. Formal conditions for obtaining advance ruling						
The request for an Advance Rulings must include: – full disclosure of the facts of the case; – applicable law and legal precedents; – the result sought by the claimant	Yes	Yes, for advance ruling regarding abuse of law	No established practice. Application must establish facts of the case	Yes	Yes	Yes. Misstatement or fraud can render ruling avoid *ab initio*

* **Tabulation is taken from an IFA publication; column regarding India has been added.**

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TAXABILITY OF ROYALTIES AND TECHNICAL FEES ARISING IN INDIA

Sandeep Tandon

I. INTRODUCTION

The topic of taxability of income arising in India, by way of "royalties" and "fees for technical services" in the hands of persons resident abroad, is both an important and a vexed issue. This article deals with the basic provisions which govern the taxability and certain difficulties arising in applying them.

II. PROVISIONS OF TAXABILITY UNDER INDIAN LAWS

A. Basis of charge in the case of non-residents

Section 4 of the Indian Income Tax Act, 1961 ("the Act") which deals with the basis of charge of income tax in India provides that every person to whom the Act applies shall be charged to income tax in respect of his total income for the previous year at the rate or rates of income tax in force for that assessment year. The term "previous year" referred to in the said section means the financial year relevant to the previous year in question. Section 5 of the Act deals with the scope of total income of an assessee. Subsection (2) of Section 5, which deals with the scope of total income of a non-resident assessee, provides that his total income for any previous year includes all income from whatever source derived which:

(a) is received or deemed to be received in India in such year by or on behalf of such person; or
(b) accrues or arises or is deemed to accrue or arise to him in India during such year.

B. Taxability on the receipts and accruals bases

Where a non-resident receives income in India, or where income is deemed to be received in India by the non-resident or where income accrues or arises to a non-resident in India, the matter is well settled by a spate of judicial pronouncements by the Indian courts. Some leading cases relating to the taxability of "royalties" and "fees for technical services" in India are discussed below.

The Indian Supreme Court in *Standard Triumph Motor Co. Ltd. v. CIT*[1] has held that royalties due to a non-resident under a collaboration agreement for sales effected by an Indian company were taxable in India on the "receipts" basis since the royalties due were credited in the books of the Indian company, even though no part of the amount had actually been received by it abroad. The legal proposition laid down by the Supreme Court is that once a royalty is deemed to be received in India by the non-resident, actual receipt of the same by the non-resident is not necessary for its taxability in India.

The Indian Supreme Court in *Raghava Reddi v. CIT*[2] has held that when an amount due to an assessee is credited on his instructions to an account in the books of the payer, such credit amounts to receipt by the assessee. Accordingly, the Supreme Court has laid down that a credit entry in the books of account amounts to a "deemed receipt", see Section 5(2)(a).

In *Performing Right Society v. CIT*,[3] the Indian Supreme Court held that royalty income received by a non-resident under an agreement executed in England accrued or arose in India, since under the agreement the non-resident assessee was broadcasting its music in India. Thus, the settled legal position is that the source of income was not relevant under Section 5(2)(b) if the income accrues or arises in India.

Thus, taxability of royalties and fees for technical services in India on an actual (or deemed receipts) basis and the accrual basis has been unambiguously held constitutional by the Indian judicial authorities.

C. Taxability on deeming basis

Section 9(1) of the Act which contains the deeming provisions for income provides for the cases in which income is deemed to accrue or arise in India. The Finance Act, 1976, amended the Act and inserted clauses (vi) and (vii) in Section 9(1) deeming income by way of royalties and fees for technical services to accrue or arise in India thus making the non-resident recipient chargeable to tax in cases where there was ambiguity or no tax liability under the pre-existing law. These deeming provisions are discussed hereinafter.

D. Taxability of royalty income

Section 9(1)(vi) of the Act deals with the taxability of "royalty" income in India on a deemed accrual basis. This section reads as follows:

> 9.(1) The following incomes shall be deemed to accrue or arise in India:
> ...
> (vi) income by way of royalty payable by
> (a) the Government; or
> (b) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

1. 201 ITR 391.
2. 44 ITR 720.
3. 106 ITR 11.

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(c) a person who is a non-resident, where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India".

For the purposes of this section, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "capital gains") for

(i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;
(ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;
(iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;
(iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;
(v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films, or
(vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (v).

E. Taxability of fees for technical services

Section 9(1)(vii) of the Act deals with the taxability of "fees for technical services" in India on an deemed accrual basis. This section reads as follows:

9.(1) The following incomes shall be deemed to accrue or arise in India:

...

(vii) income by way of fees for technical services payable by
(a) the Government; or
(b) a person who is a resident, except where the fees are payable in respect of services utilized in a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or
(c) a person who is a non-resident, where the fees are payable in respect of services utilized in a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

This section defines the term "fees for technical services" to mean any consideration (including lump-sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of the services of technical or other personnel), but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head "salaries".

F. Taxability under deeming provisions – territorial nexus

It is a well-established principle of international taxation that as far as foreigners and foreign income is concerned, a sufficient territorial nexus between the person sought to be taxed and the country seeking to tax him must exist before income tax may properly extend to that person in respect of his foreign income. The connection must be a real one and the liability sought to be imposed must be pertinent to that connection.

A close reading of sub-clauses (b) and (c) of Sections 9(1)(vi) and 9(1)(vii) would go to show that the legislature while enacting the provisions did not strictly adhere to the principle of taxability of income on the territorial nexus basis.

Under the provisions of sub-clause (b) of Sections 9(1)(vi) and 9(1)(vii), any payment made by a person resident in India towards either royalty or fees for technical services will be liable to be taxed in the hands of the recipient in India. The only exception provided in these provisions is that such income will not be taxed in India, if the remitter of the royalty/fees for technical services utilizes the benefits for its own business or profession outside India or for earning any income from any source outside India.

Such a narrow exemption results in a ridiculous situation when a remittance made by a person resident in India for the aforesaid purposes is not ultimately linked to any activity in India. For example, a marketing office of an Indian company abroad sustained by remittances from India, which is handling purely marketing activities of the Indian company's products on a global basis outside India engages marketing consultants for advising on marketing strategies. On a strict interpretation of the provisions of sub-clause (b) of Section 9(1)(vii), fees paid by the branch office to the foreign consultants will come within the ambit of this section and would render the income of the foreign consultants taxable in India. Furthermore, the branch office would be required to withhold taxes at source.

Sub-clauses (b) of Section 9(1)(vi) and Section 9(1)(vii) seek to charge a foreigner in respect of his income outside India only because the payment is made by an Indian resident, even when the income arises under a contract which is made and performed entirely outside India and despite the fact that neither the income nor the contract has any connection with India. The residence of a person from whom the income is received can never afford a sufficient, real or pertinent nexus to justify the levy of income tax on a foreigner in respect of his income which has no other connection with India. Remarking on this provision, the learned Indian jurist Mr N.A. Palkhiwala in his commentary on income tax has gone to the extent of saying that if the Indian parliament can cast the net wide enough to collect tax in such cases where the foreigner's income has no nexus with India, only because the income is derived from a transaction with an Indian then, in future, it may even introduce a provision to tax hotels, stores, professionals etc. for services rendered by them to Indians while on their visits abroad.

Under the provisions of sub-clauses (c) of Sections 9(1)(vi) and 9(1)(vii), any payment made by a non-resident in respect of a royalty or fees for technical services to any person including another non-resident will come under the mischief of this provision provided the benefits derived from such payments are utilized for the purpose of a business or profes-

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sion carried out by such non-resident in India or for the purpose of making or earning income in India. This provision has a very wide scope and does not provide for any exceptions.

A strict interpretation of this provision can result in absurd situations. The revenue authorities in India would not even have the means to access information about the transactions between two non-residents and ultimately may not be able to enforce these provisions. For example, it is common knowledge that specialized engineering firms, consultancy organizations, etc. continuously acquire technology or other technical services from their counterparts in other countries to ensure that they keep abreast of the latest developments and skills in the field in which they are engaged. From the pool of technical knowledge and skills so acquired by them, a part may be passed on to an Indian company against the payment of a royalty or technical fees. In such a situation on a strict interpretation of the provisions of sub-clauses (c) of Section 9(1)(vi) and 9(1)(vii), the payment made by the non-resident enterprise to another non-resident enterprise outside India for the technical knowledge and skills acquired from it would be taxable in India under the aforesaid sub-clause, since the said knowledge and skills have been utilized in a business in India. The first-mentioned non-resident will have to abide by all other provisions of the Act including the withholding tax provisions. It can thus be seen from this example that this provision is not only in conflict with the canons of taxation, but in practice cannot be implemented by the revenue authorities in India.

From the aforesaid analysis of sub-clauses (b) and (c) of Section 9(1)(vi) and 9(1)(vii) of the Act, it can be seen that these clauses cannot stand the legal test in a Court of Law and the Court would either rule that they are *ultra vires* the legislative powers of the parliament or restrict their scope to only those cases where, in fact, a sufficient nexus exists between India and the foreigner's income accruing and received abroad. These clauses are also against the letter and spirit of various tax treaties signed by India.

As of to date, these provisions have not been challenged as being *ultra vires* the Constitution of India and, therefore, they constitute valid provisions under the Indian law. Notwithstanding this, some of these issues have been dealt with under certain of India's tax treaties. The tax treaty aspects are examined in detail in the later part of this article.

G. Tax and deductibility of expenses

The income of non-resident companies is taxable at the rate of 55 per cent which is proposed to be reduced to 48 per cent by the Finance Bill, 1997 w.e.f. 1.4.97. If the nature of the receipts in the hands of the non-resident company is that of royalties or fees for technical services under the Act, the provisions of Section 44D of the Act will apply and the gross receipts will be subjected to tax at the aforementioned rates. Section 44D of the Act does not permit deduction of any expenditure or allowance in computing income by way of "royalties" and "fees for technical services" received in pursuance of agreements entered into with any Indian party by the non-resident company after 31.3.76.

However, Section 115A of the Act provides for a special rate of tax of 30 per cent, which is proposed to be reduced to 20 per cent in respect of agreements entered into on or after 1.6.97 by the Finance Bill, 1997 for income by way of "royalties" and "fees for technical services" of a non-resident company. This section is applicable provided the relevant agreement is approved by the central government, or where it relates to a matter included in the industrial policy of the Government of India and the agreement is in accordance with that policy. The taxability of "royalties" and "fees for technical services" on a "gross" basis has also been specifically embodied in the provisions of Section 115A of the Act in line with Section 44D of the Act as discussed above.

H. Grossing up

Section 195A provides for the "grossing up" of the "royalties" or "fees for technical services" in cases where such payments are to be made net of tax, i.e. the Indian income tax liability in respect of such payments is borne by the payer. However, where such payments are made in pursuance of an agreement which is approved by the central government or is in accordance with the industrial policy of the Government of India, the tax on such payments is exempt (see Section 10(6A) of the Act) and, therefore, in such cases no "grossing up" needs to be done.

III. PROVISIONS UNDER DOUBLE TAXATION AVOIDANCE AGREEMENTS (DTAs)

A. Provisions in the Act governing applicability of DTAs

Subsection (1) of Section 90 of the Act confers a power upon the Indian Government to enter into a DTA with any country outside India in respect of matters of avoidance of double taxation of income, granting of relief in respect of income which has been doubly taxed, exchange of information for prevention of evasion or avoidance of income tax and recovery of income tax under the corresponding laws of the respective countries.

Subsection (2) of Section 90 further provides that where the Indian Government has entered into such an agreement under subsection (1), the provisions of the Act shall apply *to the extent that they are more beneficial to that assessee*. The Indian Central Board of Direct Tax (CBDT) also, see circular No. 333 dated 2.4.1982, has clarified that where a DTA provides for a particular mode of computation of income, the same should be followed, irrespective of the provisions of the Act. Where there is no specific provision in the DTA, it is basic law, i.e. the Act, that will govern the taxation of income.

Section 91 of the Act applies, where a person resident in India has paid income tax in any country with which India

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has not entered into a DTA, in respect of income accruing or arising to him outside India. In such cases, the section provides that such person shall be entitled to a deduction from the Indian income tax payable by him of a sum calculated on such doubly taxed income at the Indian rate of tax, or the rate of tax of the said country, whichever is lower, or at the Indian rate of tax if both the rates are equal.

B. DTAs with India based on the UN Model

A UN Model Convention was finalized in 1980 by a group of experts on tax treaties between developed and developing countries. This Model Convention has now become a standard format for DTAs which are being concluded between the developed and the developing nations. The DTAs concluded by India in recent years have also been based on the UN Model with suitable modifications to reflect the Indian laws and the laws of the countries with which the agreement is concluded. India has entered into DTAs with more than 50 countries. These in most cases contain a separate article dealing with income by way of "royalties" and "fees for technical services".

C. Royalties as defined in DTAs with India

The definition of the term "royalties" under the DTAs entered into with most of the major countries, viz. the United States, the United Kingdom, Germany, Singapore, Italy, Japan, France, China, the Netherlands, Korea, Indonesia etc. is more or less on the same lines as the definition of that term given under the Act. However, the DTAs with Canada, Finland, Malaysia and the United Arab Emirates (UAE) exclude royalties, or other amounts paid in respect of the operation of mines or quarries or the extraction or removal of natural resources, from the said definition.

D. Fees for technical services as defined in DTAs with India

The meaning of the term "fees for technical services" under the DTAs varies significantly between different countries with the result that the scope of that term is very wide in certain cases whereas, in other cases, the scope is considerably restricted.

In DTAs with major European countries like Germany, Italy, France, the Netherlands, Norway, Denmark, Finland, Sweden and Spain and other countries like Japan, Korea, Canada and China, the definition is very wide and means payments of any amount in consideration for services of a managerial, technical or consultancy nature, including the provision of services by technical or other personnel, but excludes payments by the payer to its employees.

In the case of DTAs with Canada, the Netherlands, Finland, Japan, Korea, Sweden and Spain, fees for professional services rendered by an individual are also excluded from the meaning of the said term. However, such services are separately covered under a specific article for the rendering of independent personal services.

In the case of DTAs with Mauritius and UAE, there is no separate article dealing with fees for technical services and payments made for such services are covered by the residuary article dealing with any income not specifically dealt with in the DTA, in which case the income of entities based in these jurisdictions is taxable in India only if they have a permanent establishment (PE) in India.

In the case of the DTA with Malaysia, neither a specific article nor the residuary article covers fees for technical services and, therefore, its taxability is governed by the article dealing with business profits which, in turn, only establishes a liability if there is a PE in India.

E. Provisions of the India–US DTA relating to fees for technical services

It is worth noting that the India–US DTA gives a very precise and restricted meaning to the term "fees for included services" (another phrase used for "fees for technical services"), which include payments for rendering technical or consultancy services (including through the provision of services of technical or other personnel) provided that:

- such services are ancillary or subsidiary to the application or enjoyment of a right, property or information for which royalty is received; or
- they make available technical knowledge, experience, skill, know-how or processes, or consist of the development and transfer of a technical plan or technical design.

The aforesaid DTA further goes on to exclude payments for certain services from the definition of "fees for included services", viz.

- services that are ancillary or subsidiary, as well as inextricably and essentially linked, to the sale of property (other than a sale for which a royalty payment is made);
- services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic;
- services by employees as well as professional services rendered by individuals and partnership firms;
- teaching services in or by educational institutions; and
- services for the personal use of individuals.

The protocol to the DTA discusses in detail the category of services intended to be covered by the said definition and those intended to be excluded therefrom. It states that whether a particular service is covered or not by the said definition must be determined by reference to the facts and circumstances of each case. It goes on to explain that in order for a service to be considered "ancillary and subsidiary" to the application or enjoyment of a right, property, etc., the service must be related to the application or enjoyment of the right, property, etc. and the clearly predominant purpose of such arrangement must be the application or enjoyment of the right, property, etc. It further explains that technology will be considered "made available" when the person acquiring the service is enabled to apply the technology. The fact that the provision of the service may require technical input by the person providing the service does not per se mean that tech-

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nical knowledge, skills, etc. are made available to the person purchasing the service. Similarly, the use of a product which embodies technology shall not per se be considered to make the technology available.

The protocol then goes on to illustrate with the help of examples that payments for the following services will not be covered under the definition of fees for technical services:

- payments for performing a contract manufacturing service;
- payments for services relating to furnishing commercial information e.g. advising on marketing strategies;
- payments for initial installation, inspection and training services rendered as a part of an agreement to sell machinery, equipment etc.;
- tuition fees paid to an educational institution for a group of engineers sent to study for an engineering course.

The protocol makes it clear that the examples given therein are not intended to be an exhaustive list and the categorization of a service should be determined by applying the principles laid down to the facts and circumstances of each case.

For example, if an Indian company obtains commercial information from a US company on payment of fees, such fees would ordinarily have fallen within the scope of "fees for technical services", see Section 9(1)(vii) of the Act. But, due to the acceptance by the negotiators of both countries of the principle of territorial nexus, the express provisions of Section 9(1)(vii) of the Act have been overridden by the provisions contained in the protocol to the DTA and the said fees would not be taxable in India. The tax treatment would not undergo a change even if the US company had employed technical personnel in order to supply the aforesaid commercial information; since what is made available to the Indian company is only commercial information.

F. DTAs with the United Kingdom, Singapore and Switzerland

It is noteworthy that DTAs between India and the United Kingdom, Singapore and Switzerland also define the term "fees for technical services" on similar lines as the India–US DTA. However, in these DTAs, there is no protocol describing the category of services that would be covered as technical services with the help of examples as in the case of the India–US DTA. As pointed out above, the protocol to the India–US DTA itself clarifies that the examples given therein are not exhaustive but only illustrative in nature and, therefore, on settled rules of interpretation, the explanation and categorization given in the protocol to the India–US DTA can be applied in the case of these three countries also. The Indian judicial authorities have, by and large, accepted this interpretation and not much litigation has occurred on this issue.

In the light of the aforementioned analysis, it can thus be seen that, but for countries like the United States, the United Kingdom, Singapore and Switzerland, a majority of the DTAs with European and other countries give a very wide definition of the term "fees for technical services". Thus, in these cases any payment for managerial or consultancy services will come under the mischief of taxation despite the fact that the commercial information or managerial services made available to the payer in India does not have any technical element.

G. Treatment of royalties and fees for technical services as business income under DTAs

All the DTAs usually contain a provision in the specific article dealing with "royalties" or "fees for technical services" to the effect that if such income is effectively connected with a PE or fixed base which the recipient has in India, they will be taxable under the article dealing with "business profits" and not the specific article dealing with such income which provides for a concessional rate of tax on the gross amount of royalty or technical fees. Thus, in cases where a non-resident undertakes a turnkey project in India by providing know-how, managerial, consultancy and technical services and also provides services in India for the execution of the project through a PE, then, in such cases the payment received for "royalty" or "fees for technical services" from the Indian concern will be taxed in the manner provided for under the article dealing with "business profits".

In the DTAs with Mauritius and the UAE, there is no separate article dealing with "fees for technical services". However, under the residuary article in these DTAs, income by way of "fees for technical services" of the foreign resident are taxable in India if they are effectively connected with a permanent establishment or fixed base of the recipient in India, in which case they are taxable under the article dealing with "business profits".

India's DTAs with Mauritius and the UAE contain a provision that a building site or construction or assembly project or supervisory activities in connection therewith of a Mauritian/UAE entity will constitute a PE in India only if such site, project or activities continue in India for a period of more than nine months. Thus, in the case of a Mauritian/UAE entity executing a contract of the nature referred to above, the technical fees payable to the Mauritian/UAE entity would be taxable in India only if the contract continues in India for a period exceeding nine months. Therefore, in the case of such contracts of shorter duration, the non-resident Mauritian/UAE entity would not be liable to tax in India in respect of the technical fees paid for the contract.

H. Computation of income from royalty and fees for technical services when taxed under the article relating to "business profits"

In cases where the non-resident beneficial owner of the "royalties" or "fees for technical services" carries on business in India through a PE situated in India and the "royalties" or "fees for technical services" are effectively connected with or attributable to the PE, the provisions of the article dealing with "business profits" is relevant. In the first place, almost all the DTAs categorically provide that income attributable to the PE alone will be liable to be taxed in India. This income is to be determined by reducing the expenses allowable under

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the DTA from the gross income attributable to the PE. The manner of determination and the quantification of expenses allowable for computing the income of the PE varies between DTAs entered into with different countries.

In a majority of the DTAs, all expenses which are incurred for the purposes of the business of a PE including executive and general administrative expenses, whether incurred in India or elsewhere, are allowable as a deduction in accordance with the provisions of and subject to the limitations of the taxation laws of India, viz. the United Kingdom, the United States, Germany, France, Singapore, Netherlands, Japan, China, Sweden, etc.

However, under the India–Switzerland DTA, only the executive and general administrative expenses are allowable as a deduction in accordance with the taxation laws of India in computing the profits of a PE, while all the other expenses incurred for the purposes of the business of the PE are fully deductible whether incurred in India or elsewhere, without being subject to any ceilings or restrictions contained under the Act.

The DTAs with the UAE and Mauritius do not impose any restrictions on deductibility of expenses incurred for the purposes of the business of the PE and all such expenses whether incurred in India or elsewhere would be fully deductible in computing the profits of the PE without being subject to any ceilings or restrictions contained under the Act.

I. Rate of tax on income from royalty and fees for technical services which are taxed under the article relating to "business profits"

A recent ruling delivered by the Authority of Advance Rulings (AAR)[4] in *Ericsson Telephone Corp. v. CIT* [5] contains very important and far-reaching pronouncements on the issue in question. In this case the AAR examined the issue of the rate of withholding tax applicable to payments to be made by an Indian company to a Swedish company with a PE in India towards installation and training fees. The AAR held as follows:

> The fact that Article 13(3) of the India–Sweden DTA dealing with taxability of fees for technical services provides that in the event that such fees are effectively connected with a PE in India, the fees would be taxable under the article dealing with "business profits", does not take away the character of the receipts;
>
> The fees paid for installation and training services therefore constituted "fees for technical services" under Section 9(1)(vii) of the Act;
>
> Article 7(3) of the India–Sweden DTA provided that deduction in respect of expenses incurred for the purposes of the business of the PE were allowable as per the provisions of the Indian tax laws and Section 44D of the Act negated the allowance of a deduction for any expenses against fees for technical services due to a foreign company. Thus, the said fees were taxable in India on a "gross basis" without allowing any expenses;
>
> Section 115A of the Act restricted the rate of tax to 30 per cent as compared to the normal rate of 55 per cent applicable to a foreign company, in respect of income by way of fees for technical services due to a foreign company and, therefore, the said fees would be taxable in India on a "gross" basis at the rate of 30 per cent.

This leads to a very interesting situation. In the case of DTAs with a majority of countries which contain a provision similar to the one in the case of the India–Sweden DTA regarding the manner of computing the profits of a PE in India, any payments which constitute "fees for technical services" under the DTA as well as Section 9(1)(vii) of the Act would be taxed on a "gross" basis at the rate of 30 per cent, see Section 115A of the Act, if the fees are effectively connected or attributable to a PE which the non-resident foreign company has in India.

However, the provision under the India–UAE DTA and India–Mauritius DTA in such a situation would be different. Here only the "net" fees after allowing all expenses incurred for the purposes of the business of the PE as a deduction, without imposing any ceilings or restrictions under the Act, would be taxable at the rate of 30 per cent in India. Similar would be the position in the case of the India–Switzerland DTA, subject to the deduction for head office expenses being restricted to a ceiling of 5 per cent of the net fees before computing this deduction, see Section 44D of the Act. Accordingly, the tax incidence may be lower in these three countries as compared to other countries in such cases.

The following example clearly illustrates the impact of the foregoing advance ruling on the tax liability to which a PE of a foreign company will be subjected to in India depending upon the country of which the foreign company is a resident. Let us take the case of a foreign company which earns technical fees of USD 100 for rendering technical services in India and that company has a PE in India for rendering those services. Also, assume that the company has incurred expenses of USD 40 in India and head office expenses are USD 10 for the purposes of the business of the said PE. The tax liability of the PE in India depending upon the country to which the foreign company belongs is computed hereunder:

Particulars	Name of country		(In USD)
	UAE/ Mauritius	Switzerland	Any other country
gross fees	100	100	100
less: *expenses deductible:*			
expenses in India	(40)	(40)	0
head office expenses	(10)	(3*)	0
income taxable in India	50	57	100
current rate of tax	30%	30%	30%
tax liability in India	15	17.1	30

* Head office expenses in Switzerland restricted to 5 per cent of net fees after deducting other expenses.

Thus, it is clearly evident that, in such a situation, companies resident in the UAE and Mauritius have a significant tax advantage over companies resident in other countries. Companies resident in Switzerland would normally have a slightly higher tax liability as compared to their counterparts in UAE and Mauritius, depending upon the exact amount of

4. This is a body set up by the Indian Government, under the Act to pronounce advance rulings on tax issues related to transactions undertaken or proposed to be undertaken by non-residents.
5. AAR-New Delhi; 90 *Taxman* 144.

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head office expenses incurred for the purposes of the business of the PE.

It may be noted that if the technical services rendered by the foreign company do not fall under the purview of Section 9(1)(vii), viz. in the case of a construction, assembly, mining or like project, the concessional rate of tax provided (see Section 115A of the Act) will not apply and, consequently, the normal rate of tax, currently 55 per cent, applicable to a foreign company would be applicable to the income of the PE computed after deduction of all expenses, if so provided in the article relating to "business profits" in the relevant DTAs. In such a case the computation of income and the taxability of the same on the facts of the example given above will be as follows:

Particulars	Name of country UAE/ Mauritius	Switzerland	(In USD) Any other country
gross fees	100	100	100
less: *expenses deductible:*			
expenses in India	(40)	(40)	0
head office expenses	(10)	(3*)	0
income taxable in India	50	57	100
current rate of tax	55%	55%	55%
tax liability in India	27.5	31.35	55

* Head office expenses in Switzerland restricted to 5 per cent of net fees after deducting other expenses.

From the aforesaid examples it can be seen that the taxability of royalty/fees for technical services in the hands of the non-resident company under similar situations could vary depending upon the nature of the contract and the jurisdiction in which it is resident.

J. Reimbursement of expenses relating to royalty and fees for technical services between head office and the permanent establishment

All the DTAs usually contain a provision in the article dealing with "business profits" to the effect that the foreign enterprise is prohibited from claiming as a deduction in computing the profits of the PE, any payments made by the PE to its head office and other offices by way of royalties and fees for technical services, except when paid by way of reimbursement of expenses incurred by the head office or other office on its behalf. This provision also correspondingly excludes, from the profits of the PE, royalties and fees for technical services received from the head office and other offices otherwise than by way of reimbursement of actual expenses incurred by that PE.

K. Provisions of sub-clause (c) of Sections 9(1)(vi) and 9(1)(vii) diluted by DTAs

A related issue which usually arises is as to the tax treatment of any payments by way of royalties or fees for technical services made by the head office of the foreign enterprise to its other offices or affiliates or other parties outside India in respect of any right, property, or information used or services utilized either in the same or modified form for its PE in India. The question arises whether the foreign enterprise making payment to another foreign enterprise for such purposes would be obliged to deduct tax at source from such payments, see Section 195 of the Act. It is ironical that under the provisions of sub-clause (c) of Sections 9(1)(vi) and 9(1)(vii) of the Act, such payments would be taxable as "royalties" and "fees for technical services" in India although the same have accrued or arisen and been paid outside India. It, therefore, follows that the foreign enterprise would be obliged to deduct tax at source from such payments, see Section 195 of the Act.

The said sub-clause casts a very onerous responsibility on the non-resident payer. This fact is highlighted by the difficulties that arise in enforcing that provision in certain circumstances, some of which are as follows:

- the payment may have been made long before the actual utilization of the technology or the service in India; or
- the technology or service may have been considerably improved upon or changed by the payer before using it in an Indian business or source of income; or
- it may not be known at the time of payment as to whether the technology or service would be used in India; or
- it may not be known at the time of payment as to what part of the technology or services acquired to enrich its pool of information, would ultimately be utilized in India.

However, all the DTAs usually contain a saving provision in this regard in the article dealing with royalties and fees for technical services which provides that in these circumstances, such payments would be deemed to arise in India only if they are borne by the PE in India. Therefore, in cases where such payments are borne by the head office and not directly reimbursed by the PE, such payments would not be taxable in India and the question of any liability of the foreign enterprise to deduct tax at source (see Section 195) would not arise. To that extent, the harshness of the provision contained in sub-clause (c) of Section 9(1)(vi) and 9(1)(vii) is mitigated.

IV. AUTOMATIC EFFECT ON RATES OF TAX AND OTHER PROVISIONS PRESCRIBED IN THE DTAs IN CERTAIN CIRCUMSTANCES

The Indian Government has recently notified a DTA between India and Germany which has effect in India in respect of income arising in any fiscal year beginning on or after 1.4.97. This DTA provides for a concessional tax rate of 10 per cent on income by way of "royalties" and "fees for technical services" which is lower than the rate provided under most other DTAs.[6] The protocol to the DTAs signed with France, Spain, the Netherlands and Canada contain a provision to the effect that, if subsequent to the signing of those agreements, India signs a DTA with any country which is a member of the

6. The rate normally ranges between 15-20 per cent.

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OECD providing for a lower rate of tax than provided in those DTAs in respect of "royalties" and "technical fees", then the same rate would automatically apply to those DTAs also. The DTA with Switzerland contains a similar provision but states the two countries shall enter into negotiations without undue delay to provide the same rate to Switzerland. Germany is a member of the OECD. Therefore, the aforesaid lower rate of tax of 10 per cent provided in the India–Germany DTA will apply in case of payments to residents of France, Spain, the Netherlands and Canada in respect of "royalties" and "fees for technical services". Further, India and Switzerland ought to conclude negotiations in this respect so that the concessional tax treatment in respect of payments of royalties and fees for technical services is also extended to Swiss residents.

The protocol to the DTA signed between India and the Netherlands also provides that, if after the signing of that DTA, India signs a DTA with any country which is a member of the OECD providing for a scope more restricted than the scope provided for in that DTA in respect of "royalty" and "fees for technical services", the same scope shall also apply to that DTA in respect of the said items of income. The United States is a member of the OECD. The India–US DTA provides for a scope more restricted than the scope provided in the DTA between India and the Netherlands in respect of "fees for technical services". The DTA between India and the Netherlands came into force on 21 January 1989 while the India–US DTA entered into force on 18 December 1990. Therefore, the restricted scope provided in the India–US DTA in respect of "fees for technical services" will apply in case of payments of "fees for technical services" to residents of the Netherlands.

V. A CASE FOR REDUCTION IN TAX RATES UNDER DTAs

The Finance Bill, 1997 presented in the Indian parliament proposes to amend Section 115A of the Act to lower the rate of tax for foreign companies on income by way of "royalty" and "fees for technical services" received in pursuance of an agreement entered into with an Indian party on or after 1.6.97 from the existing rate of 30 per cent to 20 per cent. Since DTAs signed by India with most countries provide for a tax rate ranging from 10 to 20 per cent in respect of such income, the rates of tax under the provisions of the Act and the DTA would more or less be on par once this amendment comes into force, which would defeat the very purpose for which DTAs are negotiated. Therefore, it is essential that the rates under the existing DTAs are correspondingly reduced.

VI. CONCLUSION

Sections 9(1)(vi) and 9(1)(vii) of the Act in respect of taxability of "royalties" and "fees for technical services" are not totally in line with the principles of taxation based on the territorial nexus; yet as discussed above, the harshness of the above provisions is to a great extent mitigated by the provisions contained in the DTAs signed by India with other countries. A proper understanding and interpretation of the provisions of the DTAs read with the Act can enable foreign enterprises to claim substantial tax reliefs in India thereby making the proposition of exporting technology and specialized services to India attractive.

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THE HOLDING AND SUBSIDIARY COMPANY REGIME IN INDIA

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I. INTRODUCTION

The holding-subsidiary company structure caught the headlines of the tax magazines in India recently when the Authority for Advance Rulings (AAR)[1] ruled that on the particular facts of a case a holding company had a permanent establishment in India by virtue of having a subsidiary in India.

In India, the concept of holding and subsidiary companies owes its origin to the British rulers who were also instrumental in introducing the concept of limited liability entities. Holding and subsidiary company structures were, however, not in vogue in India for a long time after the legislature formally recognized such entities in the 1920s. Recently, however, after the "opening up" of the Indian economy in 1992 and the expansion of the operations of transnational organizations in India, such structures have become much more popular.

In India holding and subsidiary company structures offer certain advantages both in terms of savings in taxation and in reducing the regulatory approval process. Holding and subsidiary companies in India are also used for protecting intellectual property rights. These factors have meant that holding the shares of group companies in a single holding company is now increasingly common.

In light of the above, this paper explores some important aspects affecting the operations of holding companies in India by broadly discussing the general provisions regulating companies in India and the regulations governing investments into India through holding companies. It concludes with a consideration of some special aspects of taxation of holding companies, including a brief discussion on the recently published ruling of the AAR in India which concerned a Swiss company.

II. THE COMPANIES ACT

A discussion of holding companies necessitates a brief background on the evolution of limited liability entities in India.

As mentioned earlier, limited liability entities in India were the legacy of the British "raj", with the first legislation regulating limited liability entities being introduced in 1866. Four Acts, including the present one have been passed since then. These include the Indian Companies Act, 1882, the Indian Companies Act, 1913 and the Companies Act, 1956 (the Act). The Act has 658 sections and 15 schedules of which Section 3 defines a "company". The operative portion of Section 3 reads as follows:

> (i) "company" means a company formed and registered under this Act or an existing company as defined in clause (ii);
> (ii) "existing company" means a company formed and registered under any of the previous companies laws.

The Act further divides companies into two broad categories depending upon their characteristics. These are private companies and public companies. A private company is one which, by its articles:

> (a) restricts the right to transfer its shares, if any;
> (b) limits the number of its members to fifty not including
> (i) persons who are in the employment of the company; and
> (ii) persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased; and
> (c) prohibits any invitation to the public to subscribe for any shares in, or debentures of, the company.

Provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this definition, be treated as a single member.

Public companies are defined to include all companies that are not private companies. As a rule, private companies are less regulated than public companies especially in terms of reporting requirements.

III. HOLDING AND SUBSIDIARY COMPANIES DEFINED

Section 4 of the Act defines the terms "holding companies" and "subsidiary companies".[2] The important provisions of the said definition are discussed below under the following heads:

A. Control through voting rights;
B. Control over the board of directors; and
C. Foreign companies.

A. Control through voting rights

Section 4(1) describes the basic criterion for determining whether an entity is a holding company of another. This section states that a company would become a holding company if it holds:

1. The ruling given by the AAR is similar to a private ruling given in the United States.
2. For the text of Sec. 4 please refer to the Annexure.

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- more than half the nominal value of the equity share capital of the other company; or[3]
- it holds more than half the voting power in the other company either by way of equity shares or preference shares which have the same voting rights as equity shares.[4]

B. Control over the board of directors

A company would also become a holding company if it controls the composition of the board of directors of another company.[5]

A company is said to control the board of directors of another company if it can, without the consent of any other person, appoint or remove all or a majority of the directors in that other company.[6]

Interestingly, the word "control" has not been defined under the Act, hence one has to rely on case law for the definition of the same. In the old case of *Inland Revenue Commissioners v. Harton Coal Co. Ltd.*,[7] the word "control" in relation to a company was defined. It was held that "control" means the possession of the power by the exercise of voting rights to carry a resolution at a general meeting of a company.

Control can be said to exist only if the member company, i.e. the holding company, has independent power by the exercise of which either directly and/or through one or more subsidiaries it can appoint or remove the whole or a majority of the board of directors of another company.

Control may therefore be exercised indirectly. Take the example of a company, X, which holds shares in three subsidiaries, A, B and C. Now if X is in a position to control the subsidiaries of A, B and C then it would indirectly become the holding company of the subsidiaries of A, B and C.

Exploring the concept of indirect control further, consider a situation where a company, S, is controlled by another company, H, along with a group of persons (who may be the directors of H) without each individual entity having the power to control the company. Then it could be argued that S should be considered to be a subsidiary of H. However, going by the strict letter of the law, S would not become a subsidiary of H since H does not control, by itself, the board of directors of S, nor does it control more than half the voting power in S. This important lacuna in the definition of holding and subsidiary companies has been used by Indian promoters especially for controlling public companies which are listed on the stock exchange.

C. Foreign companies

Section 4(6) and 4(7) are of particular relevance to foreign companies.[8] Section 4(6) states that for considering whether a company is a holding or subsidiary company, the laws of the country in which such a foreign company is incorporated should be considered. Therefore, if an Indian company were to become the subsidiary of another company by the provisions of the laws of another country, then even if the Indian company would not be a subsidiary of the foreign company by virtue of Section 4(1),[9] it would be treated as a subsidiary of the foreign company.

Hence for example if an American company holds shares in an Indian company and by virtue of the provisions of the American law, the Indian company would be treated as a subsidiary of the American company then for the purpose of the Act too, such a company would be treated as a subsidiary of the American company.

On a close examination of the above section, an interesting situation arises which can be explained by way of the following example.

Company "A" is a company incorporated in India. Of the shares of A Ltd. 51 per cent are held by an American company, say "B" Inc. By virtue of holding a majority stake in A Ltd., B Inc. would become the holding company of A Ltd. Now if A Ltd., controls the board of directors of B Inc., then by virtue of Section 4(1), A Ltd. would become the holding company of B Inc. Ridiculous though it may seem, in situations described above, one cannot determine which company is the holding company and which company is the subsidiary company.

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3. Sec. 4(1)(b)(i).
4. Sec. 4(1)(b)(ii).
5. Sec. 4(1)(c).
6. A company shall be deemed to have power to appoint to a directorship of another company if:
   (a) a person cannot be appointed thereto without the exercise in his favour by that other company of such a power as aforesaid;
   (b) a person's appointment thereto follows necessarily from his appointment as director, or manager of, or to any other office or employment in, that other company; or
   (c) the directorship is held by an individual nominated by that other company or a subsidiary thereof. – Sec. 4(2).
7. (1960) 3 All ER 48; (1961) 43 ITR 541.
8. Foreign companies are defined under Sec. 591 of the Act. The said section provides:
   (1) (a) companies incorporated outside India which, after the commencement of this Act, establish a place of business within India; and
   (b) companies incorporated outside India which have, before the commencement of this Act, established a place of business within India and continue to have an established place of business within India at the commencement of this Act.
   (2) Notwithstanding anything contained in subsection (1), where not less than 50 per cent of the paid-up share capital (whether equity or preference or partly equity and partly preference) of a company incorporated outside India and having an established place of business in India is held by one or more citizens of India or by one or more bodies corporate incorporated in India, or by one or more citizens of India and one or more bodies corporate incorporated in India, whether singly or in the aggregate, such company shall comply with such of the provisions of this Act as may be prescribed with regard to the business carried on by it in India, as if it were a company incorporated in India.
9. For the text of Sec. 4(1) please refer to the Annexure.

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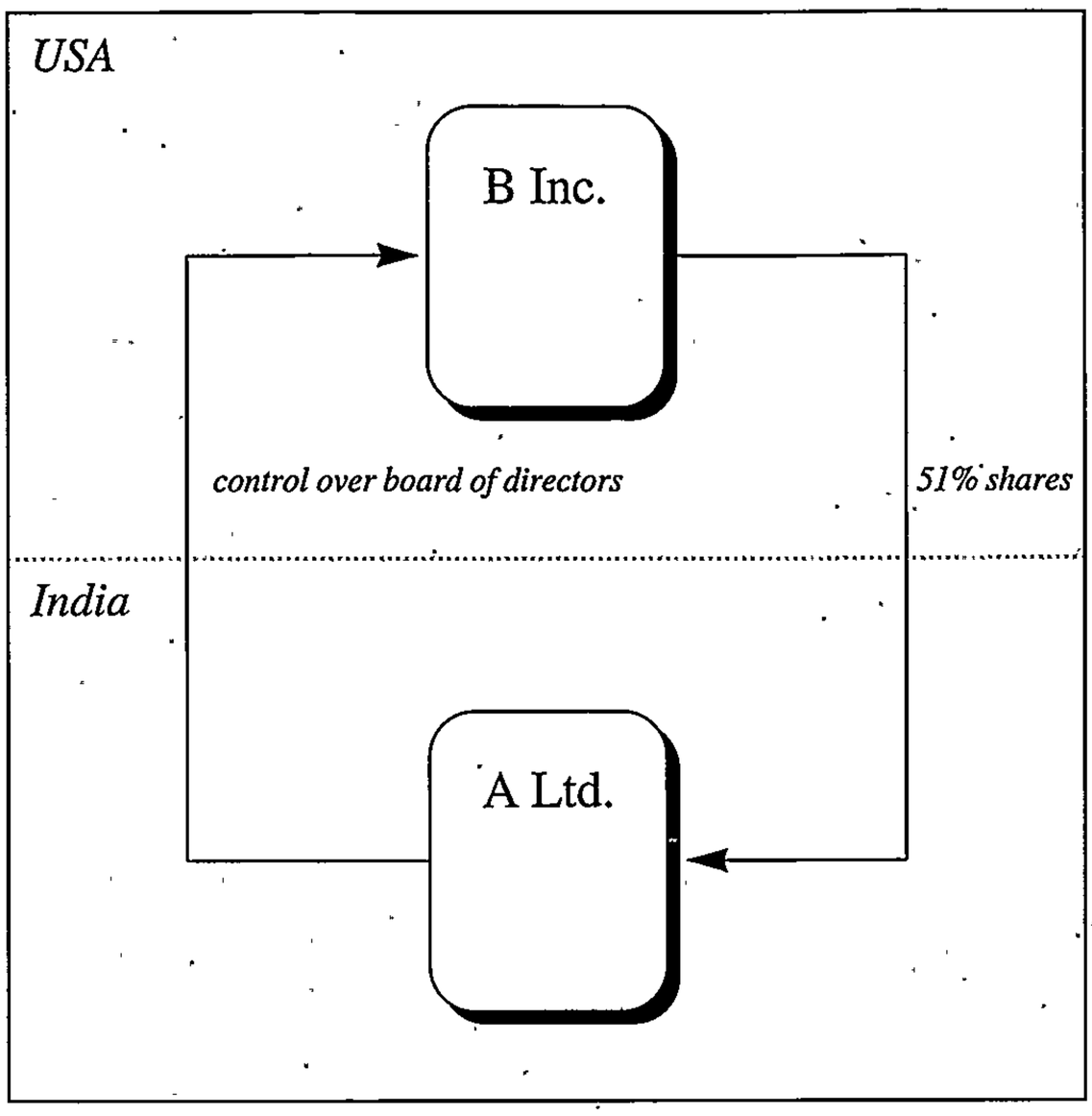

Section 4(7) was inserted in Section 4 as the result of the recommendations of the Companies Act Amendment Committee of 1957. The following extract sets out the gist of the recommendations of the said committee:

> In case of private companies which are subsidiaries of foreign bodies corporate, but in which some part of the capital is beneficially held by the Indian nationals or Indian companies, a provision be inserted in Section 4 to make it clear that such private companies will be treated as subsidiaries of public companies for all purposes of the Companies Act. As regards the treatment of private companies, the entire share capital of which is owned by one or more foreign bodies corporate, it is a matter of economic and financial policy for the Government to decide, having regard to the position of foreign investments in the country generally, whether or not such private companies should continue, as at present to remain outside the restrictions imposed on private companies which are subsidiaries of Indian public companies or whether they should henceforth be subject to such restrictions.

Complying with this recommendation, the legislation granted certain reporting exemptions to private companies that are 100 per cent subsidiaries of foreign companies by treating such companies as subsidiaries of private companies, irrespective of the fact that the holding company of such a company was a public company. Among the concessions given to companies which are subsidiaries of private companies is: a certificate for commencement of business is not required. Similarly, no limits on the remuneration of directors apply.

Another important section dealing with holding and subsidiary companies in the Act is Section 212. This section *inter alia* states that a holding company must file with the Registrar of Companies in India the balance sheet and audited accounts of its subsidiary along with its own accounts. Surprisingly, consolidation of accounts of holding and subsidiary companies is not mandatory in India and hence most holding companies do not consolidate their accounts.

Besides the two sections stated above, i.e. Section 4 and Section 212, there are no other important sections regulating holding and subsidiary companies in the Act and it seems that having formed the basic regulatory regime for holding and subsidiary companies, the Indian legislative system has been unable to keep pace with the changing business environment. This lack of concern on the part of the regulators is evident from the fact that the Act[10] does not even make it mandatory for holding companies to consolidate their accounts nor has the Institute of Chartered Accountants of India[11] issued any accounting standards or guidance notes on this topic.

IV. INVESTMENT IN INDIA THROUGH HOLDING COMPANIES ABROAD

Investment into India was till recently a highly regulated affair. The scenario changed significantly only after the New Industrial Policy was announced in 1991 when the Indian economy was opened up for foreign investment. Still, however, exchange controls are fairly strict in India and investment into India and exit from India require the approval of the government.

The investment approval process in India is in two forms, one being the automatic approval route[12] and the other involving the obtaining of approval of the Foreign Investment Promotion Board (FIPB)[13] on a case by case basis. The government has specified certain high priority industries where investment is approved on an automatic basis. Even in case of automatic approval, however, 100 per cent foreign ownership is not permitted other than where the foreign investors are persons of Indian origin[14] or overseas corporate bodies.[15]

Depending on the industry in which the investment is proposed to be made, a foreign company can hold up to 50 per cent of an Indian company's shares (industries primarily falling in the mining sector), 51 per cent (industries falling in

10. Interestingly, even the proposed companies bill, which is intended to replace the existing Act, also does not provide for mandatory consolidation of accounts.
11. The ICAI is the body which governs the working of auditors in India. The ICAI prescribes the accounting standards which are mandatory.
12. "Automatic approval" does not imply the absence of approval requirements; it only means that the foreign investor has to apply to the Reserve Bank of India (RBI) for investing into India and if his investment falls within the parameters approved for automatic investment, the RBI would generally grant approval for the investment within 21 days.
13. Till recently foreign direct investment by the FIPB was approved on a case-by-case basis without setting any precedent; recently, however, the FIPB has announced certain guidelines would be followed when granting approvals for foreign investment. While these guidelines would be generally adhered to by the FIPB, it would continue to have the power to make exceptions.
14. As per the Foreign Exchange Regulation Act, 1973: "A person (not being a citizen of Pakistan or Bangladesh) shall be deemed to be of 'Indian Origin', if
(i) he, at any time, held a Indian passport. Or
(ii) he or either of his parents or any of his grandparents was a citizen of India by virtue of the Constitution of India or the Citizenship Act, 1955. Or
(iii) that person is the spouse of an Indian citizen or of a person of Indian origin (not being a citizen of Pakistan and Bangladesh).
15. An Overseas Corporate Body is an entity in which not less than 60 per cent of the equity is held by person(s) of Indian origin.

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the priority sector) and 74 per cent (infrastructure industries).[16]

For investment into India, foreign investors have found the holding and subsidiary company structure for investment in listed companies fairly useful due to some loopholes in the Indian regulatory system. This structure is particularly attractive in case of investments in public companies, like finance/investment companies,[17] that would otherwise require the approval of the FIPB.

V. TAXATION OF HOLDING AND SUBSIDIARY COMPANIES

Having discussed the general framework governing holding and subsidiary companies in India, it is now appropriate to discuss the taxation of such companies. The tax regime in India is governed by the Income Tax Act, 1961 (the ITA). Interestingly the ITA does not define holding and subsidiary companies. However, it does contain certain provisions that affect holding and subsidiary companies which can be broadly divided into the following six categories:

- the transfer of assets from a holding company to its subsidiary;
- transfer pricing issues arising as a result of holding and subsidiary relationships;
- the subsidiary as a PE of the holding company;
- the taxation of dividends declared by the subsidiary company in the hands of the parent;
- Mauritian holding company structures for investment into India; and
- taxation of investments from India

A. Transfer of assets from a holding company to its subsidiary

Under the ITA, a capital gains tax of 20 per cent is levied on profits from the sale of long-term capital assets and a tax of 35 per cent (48 per cent in case of foreign companies) is levied on the profits from the sale of short-term capital assets. An asset would become a long-term capital asset if it is held for a period of at least 36 months. (Investments into shares of companies and other listed securities would qualify as long-term capital assets if they are held for a minimum period of 12 months.) Assets other than long-term capital assets are classified as short-term capital assets.

The ITA provides for the special treatment of transactions between holding and subsidiary companies. It provides that there would not be any capital gains tax on the transfer of an asset from a holding company to its wholly owned Indian subsidiary.[18] Similarly, there would not be any capital gains if an asset is transferred by a wholly owned subsidiary to its Indian holding company.[19]

It is important to note that the exemption from tax is granted by the ITA only in cases where the recipient of the asset is an Indian company. The exemption mentioned above would be withdrawn if the holding and subsidiary company relationship ceases to exist within a period of eight years from the date of transfer.

Also where a transfer of assets takes place between holding and subsidiary companies, the recipient has to provide depreciation on the assets using the transferor's written down value.

As is evident from the above discussion, the ITA views holding companies and subsidiary companies as one entity for the purpose of transfer of assets between these entities. Therefore, no gift tax[20] is levied in case of any transfer of an asset from a holding company to its subsidiary company.[21]

B. Transfer pricing issues arising as a result of holding and subsidiary relationships

Another important issue that arises as a result of the transactions between holding and subsidiary companies is that of transfer pricing. There are no specific regulations governing transfer pricing in India under the ITA, nor are there any regulations requiring consolidation of accounts.

This has led to widespread exploitation of this concept by many companies. One of the most prominent methods of avoiding taxes in case of holding and subsidiary companies is to transfer the profits of a profit making company to a loss making one, thereby reducing the tax burden of the profit making company. Take for example a profit making company A, which has a loss making subsidiary B. Using the concept of transfer pricing, A can transfer some of its profits to B, hence setting off the losses made by B and as a result, not pay any tax on the profits made by it. Indian tax planners adopt different means of transferring profits from one company to another. Some examples of such methods are:

- charging the costs of the loss making company to the profit making company;
- selling goods at a price lower than the market price to the loss making company; and
- buying goods from the loss making company at a price higher than the market price.

As stated above, the ITA does not lay down any scientific method to counter transfer pricing for resident taxpayers. There is, however, one Section, 40A of the ITA, that empowers the tax officer to disallow any expenditure incurred by a company where the benefit of such expenditure is derived by

16. Part A, Part B and Part C of the expansion of the Annex III industries. Part A of Annex III deals with mining industries, Part B deals with other priority industries and Part C deals with infrastructure industries. For the entire expanded Annex III list, see 3 *Asia Pacific Tax Bulletin* 3 (1997), at 73.
17. It is important to note that, as per the recently announced takeover code, if an entity were to invest in a private company being a holding company of a listed company and as a result of the investment the investing entity directly or indirectly holds more than 10 per cent of the shares of the listed company, it would have to make a public offer for acquiring at least another 20 per cent of the shares of the listed company.
18. Sec. 47(iv) of the ITA.
19. Sec. 47(v) of the ITA.
20. Gift tax is levied in India under the Gift Tax Act, 1958. The said act provides that transfers made without consideration or for inadequate consideration would be liable to gift tax under the Gift Tax Act, 1958.
21. *GTO v. Venesta Foils Ltd.* [(1980) 124 ITR 660, 673 (Cal)].

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a company in which the expending company has a substantial interest.[22] As is apparent, this section is highly subjective and leaves a lot of discretion in the hands of the tax officer.

As far as non-resident taxpayers are concerned, Sections 92 and 93 of the ITA contain certain provisions similar to Section 40A. These sections also give the tax officer the right to add to the profits of any resident taxpayer any amount he feels has been reduced by the resident while dealing with a related non-resident company.

Alarmed by the growing misuse of the transfer pricing technique especially by transnational corporations, the finance ministry in India is studying the practice of transfer pricing adopted by such organizations. According to a recent news report,[23] the finance ministry has asked the National Institute of Public Finance and Policy to undertake a study of transfer pricing and arm's length transactions adopted by transnational corporations. It is hoped that the legislation formed on the basis of the recommendations of the National Institute of Public Finance will stop the widespread misuse of transfer pricing.[24]

C. The subsidiary as a PE of the holding company

As far as international transactions are concerned, the ITA gives an option to the taxpayer to avail of the provisions of a double taxation avoidance treaty or the ITA, whichever is more beneficial to it.[25] India has over a period of time signed approximately 55 double taxation avoidance treaties. As per the provisions of these tax treaties, subsidiaries normally do not constitute a PE of their holding company. Article 5(7) of the OECD Model Convention (MC) gives effect to the above statement, and provides that:

> The fact that a company which is resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not in itself constitute of either company a permanent establishment of the other.

A similar statement is also present in the UN MC and the US MC. This article recognizes the independence that a company has under private law. Its position as a taxable entity is not affected by its dependence under company law. Nor is the controlling company a permanent establishment of the subsidiary it controls.

The MCs make this clear by using the words "of itself". In such cases the subsidiary continues as a separate taxable entity. Like any other unrelated company, however, a subsidiary, if an independent agent, can very well constitute a permanent establishment of its parent if it is held to do so by reference to Article 5(6).[26] A subsidiary may, for instance, act as an agent of its parent company and conclude such contracts for the latter on the basis of a corresponding authority so as to go beyond the ordinary course of its business.[27]

If a subsidiary acts as an agent of the parent, it would be taxed in respect of its own profits and the parent would be taxed also in respect of the profits derived from contracts concluded by the subsidiary on behalf of the parent. It is important to note that this rule does not distinguish between the person who is in control and the controlled. Therefore, the controlling company can also be an agent. Hence a holding company can also become a permanent establishment of its subsidiary.[28]

An interesting case on taxation of holding companies was published recently.[29] This case involved the determination of the tax treatment of the holding company of an Indian subsidiary based in Switzerland. In this case the AAR ruled (despite the express provision under the India–Switzerland Double Taxation Avoidance Agreement, to the effect that merely having a subsidiary in India would not make the Swiss parent have a PE in India) that the Swiss parent of the Indian Subsidiary had a PE in India.

Although the rulings given by the AAR are not binding and do not set a precedent, they do have a lot of persuasive effect. Therefore this decision, it is predicted, may well have severe effects on the operations of many transnational corporations in India.

D. Taxation of dividends declared by the subsidiary company in the hands of the parent

Till recently dividends received from the subsidiary company by the holding company were exempt from tax if the holding company distributed the same to its own shareholders.[30] This can be illustrated by means of the following example:

A is a wholly owned subsidiary of another company B. A declares a dividend of INR 100 that would be distributed to B. Now if B were to distribute this entire INR 100 to its shareholders, it would not have to pay any tax on its dividend income from A.

The aforementioned provision has been amended to provide that although there would not be any tax payable on the dividends in the hands of the shareholders of the company, the company paying the dividend would have to pay a tax of 10 per cent on the dividends declared by it.[31] Hence continuing the above example, if A wishes to fully distribute its profits it would have to pay tax of INR 9.09 on the dividends distributed by it and only the balance INR 90.91 would be paid to B. Now again if B were to declare a dividend from its income from A then it would again have to withhold tax at the rate of 10 per cent on the dividends distributed by it. This new taxation regime has made holding shares through investment companies suddenly very unattractive.

22. Sec. 40A(v) of the ITA.
23. The Business Standard, 17 June 1997.
24. How far these regulations would be effective is still unclear, considering the fact that many transfer pricing norms are inherently controversial.
25. Sec. 90(2) of the ITA.
26. Art. 5(6) lays down the circumstances where an independent agent would be a permanent establishment of the parent.
27. Schurmann, W./Reinhardt, G., 20 *AWD* (1974).
28. Para.41 MC Comm. Art. 5, 1992, which in this respect has been adopted by the UN MC commentary.
29. Petition No. 8 of 1995, In re (AAR-New Delhi) [1997] 90 *Taxman* 47.
30. Sec. 80M of the ITA.
31. Sec. 115O of the ITA.

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E. Mauritius and holding company structures for investment into India

Any paper describing the holding and subsidiary company regime in India would be incomplete without a mention of the growing use of holding companies for investment into India through Mauritius.

The importance of Mauritius has grown primarily because of the favourable double taxation avoidance treaty signed by India and Mauritius. The said treaty, among other things, provides for an exemption from capital gains tax from investment into India. Mauritius also has a well-developed offshore companies administration regime. Furthermore, the Mauritius legal system allows the formation of various hybrid entities. The favourite entity used by American companies for investment into India from Mauritius is the Limited Life Company, or LLC as it is popularly called. An LLC would be treated as a company for the purposes of Mauritius and Indian law and would be treated as a partnership under US law. One of the primary advantages of the LLC structure is that it does away with the double taxation, which usually occurs when investing through a company (i.e. taxation occurs firstly in the hands of the company on its income and secondly in the hands of the shareholder by way of tax on the dividends it receives).

The India–Mauritius Treaty has recently been criticized both by the Indian media and the Indian Tax Department. The controversy surrounding the India–Mauritius Treaty revolves around the fact that the Indian media and the Indian Tax Department view investment from Mauritius into India as being undertaken primarily to avoid Indian taxes. The AAR has also begun questioning such investments and in one case did pierce the corporate veil of a company formed in Mauritius for the purpose of making investments in India and looked at the beneficial ownership of the company.[32] However, one must note that despite all the controversy, Mauritius still remains the favourite vehicle for investment into India, and if the entity investing into India from Mauritius is able to show some commercial justification for following the Mauritius route, then its structure may also be recognized by the Indian Tax Department.

F. Taxation of investment from India

With the opening up of the Indian economy Indian entrepreneurs are looking to the international market to sell their products. When expanding operations abroad, minimizing taxation in the foreign country becomes an important issue. Though India has been fairly aggressive as far as signing treaties is concerned, there are not many countries which may be used as conduits where an Indian company wants to invest abroad. Though a Mauritian subsidiary could be used for investing from India, some old treaties signed by India which are based on the exemption method of taxation could provide a more tax efficient route.

VI. CONCLUSION

As is evident from the above discussion, regulating holding and subsidiary companies has not been a priority for the Indian legislature.[33] This is reflected in the fact that the present Companies Act does not even provide for consolidated accounts. The government now seems to have realized this and has decided to take some steps towards preventing the widespread misuse of such structures. The move to regulate abusive transfer pricing by transnational corporations can be viewed as a concrete example.

The aggressive stand taken by the Tax Department in India in the case which involved the Swiss company also goes to prove the maturity of the Indian Tax Department in dealing with complex tax issues.

Thus, as the Indian economy is now on the threshold of becoming a mature economy, it is prudent that the Indian Government sets up an adequate regulatory regime governing holding and subsidiary companies.

ANNEXURE

Meaning of "holding company" and "subsidiary".

(1) For the purposes of this Act, a company shall, subject to the provisions of subsection (3), be deemed to be a subsidiary of another if, but only if,
- (a) that other controls the composition of its board of directors; or
- (b) that other
  - (i) where the first-mentioned company is an existing company in respect of which the holders of preference shares issued before the commencement of this Act have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company;
  - (ii) where the first-mentioned company is any other company, holds more than half in nominal value of its equity share capital; or
- (c) the first-mentioned company is a subsidiary of any company which is that other's subsidiary.

Illustration

Company B is a subsidiary of company A, and company C is a subsidiary of company B. Company C is a subsidiary of company A, by virtue of clause (c) above. If company D is a subsidiary of company C, company D will be a subsidiary of company B and consequently also of company A, by virtue of clause (c) above, and so on.

(2) For the purposes of subsection (1), the composition of a company's board of directors shall be deemed to be controlled by another company if, but only if, that other company by the exercise of some power exercisable by it at its discretion without the consent or concurrence of any other person, can appoint or remove the holders of all or a majority of the directorships; but for the purposes of this provision that other company shall be deemed to have power to appoint to a director-

32. Please refer to case on *Natwest Bank* 220 ITR 377.

33. However, such an attitude of the Indian regulators can be excused since till recently India was a highly regulated economy, infested by what was known as the "licence raj", whereby practically each and every move of a corporation would have to be approved by the government. With the "opening up" of the Indian economy, finding a system for regulating the holding and subsidiary company regime has now become the order of the day.

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ship with respect to which any of the following conditions is satisfied, that is to say

(a) that a person cannot be appointed thereto without the exercise in his favour by that other company of such a power as aforesaid;

(b) that a person's appointment thereto follows necessarily from his appointment as director, or manager of, or to any other office or employment in, that other company; or

(c) that the directorship is held by an individual nominated by that other company or a subsidiary thereof.

(3) In determining whether one company is a subsidiary of another

(a) any shares held or power exercisable by that other company in a fiduciary capacity shall be treated as not held or exercisable by it;

(b) subject to the provisions of clauses (c) and (d), any shares held or power exercisable

(i) by any person as a nominee for that other company (except where that other is concerned only in a fiduciary capacity); or

(ii) by, or by a nominee for, a subsidiary of that other company, not being a subsidiary which is concerned only in a fiduciary capacity; shall be treated as held or exercisable by that other company;

(c) any shares held or power exercisable by any person by virtue of the provisions of any debentures of the first-mentioned company or of a trust deed for securing any issue of such debentures shall be disregarded;

(d) any shares held or power exercisable by, or by a nominee for, that other or its subsidiary not being held or exercisable as mentioned in clause (c) shall be treated as not held or exercisable by that other, if the ordinary business of that other or its subsidiary, as the case may be, includes the lending of money and the shares are held or the power is exercisable as aforesaid by way of security only for the purposes of a transaction entered into in the ordinary course of that business.

(4) For the purposes of this Act, a company shall be deemed to be the holding company of another if, but only if, that other is its subsidiary.

(5) In this section, the expression "company" includes any body corporate, and the expression "equity share capital" has the same meaning as in subsection (2) of Section 85.

(6) In the case of a body corporate which is incorporated in a country outside India, a subsidiary or holding company of the body corporate under the law of such country shall be deemed to be a subsidiary or holding company of the body corporate within the meaning and for the purposes of this Act also, whether the requirements of this section are fulfilled or not.

(7) A private company, being a subsidiary of a body corporate incorporated outside India, which, if incorporated in India, would be a public company within the meaning of this Act, shall be deemed for the purposes of this Act to be a subsidiary of a public company if the entire share capital in that private company is not held by that body corporate whether alone or together with one or more other bodies corporate incorporated outside India.

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THE 1990S REVOLUTION IN TAX POLICY

Parthasarathi Shome[1]

I. INTRODUCTION

If one broadly compares the current rate structures of the main central taxes in India with those prevailing at the beginning of the decade, it would be hard to deny that the 1990s have witnessed far-reaching changes in the Indian tax system (Shome, 1996). Selected states have also been attempting to clean up their sales tax rate structures[2] in this period.[3] These changes have been introduced in an environment of an extremely inefficient tax structure. For example, looking at commodity taxes, (i.e. excise duty, customs duty and countervailing duty) which are levied by the Centre, and the sales tax which is levied by states, Aggarwal (1995), using 1989-90 data, found that there were many distorting effects of those taxes:

- the burden of tax on consumers in rural areas was 11 per cent and in urban areas 12 per cent;
- the burden varied between 3-40 per cent depending on the commodity;
- on average, sales tax accounted for the highest burden, exceeding 5 percentage points of the effective tax rate;
- effective tax rates reflected substantial input taxation: more than 30 per cent of the total for most commodities and even 100 per cent for iron ore and some services; and
- the contribution of sales tax in input taxation was the highest.

Income taxation in the 1980s was also subject to very high and multiple rates. In relation to those findings, the subsequent tax structure as it has developed over the 1990s is clearly more efficient. The last two years, 1996-97 and 1997-98, have, indeed, speeded up the process to a revolutionary pace.

Lacunae do exist, however, in the form of the continuation of incentives, exemptions and uncharacteristically generous depreciation allowances that contribute to eroding the tax base. These tend to afflict most taxes and affect the horizontal and vertical equity of the tax system. Another deleterious impact of the changes in the tax structure has been on tax revenue, which has tended to fall in terms of GDP during the 1990s (Shome, 1997a, Executive Summary).

This paper attempts to assess the impact of the major changes on the efficiency, equity and revenue productivity of the tax system. Section II presents a summary of those changes in direct and indirect taxes during the 1990s, treating the details of tax changes in the 1997-98 budget independently.[4] Section III examines the revenue experience during this period. Section IV analyses the efficiency and equity effects. Section V concludes.

II. 1990s CHANGES IN THE TAX STRUCTURE

There can be no doubt that the changes that the tax structure has undergone in the 1990s are significant. Across the board, tax rates have been slashed and their dispersion narrowed on efficiency grounds, while the basic deduction in the income tax has been increased and more sources of income subjected to tax deduction at source on grounds of both equity and tax administration efficiency. The overall tax structure has increasingly begun to compare well with international trends even though insufficient success in streamlining the wide prevalence of exemptions and allowances has affected revenue productivity.

A. Direction of changes in the 1990s

The direction of changes in the structure of the main direct and indirect taxes is illustrated in Tables 1, 2 and 3. This is followed by a brief description of the tax rules for capital gains and depreciation.

Capital gains: Capital gains are divided into long-term or short-term with reference to the period of holding of the asset by the taxpayer or by the previous owner and the taxpayer under certain circumstances. The capital gain is the difference between the cost of acquisition (adjusted for inflation)[5] and the fair market value on the date of the transfer. The gain is chargeable as income of the previous year in which the transfer took place. The long-term capital gain is subjected to a flat rate of income tax, which is 20 per cent for an individual, Hindu Undivided Family (being resident) and a domestic company and 30 per cent for a foreign company. Foreign institutional investors and non-resident Indians are taxed at the rate of 10 per cent (introduced in the 1997-98 budget). A short-term capital gain is treated as part of the taxpayer's gross income and, therefore, is subject to the standard income tax rates.

Depreciation: Under Section 32(1) depreciation on machinery and plant is to be allowed as a deduction only to the owner who actually uses the asset for the purpose of its busi-

1. This article was written in May 1997 when the author was Director, National Institute of Public Finance and Policy, New Delhi. He is currently Advisor, Fiscal Affairs Department, International Monetary Fund, Washington D.C. The author is grateful to Dr H. Mukhopadhyay, Senior Economist, NIPFP, for helping with statistical information. The opinions expressed in this article are solely those of the author and not necessarily of any other individual or institution unless mentioned.
2. The focus of this paper is, however, on central taxes. State level taxes are not considered.
3. At the local level also, property taxation, which is the mainstay of local taxation in so many countries, yields very little revenue in India. This issue is not looked at in the paper, however.
4. The Indian fiscal year is between 1 April and 31 March.
5. The acquisition cost is to be increased by the cost inflation index.

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ness or profession. Different rates of depreciation for different categories of assets are notified in the Income Tax Rules, 1962. However, the rates have been revised several times in the past. Some current rates are as follows:

- furniture and fittings: 10 per cent
- plant and machinery: 33.33 per cent
- water pollution control devices: 100 per cent
- energy saving devices: 100 per cent

B. The "watershed" budget, 1997-98

In his 1997-98 budget speech, the Minister of Finance reiterated that the thrust of tax reform in the form of moderate rates, a broad tax base and administration through simple rules, would continue. The "supply side" element in the budget was underlined by the scaling back of the personal income tax rates from a rate structure of 15, 30 and 40 per cent to 10, 20 and 30 per cent, respectively. The standard deduction was increased further to INR 20,000 and senior citizens were given 100 per cent relief up to INR 40,000 annually. In addition, in order to obviate the double taxation of dividends, they were made taxable at a flat rate of 10 per cent.[6] The surcharge of 7.5 per cent on the corporate income tax was abolished and the tax rate on domestic companies was reduced to 35 per cent (though that on foreign companies

6. This tax is deducted at source by the company.

Table 1
Personal Income Tax Rates

Taxable Income INR '000	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
0- 12	Nil	Nil	Nil	Nil	Nil	Nil	Nil	Nil
12- 18	Nil	Nil	Nil	Nil	Nil	Nil	Nil	Nil
18- 20	Nil	Nil	Nil	Nil	Nil	Nil	Nil	Nil
20- 22	Nil	Nil	Nil	Nil	Nil	Nil	Nil	Nil
22- 25	20	20	Nil	Nil	Nil	Nil	Nil	Nil
25- 28	20	20	Nil	Nil	Nil	Nil	Nil	Nil
28- 30	20	20	20	Nil	Nil	Nil	Nil	Nil
30- 35	30	20	20	20	Nil	Nil	Nil	Nil
35- 40	30	20	20	20	20	Nil	Nil	Nil
40- 50	30	20	20	20	20	20	15	10
50- 60	40	30	30	30	20	20	15	10
60-100	40	30	30	30	30	30	30	20
100-120	50	50	40	40	30	30	30	20
120-150	50	50	40	40	40	40	40	30
over 150	50	50	40	40	40	40	40	30

Source: Budget documents.

Note: For the years 1990-91 and 1991-92, surcharge is leviable where total income exceeds INR 75,000. For the years 1992-93 and 1993-94, it is leviable when total income exceeds INR 100,000.

Table 2
Corporation Tax Rates

	1990-91	1991-92	1992-93 to 1994-95	1995-96	1996-97	1997-98
Domestic Company	50	40	45	40	40	35
Foreign Company	65	65	65	55	55	48

Source: Budget documents.

Note: 15 per cent surcharge (for the AYs 91-92 to 96-97) or 7.5 per cent surcharge (AY 1997-98) on income tax if the total income of a domestic company exceeds INR 75,000. No surcharge is payable in the case of a foreign company. (AY = assessment year.)

The distinction between widely held and closely held domestic company was abolished in 1995-96. Reported figures before 1995-96 are for the widely held domestic company. The tax rates for the other group of domestic companies is always higher by 5 percentage points till 1994-95.

Table 3
Peak Rates for Customs and Excise (per cent)

	Tariff rate	Excise
1991-92	150	110+ INR 15,750
1992-93	110	110+ INR 15,750
1993-94	85	110+ INR 15,750
1994-95	65	70
1995-96	50	50
1996-97	50	50
1997-98	40	40

Source: Budget documents and CII's post budget memorandum.

Note: Import-weighted average tariff rates for 1992-93 and 1994-95 were 55.5 per cent and 30 per cent, respectively. They have declined further to about 28 per cent currently, though exact figures are not yet available.

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remains at 48 per cent). Further, in order to remove a remaining inequity against Non-Resident Indians (NRIs)[7] who invest in India, the capital gains tax on transfers applicable to them was reduced to 10 per cent from 20 per cent to make it comparable with the rate applicable to foreign institutional investors. The Minimum Alternative Tax (MAT) that had been reintroduced in 1996-97[8] at a 10.5 per cent rate on book profits, was rationalized by allowing the associated tax credit to be carried forward for five years.[9] However the exclusion of exporters from the scope of MAT can be seen as a movement in the opposite direction.

The gambit of incentives was further expanded. Telecommunications companies were given tax holidays with the objective of promoting improvements in infrastructure and tax rebates were provided under Section 88 of the Income Tax Act.[10] Tourism was granted a deduction of 50 per cent of profits in new investment in hill, rural and pilgrimage areas. Limits on business expenses were also increased. Thus, the budget could not ultimately maintain a tight lid on granting additional erosionary tax incentives, exemptions and allowances.

In continuation of the customs tariff reform the peak rate of customs duties was brought down from 50 per cent to 40 per cent with most intermediate goods being charged at 20 per cent. It was announced that ASEAN levels of customs duties would be reached by the end of the century while, within three years, the number of excise duties would be brought down to four from the prevailing nine. The new mean excise rate was set at 18 per cent.

The taxation of services remains haphazard. Selected services were brought under the tax net, including road transport, air travel and tours, consulting engineers, clearing house agents, manpower agencies and temporary construction ("mandals") for ceremonies. Such a mere experimentation with services taxation created a bad feeling among disaffected businesses. A nationwide strike was called by road transporters, adversely affecting economic activity at considerable cost to the exchequer and GDP.

To conclude, despite the obvious lacunae in the 1997-98 budget, a new direction was given through it in the form of lowering the nominal tax burden for all taxpayers, thereby exhorting them as well as non-filers to improve compliance voluntarily and enter into a more mature relationship with the tax authorities. The likelihood of success or failure of this strategy is yet to emerge but, as will be pointed out in Section IV, the Minister of Finance has given definite pointers regarding his seriousness in pursuing tax evaders with a "fist" behind his "rubber glove".[11]

III. REVENUE IMPLICATIONS

While the positive changes to the tax structure are widely agreed to have improved the efficiency of the tax structure by reducing its cascading and other distortionary elements, it may have been inevitable that tax revenue would decline in terms of GDP because of the relative inaction in terms of expanding the tax base, for example, by ridding the system of exemptions or making sustained attempts to increase the number of taxpayers. India experienced the beginning of an economic crisis in 1990-91 when it entered into an International Monetary Fund supported Stand-By Arrangement, initiating major economic reforms and hastening significant tax policy changes. In 1990-91, the tax to GDP ratio of the Centre stood at almost 11 per cent, higher than in 1994-95 when the financial crisis was over and the economy had stabilized. By the latter year, the tax to GDP ratio had fallen to less than 10 per cent (Table 4). This decline of about 1 per cent of GDP can be broken down into a 1 per cent of GDP decline in customs revenue, a ½ per cent of GDP decline in excise revenue, and a ½ per cent of GDP increase in income tax revenue (shared about equally between individual and corporate income tax, Bagchi, 1994).

As will become more obvious in Section IV, the nature of reforms emphasizing efficiency improvements was expected to lead to a possible decline in revenue from indirect taxes. The rise in direct tax revenue has only partially offset this decline.

7. Those Indians or persons of Indian origin who spend more than half the tax year abroad.
8. MAT was originally introduced for a trial period of two years in the late 1980s.
9. This follows the Mexican model, which was initiated with a five-year arrangement but which later incorporated indefinite carry-back and carry-forward (McLees, 1991).
10. This section harbours various tax credit schemes.
11. Parliamentary deliberations on 9 May 1997.

Table 4
Trends in Tax to GDP Ratio (per cent)

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97 (r.e) [1]	1997-98 (b.e) [2]
Gross tax revenue	10.8	10.9	10.6	9.5	9.8	10.2	10.5	10.6
Corporation tax	1.0	1.3	1.3	1.3	1.5	1.5	1.5	1.5
Taxes on income	1.0	1.1	1.1	1.1	1.3	1.4	1.5	1.5
Customs	3.9	3.6	3.4	2.8	2.8	3.3	3.5	3.6
Excise	4.6	4.7	4.4	4.0	4.0	3.7	3.7	3.6
Other taxes	0.3	0.4	0.5	0.3	0.2	0.3	0.3	0.4

Source: Shome (1996) and Budget documents for 1997-98.

Note: 1. r.e. = revised estimates of the Government of India.
2. b.e. = budget estimates of the Government of India.

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The increase in direct tax revenue has occurred despite (or because of) a scaling back of income tax rates, faith on which has led to further slashing of rates in 1997-98. The belief that supply-side responses may be relied upon seems to have taken hold in Indian taxation philosophy at the moment; the accompanying policy measures that are necessary to generate more revenue will be dealt with in Section IV.

In 1995-96, there was a sharp improvement in the tax to GDP ratio, which crossed the 10 per cent mark once again. But this mainly reflected a depreciation in the domestic currency. This bolstered customs revenue, which gained back 2/5 per cent of GDP although excise revenue declined further by 1/5 per cent of GDP as the scope of input tax credit against the excises was broadened. Preliminary 1996-97 figures point towards the same upward movement; nevertheless, the figure of 10.5 per cent is lower than the 10.8 per cent of 1990-91. This ratio is budgeted to remain about the same at 10.6 per cent in 1997-98, lending credibility to the argument that the rapid GDP growth of the 1990s has not only not led to a rise in the tax to GDP ratio but has actually resulted in a decline. This has worried many social scientists for two diverse reasons: first, because of high expenditure commitments of which interest payments are a rising component and, second, reflecting the preoccupation that, even though an overall progressive tax structure should have automatically yielded a higher tax to GDP ratio as incomes rise, India's recent experience seems to have negated this orthodox view.

IV. EFFICIENCY AND EQUITY RAMIFICATIONS

Efficiency and equity issues are often intrinsically linked because of the nature of various effects of a particular change in the tax structure. Nevertheless, they are separately treated where feasible while their interlinkages are pointed out wherever needed.

A. Efficiency aspects

Within the income tax, the drastic reductions in the tax rates are a clear impetus to efficiency, both in terms of encouragement of savings as well as a motivation to work. Economic literature has been in consensus for some time now that savings incentives do not encourage overall savings but merely channel the same quantum of savings in new directions (Messere, 1993). On the other hand, it is likely that a scaled back tax rate structure may raise the overall savings rate, at least in developing countries (Muhleisen, 1997).[12] A similar efficiency effect may be expected in terms of encouragement of work effort, thereby providing the necessary impetus for growth. Thus the changes in the income tax structure in India in the last two years should undoubtedly have a salient efficiency impact through different channels.

Improvement in efficiency has, in no small measure, been introduced in the indirect taxes as well. Export duties have been abolished. The customs tariff structure has been fully rationalized in terms of progression over capital, raw material and final goods. The effective tariff rate has been slashed over the 1990s with a top rate of only 40 per cent as indicated above, even though the overall levels remain on the higher side by international standards. The Minister of Finance in his 1997-98 budget speech indicated that international comparability will be reached by early next century.

Excises have also been virtually rid of cascading, redressing many distortions that had affected productive decisions adversely prior to the expansion of the Modified Value Added Tax (MODVAT) scheme. This scheme in the quintessentially self-styled manner of the Indian tax system, expanded over many years the coverage of "VATable" commodities to an increasing number of goods.[13] The total number of rates has been reduced to nine (plus two extreme rates), their dispersion has been reduced, and the tax paid on inputs has been made creditable. First, only taxes on raw materials were made creditable. In 1994-95, taxes on capital goods were also made creditable but only when actually installed and utilized against a "VATable" item. In 1995-96, this restriction was removed. After the 1997-98 budget was passed, the Minister of Finance added that further excise reform would be carried out in the near future.

B. Equity issues

While efficiency improvements have been significant, the lack of progress in terms of eliminating exemptions and incentives still renders the tax system inequitable. Both the customs tariff and excise structures, for example, continue to be replete with them (Shome, Mukhopadhyay and Saleem, 1996). They run into pages, leading to problems of interpretation of the intent of the law, and often end up in litigation. Revenue collection is postponed and, therefore, its real value is eroded because of inflation. Further, not only is the system rendered inequitable because of the difference that obviously emerges between those favoured with and those excluded from the incentives structure, but the system also tends to become inefficient because, when their rationale becomes unclear, the exemptions and incentives could very well worsen resource allocation rather than redirecting resources in desired channels.

Another source of inequity in indirect taxation is the marginal inclusion of services in the tax base. As pointed out in Section II, its lackadaisical extension covered only a handful of services even though the services sector has been one of the dynamic growth sectors as a result of liberalization. The perceived unfairness of this strategy has led to strikes and the stoppage of economic activity. Much preparation and rationalization is needed in this area so that services could be adequately and broadly included in the tax net. Also, the states have to be necessarily brought into the picture since not only are many services that are consumed at local levels, more

12. In developed countries, the permanent income hypothesis is more likely to hold, i.e. there is a proportional relationship between income and savings in the long run (OECD, 1994, Robson, 1995).

13. The process began in 1986. This contrasts markedly with the experiences of other countries where, typically, an initial preparation for the VAT is made for two to three years after which a full-fledged VAT is usually introduced.

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amenable to state level taxation, but the constitution is also not too categorical about the assignment of the taxation of services.

The income taxes also suffer from base erosion. It is well known that many profit making companies have not paid income tax because of generous depreciation provisions, allowances, incentives and exemptions: they are commonly called "zero-tax companies".[14] In 1996-97, a minimum company income tax called the Minimum Alternative Tax (MAT), based on book profits (as opposed to the usual tax calculation based on taxable profits) was introduced but, under pressure, exporters were exempted from it in 1997-98. A minimum tax based on book profits has a relatively narrow scope and is subject to the possibility of continued tax avoidance and evasion. A better alternative would be one based on gross assets.

A gross assets based MAT is one of the least understood taxes. Yet it has both efficiency and equity properties. It is efficient because it results in a company having to earn a minimum rate of return on its assets in order to meet tax obligations; otherwise capital would have to be redirected. It is equitable because it spreads the tax burden more evenly across capital use and, therefore, on profits. Thus companies pay tax according to profits irrespective of size or clout, thereby promoting both horizontal and vertical equity.[15]

Another matter of inequity is that foreign companies are subjected to higher nominal rates of taxation than are domestic companies. Modern taxation norms would not uphold this practice. On the other hand, there seems to be inadequate understanding and preparedness in the Income Tax Department (hereinafter: Department) regarding the practices of multinationals to maintain "arm's length" when dealing with their branches and subsidiaries, or how they operate internationally through "transfer pricing" mechanisms to minimize their total tax burden, with possible detrimental effects on a particular country's revenue intake. It would be preferable to tax foreign companies at similar rates to domestic companies but to be well aware of their tax planning strategies so that revenue productivity does not suffer.[16] However, this approach would require investment in an in-depth study and analysis of at least those multinationals that are or are likely to set up operations in the country. Latin American countries have tended to adopt this tenacious yet more result-oriented approach to the taxation of multinationals.

The equity problem with the personal income tax has also emerged in full force. Much of the tax revenue is collected from fixed salary earners, the total taxpayer list not exceeding 12 million.[17] A simple calculation indicates that less than one sixth of potential taxpayers are in the tax net. If the middle class comprises 300 million individuals, of which 20 per cent is excluded as belonging to the untaxed agricultural sector, with a family size of five and a 1.5 person average income earning capacity per household, this result follows.

The Department has extended the instrument of tax deduction at source (TDS) to various sources of income beyond the commonly subjected sources such as wages and interest in order to enhance equity in the taxation of different income sources. Nevertheless, there is still much room for further expansion in scope, especially in areas in which black money is easily generated. However, various improvements are needed in the administration of TDS before coverage could be broadened. These include updating of the taxpayer list, adequate dissemination of information to taxpayers, making requisite forms available to taxpayers as well as to withholders, providing sufficient compensation to withholders for the free service provided by them to the Department, not subjecting withholders to double audit pertaining to regular activity and, again, for activity as a withholder and, last but not least, the provision of innovative measures for computerization by allowing some independence to local offices to computerize in the short run while progressing quickly on the installation of a nationwide computer network (Shome, Aggarwal and Singh, 1997).

The 1997-98 budget introduced another mechanism based on the idea of presumptive taxation in an attempt to reduce evasion of the personal income tax and improve equity. Any individual is now required to file a return if he has fulfilled any two of the following four criteria during the previous fiscal year: ownership of property, a phone or an automobile, and undertaking of a trip abroad. At the same time, a tax amnesty was announced in the hope of initiating the action on a clean slate.[18] As an indication of iron resolve, the Minister of Finance said in the parliament during the budget deliberations on 9 May 1997 that he plans to initiate prosecution against tax evaders. However, the tax administration infrastructure in place – both in terms of manpower and computerization – remains inadequate to handle the situation even if only a portion of the potential taxpayer base responds to his call. Further, Rajaraman, Singh and Roy (1995) point out that presumptive taxation based on consumption indicators is likely to be far less successful than a system based on pro-

14. There is a 100 per cent exemption for operating profits from exports of goods and merchandise. Indeed, while duties on exports reduce export competitiveness in international markets and have virtually been eliminated, there is no apparent justification for export incomes also not to be taxed at all. Second, there are concessions relating to: backward area location (terminating on 31.3.1998), backward areas in non-backward states (scheduled but not yet notified), power generation and distribution (up to 31.3.1998), small-scale units (up to 31.3.2000), and infrastructure investment (not income bound). Third, while the existing investment allowance provision was terminated on 31.3.1990, the depreciation allowances were enhanced starting 1.4.1988. The accelerated write-off now possible under Sec. 32 is the most widely exploitable means by which corporate tax liability is reduced (NIPFP, 1997).

15. If a Constitutional amendment is needed for this, it may be better to prepare steadily for the tax, comprehend its ramifications fully and then introduce it in the best form possible, rather than apply it on a narrow base, and even then not very convincingly.

16. Even developed countries are becoming increasingly preoccupied with the question of adequate control of multinationals for tax purposes especially as they increasingly reveal tendencies to minimize loss in the form of contribution to tax revenue across the globe. See the 1996 conference proceedings of the panel on 21st century taxation, International Fiscal Association (1997, forthcoming).

17. This list is not updated since there is delay in netting out stop-filers and the deceased. The more likely number is 10 million.

18. This was termed the Voluntary Disclosure Scheme through which the amount disclosed as cash, securities or assets is to be taxed at the new highest rate of 30 per cent. The scheme will be terminated in 1997. Of the amount collected, 77.5 per cent will accrue to the states and will finance basic minimum services and infrastructure. Unfortunately, international evidence including that of India points to the ineffectiveness of amnesties in achieving their goals (Tanzi and Shome, 1993).

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duction indicators. Clearly though, the imperative prerequisite in the form of the strong resolve of policy makers at the very top to attack tax evasion seems to have emerged unmistakably on the horizon.

V. CONCLUDING REMARKS

Much has been achieved in India's programme of tax reforms especially in the last two years, but further action is essential in selected areas. Summarizing the achievements as well as future needed action, first, under the income tax, it should be recognized that the 1997-98 budget has slashed rates for both personal and corporate income tax to their lowest levels in India's post-independence economic history. India's rates now compare with those in Latin American countries, and are lower than in most OECD countries. In this, the Finance Minister has placed responsibility on the taxpayer to respond to his call for voluntary reporting. Nevertheless, to ensure revenue productivity from such a scaled back rate structure, administrative mechanisms have to be hurriedly improved. Measures needed include:

- the completion of the computerization process and the issuance of Permanent Account Numbers (PAN);
- the reinstitution of meaningful information systems; and
- more transparent enforcement mechanisms.

The Voluntary Disclosure Scheme announced in the 1997-98 budget whereby individuals are expected to file returns voluntarily if any two criteria of four – ownership of telephone, car, or real estate and foreign travel – apply to them for the previous year, could not be expected to be successful without an adequate administration structure in place. With respect to companies, exemptions and incentives should be eliminated from the corporation income tax. Further, either depreciation allowance should be cut back or a minimum tax based on gross assets should be introduced.

Second, while the 1997-98 budget has not regressed from earlier achieved excise reform, much room exists for the final phase of reform. The number of MODVAT rates has to be reduced to two or three. That would allow the reintroduction of additional selected traditional excises, typically on petroleum products, tobacco products and alcoholic beverages (the last is a state matter in India) as well as on a very few select items of extreme luxury. This is the common practice in other – including OECD, Asian and Latin American – countries and should be reinstated in India for revenue reasons so that the downward slide in excise revenue may be arrested. In the longer term, a harmonized VAT between the Centre and the states has to be designed. However, at present there is little progress even towards harmonization at the states level. States should together take the opportunity of the existence of a coalition government at the Centre with a large regional representation to make possible the introduction of a harmonized VAT at the state level. For those states that would initially lose revenue, the possibilities of compensation should be worked out including service taxation at the state level. Other compensation mechanisms are also possible. Ideally, the country should move to a dual VAT encompassing the Centre and the states in order to internalize the full benefits of a broad based, distortion reducing, comprehensive VAT.

Third, as mentioned above, the lack of coordination among states, and between the Centre and states, has emerged as a significant problem, the longer-run negative implications of which may not be immediately obvious. This has had adverse ramifications in various directions, for example, for the taxation of services. Services should be brought in comprehensively under the tax net. VATs in most countries cover not only goods but also services. In India, services have fallen between the two stools of Central and state jurisdictions. On the one hand, the Centre taxes manufacturing while the states tax sales. On the other, the Centre has all residual powers of taxation, thereby expanding the coverage of services from time to time and very slowly. Even in the 1997-98 budget, the issue of service tax was dealt with lackadaisically at best, with the Centre naming a few services to be taxed. For example, why consulting engineers alone – among a host of professional services that could be easily taxed – were singled out is puzzling. Instead, there should have been exhaustive discussions with the states before such an obviously hurried and incomplete list was made law. Indeed, various states are now unilaterally coming up with a list of services to be taxed by them in their 1997-98 budgets. The pace of drawing up an appropriate list of taxable services should be rationally and comprehensively expanded in a coordinated manner. This could be achieved under the auspices of an expert committee that could also look into the possibility of allowing states to tax services *pari passu* with the introduction of a harmonized VAT at the state level.

Fourth, customs tariff reform should progress at a brisk pace with the aim of making the structure comparable with international standards. Given the pace of reform and recent announcements on various occasions by the Finance Minister there is reason to be optimistic on this score. The ultimate goal should be a single tariff policy – as in Chile – which has the attractive property of minimizing disputes, lobbying and corruption.

Fifth, the prevalence of exemptions and incentives in the income taxes, capital gains tax, domestic production taxes as well as customs duties – despite some attempts at containment – is just too wide to make the tax structure meaningfully equitable or efficient. The effective customs tariff rate, VAT rate and corporate income tax rate for different industries are almost impossible to compute because of exemptions and incentives and, in any event, they keep changing constantly. This must have significant deleterious effects on production decisions. Exemptions must be eradicated from the tax system.

Finally, even though not directly addressed in the paper, a rational and meaningful approach must be taken towards property taxation and, associatedly, rent control laws. Without it, not only will cities and, commensurately, their infrastructures, break down, but the general government's overall fiscal deficit – consolidating central, state and local government – is bound to remain unchecked in terms of GDP. Taiwan has had a successful tax on the speculative increase in

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the value of urban land and Korea has considered it. Such a tax has been imposed at the point of transaction (see Tanzi and Shome, 1992) and Indian laws should be changed to make it feasible.

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TRANSFER PRICING REGULATIONS IN INDIA: CHALLENGES AHEAD

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I. INTRODUCTION

Transfer pricing refers to the value attached to the transfer of goods or services including technology between related entities. The issues related to it are currently one of the most important subjects in the area of international taxation.

The enactment of Section 482 (Final Regulations) by the United States[1] in July 1994 and the publication of the revised Guidelines on Transfer Pricing by the OECD in July 1995[2] are the two most significant events related to the subject. Following these developments, many countries from the different trade blocks such as the European Union, the North American Free Trade Agreement (NAFTA) and the ASEAN Free Trade Area (AFTA) have tried to harmonize their transfer pricing regulations. However, transfer pricing remains a vexing problem for most developing countries, including India.

In the context of the growing importance of transfer pricing issues and considering the fact that almost half of the transactions in international trade are potentially susceptible to transfer pricing,[3] this paper aims at presenting a critical analysis of the existing transfer pricing provisions under different statutes in India and at making suitable recommendations on the issues relating to this subject.

The scheme of presentation is as follows: Section II examines the significance of the issues in transfer pricing in the context of the globalization of the Indian economy. The next section reviews the theoretical developments of transfer pricing in different countries. Section IV analyses the existing provisions under Indian statutes. These provisions include regulations under different taxes viz., income tax, customs duty, and union excise duties. The following section puts forth the suggested reforms to the regulations. Finally, Section VI presents a summary of conclusions and recommendations.

II. SIGNIFICANCE OF THE ISSUES

The importance of issues related to transfer pricing has long been recognized. The issues have, however, become critical in India during the last five years due to three important factors. Firstly, since 1991-92 India has embarked upon a course of structural reforms. This has paved the way towards globalization of the Indian economy and resulted in the removal of barriers such as prohibitive customs duties. The reforms have also done away with most of the other fiscal and regulatory restrictions in order to enable foreign enterprises, especially the multinational corporations (MNCs) to participate in the economic development of the country through their capital and technology.

Secondly and more importantly, as the prevailing trends suggest, there is a feeling that, in general, the MNCs pay less tax than comparable domestic organizations.[4] In the Indian context it is felt that since the tax administration is lax and the management information system (MIS) in the tax departments is practically non-existent, the MNCs would certainly not pay the tax due to the country.

Thirdly, with the expansion of the export sector, the Indian undertakings engaged in exporting their products could increasingly exploit transfer pricing to reduce their tax liabilities through undervaluing their exports to their related or affiliated counterparts located in foreign low-tax regimes. These related enterprises would in turn transfer their products back to the same or a related enterprise in India at higher prices and thus avoid the incidence of tax. In order to protect India's tax base it is therefore important that the laws are tightened.

As the inflow of direct foreign investment is increasing over time, the above issues raised by transfer pricing are achieving a higher profile.

III. THEORETICAL DEVELOPMENTS IN TRANSFER PRICING

Transfer pricing concerns the valuation of transfers of goods or services between related entities, i.e. parent and subsidiary corporations, or sister corporations. To illustrate, domestic company A has a subsidiary or an associate multinational

1. Internal Revenue Service Final Regulations (TD 8552), relating to intercompany transfer pricing under Sec. 482 (referred to as US (1994)) published in Federal Register on 8 July 1994.
2. OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, Report of the OECD Committee on Fiscal Affairs*, Paris. Part I of the Draft titled "Principles and Methods", addresses the issues related to the transfer of goods. Part II relates to the areas of transfer pricing for intangibles and services.
3. Quoted in CCH *Australian Master Tax Guide* (1996), at 1234.
4. In a Report from Price Waterhouse it is shown that 30 per cent of the worldwide sales and 43 per cent of the reported book profits of the US MNCs originate from their foreign offices.

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company B. Company A transfers some products (inputs or finished goods) or assets to B. The value attached to the products transferred by A to B is the transfer price. It is important that the transfer prices of the products in question were fairly set when determining the tax revenues due to countries A and B.

To find an answer to this problem, the approach of the OECD emphasizes that the guiding principle is the arm's length criterion. The OECD Guidelines are intended to suggest mutually acceptable solutions. Accordingly, the Guidelines indicate different pricing techniques, as set out below.

First, there is the principle of arm's length (elaborated in chapter I of the Guidelines) which states that if the price or the margin is not within the arm's length range, adjustment should be made by the tax administration. However, the taxpayer must be given the opportunity to present additional evidence. The US regulations are more rigid than the OECD Guidelines.

Secondly, the Guidelines present the technique of comparable uncontrolled prices (CUP). Since in a related party transaction price can be controlled, there must be a reference to a comparable situation where price is not controlled, i.e. a benchmark.

Thirdly, there is a cost-plus technique. The starting point in this method is the cost incurred by the supplier of the goods in a transaction between the related enterprises. A profit mark-up is added to the costs. It is ideal in a sellers' market, where the international norms vary between 5 and 10 per cent. Disputes may however occur since it is possible that the cost is likely to include a fair return on investment. What is a fair return is not a matter of law but of commerce and may be hotly contested.

Fourthly, the Guidelines refer to a technique called resale minus. According to this technique, the fair price is the price at which the product is sold to an independent third party by a related enterprise, which subsequently resells the product. This resale price is reduced by a gross profit margin which takes into account the relevant costs and expenses and also a reasonable profit in the light of the functions performed, assets used and risks assumed. It is possible that the product sold by a company may not be sold by any other company but the point here is not the price of the product but the margin of the dealer. For example, generally speaking, a distributor earns a 15 per cent commission. If the commission substantially exceeds 15 per cent, the issue may require investigation by the tax officials.

Fifthly, there is the method called transactional profit method or the profit split method. In such a method, the profit to be split must be identified. Following this, the profit could be split between the related enterprises. The Guidelines state that this method is useful in the absence of comparables.

Finally, there is a method called the net margin method. This method examines the net profit margin in relation to the costs, sales, or assets, which a taxpayer realizes from a transaction or aggregated transactions with a related party.

The above approaches suggest various arm's length solutions to the problem of transfer pricing. There is no one multilaterally applicable solution to cover all situations. National rules differ with regard to the priority of the methods.

IV. PROVISIONS UNDER THE INDIAN STATUTES

Various tax statutes, the company law regulations, and the foreign exchange regulations in India have dealt with the issues related to transfer pricing. The following are the main provisions related to the issues.

A. Provisions under income tax

Under the income tax laws, if a business transaction between a resident and a non-resident is so structured that it results in no profit or less than the ordinary profit, the tax authorities may determine a "reasonable" amount of profit from the transaction. The profit which has been so "deciphered" is added to the taxable income of the resident assessee. The profit may be determined with reference to the value of the transaction by applying the ratio of total business receipts or by using any other appropriate method.

Section 92 of the Indian Income Tax Act, 1961,[5] covers transfer pricing among other devices designed to avoid tax between a resident and a non-resident.[6] When it appears to the Assessing Officer that "owing to the close connection between them, the course of business is so arranged that the business transacted between them produces to the resident either no profit or less than the ordinary profit which might be expected to arise in that business, the Assessing Officer shall determine the amount of profit which may reasonably be deemed to have been derived therefrom and include such amount in the total income of the resident." Rules 10 and 11 of the Income Tax Rules, 1962, prescribe the methods for determining such income. Normally, it is calculated as a percentage of the turnover. These provisions have, however, rarely been invoked by the tax authorities.

In *Mazagaon Dock Ltd. v. Commissioner of Income Tax and Excess Profits Tax*[7] the Supreme Court considered the application of the provisions. In this case the appellant was a private limited company incorporated under the Indian Companies Act and was carrying on business as marine engineers and ship repairers. Its registered office was in Bombay and it was resident and ordinary resident in India. Its entire share

5. The provisions of the Income Tax Act are amended from time to time. The Act and the rules presented here are as amended by the Finance (No. 2) Act, 1996.

6. Some related provisions also exist in Sec. 93 concerning income from an asset transferred to a non-resident as income of the resident under certain situations and Sec. 94 relating to avoidance of tax on certain transactions in securities. However, the mere fact that the transfer resulted in the avoidance of tax liability cannot be the proof of the intention to avoid the liability. See *CIT v. Mohammed Ibrahim Sahib* (1962) 45, *Income Tax Reporter*, 301, (Cal).

7. *Commissioner of Income Tax/Excess Profits Tax v. Mazagaon Dock Ltd.* (1955) 28 I.T.R. 35 affirmed.

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capital was beneficially owned by two British companies, the P&O Steam Navigation Corp. Ltd. and the British Indian Steam Navigation Co. Ltd., whose businesses consisted in plying ships for hire. Under an agreement, entered into with these two companies, the appellant repaired their ships at cost, and charged no profits. Now, the point of determination was whether on these facts, the appellant was chargeable to tax under Section 42(2) of the Income Tax Act, 1922.[8]

The Income Tax Officer, Bombay, who dealt with the matter took the view that the appellant company had so arranged its business with the non-resident companies that it did not produce any profits, and that was because it was those companies that really owned its share capital, and that, therefore, the profits which it could ordinarily have made but for their close financial connection were liable to be taxed under Section 42(2), and computed the same at INR 680,000 for the account year 1943-44, etc. On the basis of the above findings, orders of assessment of income tax were made. Against these orders the appellant preferred appeals to the Appellate Assistant Commissioner who confirmed the same. The matter was referred to the Appellate Tribunal and the orders were set aside. On appeal by the Department before the High Court it was held that Section 42(2) was applicable and that the appellant was liable to be assessed to income tax. The taxpayer appealed. Finally, the Supreme Court dismissed the taxpayer's appeal on the basis that the charge was on the business of the appellant and not on the non-resident company.[9]

Section 142 (2A) of the Income Tax Act further envisages that

> if, at any stage of the proceedings before him the Assessing Officer, having regard to the nature and complexity of the accounts of the assessee and the interest of the revenue, is of the opinion that it is necessary so to do, he may with the previous approval of the Chief Commissioner or Commissioner, direct the assessee to get the accounts audited by an accountant as defined in the Explanation below subsection (2) of Section 288, nominated by the Chief Commissioner or Commissioner in this behalf and to furnish a report of such audit in the prescribed form duly signed and verified by such accountant and setting forth such particulars as may be prescribed and such other particulars as the Assessing Officer may require.

This is a powerful tool given to the Assessing Officer by the Income Tax Act.

B. The role of tax treaties

Tax treaties are useful in handling the issues related to transfer pricing. These treaties could affect transfer pricing in two different ways. First, by providing specific clauses, the treaties define a specified base for allocation of income. And secondly, the treaties identify the transaction to which the basis would apply and provide for resolution of disputes.

So far India has entered into more than 60 Double Taxation Avoidance Treaties.[10] These treaties provide a safeguard against transfer pricing abuse by the "Associated Enterprises". Therefore, each treaty incorporates an article on this aspect, primarily following the OECD and the UN Models. It stands as follows:

> 1. Where – (a) an enterprise of one of the States participated directly or indirectly in the management, control or capital of an enterprise of the other State, or (b) the same person participates directly or indirectly in the management, control, or capital of an enterprise of one of the States, and an enterprise of the other State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
>
> 2. Where one of the States includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the States shall if necessary consult each other.

The above clause makes the following important points relating to arm's length transactions:

- it addresses the question of the apportionment of profits and commercial and financial relations;
- its scope is not limited to transactions or their pricing; and
- it refers to certain pre-conditions to the application of the article, such as the degree of association or inter-connection between taxpayers, and whether the arrangements or dealings provided are different from those that would have been entered into in an unrelated situation.

However, it is important to note that the word "association" is capable of a wide meaning and may be interpreted subjectively. It refers to "direct" or "indirect" participation as well as "management, and control".

8. The corresponding section in the current Act is Sec. 92, which deals with the determination of profits. In addition there are provisions governing calculation of income through Secs. 37(1), 40A(2), and 44 C, each dealing with aspects relating to expenses for calculating income.

9. *Income Tax Reports* (1958), Vol. 34, at 368-378. Here it is important to note that for preventing evasion of tax, sufficient powers are provided by the Income Tax Act for the assessing officer to determine the taxable income of a business or profession. Sec. 37(1) entitles the assessing officer to examine whether or not expenditure has been incurred wholly and exclusively for the purpose of the business. Sec. 80 I or 80 IA, empowers the Assessing Officer to determine the deduction allowable to reduce the total income of the company. Sec. 40A(2) specifically states that "where the assessee incurs any expenditure in respect of which payment has been or is to be made to any persons referred to in clause (b) of this sub-section, and the Assessing Officer is of the opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of the expenditure as is considered by him to be excessive or unreasonable shall not be allowed as a deduction." Also, Sec. 44C imposes a ceiling on the allowances of the head office expenditure in the case of non-residents. However, the Calcutta High Court has held that the above restriction does not apply to a foreign company having its entire business in India. *Rupanjuli Tea Co. Ltd. v. CIT* (1991) 92 CTR (Cal) 37: (1990) 186 ITR 301 (Cal).

10. See for details, Srinivasan K. (1997), *Guide to Double Taxation Avoidance Treaties*, Vidhi Publishing, New Delhi-110 002.

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Notwithstanding the above limitation, the article embodies the essentials of a "fair price". It suggests that the adjustments should be made in such a way that the profits are derived and taxed in the hands of the enterprise, as if the concerned enterprise was not dealing with an associated enterprise. However, the matter is not so simple. The profit that would have arisen to that enterprise itself is likely to create a problem of transfer pricing. The two contracting states may themselves not agree on what is an arm's length price. The potential for disagreement is much more when one of the contracting states has an aggressive approach to transfer pricing and may operate a system of determining profit allocation which may not be strictly in accordance with the arm's length principle.

In addition, double taxation avoidance treaties derived from the OECD/UN Models in general lack teeth. The article provides for a consequential rate adjustment, based on an adjustment that the enterprise in the other contracting state has made.

It is also important to note that paragraph (2) of the article does not specify the method for making the adjustment. It is possible that some states would make corresponding adjustments by reducing the taxable profits whereas others would prefer simply to give a tax credit.

Where the profits of a subsidiary taxable in India are artificially reduced India may take recourse to Section 92 of the Indian Income Tax Act, 1961, to adjust the profits of the subsidiary upwards. The parent company should via the treaty make an application to the appropriate tax authorities in its own home country. The newly drafted OECD Guidelines for transfer pricing[11] have attempted to reconcile the tax regimes of various countries; whether it has been successful in its attempts is not yet clear.

C. Company law on transfer pricing

The effect that transfer pricing may have on the profitability of a company is also considered in the provisions of the Indian Companies Act, 1956.

Section 211 dealing with the form and contents of the balance sheet and the profit and loss account requires that every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year and shall, subject as aforesaid, comply with the requirements of Part II of Schedule VI, so far as they are applicable thereto: Provided that nothing contained in this subsection shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of profit and loss account has been specified in or under the Act governing such class of company.

In addition, the Government of India, under the Companies Act has the power to direct a special audit in certain cases. Section 233A states that

> (1) Where the Central Government is of the opinion
> (a) that the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or
> (b) that any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or
> (c) that the financial position of any company is such as to endanger its solvency;
>
> the Central Government may at any time direct that a special audit of the company's accounts for such period or periods as may be specified in the order, shall be conducted and may by the same or a different order appoint either a chartered accountant as defined in clause (b) of subsection (1) of Section 2 of the Chartered Accountants Act, 1949 ... to conduct such special audit. Provided that the special auditor shall, instead of making his report to the members of the company, make the same to the Central Government. The expenses of, and incidental to, any special audit under this section (including the remuneration of the special auditor) shall be determined by the Central Government and paid by the company.

In addition, the central government is empowered under Section 233B of the Companies Act to order the audit of cost accounts in certain cases.

Section 227 of the Companies Act specifies the duties of the auditors. Accordingly, an auditor is required to report under the Manufacturing and Other Companies (Auditor's Report) Order, 1988 (MAOCARO) whether purchases of goods and materials and sales of goods, materials and services between associated parties are made at prices which are reasonable having regard to comparable market prices for transactions with other parties.[12]

The above provisions have enough teeth to look into the problem of transfer pricing of resident as well as non-resident companies, as and when the need arises.

D. Provisions under FERA

The Foreign Exchange Regulations Act (FERA), 1973, incorporates further checks relating to the misuse of foreign exchange. Section 18(16) under FERA provides that

> where the value of the goods specified in the declaration furnished under that subsection is less than the amount which in the opinion of the Reserve Bank, in a case falling under sub-clause (i) of clause (a) of that subsection, represents the full export value of those goods, or in a case falling under sub-clause (ii) of that clause, the value which the exporter can, having regard to the prevailing market conditions, expect to receive on the sale of the goods in the overseas market, the Reserve Bank may issue an order requiring the person holding the shipping documents to retain possession thereof until such time as the exporter of the goods has made arrangement for the Reserve Bank or a person authorized by the Reserve Bank to receive on behalf of the exporter payment in the prescribed manner of an amount which in the opinion of the Reserve Bank represents the full export value of such goods or the value which the exporter, having regard to the prevailing market conditions, can be expected to receive on the sale of the goods in the overseas market.

These are additional checks on any party entering into transfer pricing to avoid payment of due tax.

11. See for details, *supra* note 2.
12. As per para 4 (A) (xi) of MAOCARO the auditor is required to certify the reasonableness of the price charged/paid for the transactions.

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E. Transfer pricing under customs duties

Transfer prices are directly relevant in determining the quantum of customs duties where the duty is charged on an *ad valorem* basis. Under arm's length principles, the value of imported goods should reflect an open market price. However, where the taxpayers are related the importer may be induced to declare a value which is lower than the fair market price to enable the importer to pay a reduced amount of duties.

To examine whether the importer has declared the correct transfer prices, the authorities are armed with the powers derived from the Indian Customs Act, 1962. Also, there are specific provisions for valuation under the Customs Valuation (Determination of the Price of Imported Goods) Rules, 1988. If need be, the General Agreement on Tariffs and Trade (GATT)[13] could also be used to invoke the relevant powers of the authorities. The GATT which has been signed by more than 120 countries, is binding upon all of them.[14] India and all the other signatories of GATT therefore have an obligation to review, upon a request by another contracting party, the operation of their domestic law relating to valuation of goods for domestic purposes.

In the Indian context, Section 14 of the Customs Act, 1962, provides that the assessable value of imported goods shall be

> deemed to be the price at which such or like goods are ordinarily sold or offered for sale, for delivery at the time and place of importation or exportation, as the case may be, in the course of international trade, where the seller and the buyer have no interest in the business of each other and the price is the sole consideration for the sale or offer for sale.[15]

In this context the case of *Orson Electronics Pvt. Ltd. v. Collector of Customs Bombay* is an important illustration showing the modus operandi of evasion under this section. In this case the transaction took place between Indian and Japanese companies. Higher value was declared to the Japanese Customs House and lower value was declared to the Indian Customs. The importing company had a 51 per cent share in the supplier firm. The revaluation was done on the basis of the documents seized by the Japanese Customs at the insistence of the Indian Customs.[16]

The valuation rules under the Customs Valuation (Determination of the Price of Imported Goods) Rules, 1988, provide an exhaustive list of the circumstances in which the transaction value between the two parties needs to be examined carefully before it is accepted as the transfer price on the basis of which assessable value can be determined. However, the transaction value will not be accepted where the buyer and the seller are related.

The circumstances where the buyer and the seller are deemed to be related are given in Rule 2(2) which states that it

> includes where
> (i) they are officers or directors of one another's business;
> (ii) they are legally recognized partners in business;
> (iii) they are employer and employee;
> (iv) any person directly or indirectly owns, controls or holds 5 per cent or more of the outstanding voting stock or shares of both of them;
> (v) one of them directly or indirectly controls the other;
> (vi) both of them are directly or indirectly controlled by a third party;
> (vii) together they directly or indirectly control a third person; or
> (viii) they are members of the same family.
>
> Explanation:
> 1. The term person also includes legal persons.
> 2. Persons who are associated in the business of one another in that one is the sole agent or sole distributor or sole concessionaire, however described, of the other shall be deemed to be related for the purpose of these rules, if they fall within the criteria of this sub-rule.

When the customs value cannot be determined under the Customs Act, a process of consultation between the customs administration and the importer is initiated and the valuation is determined under the Customs Valuation Rules, 1988. However, the interpretative notes to the Rules indicate the following relevant aspects related to transfer pricing:

(a) the sale price used between related buyers and sellers needs to be scrutinized only where there are doubts about the acceptability of the price;
(b) where related buyers and sellers buy from and sell to each other as if they are not related, this would demonstrate that the price has not been influenced by the relationship;
(c) where it is shown that the price is adequate to ensure recovery of all costs plus profit, the cost-plus formula could be accepted as a satisfactory estimate of transfer price;
(d) in determining whether one value closely approximates to another value, various factors such as the nature of the imported goods, the nature of the industry, the season in which the goods are imported, etc. are required to be taken into consideration; and
(e) in comparing the prices both the commercial level and the quantities in which the goods are sold are considered relevant.

Recognizing the difficulty in arriving at an acceptable transfer price for the imported consignment, the best judgement of the officer could be adopted using "reasonable means consistent with the principles and general provisions of the Customs Rules".[17] However, in arriving at such a price some principles have been enunciated through different judgements of the Supreme Court. First, the transactions must be between related persons. Secondly, there should be mutuality of interest among these related persons. The Supreme Court has held that it is not sufficient to show that the parties are

13. It is however important to note that the rules of the GATT are not specifically meant to safeguard the problem of transfer pricing. Nonetheless, it does give guidelines for valuation of the imported goods. See GATT (1994), *Guide to GATT Law and Practice*, at 233-242.
14. GATT provides for principles for valuation for customs purposes. These are set forth in Art. VII of the Agreement.
15. The Act does not accept as the basis for determination of assessable value a transfer price where the seller and the buyer have an interest in the business of each other or where the price is not the sole consideration for the sale.
16. 1996 (82) *Excise Law Times*, 499 (Tribunal) in the CEGAT, Court I, old special bench A, New Delhi, at 499-503.
17. In the recent case of *Poonam Leather Industries v. Collector of Customs, Cochin* it has come to light that for want of careful investigation the transfer price could be reduced considerably, and the goods could be mis-declared. See, 1996 (82) *Excise Law Times*, 493 (Tribunal) in the CEGAT, special bench A, New Delhi, at 493-499.

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related; it is also necessary to show that the related parties have some mutual or common interest. Finally, it has to be proved that the related persons flow back the differential in price to the concerned parties. The flow back could be direct through cash flow (an amount being deposited in a bank or being paid to someone at some other place) or indirect in the form of doing some service for the related party (for example, advertisement expenditure to be incurred for the concerned party). By enunciating these principles the Supreme Court has diluted the concept of related persons considerably.

It is useful to consider the rules as given in GATT. For example, Article 5 relating to deductive value or Article 6 concerning computed value could be important. These methods correspond to the Resale Price Method and Cost-Plus Method, respectively. Similarly, Article 2 (dealing with the transaction value of identical goods) or Article 3 (dealing with the transaction value of similar goods) resemble the Comparable Uncontrolled Price Method (CUPM) used to determine the arm's length transfer price for income tax purposes.[18]

The law also provides for an anti-dumping levy. This is in response to one aspect of the abusive use of transfer pricing. The aim of the anti-dumping levy is to offset or prevent dumping. Thus, the anti-dumping levy works as a backstop to abusive transfer prices.

F. Provision under the union excise duties

The concept of transfer pricing is equally important for the revenue generated by the government from the union excise duties. The tax is charged on an *ad valorem* basis on the price of the commodity despatched by the manufacturer, in the form of sale, or for storage to any other place or for captive consumption. When the goods are sold to another manufacturer for use as input, the problem of transfer pricing is not very serious because the concept of value added has been introduced under the union excise duties.[19] Since the chain of transactions is properly traceable under VAT, transfer prices do not create any serious problem. For instance, when the goods are transferred from Company A to Company B at a lower price than the market price, the set-off available to B would be the same as the amount of tax paid by A. The balance of the tax would have to be paid by Company B, when it finally sells the goods.

The problem still remains for the four commodities not covered under MODVAT.[20] Also, the issue remains important when the goods are sold for resale or consumption where the next transaction is not under the purview of MODVAT.[21]

The Central Excise Act, 1944, provides for determination of assessable value on the basis of the normal price which is defined as

> the price at which such goods are ordinarily sold by the assessee to a buyer in the course of wholesale trade for delivery at the time and place of removal,[22] where the buyer is not a related person and the price is the sole consideration for the sale.

The Excise Act thus takes an extreme position of disregarding as unreliable, the transfer price adopted by the two associated concerns or related persons. It is, however, important to note that in many cases the "normal price" under Section 4 of the Central Excise Act is determined by the Excise Authorities on the basis of available evidence. In *Air Control & Chemical Engineering Co. Ltd. v. Controller of Central Excise* "complete compressors were manufactured by the assessee but compressors and its parts were packed and billed separately". Such splitting up of the price between the compressor and its parts was not done for commercial reasons but merely to evade excise duty.[23]

The term "related person" is defined to mean "a person who is so associated with the assessee that they have interest, directly or indirectly, in the business of each other and includes a holding company, a subsidiary company, a relative and a distributor of the assessee and any sub-distributor of such distributor". Considering the objective of safeguarding the revenue, the scope of the term "related person" has been cast fairly wide. Judicial interpretations have, however, narrowed down the concept. For example, in *Union of India v. Atic Industries Ltd.* it was held that the two persons should be considered related only when each has an interest in the business of the other. That is, where Company A holds some part of the equity of Company B and vice versa, but not in a case where company A holds some part of the equity of B, but Company B does not hold any part of the equity of Company A.[24] Similarly, in *Union of India v. Bombay Tyres International P. Ltd.* it was held that a relative is considered to be a related person only when he is both a relative and a distributor of the assessee. Similarly, a distributor is to be considered a related person only where he is both a relative and a distributor of the assessee.[25]

In view of various judgements and the policy decisions of the department, where the first sale is to a related person, the assessable value is determined on the basis of the price at which the goods are ordinarily sold by the related person (i.e. buyer) in the wholesale trade; the given sale price of the first sale is ignored. The effect is to assume that the price of the first sale to a related person does not indicate the arm's length price and consequently the transfer price should be the price charged to an unrelated person. However, it is important to note that where a manufacturer sells his goods through say

18. Art. 2 is similar to the use of the exact comparable and Art. 3 approximates to the use of the inexact comparable. See GATT, *supra* note 13.
19. The union excise duties are levied by the Union Government. They follow the principles of value added tax. It is known as Modified Value Added Tax (MODVAT). Over the years the coverage of MODVAT has increased and now it covers almost all items, yielding more than 85 per cent of the revenue from duties.
20. The commodities not covered under MODVAT include petroleum products, tobacco (including cigarettes), cinematographic films, and matches. These items yield approximately 15% of the total revenue from the union excise duties.
21. The tax on sale is a state matter. Hence the sales tax is levied by the state governments on all transactions of sale by the manufacturer, wholesaler or retailer.
22. The basis of the tax is the "clearance" of goods from the factory. This is also known as the time of removal of goods.
23. During investigations it was found that the appellant was manufacturing complete compressors but after testing them packing the compressor and its parts separately. 1994 (72) *Excise Law Times*, 291 (Tribunal) in the CEGAT, special bench A, New Delhi, at 291-306.
24. 1984 (17) *Excise Law Times*, 323, 327 (SC).
25. 1983, *Excise Law Times*, 1986 (SC).

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four distributors, one of whom is a relative and the price charged to each of the distributors is uniform, the assessable value would be determined by the price charged to the unrelated distributors.

The Central Excise (Valuation) Rules, 1975, provide detailed procedures for estimating the transfer price. The different circumstances under which the transfer price would be recalculated are as follows:

(i) where the price charged is not the sole consideration the money value of any additional consideration is included in determining the assessable value (Rule 5):
   - the salaries of the chief executive and the works manager borne by the holding company;[26]
   - expenditure on sales promotion publicity;[27] and
   - expenditure incurred by the buyer on advertisements and after sales service, during the warranty period.[28]

(ii) Where the goods are captively consumed and also sold (the same or comparable goods) the transfer price is based on the value of the comparable goods which should be based on the arm's length selling price or the normal price, as defined in the Act.

(iii) Where the goods are captively consumed and there are no comparable goods on the basis of which value can be determined, the transfer price is taken to be the cost of production or manufacture including profits, if any, which would have normally been earned on the sale of such goods [Rule 6(b)(ii)].

In *Madurai Soft Drinks (P) Ltd. v. Collector of Central Excise, Madurai*, it was held that various expenses incurred by the assessee were not included in the sale price. These charges were recovered by a separate debit note and not disclosed to the department. Hence, as per Rule 5 of the Central Excise (Valuation) Rules, 1975, these have to be included in the value of the commodity.[29]

V. SUGGESTED REFORMS

India's existing provisions on transfer pricing have not kept up with global developments. The efforts of the Indian Government to liberalize the economy and to put the country on the international trade map, will significantly increase the number of MNCs coming to India. Already in most sectors there is a positive trend in the inflow of direct foreign investment. Transfer pricing issues will therefore become increasingly important. In future it might be all the more difficult to face the issues with the given provisions of different taxes. It is suggested that the following reforms are needed to protect India's tax base.

Income tax: As regards income tax, it is essential that the existing provisions under the Indian Income Tax Act, 1961 are revitalized to take care of the intricate issues involved in the transfer pricing by the MNCs.

Firstly, measures recommended in the OECD Guidelines for Multinational Enterprises and Tax Administration (1995) should be adopted wherever relevant and applicable, as has already been done by the United States and many Asian and European countries.

Secondly, "where necessary" special rules should be adopted to strengthen the hands of the assessing officer "to enable him to apply a special clause of The Scheme of DIV 13, based on the pattern of the Australian Income Tax Law".[30] This provision could take a superior place in the statute and remain in addition to the existing laws. It is significantly different from the existing provisions in as much as it is not limited to arrangements which have a dominant tax avoidance purpose. These provisions could be applied to transactions where transfer pricing could be one among many reasons. The discretion would be left to the assessing officer. The provisions of DIV 13 could be applied to attribute income to a resident company if a non-arm's length agreement has resulted in the shifting of income from India regardless of the motive or purpose. An important feature of the DIV 13 is that an additional tax is attracted if this provision is applied. The level of additional tax depends on the extent to which tax avoidance played a part in the transfer pricing arrangement concerned and on whether it is reasonably arguable that the transfer pricing provisions are not applicable.[31]

Here it is important to note that recognizing the prevailing practices of avoidance of tax through the mechanism of transfer pricing, the Report of the Expert Group to Rationalise and Simplify Income Tax Law[32] has suggested that the following subsections be added to Section 92 of the Indian Income Tax Act:

Subsection (1)
Where the Assessing Officer is satisfied that the purpose or effect of any arrangement is directly or indirectly –
(a) to alter the incidence of any tax which is payable by or which would otherwise have been payable by any person;
(b) to relieve any person from any liability to pay tax or to make a return under this Act; or
(c) to reduce or avoid any liability imposed or which would otherwise have been imposed on any person by this Act, he may, without prejudice to such validity as it may have in any other respect or for any other purpose, disregard or vary the arrangement and make such adjustment as he considers appropriate, including the computation or re-computation of gains or profits, or the imposition of a liability to tax, so as to counteract any tax advantage obtained or obtainable by that person from or under that arrangement.

Subsection (2)
In this section, "arrangement" means any scheme, trust, grant, understanding, covenant, agreement, disposition, transaction and includes all steps by which it is carried into effect.

26. This refers to *Kerala Electric Lamp Works Ltd. v. CCE*, 1988 (33) *Excise Law Times*, 771 (T).
27. *Eddy Current Control (India) Ltd. v. CCE*, 1989 (39) *Excise Law Times*, 147 (T).
28. *CCE v. R. Gas Electrodes Pvt. Ltd.*, 1988 (33) 485 (T).
29. 1994 (74) *Excise Law Times*, 647 (Tribunal) in the CEGAT, special bench A, at 647-655.
30. See for details CCH (1996), *Australian Master Tax Guide*, Sec. 30-500 at 1234-1244.
31. Notwithstanding the overriding provisions, the DIV 13 does not prevail over the International Agreements or any of the provisions of a double taxation treaty.
32. See Government of India (1997), *The Report of the Expert Group to Rationalise and Simplify Income Tax Law*, Department of Revenue, Ministry of Finance, New Delhi, at 74-75.

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Subsection (3)
This section shall apply to any arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act but, shall not apply to any arrangement carried out for bona fide commercial reasons which had not as one of its main purposes the avoidance or reduction of tax.

Proviso: Provided that the Assessing Officer cannot take any action under this section without the previous approval of the Commissioner.

The proposed provision is however not to be applied in case of ordinary commercial transactions.[33] Notwithstanding the above recommendations of the Committee it is felt that the Australian provisions would better be able to combat the menace of transfer pricing in India.

Company law: Although many powers are provided under the Companies Act, most of these are of an investigative nature. It would be useful if an amendment was made to impute an adverse inference in the event of non-production of necessary information by foreign companies under Section 239 of the Act.

Customs duty: The rules related to customs duty have basically endorsed the regulations of GATT and the resolutions of the WTO. The provisions have been based on the principles of related persons, the mutuality of interests and direct or indirect flow back. Over the years the Supreme Court has diluted the concept of related persons considerably. However, no major change in the law could be enacted without having requisite changes made to the GATT or WTO provisions. Nevertheless, it is important to follow the Australian system of better investigation and in particular to have a well-researched price list. On the basis of these lists the valuation could be done by the customs authorities because they would be backed by the flow of information from many countries. In addition, their own staff could provide research support.

Union excise duties: The provisions under the union excise duties (MODVAT), as they currently stand, are strong enough to take care of the issues on valuation. The rules define the normal sale price and also take care of the "cost" and "profit". For this purpose they concentrate on the condition of comparability.[34] Nevertheless, it is important to gear the excise department to cope with a larger share of the MNCs in the manufacturing and service sector.[35] For this reason it must develop a research wing in order to have a complete marketing pattern of goods and services available to it. In addition, it must independently establish the pattern of invoices and the prices of the commodities/services supplied.

VI. SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

The above analysis of the existing provisions of different laws in India indicates that provisions already exist to combat the evasion of tax through the procedures of transfer pricing. The Income Tax Act provides for the assessment of reasonable profits derived by residents from transactions with non-residents under Section 92, although the provision has rarely been invoked. The provisions of Section 142(2A) of the Income Tax Act further envisages that the Assessing Officer is empowered to order a special audit of any company, if he so wishes. Section 211 of the Indian Companies Act dealing with the form and contents of the balance sheet and profit and loss account requires that "every profit and loss account of a company shall give a true and fair view of the profit or loss of the company". In addition, the central government has the power under the Companies Act to direct a special audit under Section 233A and to order an audit of cost accounts in certain cases, under Section 233B. These provisions are supported by Section 18(16) under the Foreign Exchange Regulations Act 1973, which provides that the Reserve Bank of India could issue an order requiring the person holding the shipping documents to retain possession until such time as the exporter of the goods has made arrangements to make good any underpayment where the value of the goods specified in the declaration furnished is less than the due amount. These are additional checks on any party entering into transfer pricing to avoid payment of due tax. With all these provisions the corporate veil can be pierced when there is a fraud or attempted evasion of tax.

However, with the structural adjustment programme, India has liberalized its economy. As a player in the global market, the available fiscal instruments might not be strong enough. It would be useful to adopt necessary clauses from the OECD 1995 Guidelines. Alternatively, we could adapt the provisions of the Australian Income Tax Laws.

The rules related to customs duty have basically endorsed the regulations of GATT and in turn the resolutions of the WTO. Nevertheless, it is important to follow the Australian system of better investigation which is facilitated through maintaining a well-researched price list. The valuation could be made by the Customs authorities on the basis of these lists.

In regard to the union excise duties it is important to develop a research wing in order to have a complete marketing pattern of the goods and services administered by the excise department. It must establish the pattern of invoices and the prices of the commodities/services supplied.

It is also necessary to appreciate the importance of the emerging trade blocks that provide a movement towards economic integration. India should play a key role in harmonizing the tax systems of all the ASEAN countries who have signed the AFTA Agreement in 1992.[36] This would help in the creation of a common market and the strengthening of economic cooperation. It could also be used to facilitate the exchange of information and experiences in tax matters between ASEAN countries.

33. This provision is adapted from Sec. 33 of the Singapore Income Tax Act.
34. For example, the liquid and dry chlorine are not comparable. Hence, Rule 6(b) will not be applicable. See *Dharangadhara Chemical Works Ltd. v. CCE*, 1988 (34) *Excise Law Times*, 656, 661 (T).
35. The excise department levies a service tax and administers it. See for details Purohit, Mahesh C., "Taxation of Services: Some Policy Imperatives for India", 51 *Bulletin for International Fiscal Documentation* 1 (1997), at 35-46.
36. See for details Sy Dante V. (1996), "Transfer Pricing and Fiscal Incentives: Issues for Coordination and Harmonization", *NTRC Tax Research Journal*, Vol. 8, No. 5, Sept.-Oct., at 1-14.

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Conference diary

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

OCTOBER 1997

International Tax Aspects of Electronic Commerce, Amsterdam, the Netherlands, 3 October 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

Corporation Tax Compliance, London Park Lane Hilton Hotel, the United Kingdom, 9 October 1997 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-453 2707, Fax: 44-171-453 2036, E-mail: julietneckar@ibcuklon.-ccmail.compuserve.com

51st Congress of the International Fiscal Association, New Delhi, 19-24 October 1997 (simultaneous translations into French, English, German and Spanish):

IFA General Secretariat, World Trade Center, Beursplein 37, 3011 AA Rotterdam, the Netherlands, Tel.: 31-10-405 2990, Fax: 31-10-405 5031.

Taxation for International Companies in Russia and the CIS, The Marriott Hotel, Vienna, 22-23 October 1997 (English):

Business Seminars International Ltd, Sussex House, High Street, Battle East Sussex, TN33 OAL, United Kingdom, Tel.: 44-171-490 3774, Fax: 44-1424-77 3334, E-mail: 1004513120@compuserve.com reference number XBA03

E-ATI 20th Annual Congress, Carlton Inter-Continental Hotel, 58, La croisette, BP 155, 06406 Cannes Cedex, France, 27-29 October 1997 (English):

The European-American Tax Institute, Falmer Court, London Road Uckfield, East Sussex TN22 1HN, United Kingdom, Tel.: 44-1825-760 901, Fax: 44-1825-760 903

Expatriate Management Conference, Hyatt Regency Scottsdale at Gainey Ranch, Scottsdale, Arizona United States, 27-29 October 1997 (English):

Mr Michael J. Bisshko, Ernst & Young, 787 Seventh Avenue New York, NY 10019, United States, Tel.: 1-212-773 2595, Fax: 1-212-773 2550.

Non-Discrimination, Amsterdam, the Netherlands, 30-31 October 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

NOVEMBER

Transfer Pricing Audits, Amsterdam, the Netherlands, 20-21 November 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

DECEMBER

Double Taxation Relief, Amsterdam, the Netherlands, 11-12 December 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

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FINANCIAL STRUCTURES FOR NON-RESIDENTS INVESTING IN INDIA

Har Govind

I. INTRODUCTION

One of the first important decisions a non-resident investor has to take at the time of setting up business in India is the suitable legal form of ownership of the business undertaking. Three commonly envisaged forms of business structure are: proprietary business, partnership firm and limited liability company.

Generally, non-residents prefer to do business in India as individual entrepreneurs or through a company. Investment through a company may be via a branch of a foreign company or through an Indian subsidiary or associate of a foreign company. This Article discusses in brief the legal financial and tax structures for non-residents investing in India.

II. RESIDENTIAL STATUS

The scope of the income liable to tax under the Indian Income Tax Act, 1961 (ITA) in a tax year depends on a taxpayer's residential status. It does not depend on citizenship or domicile. Under the ITA the accounting year, also called the previous year, is the financial year beginning 1 April and ending on 31 March next. The income of a financial year becomes due for assessment or audit in the next financial year which is called the assessment year.

An individual is a "resident" in India in any accounting year, if he is in India in that year for an aggregate period of 182 days or more or having been within the four years preceding that year in India for an aggregate period of 365 days or more and is in India for an aggregate period of 60 days or more in that year.

A company is "resident" in India if it is an Indian company or the control and management of its affairs are wholly situated in India. Even if part of the control and management is situated outside India, the company becomes "non-resident". A foreign company being registered outside India is invariably "non-resident" for the purposes of the ITA. A taxpayer is generally "non-resident" in India if he is not a "resident" of India.

The formation of a company in India is comparatively easy. It can be formed by nominees of a single person including a foreign company.[1] A Company Law Board Circular No. 128 dated 27 July 1984 also permits an agent to sign the Memorandum and Articles of Association to facilitate the formation of a company if such an agent is authorized by a power of attorney. These legal provisions facilitate non-resident individuals and foreign companies in forming a company in India through their nominees. A company registered in India is an Indian company regardless of the fact that some or all of its equity capital is held by "non-residents".

III. NEW INDUSTRIAL POLICY

Over the years a well diversified industrial structure has been established in India. However, barriers to entry and limits on growth in the size of companies led to a proliferation of licensing arrangements and an increase in the degree of monopoly. There was inadequate emphasis on reduction of costs, upgrading of technology and improvement of quality standards. To foster increased competition in the domestic market, so that there are adequate incentives for raising productivity and reducing costs, a major deregulation of the domestic industrial sector was introduced by a New Industrial Policy (NIP) announced on 24 July 1991. In a radical departure from the past, the NIP introduced drastic structural changes, summarized briefly below.

A. Industrial licensing abolished

Industrial licensing has been abolished for all projects except for 16 industries related to security, strategic or environmental concerns and certain items of luxury consumption that have a high proportion of imported inputs. There are six industries reserved for the public sector and 822 reserved for the Small Scale Sector (SSI). The government has recently raised the investment ceiling for plant and machinery of SSIs to INR 30 million. The list of SSIs has also been pruned from 836 to 822 on the recommendation of the Abrid Hussain Committee. The exemption from licensing also applies to the expansion of existing units.

B. Entry and growth barriers removed

The earlier provisions of the Monopolies & Restrictive Trade Practices Act 1969 (MRTP Act) contained restrictive provisions which limited the expansion of units with assets worth INR 1,000 million and more. The government has wholly restructured the MRTP Act by a major amendment. Pre-entry restrictions have been removed with regard to the requirement for prior approval of a new undertaking, expansion, amalgamations, mergers, takeovers and appointment of

1. Decision of House of Lords in *Aron Soloman v. Soloman & Co.*: (1987) AC 22 (HL).

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directors. In future, no undertaking will be required to be registered as an MRTP undertaking.

C. Majority holding for foreign investors

In conjunction with industrial deregulation, the government has provided greatly increased opportunities for foreign investment. Such investment would bring the attendant advantages of technology transfer, marketing expertise and the introduction of modern managerial techniques as well as promoting the much needed shift in the composition of external private capital inflows towards equity and away from debt-creating flows. In addition, restrictions on technology agreements have been relaxed. These broad objectives have been implemented through the following steps:

(i) Automatic approval will be given for direct foreign investment in 35 groups of high priority industries provided the foreign held equity does not exceed 51 per cent. The previous ceiling was 40 per cent. Foreign banks are already operating and will continue to do so through their branches. All applications for automatic approval have to be made to the Reserve Bank of India (RBI) which gives the approval within a month after verifying that the applicant satisfies all the parameters laid down in the NIP.

(ii) Initially the approval for foreign investment was to be promptly given if (a) equity inflows were sufficient to finance the import of capital goods from the state making the investment and (b) dividends were balanced by export earnings over a period of time. The condition (ii)(a) has since been substituted by the condition that the import of capital goods will be governed by the export import (E&I) policy in force at the time of import. Condition (ii)(b) has been subsequently modified and eased as discussed later in this article.

As announced by the Finance Minister on 22 July 1996, in his 1996 budget speech the government has recently expanded the list of industries eligible for automatic approval for 51 per cent foreign held equity. The existing list of 35 industries has been enlarged to cover 16 more industries. In addition, foreign held equity of up to 74 per cent may qualify for automatic approval in ten industries. These lists are contained in Notification 2 dated 17 January 1997 issued by the Ministry of Industry, Department of Industrial Policy and Promotion.[2]

D. Controlling equity for foreign export houses

Pursuant to raising the ceiling applying to foreign held equity to 51 per cent the government also decided to allow foreign persons to hold equity of up to 51 per cent in domestic trading companies primarily engaged in export activities. The Ministry of Industries has since issued a Press Note on 2 January 1992 laying down the principles and procedures for approval of such foreign investment The criteria for granting export house, trading house or star trading house certificates has been recently amended through the new export-import policy announced on 31 March 1997. Under the new criteria, the average FOB value of exports in the three preceding licensing years should not be less than INR 200 million for export house certification. The eligibility limits for trading house, star trading house and super star trading house have now been fixed at INR 1,000 million INR 5,000 million and INR 15,000 million, respectively.[3]

E. Raising the foreign equity level in existing companies

The government has notified revised procedures for increasing foreign held equity to the new 51 per cent limit in existing companies. The increase in equity level must result from the expansion of the equity base of the existing company. The foreign equity must be funded from a remittance of foreign exchange.

The proposals for increasing the foreign equity level must be approved by the RBI. On receipt of RBI approval, the company must pass a special resolution proposing preferential allocation of the required volume of equity to the foreign investor. Existing closely-held or widely-held companies intending to take advantage of the new limits could issue equity at the price determined by the shareholders in a special resolution which should conform to the guidelines issued by the Securities and Exchange Board of India (SEBI).

In a landmark decision in the case of *Hindustan Lever Employees Union v. Hindustan Lever and others*.[4] the Supreme Court of India has ruled relying on the NIP that raising the ceiling on foreign equity to 51 per cent does not violate the principles of public interest or public policy and is fully consistent with the law.

F. Foreign technology import norms liberalized

The government has liberalized the import and payment norms regarding foreign technology. The government has identified 35 high priority industries mentioned earlier for automatic approval of the foreign technology agreements. No permission will be necessary for the hiring of foreign technicians or the foreign testing of indigenously developed technologies. Payment may be made from blanket permits or free foreign exchange according to the RBI guidelines. Earlier, import of foreign capital used to be tied with the import of foreign technology. Foreign equity proposals need not now be accompanied by technology transfer agreements. The automatic approval ceiling of INR 10 million for a lump sum payment has now been raised to INR 70 million (USD 2 million). Automatic approval also applies where payment is made through royalties of up to 5 per cent on domestic sales or 8 per cent on export sales. Total payments must not exceed

2. The lists of industries reserved for public sector units, small-scale industries, industries requiring licences and industries in which foreign-held equity of up to 51 per cent and 74 per cent is permitted may also be obtained from that Ministry located at Udyog Bhawan, New Delhi 110 001. Tel: + 91-11-3011815, Fax: + 91-11-3012626.

3. For full details, the Handbook of Export-Import Policy issued by the Ministry of Commerce may be referred to.

4. *Hindustan Lever Employees Union v. Hindustan Lever And Others*. (1994) 4 *Company Law Journal* at 267 (SC).

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8 per cent of sales over a ten-year period from the date of the agreement or seven years from the commencement of production. The prescribed royalty payments are net of taxes.

G. Approval machinery

Automatic approval is given by the RBI if the application for approval meets the guidelines laid down by the RBI. In short the RBI verifies that the application is within the parameters set by the NIP. Where an application does not come within the parameters of automatic approval, it goes to a specially empowered body, i.e. the Foreign Investment Promotion board (FIPB). This board invites, negotiates and facilitates investments from international companies on the basis of commercial availability and mutually acceptable profitability. This is a high powered body having full flexibility to consider and finalize proposals even outside policy parameters. No application forms are prescribed. No fee is payable. The FIPB is located in the Prime Minister's office. It is chaired by the Principal Secretary to the Prime Minister.

Since 23 September 1992, the government has constituted an empowered committee to deal with foreign investment proposals recommended by the FIPB for which the total investment in the project is up to INR 3,000 million. Proposals exceeding an investment of INR 3,000 million are submitted to the Cabinet Committee on foreign investment. The empowered committee is chaired by the Industry Minister.[5]

H. Stocks opened to foreign institutional investors

The government has recently issued guidelines allowing Foreign Institutional Investors (FIIs) to invest in shares and securities in India. A foreign institutional investor is defined in Section 115 AD of the ITA. It means such investor as the central government may notify in the official gazette. The government has issued such notifications from time to time. FIIs including institutions such as Pension Funds, Mutual Funds, Investment Trusts, Asset Management Companies, Nominee Companies and Incorporated or Institutional Portfolio Managers (or those holding a power of attorney for these businesses) would be welcome to make investments. They will be able to invest in all securities traded on the primary and secondary markets, including the equity and other securities or instruments of companies which are listed on the stock exchanges in India, including the Over the Counter (OTC) Exchange of India.[6]

There would be no minimum or maximum restriction on the volume of investment for the purpose of entry of FIIS, in the primary or secondary market. Also there would be no lock-in-period prescribed for the purpose of such investment.

Portfolio investments in primary or secondary markets were subject to a ceiling of 24 per cent of issued share capital in respect of the total holdings of all registered FIIs, in any one company. This ceiling of 24 per cent is now raised to 30 per cent through the 1997 budget, subject to the condition that the Board of Directors of the company approve the limit and the general body of members of the company passes a special resolution to this effect.

I. FIIs will also enjoy concessional tax treatment

A flat rate of tax of 20 per cent applies to the gross interest income and a tax rate of 10 per cent to long-term capital gains arising from the sale of shares held for one year or more. However, short-term capital gains would be treated as business income and taxed at the rate of 30 per cent. The fairly low rate of 10 per cent for long-term capital gains is an inducement to FIIs to retain their investment over a longer period.

J. Foreign exchange rules relaxed

The RBI has issued notifications under Sections 26(7), 28, 29 and 31 of the Foreign Exchange Regulation Act 1973 (FERA) revising the provisions of these four sections giving wide-ranging concessions to FERA companies other than banking. The changes have been made to attract more foreign investment in India. Stated briefly, FERA companies will now be placed on a par with Indian companies and will not be subject to any special restrictions under FERA. FERA companies broadly mean companies with foreign equity of more than 40 per cent.

Under the existing provisions of Section 26(7) of FERA, no person who is resident in India can lend any money to or deposit any money with, a FERA company, not being a banking company unless the permission of the RBI has been obtained. Now, FERA companies are free to borrow money and accept deposits in India. This move also allows FERA companies to raise resources by way of deposits in order to meet working capital requirements.

Presently, Section 28 of FERA, imposes restrictions on the appointment of certain persons as agents or technical or management advisers in India and also on the use of trade marks in India. The Notification under Section 28 will allow FERA companies to use their trade marks freely in India and permit them to act on behalf of or advise any person or company.

Section 29 of FERA, as it stands at present, is intended to keep a watch on and regulate the trading, commercial or industrial activities of non-residents, non-Indian citizens and foreign companies and their offices or branches in India. Hitherto; FERA companies were encouraged to open subsidiaries instead of branches.

After the issue of the Notifications under this section, there will be no restriction. FERA companies will be permitted to open branches and liaison offices and to carry on in India any activity of a trading, commercial or industrial nature. This new policy is expected to prove attractive to trading compa-

5. The Minister in charge of the administrative ministry, chairman FIPB, Cabinet Secretary, Finance Secretary and Secretary (Industrial Development) are members.
6. These would include shares, debentures, warrants and the schemes set up by domestic Mutual Funds.

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nies which are primarily interested in buying new materials from India for export.

The provisions of Section 31 of the FERA seek to impose restrictions on the acquisition, holding and disposal of immovable property in India, by foreign nationals and foreign companies. The object was to reduce the potential drainage of foreign exchange repatriation of income from immovable property (and sale proceeds in the case of disposal, if any, of such property). The Notification issued under Section 31 now permits FERA companies to acquire and sell immovable property in India, provided the purchase consideration is made in foreign exchange out of remittances from abroad, and neither the rental income nor the sale proceeds of the property will be allowed to be remitted at any time outside the country.

The new FERA reforms effected through notifications have also been placed on the statute book by amendment to the Act itself. These amendments will have a healthy impact on the climate for foreign investment in India. Two of the changes merit special attention. The government's earlier preference for foreign investment via subsidiaries instead of through branches was costlier and also entailed different legal obligations and led to dilution of foreign equity stakes. Since they are no longer obliged to set up a subsidiary, foreign trading companies should find India an easier and more attractive place to operate from. Likewise, with the removal of the restrictions on consultancy services, the expertise available in FERA companies should now become more readily available to Indian companies.

K. Dividend repatriation eased

The government has removed all the controls on dividend repatriation other than the controls which apply to 22 industries in the consumer goods sector. An official press release dated 19 June 1992 says that dividend balancing will also not be applied in case of investment by approved international organizations like the International Finance Corporation (Washington), the German Development Agency (DEG), the Commonwealth Development Corporation and the Asia Development Bank.

By a subsequent Press Note, No. 12 of 1992 dated 26 June 1992, the Ministry of Industry has issued a list of 22 consumer industries which will continue to require dividend balancing with their export earnings.[7]

L. Convertibility of the rupee

Under a system of partial convertibility of the rupee, the government has allowed exporters and other foreign exchange earners to convert 100 per cent of their earnings at the market rate. All imports will also henceforth be paid at the market rate. Repatriation of dividends is now comparatively unrestricted. Thus the rupee is now fully convertible on "trade account" but not on "capital account". The government is also desirous of achieving capital account convertibility. The RBI has appointed an Expert Committee to prepare guidelines for capital account convertibility. Further action will be taken on receipt of the Expert Committee's report.

M. Privatization in core sectors

The post-1991 period saw considerable progress towards partial or full privatization in some core sectors briefly recapitulated here.

(i) Non-fuel minerals: In 1993, a New Mineral Policy (NMP) announced in the parliament, freed from state control 13 non-fuel minerals previously reserved exclusively for state undertakings.[8] To give effect to the NMP, the Mines and Minerals (Regulation & Development) Act of 1957 has been amended, allowing for foreign investment of up to 50 per cent in the mining industry. Foreign participation may also be allowed in excess of 50 per cent by negotiation on a case-by-case basis by the FIPB.

(ii) Coal: The Union Cabinet decided on 11 February 1997 to open coal mining and exploration to the private sector and deregulate distribution and pricing. A bill is expected to be introduced in the parliament soon to amend the existing coal mining laws to implement deregulation. This new policy will allow automatic approval for 50 per cent foreign equity. Investment in excess of 50 per cent foreign equity could be permitted by negotiation by the FIPB.

(iii) Power: To bring in additional resources in the electricity sector, the government has formulated a new scheme to encourage greater participation by private enterprises in electricity generation, supply and distribution. The important provisions of the new scheme are:
- The Indian Electricity Act, 1910 and the Electricity (Supply) Act, 1948 have been amended to usher in a new legal, administrative and financial environment for private enterprises in the electricity sector.
- Through negotiation up to 100 per cent foreign equity participation can be permitted for projects set up by foreign private investors.

(iv) Insurance: In 1993 the government set up a High Powered Committee headed by former Reserve Bank of India Governor R.N. Malhotra for an in-depth study of the insurance industry aimed at introducing a more competitive environment subject to suitable regulation and supervision.

The Malhotra Committee in its report called for sweeping changes including the entry of the private sector, in both life and general insurance business and privatization of the life and general insurance corporations. The Committee suggested that foreign insurance companies should preferably enter the market by way of joint ventures with Indian partners. The much awaited privatization has been initiated though only in part, through the

7. The list of 22 industries can be obtained from the Ministry of Industry; see *supra* note 2.

8. These 13 minerals are chrome, copper, diamond, gold, iron ore, lead, manganese, molybdenum, nickel, platinum, sulphur, tungsten and zinc.

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1997 budget. The government has opened up the health insurance sector by permitting the General Insurance Corporation (GIC) to set up joint ventures with selected Indian companies. Foreign operators can acquire up to 49 per cent of the equity in such joint ventures. The government has allowed the Life Insurance Corporation (LIC) to promote joint ventures in the pensions business. According to Mr James Robertson, the India manager of Eagle Star Insurance, this is an encouraging first step and augurs well for the future.

(v) Drug companies: Industrial licensing has been abolished for all bulk drugs and their intermediates and formulations except for certain bulk drugs reserved for the public sector.[9] Foreign investment of up to 51 per cent and foreign technology agreements in the case of all bulk drugs, their intermediates and formulations thereof, except those produced by the use of recombinant DNA technology, will be granted automatic approval subject to the parameters laid down by the RBI.

(vi) Ports: Opportunities are now available for private parties to participate in port construction activities.[10]

(vii) Telecommunications. Under a new telecom policy:

- multinational companies are allowed 49 per cent equity participation in basic telecom services. Indirect ownership of 49 per cent of the balance of the equity is permitted through an Indian holding company. Automatic approval is available for up to 51 per cent foreign held equity in companies manufacturing telecom equipment.
- the Telecom Regulatory Authority of India (TRAI) has been set up with retired Justice S.S. Sodhi as Chairman and Mr N.L. Zutshi and Mr N.S. Ramachandran as members to regulate and supervise the orderly development of the basic and cellular telecom services.

In a landmark decision delivered on 19 February 1996, the Supreme Court of India upheld the validity of the policy and procedure adopted by the central government for inviting domestic and foreign sector promoters to provide basic telephone services. This has freed up the process of issuing licences to private companies.

N. Investment protection agreements

To allay fears of confiscation and to accelerate the flow of direct foreign investment the government has entered into comprehensive investment protection agreements with some foreign countries. A typical agreement with Germany is briefly described here.

On 19 June 1995 India and Germany signed an investment treaty making German investment in India attractive. The broad intent of the bilateral agreement is to promote and protect investment from either country into the other. The word "investment" is broadly defined as meaning every kind of asset including intellectual property rights invested in accordance with the national laws of the country in which the investment is made.

The agreement further provides that nationalization or expropriation shall not be resorted to except in the public interest, by laws and on a non-discriminatory basis and against compensation. Nationalization and expropriation shall also be subject to review by a judicial or other independent authority. There are also special conditions under which compensation for losses can be paid. Each country shall grant to investors of the other country a free transfer of investments and returns.

IV. TAX INCENTIVES

Some important amendments made by the Finance Act 1997 which are of interest to non-residents are discussed below.

Unless indicated otherwise the amendments made by the Finance Act 1997 (FA) will take effect from 1 April 1998 and will accordingly apply in relation to the assessment year 1998-99 and subsequent years.

A. Individuals

There is no change in the exemption limit, which remains at INR 40,000. However, the tax rates have been significantly reduced at all income levels and the income slabs have also been changed as tabulated below. These rates apply to all individuals, that is "residents" as well as "non-residents", regardless of their nationality or domicile.

Income (INR)	Existing rates (%)	Income (INR)	New rates (%)
up to 40,000	Nil	up to 40,000	Nil
40,001 – 60,000	15	40,001 – 60,000	10
60,001 – 120,000	30	60,001 – 150,000	20
over 120,000	40	over 150,000	30

The maximum rate of income tax is now only 30 per cent on taxable income above INR 150,000[11] compared to the previous rate of 40 per cent on taxable income of above INR 120,000.

9. Licensing will, however, be required for bulk drugs such as Vitamin-B1 and its salts and derivatives. Vitamin-B2, folic acid, tetracycline and its salts and oxytetracycline and its salts. Licensing will also be required for bulk drugs involving the use of recombinant DNA technology and bulk drugs requiring the use of nucleic acid as the active principal. Formulations based on the use of specific cells/tissue-targeted formulations will also need industrial licensing.

10. I.e. for container handling facilities, construction of berths and jetties, equipment handling and storage and warehousing facilities of the country's major ports.

11. Under the existing provisions of Sec. 16 of the ITA a standard deduction of a sum equal to 33⅓ per cent of the salary or INR 15,000 whichever is the lower is allowed. A higher deduction of INR 18,000 is allowed to women whose total income does not exceed INR 75,000. A similar deduction is also available to other persons, if their gross salary is not more than INR 60,000. The FA enhances the upper limit of standard deduction to INR 20,000 in the case of all persons.

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B. Companies

The existing and new rates of tax are as below.

Company type	Existing rate		New rate	
	Income tax (%)	Surcharge on income tax	Income tax (%)	Surcharge on income tax[12]
Domestic	40	7.5% of income tax	35	Nil
Foreign company	55	Nil	48	Nil

C. Concessions under tax treaties

Since 1976 India has expanded its treaty network considerably. India's tax treaties with foreign countries follow a mix of the OECD Model and the UN Model. India gives greater importance to source taxation as against taxation on the basis of citizenship or domicile. To date, the country has entered into tax treaties with 65 countries. Of these, 43 treaties are in respect of taxes and income earning activities and the remaining 22 treaties are partial treaties which cover only shipping or aircraft profits. The ITA makes a provision in Section 90 as amended in 1991 that if the tax regime under the ITA is more beneficial as compared to the regime under a tax treaty, the more beneficial tax regime, that is the one under the ITA, will be applicable. Indian courts have also decided that if the provisions of the tax treaty are more favourable as compared to the provisions of the ITA, the provisions of the tax treaty will prevail.[13]

D. Treaty rates of tax on royalties and similar payments

Earlier, the tax rates for deduction of tax at source from royalties and fees for technical services, dividends and interest, were 30 per cent, 25 per cent and 25 per cent, respectively. By the Finance Act 1995, the government reduced the rate on dividends and interest to 20 per cent. It may be mentioned that the Finance Act, 1997 totally exempts dividends in the hands of shareholders. The tax rate on royalties and fees for technical services has also been reduced by the FA 1997 from 30 per cent to 20 per cent. The government has recently ratified the India–Germany treaty. As per this treaty, the tax rate on royalties, dividends and interest has been reduced to 10 per cent as per the table below.

Item	Domestic rate (%)	Rate in the existing agreement (%)	Rate in the new agreement (%)
Dividends	20	15	10
Interest	20	10 (banks) 15 (others)	10
Royalties	20	20	10
Fees for technical services	20	20	10

The low withholding tax rates in the India–Germany tax treaty will not only attract investment from Germany but will also encourage investment from other OECD countries because there are stipulations in many of the tax treaties between India and OECD[14] countries, e.g. Norway and France, which specifically provide that if subsequent to their signing of a tax treaty with India India enters into a tax treaty with any OECD country and the tax rate for royalties and technical services as per that treaty is lower than the tax rate stipulated in their treaty, that lower rate will also be applicable to them. Thus, the lower rate of 10 per cent as applicable to Germany will also become applicable in respect of OECD countries having tax treaties with India containing the aforementioned provision.

E. Tax holiday for infrastructure industries

Under the provisions of Section 80-IA of the ITA, a five-year tax holiday and a deduction of 25 per cent (30 per cent in the case of companies) in the subsequent five years is allowed to an undertaking engaged in the business of generation, or generation and distribution of power, or to an industrial undertaking set up in backward states/districts.

To encourage investment in the telecommunication sector, both basic and cellular, the FA extends the benefits of Section 80-IA to the telecommunication sector.

Now 100 per cent deduction from the profits of a taxpayer engaged in the business of providing telecommunication services will be allowed for the initial five assessment years. A deduction of 25 per cent (30 per cent in the case of companies) from such profits will be allowed for a further period of five years. The deduction will be allowed to an undertaking which begins to provide telecommunication services at any time during the period commencing on 1 April 1995 and ending on 31 March 2000.

The proposed amendment will take effect retrospectively from 1 April 1996 and will accordingly apply in relation to assessment year 1996-97 and subsequent years.

F. Amortization of telecom licence fees

In order to give fillip to this sector in addition to the tax holiday, the FA inserted a new Section 35ABB into the ITA. This section provides that any capital expenditure incurred and actually paid by an assessee on the acquisition of any right to operate telecom services by obtaining a licence will be allowed as a deduction in equal instalments over the period for which the licence remains in force.

G. Abolition of tax on dividends

Under the existing system of collection of tax on dividends, every company, at the time of paying dividends to a shareholder in excess of INR 2,500, is required to deduct tax at the

12. From the assessment year 1998-99, the surcharge has been withdrawn.
13. *Commissioner of Income tax v. Davy Ashmore India Ltd.* (1991) 190 *ITR* at 626 (Calcutta).
14. Organisation for Economic Co-operation and Development.

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specified rate and deposit it in the central government account. The company is also required to issue TDS certificates to all shareholders in whose cases the tax has been deducted. The shareholders in turn have to show the dividend in their return of income and pay the tax at the rate applicable in their case. They also have to enclose the TDS certificates along with the return and claim credit for the deduction at source. Often, the tax deducted or a part thereof is required to be refunded to the assessee. Thus, the procedure for tax collection is cumbersome and involves a lot of paperwork.

In order to encourage investment in the shares of domestic companies, the FA exempts from income tax dividends received from domestic companies on or after 1 June 1997.

H. Tax on distributed profits

The FA introduced new provisions for levying a moderate tax on distributed profits. Under the new provisions, the amount declared, distributed or paid on or after 1 June 1997 by a domestic company by way of dividends shall be charged to additional income tax at a flat rate of 10 per cent. In addition to the normal income tax chargeable on the income of the company, the company shall be liable to pay the said income tax to the central government within 14 days from the declaration of its dividends. No deduction under any of the provisions of the ITA shall be allowed to the company or the shareholder in respect of the tax on distributed profits.

The new provisions are to be made effective in respect of amounts declared, distributed or paid as dividends on or after 1 June 1997.

I. Minimum Alternative Tax on companies

The Minimum Alternative Tax (MAT) on companies was introduced by the Finance (No. 2) Act 1996 with effect from 1 April 1997 to ensure that companies with business profits do not regularly avoid paying tax. This was necessary due to the rise in the number of zero tax companies in view of tax preferences granted in the form of exemptions, deductions and high rates of depreciation. The rate of the minimum tax was kept at a modest figure by deeming 30 per cent of book profits to be total income. This modest amount is likely to be reduced in line with the downward revision of the corporate tax rate and abolition of the surcharge.

The FA exempts the export profits that are eligible for deduction under Section 80HHC from the purview of the Minimum Alternative Tax.

The FA also inserts a new Section 115JAA into the ITA to provide a tax credit scheme by which the MAT paid can be carried forward to set off against regular tax payable during the subsequent five-year period subject to the following conditions:

(i) When a company pays tax under the MAT, the tax credit earned by it shall be an amount which is the difference between the amount payable under the MAT and the regular tax. Regular tax in this case means the tax payable on the basis of the normal computation of the total income of the company.
(ii) The MAT credit may be carried forward for a period of five assessment years immediately succeeding the assessment year in which the MAT is paid. Unabsorbed MAT credit will be allowed to be accumulated subject to the five-year carry-forward limit.
(iii) In the assessment year when regular tax first becomes payable, the difference between the regular tax and the tax computed under the MAT for that year will be set off against the MAT credit available.
(iv) The credit allowed will not bear any interest.

The rationale for allowing credit in respect of taxes paid under MAT in the aforesaid manner is that a company should always pay a minimum tax. The above method will ensure that the company will always pay a minimum tax even when offsetting the MAT credit against regular tax.

This amendment will take effect from 1 April 1997 and will, accordingly, apply in relation to assessment year 1997-98 and subsequent years.

J. Reduction in the tax rate applying to royalties and technical services fees

Section 115A of the ITA, *inter alia*, provides for a concessional tax rate of 30 per cent in respect of income by way of royalties and fees for technical services received by foreign companies from the government or an Indian concern in pursuance of an agreement made after 31 March 1976 which fulfils the specified conditions.

The FA further reduces the aforesaid concessional tax rate of 30 per cent to 20 per cent. The reduced rate will be applicable to royalties and fees for technical services received by foreign companies under agreements made on or after 1 June 1997.

K. TDS returns on magnetic media

Section 206 of the ITA provides for filing of returns of tax deducted at source by persons responsible for deducting tax in accordance with the provisions of Chapter XVII-B.

The returns of tax deduction contain voluminous data, particularly in the case of large organizations. Preparing these returns and then verifying the data contained therein requires substantial manual effort.

The amendment, therefore, provides for filing of these returns on magnetic media such as floppies, diskettes, etc. as may be specified by the Board. It is also provided that the information in such returns shall be admitted in evidence in any proceeding under the ITA.

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V. EPILOGUE

Despite isolated instances of some objectionable activities of multinationals, foreign companies have a good business image in India. Though the track record of some Indian companies is better than of many foreign companies, generally speaking, the quality of management of foreign companies is high. They pay better wages and follow fair labour practices. Business collaboration with foreign companies is quite popular as evidenced by the generally high demand for their goods and services and the handsome premia commended by the shares of Indian subsidiaries and associates of foreign companies. These positive factors together with the independent judicial system[15] and liberal financial and tax structures in India provide a mutually beneficial environment for non-resident investment in India.

15. The judiciary in India is independent of the executive. Under the Constitution of India, an aggrieved party has access to the courts for redressal of its grievances. The Supreme Court has given important rulings in the *Hindustan Lever* case and the telecommunications case briefly discussed earlier.
Apart from the separate appellate machinery for tax administration, there are also provisions for advance rulings by an Authority for Advance Rulings (AAR) for non-residents. These rulings, though limited in their application only to the non-resident applicant and his assessing authorities, have great persuasive value. The AAR is headed by a retired judge of the Supreme Court of India. Established in 1993, the AAR has given many rulings on residential status and taxability of specific items of income. Such rulings are regularly reported in the Income Tax Reports published in *Madras* and other tax journals.

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INDIA–MAURITIUS DTA
REAPING TAX BENEFITS, WHILE THE SUN SHINES

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I. INTRODUCTION

A tiny coral island surrounded by sandy beaches and sunny skies, Mauritius is a well-known tourist destination. Surprisingly, however, it is not the beaches of Mauritius but its offshore business regime that has been the prime attraction for the businessmen visiting Mauritius. The Mauritius Offshore Business Activities Authority (MOBAA) which began operations in 1992 has been extremely successful particularly in routing investments into India.

II. KEY ADVANTAGES OF THE INDIA–MAURITIUS DTA

This small island of Mauritius with a population of less than one tenth of that of Mumbai has now become the fourth largest foreign investor in India. The popularity of Mauritius for routing investment into India is primarily the result of both the favourable double tax avoidance treaty between these two countries and the offshore taxation regime in Mauritius that gives a Mauritian based offshore company an option to pay tax within a range of 0 to 35 per cent[1] at its discretion. The treaty, christened the "Convention for Avoidance of Double Taxation and Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains and for Encouragement of Mutual Trade and Investment between India and Mauritius" (the DTA), was signed in 1983 and for non-residents is one of the most beneficial treaties signed by India. The DTA offers the following advantages for investment into India.

A. Concessions on dividend income

One of the most important advantages offered by the DTA was in terms of the reduced withholding tax on dividends paid by Indian companies to Mauritian companies.[2] Recently, however, the Indian Income Tax Act, 1961, (the ITA) was amended to provide that there would be no taxation in the hands of a shareholder of dividends received by it from an Indian company. The dividend paying company, however, would be liable to pay tax at the rate of 10 per cent on the amount of dividend declared by it. This tax of 10 per cent would be in addition to the tax payable by the Indian company on its profits at the rate of 35 per cent.

Since the ITA provides that any taxpayer can take the benefit of either a double taxation treaty or the provisions of the ITA whichever is more favourable,[3] the concessions provided by the DTA would no longer seem to be attractive. However, certain very interesting issues arise as a result of the dividend exemption. The main one being that of the availability of tax credit for the underlying tax payable by the company. The ITA provides that in India, neither the shareholder nor the dividend paying company would be allowed to take credit for the 10 per cent tax paid on the dividend, however, the MOBAA has announced that any Mauritian company holding at least 5 per cent of the shares of an Indian company would be entitled to a tax credit for the 10 per cent tax paid by the Indian company.[4] This credit would be beneficial for companies based in Mauritius especially after 1 July 1998 when Mauritian offshore companies would have to pay a tax of 15 per cent on their profits.

B. Capital gains exemption

The other important advantage offered to investors by the DTA is that there would be no capital gains tax payable in India by a Mauritian company on the profits made by it on the sale of shares held in an Indian company. Normally, a non-resident foreign company would have to pay capital gains tax at rates of 20 per cent or 48 per cent[5] on any capital gains made by it. This exemption has proved to be a good incentive for investment managers to hold their funds formed for investment into India, in Mauritius. It is interesting to note that the shares of the Mauritian company are not required to be beneficially owned by Mauritian residents in order for the exemption from capital gains tax to apply.

1. These rates are applicable to offshore companies incorporated in Mauritius. One can also incorporate international business companies in Mauritius which are tax exempt. However, such companies are not entitled to the benefits of the double taxation avoidance treaties signed by Mauritius.
2. Till recently, any dividend paid by an Indian company to a non-resident shareholder was liable to a withholding tax of 20 per cent. However, if the Indian company was to pay a dividend to a Mauritian company that beneficially owned more than 10 per cent of the shares in the Indian company, the withholding tax was reduced to 5 per cent and in other cases, the withholding tax was reduced to 15 per cent.
3. Sec. 90(2) of the ITA.
4. *The Economic Times*, 28 June 1997, at 3.
5. A non-resident would have to pay tax at the rate of 20 per cent on the profits made by it on the sale of a long term capital asset and a tax of 48 per cent on the profits made by it on the sale of a short-term capital asset. A share in an Indian company or any other listed security would qualify as a long-term asset if it is held for a period exceeding 12 months. In all other cases it would be treated as a short-term capital asset.

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C. Payment of fees for technical services

Like many of the old double taxation avoidance treaties signed by India, there is no provision in the DTA for the taxation of fees for technical services. This provides an opportunity for routing technical services through Mauritius.

In the absence of any provision specifically covering the payment of fees for technical services, such fees would either be covered by Article 7 (Business Profits) or Article 22 (Other Income) depending upon the nature of the activities undertaken by the Mauritian company. In both cases, if the provider of technical services does not have a permanent establishment in India, the fees received by it would not be taxable in India.

The above mentioned proposition was recently confirmed by the Authority for Advance Rulings (AAR) in India in the case of *Tekniskil (Sendirian) Berhard v. C.I.T.* (AAR).[6] Though the ruling in this case was based on the India–Malaysia treaty, the authors feel that it would also be applicable to the DTA since both the treaties are similarly placed as far as the taxation of fees for technical services is concerned.

D. Income from investment in entities other than companies

A tax efficient structure for portfolio investments into India involves investing into the units of an Indian mutual fund.[7] The income from the mutual fund would not be liable to any taxation in India[8] but would be taxed in Mauritius only. Since the investors in such funds would be issued units and not shares in the mutual fund, the income derived from the investment would not be dividend income. Therefore, in the absence of any specific provisions dealing with such income, it would fall under Article 22 of the treaty and would be liable to taxation only in Mauritius. This view has been upheld by the AAR recently in a ruling pronounced in the case of DLJMB Mauritius Investment Company.[9]

III. INVESTMENT FROM INDIA USING MAURITIUS

It is worth mentioning that though Mauritius is a good country for investing into India from abroad, it does not prove to be tax effective for investment from India. This is primarily due to the fact that the income received by an Indian investor from its Mauritian entity would be taxed in the hands of the Indian company at the rate of 35 per cent (which the Indian company might not pay if it invested through a country other than Mauritius).

IV. *NATWEST* AND *AIG*

The AAR in *Natwest Bank*[10] refused to give a ruling to Natwest's 100 per cent owned Mauritian subsidiary formed for investment into India on the grounds that its investment was designed prima facie for the avoidance of Indian taxes. When denying the ruling in the said case, the AAR made certain observations which were in the nature of an *obiter dictum*. These observations created an impression that the AAR was of the view that investments made into India from Mauritius are primarily for the avoidance of taxation.

The effects of the observations made by the AAR in Natwest Bank were overruled to a substantial extent in another case before the AAR. This case dealt with the Mauritian subsidiaries of the insurance giant AIG[11] wherein these companies were able to show a certain amount of commercial justification for the investment into India via Mauritius. While accepting that taxation did form an important reason for the AIG subsidiaries routing their Indian investments through Mauritius, it was not the only reason for their doing so. The AAR stated, "... certain suspicious features notwithstanding, a ruling cannot be declined on the ground that the transaction was designed for the avoidance of tax".

On a detailed reading of these two rulings, one may conclude that the AAR was, to a certain extent, justified in denying a ruling to the Natwest Bank. This is because of the fact that, though tax planning is perfectly legitimate in India, the AAR is not an authority set up to approve the tax planning schemes of non-residents.

V. MAURITIUS – THE FUTURE

Mauritius has decided to levy a 15 per cent tax on the profits of offshore companies from 1 July 1998. However, on a close examination of the provisions, one notices a number of loopholes, the important ones being:

- existing Mauritian offshore companies may decide if they wish to fall under this regime; and
- offshore companies owning more than a 5 per cent share in an Indian company would be entitled to take credit for the Indian taxes paid on the profits made by that Indian company. (Interestingly, even if the company in which the investment is made is a tax exempt entity, the offshore company would be deemed to have paid tax on its income at the tax rate prevailing in the country of investment.)

Thus Mauritian companies would still only pay a paltry amount of tax in Mauritius.

To conclude, one may say that Mauritius has proved a blessing for investors wishing to invest in India. Indeed India probably would not be such an attractive place to invest in, sans Mauritius because, though tax may not be the only determining factor, for foreign investors usually it is high on the agenda. One must also, remember that the DTA is one of the few treaties which has not only been signed for the avoidance of double taxation but also for the encouragement of mutual trade and investment. The offshore business regime can be said to have promoted trade between India and Mauritius to a great extent!

6. [1996] 222 ITR 551.
7. These funds are usually formed as trusts.
8. See provisions of Art. 22 of the treaty.
9. AAR No. 315 of 1997. This ruling overrules the earlier opinion on this topic given by the AAR in the case of Dr Rajnikant R. Bhatt [1996] 222 ITR 562.
10. Please refer to 220 ITR 377.
11. *Tax expert* 566 of 1995.

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AN OVERVIEW OF THE INDIAN TAX SYSTEM

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I. ECONOMIC REFORMS

The recent radical changes in fiscal, industrial and trade policies signal major milestones in India's economic history. The Government of India has amply demonstrated its commitment to provide a distinct outward orientation to its policy regime in order to facilitate India's rapid integration into the world economy.

In the past the major obstacles facing foreign investors included:

- long bureaucratic delays in the Indian system which prevented quick decision making;
- the very rigid and cumbersome policy and procedural framework that had to be complied with;
- short visibility and lack of continuity in the Indian Government's policies towards foreign investors;
- limitations on the quantum of foreign equity participation in joint venture projects;
- the rapid rate of indigenization by way of a phased manufacturing programme which the Indian Government made applicable for all new projects; and
- inadequate infrastructure facilities as compared to the other countries competing for foreign investment.

India's comprehensive policy reform package is directed towards liberalizing the economy by removing restrictions, simplifying procedures, opening up several areas to the private sector hitherto reserved for the state, encouraging competition and inviting foreign investment. Therefore, the changes to government policy have removed many significant hurdles that previously had impeded potential foreign investors. India is now moving towards a non-discriminatory regime in which the government's regulatory role over industry has been substantially reduced. The government is thus aware of the deficiencies inherent in the Indian system and which have thus far isolated India from the rest of the world. The object of this new reform package is to remove whatever obstacles there might be and enable the Indian economy to rapidly integrate with the global economy.

II. EMERGING FAVOURABLE TAX REGIME FOR FOREIGN INVESTMENT

India has undertaken major reforms of its tax structure in recent years as part of the economic reforms initiated in 1991. Sweeping changes have been brought about, the thrust being towards a structure that has a wide base but moderate rates, drawing on the blueprint chalked out by the Tax Reform Committee set up in 1991 with Prof. Raja J. Chelliah as Chairman. The focus of the government has been the simplification of the law through rationalization of its structure, the removal of redundant sections, and the codification of a new law in order to meet the requirements of an increasingly open and competitive economy. The beneficial effects of these reforms have resulted in increased Foreign Direct Investment (FDI).

Since 1990, FDI flows have become the largest and fastest growing single component of external finance for the developing world. The noted economist, Dr Raja Chelliah says, "simplicity, transparency and perceived fairness are essential to attracting the much-needed foreign investments". And this has been the thrust of government policy over the last five to six years.

The focus of government policy has been broadened to encourage private investment in infrastructure, particularly in the power, highways and telecom sectors. In addition the government's emphasis is now on the upgrading of technology and the promotion of foreign exchange earnings:

III. TAX STRUCTURE

India has a federal structure of government, and taxes are levied by the central government, the states and local authorities. The taxes levied by the central government can be broadly classified as Direct and Indirect taxes.

Direct taxes are taxes on income (except from agriculture), taxes on wealth, gift tax and interest tax while indirect taxes are customs duties, central excise duties, expenditure tax and service tax.

State governments also levy excise duties and a sales tax, as well as a tax on agricultural income. Local authorities have limited powers to levy and collect taxes.

IV. DIRECT TAXES

A. Income tax

In India the basis of the charge to income tax is independent of the nationality and domicile of the taxpayer. It depends on the taxpayer's personal[1] residential status. The residential status is linked in the case of an individual to the number of

1. I.e. whether individual, firm, company, etc.

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days of stay of the taxpayer in India. In the case of a company a company is treated as resident if it is incorporated in India or the control and management of its affairs is situated exclusively in India. All other companies are treated as non-resident. A taxpayer, whatever his residential status, is taxed on all incomes derived from whatever source which is received or deemed to be received in India by him or on his behalf or accrues, or arises, or is deemed to accrue or arise to him in India. Only taxpayers with resident status are taxed on income which accrues or arises to them outside India. The tax base is, thus, narrower for non-residents.

In computing the taxable income, resident and non-resident taxpayers are, by and large, treated at par. Taxable income is arrived at after deducting all revenue expenses incurred wholly and necessarily for the purpose of the taxpayer's business or profession. However, certain expenses are expressly disallowed e.g. the expenditure on an advertisement published by a political party. Depreciation is allowable at specified rates on blocks of assets of the same class. For foreign companies, limits have been specified for allowances of head office expenses.

The basic rate of corporation tax applying to a domestic company in India is 35 per cent. Foreign companies are subject to tax at the rate of 48 per cent. However, a concessional rate of 20 per cent has been specified for income from dividends and interest received from an Indian concern. Royalty and technical service fee receipts are also taxed at 20 per cent although lower rates of tax have been provided for in various tax treaties. India has concluded comprehensive tax treaties with over 50 countries while with five others there are limited agreements covering shipping profits and nine agreements covering aircraft profits. India has adopted the UN Model as a blueprint when negotiating its tax treaties. An important aspect of the treaties entered into by India is the tax sparing clause so that the country with which the treaty is being negotiated grants to its residents a credit for the tax spared by the tax incentive provisions in India. In addition to the tax treaties, the Income Tax Act provides unilateral relief in respect of income that is taxed both in India and a foreign country with which India has no tax treaty.

1. Tax on distributed profits and exemption of dividends from domestic companies

Dividends received from domestic companies are exempt from income tax. However, the amounts declared, distributed or paid by a domestic company by way of dividends are charged to income tax at a flat rate of ten per cent, in addition to the normal income tax chargeable on the income of the company. No deduction under the provisions of the Income Tax Act is allowed to the company or the shareholder in respect of the tax on distributed profits. The additional income tax so paid by the company is treated as the final payment of tax in respect of the amount distributed and no further credit for such tax can be claimed either by the company or by any other taxpayer.

2. Taxation of non-residents: specific provisions

In addition to providing special rates of tax for non-residents, the Income Tax Act contains some special provisions for computing profits and gains in the case of non-residents engaged in certain specified businesses. These provisions – Sections 44B, 44BB, 44BBA, 44BBB, and 44C – in effect provide for taxation of presumptive income from these activities. They were introduced with a view to simplifying the assessment procedure for non-residents since, in many cases, their books of account are maintained abroad and are prepared pursuant to the laws of another country, making it difficult to verify various expenses and compute income for income tax purposes. The relevant provisions are described as follows.

Oil exploration. Section 44BB provides that in the case of a non-resident engaged in the business of providing services and facilities in connection with, or supplying plant and machinery on hire used or to be used in the exploration of and production of mineral oils, a sum equal to 10 per cent of the aggregate of certain specified amounts will be deemed to be income chargeable to tax. This will include the amounts received or due to be received in India on account of the provision of such services or facilities or supply of plant and machinery. This section was inserted by the Finance Act, 1987 with retrospective effect from 1 April 1983.

Shipping enterprises. Section 44B provides that in the case of a non-resident engaged in the business of operating ships, the profits and gains from such business are deemed to equal 7.5 per cent of gross receipts on account of carriage of passengers, livestock, mail, or goods shipped at any Indian port, plus the full amount received or deemed to be received in India on account of such carriage of passengers, etc., shipped at any port outside India. The provisions of this section became operative from the assessment year 1976-77. Prior to the introduction of this section, the taxable profits of foreign shipping enterprises were determined by suitably apportioning their global profits between their Indian business and foreign business or on the basis of "voyage accounts".

Aircraft operations. Section 44BBA provides that the income of a non-resident engaged in the business of operating aircraft shall be computed at a flat rate of 5 per cent of the amount received or receivable for carriage of persons, livestock, mail, or goods from any place in India and the amount received or deemed to be received in India on account of such carriage from any place outside India. The provisions of this section were introduced by the Finance Act, 1987, with effect from 1 April 1988.

Turnkey power projects. Section 44BBB provides that in the case of a foreign company engaged in the business of civil construction, erection, testing, or commissioning of plant and machinery in connection with a turnkey power project approved by the central government and financed under any international aid programme, income shall be deemed at 10 per cent of the amount paid or payable to such taxpayer or to any person on his behalf, whether in India or outside India. This section was inserted in the Income Tax Act by the Finance Act, 1989, with effect from 1 April, 1990.

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Deduction ceilings for head office expenses. Section 44C, inserted in the Income Tax Act, with effect from 1 June, 1976, lays down certain limits for the deduction of head office expenses in computing the taxable profits of non-resident taxpayers. Under this provision, non-residents carrying on any business in India through their branches are entitled to a deduction of head office expenditure and this deduction is limited to either 5 per cent of the "adjusted total income" of the taxpayer for the relevant year, or the actual amount of head office expenditure attributable to the business of the taxpayer in India, whichever is lower.

3. Tax incentives

There are a variety of tax concessions. The most important are the partial tax holiday for newly established small-scale industrial undertakings, the full five year tax holiday for entrepreneurs building infrastructure facilities and the full tax holidays for industrial units established in Free Trade Zones (FTZs) and for 100 per cent Export Oriented units. In addition to tax holidays all profits derived from the export of computer software are deductible in computing taxable income. Furthermore exporters of goods or merchandise are also allowed a 100 per cent deduction in respect of profits derived from their export trade in computing their taxable income. These benefits can be passed on to the supporting manufacturers whose goods are exported through the trading or export houses.

For companies a minimum alternative tax (MAT) linked to "book profit" applies where the total income of the company, as computed under the Income Tax Act after availing of all eligible deductions is less than 30 per cent of the book profit. In such cases the company's total income is deemed to be 30 per cent of the book profit and tax is charged accordingly. Companies engaged in the power and infrastructure sectors, establishments and industrial undertakings in backward areas and export profits fully deductible under Section 80HHC are, however, exempted from the levy of MAT. When a company pays MAT, the tax credit earned by it may be carried forward for a period of five assessment years commencing with the assessment year in which regular tax becomes payable. The differences between the regular tax and tax computed under MAT for that year may be set off against the MAT credit available. Thus, at the new 35 per cent rate of corporate tax, every company (including the so-called "zero-tax companies") will have to pay income tax of not less than 10 per cent on their book profits. The credit allowed will not bear any interest.

Special tax treatment has been provided to foreign institutional investors in respect of income from securities and capital gains. Dividends and interest on investments made by foreign institutional investors are taxed at a concessional rate of 20 per cent and long-term gains at a rate of 10 per cent. Short term capital gains arising on the sale of securities are subject to tax at the rate of 30 per cent. Indian companies are required to pay 20 per cent tax on long-term capital gains. Foreign companies and non-resident non-corporate taxpayers are also charged a 20 per cent tax on long-term capital gains.

The existing tax incentives can be divided into two groups:

- measures specifically aimed at attracting foreign capital and augmenting exchange earnings; and
- other measures designed to secure investment growth.

4. Measures to attract foreign capital and augment exchange earnings

(a) Measures inducing better export performance

Exemption for new industrial undertakings in FTZs. A complete tax holiday is available to industrial undertakings established in specified FTZs, Electronic Hardware Technology Parks or Software Technology Parks. In total there are six FTZs. The benefit is an exemption of the profits of an undertaking for five consecutive assessment years beginning with the initial assessment year. For this purpose the undertaking should have been set up in an FTZ and commenced manufacture during the previous year relevant to the assessment year 1981-82 and subsequent years. However, the law provides a choice to the taxpayer. The concession offered is in lieu of other benefits like the tax holiday scheme contained in Section 80IA.

Deduction of profits from projects outside India. To stimulate the export of projects, a tax benefit is available to Indian companies or non-corporate entities resident in India at 50 per cent of the profits earned on a foreign project provided the said 50 per cent of profits are remitted to India in foreign exchange within six months of the end of the relevant previous year and a reserve account is also created for the same. The amount in the reserve account can be utilized only for business purposes for a period of five years. The expression "foreign project" connotes work carried on outside India relating to the construction of roads, buildings etc., assembly or installation of plant or machinery; and such other work, as may be prescribed.

Deduction of profits earned from an export business. An exporter of goods or merchandise is allowed a 100 per cent deduction of profits derived from an export trade in computing its taxable income. This benefit can be passed on to the manufacturers when goods are exported through a trading or export house.

Deduction of royalties and other payments for foreign enterprises. A 50 per cent deduction from the income arising to an Indian company and other non-corporate taxpayers from royalties, commissions, fees or similar payments received or receivable in convertible foreign exchange and brought into India as per the Foreign Exchange Regulations, is provided for. The income earned must be in respect of the provision by the taxpayer to a foreign government or enterprise for use outside India of any patent, invention, model design, secret formula or process, or similar proprietary right or information concerning industrial, commercial or scientific knowledge, experience or skill. The income earned from professional services rendered from India is also deductible under this provision.

Exemption for foreign technicians. Foreign technicians including non-resident Indians, required to serve in India under an approved contract of service are generally paid

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remuneration net of tax. The tax liability is borne by the Indian enterprise employing the technician, and the technician will owe no further tax.

Deduction of profits derived from the export of computer software. Section 80HHE of the Income Tax Act, 1961, provides for the deduction from the total income of the taxpayer of all profits derived from the export of computer software. This concession is available to Indian companies as well as resident non-corporate taxpayers. The broad features of the deduction are as follows:

- the concession is available with regard to profits from the export of software[2] and consultancy services delivered to the foreign client outside India;
- the concession is available only when the export profits are received in or brought into India in convertible foreign exchange within six months of the end of the relevant financial year or within such further period as the Commissioner of Income Tax may allow;
- to claim the tax concession, the taxpayer must furnish along with its return of income, a report of a chartered accountant certifying the correctness of the claim for deduction.

(b) Measures inducing inflow of foreign investment

Concessional tax rates for foreign institutional investors. To promote investment by foreign institutional investors in the Indian capital market, such investors are subject to tax at concessional rates on certain income. Income received from securities listed on a recognized stock exchange in India in accordance with the Securities Contracts (Regulations) Act, 1956, is taxed at the rate of 20 per cent. Long-term capital gains arising from the transfer of the said securities are taxed at the rate of 10 per cent and short-term capital gains at the rate of 30 per cent. To qualify as long-term capital gains the securities must be held for a period of more than 12 months.

Section 196D provides for withholding tax (at 20 per cent) from income derived by foreign institutional investors from securities. The deduction must be made either when the income is credited to the payee's account, when payment is made in cash, or when a cheque or draft is issued, whichever is earlier.

Exemption of investment income of EEC investors. Under the EC International Investment Partners Scheme, the European Economic Community (EEC) provides grants, interest-free loans, and equity participation financed through the reinvestment of dividend income accruing in India from investments made under the scheme. To facilitate investment by the EEC in India such income from investment has been made exempt from income tax. Clause 23BBB in Section 10 provides a complete income tax exemption for Indian-source income in the form of dividends, interest or capital gains derived by EEC investors from investments made out of funds under the scheme.

Incentives for investment by non-residents of Indian origin. With a view to encouraging investment made with foreign exchange in India by non-resident Indian (NRI) citizens and foreigners of Indian origin, the law provides for concessional tax treatment of their incomes. In their case, the income derived from any foreign exchange asset is taxed at the flat rate of 10 per cent. Foreign exchange assets mean any specified asset acquired, purchased or subscribed to by the non-resident Indian in foreign currency in accordance with the Foreign Exchange Regulation Act, 1973, and any rules made thereunder. "Specified asset" means:

- shares in an Indian Company;
- debentures issued by a Public Limited Indian Company;
- deposits with a Public Limited Indian Company;
- securities of the central government;
- units of a unit trust of India; or
- any other asset which the Government of India may specify by notification in the Official Gazette.

Having made an investment in foreign exchange assets, the taxpayer eventually may wish to sell those assets, which may give rise to a capital gain. If the sale or transfer of such an asset takes place after a period of 36 months (12 months in case of shares etc.), the capital gains arising therefrom are taxed at a concessional rate of 20 per cent. If a taxpayer decides to change his investment from one foreign exchange asset to another, he can avoid liability for this capital gains tax by investing or depositing, within six months, the net proceeds realized on the transfer of a foreign exchange asset in any other specified asset or in a non-resident (external) account in any bank in India or in a savings certificate notified by the central government. If the investment in the new asset or the amount deposited in the new account is less than the net proceeds realized on transfer of the foreign exchange assets, the exemption from the capital gains tax is allowed on a proportionate basis, i.e. in the same proportion as the cost of acquisition of the new asset or the amount of deposit bears to the net proceeds.

Relaxed procedures for non-resident Indian investment. The Indian Government also has relaxed certain procedural rules for the setting up of industrial and other ventures by NRIs. NRIs are permitted to make investments on a "non-repatriate" basis in new sectors, including infrastructure, housing and real estate development. NRIs with foreign nationality will not have to obtain permission under Section 31 of the Foreign Exchange Regulation Act when acquiring any residential property in India. However, they are not allowed to repatriate the rental income and proceeds from the sale of such property from India. A chief Commissioner for non-resident Indians has been established to facilitate interaction between non-resident Indians and the central government.

5. Other measures to induce investment growth

(a) Tax holiday

Section 80IA of the Income Tax Act, 1961 allows a certain percentage of taxable income derived from a small-scale new industrial unit, ship or a hotel as a deduction. The deduction rate is 30 per cent of profits derived from the new industrial undertaking, etc. in the case of companies for a period of 10

2. Export includes export through magnetic media, paper and through satellite data links.

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years and 25 per cent of such profits for a like period in the case of other business entities. For cooperative societies, the benefit period is 12 years. In addition to this general, partial tax holiday, enterprises engaged in specific investment projects are entitled to other full tax holidays as well: These are described below.

Tax holiday for industrial parks. A tax holiday is available to industrial parks notified for this purpose in accordance with any scheme to be framed by the central government. Industrial parks which start operating during the period beginning on 1 April 1997 and ending on 31 March 2002 will be eligible for a 100 per cent deduction for the initial five assessment years followed by 25 per cent (30 per cent in case of companies) for the subsequent five assessment years.

Tax holiday for new industrial undertakings in underdeveloped areas. With a view to encouraging new investment in industrially underdeveloped states and Union Territories, the government offers a full five-year tax holiday commencing in the year the production begins for new industrial undertakings located in the North-Eastern States, Jammu & Kashmir, Himachal Pradesh, Sikkim, Goa, the Union Territories of the Andaman and Nicobar Islands and Dadra and Nagar Haveli, Daman and Diu, Lakshdweep and Pondicherry. A similar deduction is offered to new industrial undertakings in certain backward areas of other states.

After the fifth year, the industrial undertaking is entitled, for the balance of the applicable period (i.e. seven additional years for cooperative societies and five for other entities), to the profits deduction provided under Section 80IA (See above[3]).

Tax holiday for the power generating sector. A full five-year tax holiday is available in respect of the profits and gains of new industrial undertakings set up anywhere in India for power-generating projects. The five-year tax holiday is available to undertakings that have begun or will begin to generate power on or after 1 April, 1994. When the tax holiday expires, the undertaking will be allowed to deduct 30 per cent of its profits if it is organized as a company, and 25 per cent if it is a non-corporate entity. Again, these deductions will be available for seven assessment years to cooperative societies and five years to other taxpayers.

Tax holiday for infrastructure building. To promote the expansion of quality infrastructure, a full five-year tax holiday is available to any enterprise that builds, maintains, and operates any infrastructure facility, such as roads, highways or expressways, new bridges, airports, ports, rapid rail transport systems or water supply projects, irrigation systems, sanitation and sewage systems on a BOT (build, operate, transfer), BOOT (build, own, operate, transfer), or similar basis. The enterprise must have entered into an agreement with the central or state government, a local authority, or any other statutory authority for this purpose. The period within which the infrastructure facility has to be transferred needs to be stipulated in the agreement between the undertaking and the government concerned.

The tax holiday is allowed in respect of income derived from the use of the infrastructure facilities developed by the taxpayer. The five-year tax holiday is available to an entrepreneur who has begun or will begin to operate infrastructure facilities on or after 1 April 1995. When the initial five-year tax holiday expires, the entrepreneur will be allowed to deduct 30 per cent of its profits, if it is a company and 25 per cent if it is a non-corporate entity. This incentive is available to cooperative societies for the first 12 years and to others for the first ten years of operation. (For the computation of these periods see below.)

An entrepreneur is allowed to choose the initial year from which he wants to avail of the five-year tax holiday. The tax holiday has to be availed of within the span of the first 12 years of operation (in case of a cooperative society). This means that a cooperative society which chooses the fourth year of operation as the initial year gets a full tax holiday for five years from the fourth to the eighth year and the 30 per cent deduction for the remaining four years, that is from the ninth year to the twelfth year.

As an incentive for financial institutions to provide long-term financing for the development of infrastructure facilities, a deduction of 40 per cent of their taxable income derived from financing investments in infrastructure facilities is also allowed to such institutions provided this amount is credited to a special reserve.

Tax holiday for scientific and industrial research. A five-year tax holiday is available to approved companies exclusively engaged in scientific and industrial research development activities conducted on a commercial basis. This incentive is available to a company that has as its main objective activities in the areas of scientific and industrial research and development and which has been accorded approval by the prescribed authority. The tax holiday is available to any company, whether new or existing, which is accorded approval by the prescribed authority at any time before 1 April 1998. The 100 per cent deduction for a five-year period shall commence from the assessment year relevant to the previous year in which the approval by the prescribed authority is accorded to such a company.

(b) Deduction of expenditures for scientific research

Section 35 of the Income Tax Act allows a deduction for contributions to approved scientific research associations, universities, colleges, or other institutions that are to be used for scientific research. To encourage industry to make use of facilities offered by national laboratories and research institutes, this section also allows a weighted deduction of 125 per cent of contributions to approved national laboratories and institutions carrying out research and development in natural and applied sciences.

A "national laboratory" is defined as a scientific laboratory functioning at the national level under the aegis of the Indian Council of Agricultural Research, the Indian Council of Medical Research, the Council of Scientific and Industrial Research, the Department of Electronics, the Defence

3. I.e. a 30 per cent deduction of the profits of such undertakings in the case of companies and a 25 per cent deduction in the case of other entities.

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Research and Development Organization, the Department of Biotechnology and the Department of Atomic Energy and which is approved by the prescribed authority for this purpose.

(c) Exemption of venture capital income

To encourage venture capital financing, clause 23F to Section 10 of the Income Tax Act provides an income tax exemption for all dividends and long-term capital gains of a venture capital fund or a venture capital company from investments made by way of equity shares in venture capital undertakings. To obtain this exemption, the venture capital fund or company must obtain approval from the prescribed authority and satisfy the prescribed conditions. The approval by the prescribed authority will have effect for the immediate assessment year or up to three assessment years, as may be specified in the order of approval.

If the equity shares are transferred by the venture capital fund or company at any time within three years from the date of their acquisition (other than in the event that the shares are listed on a recognized stock exchange of India), the aggregate amount of dividend income on such equity shares that has not been included in income in the years preceding that in which the transfer has taken place shall be deemed to be income of the venture capital fund or company for the year in which the transfer took place. In these circumstances no exemption will be allowed in respect of long-term capital gains, if any, arising on the transfer of the shares.

6. Adjustment for business losses

In India, there are five broad heads of income under which a taxpayer's different sources of income may be grouped. Except for speculation losses, long-term capital losses and losses from some specified sources like horse-races, gambling, etc., losses from any source are eligible for set-off against the profits from any other source under the same head of income. The net loss under any head is further eligible for set-off against income arising under other heads. However, capital losses are not allowed to be set off against income from other heads but may only be carried forward to be set off against capital gains arising in the subsequent eight years.

If a loss cannot be set off against profits under the same head or under different heads on account of inadequacy of profits in the same year, it may be carried forward and set off against the income arising under the same head in subsequent years. Business losses and unabsorbed depreciation allowances can be carried forward for eight years.

Another welcome provision aimed at salvaging loss-making units permits the carry-forward and set-off of accumulated business losses and unabsorbed depreciation allowances of the amalgamated loss making unit in certain cases of amalgamations.

India's Income Tax Act unlike the tax statues of some of the advanced nations does not allow the carry-back of business losses. However, India has made a promising start in the reform of its tax regime, and future progress in this area is certain.

7. Advance rulings for non-residents

India offers a scheme for issuance of advance rulings on questions of law or fact in respect of proposed transactions or transactions undertaken by non-residents. The taxpayer must apply to the Advance Ruling Authority in the prescribed form and manner, and pay a fee of INR 2,500. A request for a ruling may be withdrawn within 30 days. The authority may accept or reject an application, although no ruling will be issued where the request involves an issue already pending before the income tax authority, the Appellate Tribunal or any court; involves the determination of the fair market value of any property; or relates to a transaction which is designed prima facie for the avoidance of income tax.

The Advance Ruling Authority is required to issue an advance ruling within six months from the date of receipt of the application. The ruling is binding on the applicant in respect of the specific transaction to which the ruling was sought. The Commissioner of Income Tax is also bound by the ruling. The scheme does not provide for any right of appeal to the courts against the advance ruling.

An advance ruling may be revoked if it is subsequently discovered that it was obtained by fraud or the misrepresentation of facts. The ruling will continue to remain in force unless there is a change in the law or in the facts on the basis of which it was granted.

8. Return of income

Each taxpayer has to file a return of income or loss for the previous year by specified dates:

(i) company: 30 November.
(ii) non-company, which is required to get its accounts audited, or furnish audit certificates for claiming certain deductions: 31 October.
(iii) non-company, having income from business but not requiring audit: 31 August.
(iv) non-company, no income from business: 30 June.

These dates are mandatory. If the return is delayed, interest at 2 per cent per month or part thereof, on the tax (excluding advance tax and withheld tax) has to be paid, and proof of payment attached with the return.

9. Assessment procedure

The income disclosed is generally accepted, subject to the adjustment of prima facie incorrect claims. Any further tax found due on such adjustment will carry a 20 per cent additional levy. The system is thus basically one of self-assessment. The Assessing Officer may scrutinize selected cases. If the taxpayer does not file a return despite notice, or fails to produce the accounts and evidence for scrutiny, the Assessing Officer may make the assessment *ex parte*, to the best of his information. An order of assessment after scrutiny or a tax demand arising from an adjustment of prima facie incorrect claims has to be made within three years from the end of the accounting year.

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(a) Partnerships

Salary to working partners and interest paid to partners as per the partnership agreement are deductible up to specified limits. The partner will bear the tax on the salary and interest received by him, and the firm will be taxed on the profit in its accounts. The partnership firm is subject to tax at the maximum marginal rate of income tax applicable to individuals.

(b) Association of persons (AOP)

An AOP comprises two or more persons joining in an activity for profit. An AOP is taxed at the maximum marginal rate of 40 per cent in most cases.

(c) Trusts

Public trusts set up for religious or charitable purposes are generally exempt from tax, if specified conditions are met. Private discretionary trusts (where the shares of the beneficiaries are not known) are taxed at the maximum marginal rate of 40 per cent. In the case of a private trust where the beneficiaries shares are known the beneficiaries are taxed on their share of income, either directly or through the trustees; but if the trust has an income from business, the maximum marginal rate will apply.

(d) Joint-ventures

Joint-ventures (JVs) between a non-resident and a resident in India will be taxed according to the constitution of the JV, i.e. as a partnership, association of persons, or company, as the case may be.

(e) Non-residents and their agents

A non-resident may appoint an agent in India to look after his tax matters, failing which it is open to the Assessing Officer to treat an employee of the non-resident, or a person with a business connection in India, or through whom the non-resident receives any income, as the agent of the non-resident for tax purposes.

10. Appeals

The taxpayer can appeal to the Commissioner (Appeals). The Revenue and the taxpayer can appeal further to the Income Tax Appellate Tribunal. On points of law, questions can be referred to the High Court and further appealed to the Supreme Court. Only lawyers can appear in the courts. Lawyers, accountants, or employees, duly authorized, can appear before tax authorities and the Tribunal.

11. Withholding taxes

On certain payments the payer must withhold tax at source, and pay it to the government. The payee can claim credit for the amount so withheld, in his tax return. For this purpose, the payer issues a certificate of deduction of tax to the payee. These certificates should be filed with the return to support the claim for tax credit.

The rate at which tax is to be deducted from each type of payment is specified in the Finance Act of each year. Important payments are salaries, interest, dividends, rent, income from units of mutual funds, lottery and race winnings, payments to contractors and sub-contractors, payments for professional and technical services, and certain incomes for non-residents. The tax withholder has to file with the tax office periodical statements of the taxes deducted by him and paid to the government.

B. Other direct taxes

1. Wealth tax

An annual wealth tax is levied on non-productive assets (residences, jewellery and bullion, yachts, aircraft and unutilized urban land) of individuals, Hindu undivided families and companies. Mutual funds are exempted. Certain debts and liabilities are deductible, but debts located outside India are not admissible in the case of a non-citizen, a non-resident, or a foreign company. Wealth tax is charged at 1 per cent of the net wealth exceeding INR 1.5 million.

2. Gift tax

Gift tax is payable by a donor at 30 per cent of the aggregate value of taxable gifts made by him in any previous year. Public companies, a company in a scheme of amalgamation with an Indian company, and charitable and religious trusts whose income is exempt from tax, are exempted from gift tax.

3. Expenditure tax

This is a 10 per cent tax on expenditure (including accommodation, food and beverages, and other services) in a hotel where the room charge is INR 1,200 or more per day per person. This is collected by the hotel and paid to the government.

4. Interest tax

A tax at 2 per cent is levied on the gross interest income of credit institutions such as banks and public financial institutions, including companies carrying on hire purchase, investment, and other similar activities. "Gross interest" includes commitment charges and discounts; but interest earned by a credit institution on loans and advances given to another credit institution is excluded.

Interest tax is deductible in computing the income tax liability of the credit institution. Interest tax is payable in advance during the accounting year, in three instalments due on 15 September, 15 December and 15 March. Returns are to be filed by 31 December of the following year.

V. INDIRECT TAXES

Since India is a developing country, the general income level of its population is low. Consequently, the tax base of direct taxation is narrow. Inevitably, therefore, indirect taxes provide the lion's share of the government's revenues. These taxes broadly include import duties, Union Excise Duties

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levied by the central government at the manufacturer's level, sales tax, motor vehicles tax, passenger and goods tax and octroi levied by the states.

A. Customs duty

Customs duty is levied on an *ad valorem* basis on all the goods that are imported into the country. With a view to opening up the Indian economy, the reforms that started in 1991-92 reduced the peak rate of import duty. It was brought down to 150 per cent in 1991-92 and to 50 per cent in 1995-96, with the average effective rate reducing to 28 per cent from a high of over 44 per cent in 1991-92. Furthermore, the procedures have been simplified and various requirements which applied to bonds, certificates, test reports, end use certificates, etc. have been abolished with a few exceptions for concessional or duty free imports. Applicable rates of duty have been rationalized to the extent that there are now no more than three rates in a chapter. The bulk of the components and parts required by industry in India carry a rate of duty of only 25 per cent as against 65 per cent in 1993.

Special concessional low rates of import duty are levied on some specified sectors. Also, all import items used to produce goods for export are exempt from import duty.

Up until 1991-92 there were many specific duties in force. During the last few years, they have all been made *ad valorem*, leaving little scope for disputes on classification of goods or on rates.

In order to encourage the growth of industrial units in specified sectors such as leather goods, electronics and telecommunications, special concessional rates have been continued.

India's objective is to have a duty regime which is similar to those in the newly industrializing countries within the next two to three years. Indian industries engaged in competitive areas should be able to reorganize production to meet external competition in that time. The process of downward adjustment of rates was continued in the 1997-98 budget.

B. Union excise duty (MODVAT)

Excise duty is levied on all the goods manufactured in India. The tax is paid at the time of removal of goods by the manufacturer from his factory premises. Since 1986, a Modified Value Added Tax (MODVAT) has been introduced. All the goods under the Union excise duties except petroleum products, tobacco products including cigarettes, cinematographic films and match boxes are taxed under MODVAT implying that the set-off for the tax paid at the input stage is given when the goods are finally sold. The Union excise duty therefore does not suffer from the cascading effect. The reforms have led to the tax rate being made *ad valorem* in most cases. The rate categories have also been reduced considerably. Currently there are only nine rate categories. Furthermore, procedural reforms have been introduced particularly for the small dealers.

Though initially capital goods were generally kept out of the MODVAT scheme, from the 1994 budget the government has included capital goods under the scheme.[4] In India the assessees are given a full tax credit for the excise duty suffered once the capital goods are delivered and put into use. The credit can be used immediately for paying duties on finished excisable goods produced in the factory even though the capital goods may be used for producing goods for a number of years.

There have been difficulties in extending MODVAT credit benefits for the various inputs including capital goods in India, where these goods get supplied otherwise than directly from the original producer. This is mainly because the dealers are not liable to payment of excise duty as they are only involved in the sale of goods in the further chain of distribution and do not undertake any manufacturing activity which would generate a liability to MODVAT. However, to make the MODVAT scheme operational and to provide the intended input relief the government has evolved various rules and procedures even when the inputs/capital goods are routed through one or more intermediary dealers. The dealers are required to be registered and follow certain prescribed formalities concerning documentation, storage of goods etc.

A number of simplifications have also been effected in the years 1995, 1996 and 1997 for easier administration of the MODVAT provisions. For example the Central Excise Department has introduced certain measures to simplify operational procedures. Self-assessment and Selective audit are two such schemes.

Self-assessment:
- New simplified format of monthly return (RT-12).
- Self-assessment of duty by assessee on the RT-12 return.
- No need to await assessment order by Central Excise Officers, an acknowledgement suffices.
- No need to attach invoices to the return.
- Quarterly returns for Small Scale Industry (SSI) units continues.
- Assessees can request a provisional assessment in certain cases.
- Assessees must mention Excise Control Code (ECC) of supplier and buyer of inputs/capital goods in the MODVAT return (RG 23) to facilitate on-line verification by computer.
- Scrutiny of returns of larger assessees by higher level officers.

Selective audit:
- Large-scale units (paying duty of INR 10 million and above annually) shall now be subject to excise audit, normally only once a year. However, commissioners may order a higher frequency of audit to reflect risk perceptions based on prescribed objective factors including the assessees compliance record.
- Units paying duty of less than INR 10 million would be audited only selectively, based on objective factors like

4. This is unlike many countries which have adopted the VAT system and which had either not extended VAT to capital goods, or when extended provided relief of duties paid on capital goods over a period of time and not completely in the year of receipt.

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negative revenue trend and evasion-prone commodities, etc.
- SSI units to be visited only on written authorization by the Assistant Commissioner concerned.
- Invoices are not to be submitted with the returns (RT-12), but they have to be produced on demand to Range staff/Audit parties.
- Audit would cover statutory records as well as internal records i.e. balance sheets, bank statements, stores and customers ledgers, etc.

While almost all Central Excise Commissioners and their divisions in the country are already computerized, many new steps are being considered to make the system more effective and to move towards Electronic Data Interchange (EDI) in the near future.

C. Appellate procedures

Once the final order requiring any person to pay a specific amount of Central Excise duties, fines and penalties is passed by the proper officer, the assessee has two options. If he is reasonably satisfied by the order, he complies with it. On the other hand, if he feels aggrieved by the order, he can appeal.

There are two tiers of quasi-judicial appellate authorities: the Commissioner (Appeals) and the Central Excise & Gold Control Appellate Tribunal (CEGAT).

Appeals to the Commissioner (Appeals) may be made against orders passed by any Central Excise officer up to the rank of Additional Commissioner, while that to the CEGAT lie against orders of the Commissioners and above. The Commissioners (Appeals) of the Central Excise function have specified jurisdictions, depending on work-load. The CEGAT has regional benches at Calcutta, Chennai, and Mumbai and principal benches at Delhi.

The Commissioners (Appeals) pass orders-in-appeal after observing the principles of natural justice. A second appeal lies against this order to the CEGAT. The orders of CEGAT are not appealable in any High Court. However, special leave petitions can be filed against these in the Supreme Court by either the assessee or the department. The CEGAT can be petitioned for rectification of mistakes (on the face of the record) in its orders and also for reference of any point of law to the jurisdictional High Court.

D. Service tax

Every taxable service is taxed at the rate of 5 per cent of its value. Taxable services include services of stock brokers, telegraph services, insurance agents, advertising agencies, pager services, courier services, transporters of goods by road, consulting engineers, customs house agents, steamer agents, air travel agents, clearing and forwarding agents, outdoor caterers, *pandal* contractors and *mandap* keepers, manpower recruitment agencies or consultants and tour operators including car rentals.

E. Sales tax

Sales tax is levied on the sale of moveable goods within India. The rate of tax varies depending upon the type and nature of the goods and the state in which the sale takes place. The Union government levies tax on inter-state sale transactions, while the state governments levy sales tax on sale transactions concluded within the state. Generally, in most states, goods sold more than once within the same state, in the same form, are taxed only once. Subject to compliance with certain requirements, sales tax is levied at 4 per cent on most inter-state transactions. Tax payable on intra-state transactions varies from 2 per cent to 25 per cent. Exports and services are exempt from sales tax.

Since 1995, efforts have been made to replace sales tax by destination-based VAT by the states. Maharashtra State currently levies VAT on all dealers having a turnover above INR 5 million, and Madhya Pradesh State and Tamil Nadu State have proposed to levy VAT on all dealers having a turnover above INR 10 million and 7.5 million respectively. In addition, Andhra Pradesh State levies VAT on 20 select commodities.

F. Octroi

Octroi is levied on the entry of goods into municipal areas for consumption, use or sale. The levy of octroi varies, depending on the municipal jurisdiction.

G. Research and development cess

Research and development cess is at present levied at the rate of 5 per cent on the import of technology into India and is payable by the importer. Technology refers to any special or technical knowledge or any special service required for any purpose by an industrial concern under any foreign collaboration and includes designs, drawings, publications and the services of technical personnel.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 71-72 of the January 1997 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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CHINA

COUNTERACTING CORRUPTION IN THE TAX ADMINISTRATION IN TRANSITIONAL ECONOMIES: A CASE STUDY OF CHINA

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I. INTRODUCTION

Like bacteria, corruption is omnipresent and resilient. While it stubbornly endures mature capitalism, it thrives in "transitional economies". In countries converting from command to market economic structures, opportunities for corrupt practices are ruinously abundant. Corruption bleeds public revenue and retards economic development. It corrodes the (already fragile) confidence of citizens in the public framework and public institutions. It undermines the ability of the state to finance and implement public policy.[1]

The Chinese tax administration provides an illuminating case study in corruption.[2] China began its economic transition and construction of a modern tax system in the late 1970s, about a decade earlier than Russia and other transitional countries. To a large extent, the causes and effects of corruption in China reflect those in other transitional economies. China's recent experiments with corruption control may provide some useful lessons for other countries.

This paper probes the nature and origin of corruption in transitional economies. It examines opportunities for corruption in the tax administration and argues that corruption can be controlled. The paper sets out short-term and long-term strategies for fighting corruption in the tax administration and uses China as a case study.

II. CORRUPTION AND TRANSITIONAL ECONOMIES

A. Corruption – definitional and data problems

Corruption in the tax administration is a difficult subject to study. One of the difficulties is defining "corruption". In general terms, "corruption" means the misuse of public power for private profit (need not be monetary).[3] One cannot assume, however, that corruption always means the same thing. It varies based on the cultural/moral standard and social or legal norms. In the Chinese context, for example, "corruption" is understood to include all types of irregulari-

1. There are two widely divergent views on the effects of corruption in developing countries. One is that corruption contributes to national integration, maintains political stability, fosters political development, and promotes economic growth. The other is that corruption impairs bureaucratic effectiveness, political development, and economic efficiency. The more accepted view is the latter. Corruption has been described as "cancer" (or another such fatal disease) by the World Bank and leaders of many countries. For general discussions, see M. Shahid Alam, "Some Economic Costs of Corruption in LDCs," (1991) *Journal of Development Studies* 27 at 89-97; Frank Anechiarico and James Jacobs, *The Pursuit of Absolute Integrity: How Corruption Control Makes Government Ineffective* (John Hopkins University, 1997); David Bayley, "The Effects of Corruption in a Developing Nation," (1993) *The Western Political Quarterly*, at 723; *Building a Global Coalition Against Corruption: Transparency International Report* 1995 (Transparency International, Berlin: 1995); David Gould and A. Amaro-Reyes Jose, "The Effects of Corruption on Administrative Performance: Illustrations from Developing Countries," World Bank Staff Working Papers, No. 580, Management and Development Series No. 7, 1983; Robert Klitgaard, *Controlling Corruption* (Los Angeles, University of California Press, 1988); S. J. Rubin, "International Aspects of the Control of Illicit Payments," (1982) Vol. 9 *Syracuse Journal of International Law and Commerce* at 325; Duc V. Trang, ed., *Corruption & Democracy* (Budapest: Institute for Constitutional and Legislative Policy, 1994.

2. Like other transitional countries, China's economy is being transformed into a market economy. Unlike many other transitional countries, however, the transition in China has been largely limited to an economic transition and the accompanying changes in the legal system. China's political system remains dominated by the Communist Party. China's approach to economic and legal transition is "evolutionary" rather than "revolutionary" as in many Eastern European countries and Russia. The evolutionary approach has also been adopted in the development of the tax system and legal system. Despite the differences in approach to the transition, the causes and effects of corruption in the tax administration are similar in China and other transitional countries. China's experiments with corruption control may be representative of similar experiments in other transitional countries, or provide some useful lessons for other transitional countries.

3. J.J. Senturia, *Encyclopedia of Social Sciences*, Vol. VI (1993); Gould, et al., *supra* note 1. David Gould states that administrative corruption is the "institutionalized personal abuse of public resources by civil servants" in *Handbook of Comparative and Development Public Administration*, ed. by Ali Farazmand (1990), at 467.

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ties and connotes bribery, embezzlement, extortion, expropriation of public money, favouritism, and nepotism.[4]

It is beyond the scope of this paper to provide a single definition of corruption. For the purposes of this paper, "corruption in the tax administration" refers to the behaviour on the part of tax officials to improperly and unlawfully enrich themselves, or those close to them, by the misuse of the public power entrusted to them.[5]

1. Forms of corruption

Broadly speaking, corrupt behaviour in the tax administration can be categorized into two general classes. Class A corruption involves practices that are clearly illegal in formal terms and involve a personal infringement of institutional rules for purely private purposes. In the Chinese context, these crimes include:

- embezzlement;
- graft;
- bribery, also called "gifts" "favours," "sweeteners," "inducements," "gratuities," "commissions";
- official speculation (trading of goods or services by taking advantage of the official position for private profit);
- fraud;[6]
- stealing state property;
- maintenance of luxury living based on the abuse of public property (such as cars and housing); or
- enjoying large-scale gifting or entertainment (dining, sightseeing, and amusement) from taxpayers.

Corrupt officials are punishable by both criminal and administrative penalties. For example, in China, a tax official who was found guilty of embezzling tax funds of 100,000 yuan (about USD 11,500) was imprisoned for 16.5 years;[7] a tax auditor was found guilty of soliciting bribes totalling 36,500 yuan (about USD 4,350) and was sentenced to a short-term of imprisonment;[8] tax officials who profited from selling certificates of tax payment resulting in the loss of tax revenue of 10,390 yuan were convicted of the crime of official speculation and punished by a two-year term of imprisonment;[9] and tax officials who assisted taxpayers in fraudulently obtaining tax refunds were sentenced to a 12-year term of imprisonment.[10]

Class B corruption reflects the operation of pervasive networks of personal ties that give rise to patterns of behaviour that are often regarded as corrupt. These include:

- preferential treatment for friends and relatives;
- "bending" rules to benefit individuals or small groups; or
- expenditures on gifts and entertainment to create and maintain connections with superiors.

For example, certain Chinese tax officials who "waived" various taxpayers' liabilities or penalties out of friendship or family relationships were found guilty of corruption.[11] Accepting gifts from subordinates in the form of "lucky money" or a "bonus" is punishable by administrative discipline or, in serious cases, by imprisonment.

2. Data problem

Data on corruption is difficult to obtain and trends in corruption are difficult to quantify. Because bribery and other forms of illicit payments are by their nature covert, it is impossible to accurately quantify their amount or frequency. But accounts from business executives, development economists, officials from transitional economies, and journalists throughout the world underscore the breadth and seriousness of corruption in transitional economies. For example, Transparency International's annual surveys on corruption ranked China, Russia, and other transitional economies as among the most corrupt countries in the world.[12]

Press reports in China also serve as useful evidence of the extent of the problem and the growth of corruption in that country. Although these reports are part of a larger struggle in which allegations of corruption are political weapons, they are nonetheless impressive. Between 1982 and 1986 the Communist Party's Central Discipline Inspection Commission investigated 230,000 cases in which 148,163 Party members were disciplined for bribery and theft, and an average of 22,000 cases of corruption were tried per year. From 1988 to 1993, over 870,000 cases were investigated, with 730,000 members being disciplined and 150,000 expelled from the Party. The Supreme People's Procutorate (which now has an anti-corruption bureau) was reported to receive citizen reports of corruption at a rate of about 1.25 million per year in recent years.[13] Given the general ineffectiveness of corruption control measures, these numbers make one wonder how many more cases of corruption there are that remain undiscovered.

In Russia, there also have been many reports that crime and corruption are rampant.[14] Corrupt payments apparently transcend all levels of government: two thirds of state and commercial bodies are involved in corruption, including financial

4. Michael Johnston and Yufan Hao, "China's Surge of Corruption: Delayed Political Development, Markets, and Democratic Reform," (1995) *Journal of Democracy*; Ting Gong; *The Politics of Corruption in Contemporary China: An Analysis of Policy Outcomes* (Westport, CT: Praeger, 1994); and Mayfair Yang, *Gifts, Favors, and Banquets: The Art of Social Relationships in China* (Ithaca, NY: Cornell University Press).

5. See Transparency International, *National Integrity Systems: The TI Source Book* (hereafter "*TI Source Book*"), Chap. 2.

6. In 1994, at least 56 tax officials were found guilty of committing fraud involving VAT invoices; *Zhongguo Shuiwu*, 1995, No. 6, at 6.

7. The director of a local tax bureau who embezzled 10,070 yuan (about USD 1200) was sentenced to a five-year term of imprisonment; see *Zhongguo Shuiwu Bao*, 17 February, 1995, at 3.

8. Supplementary Provisions Concerning the Punishment of the Crimes of Embezzlement and Bribery, promulgated by the Standing Committee of the National People's Congress on 21 January 1988. The case was reported in Liu Lixian, ed., *The Crime of Bribery* (Beijing, China Procutorate Press, 1996), at 135.

9. Ye Huilun, Cao Kang, Shen Yuedong, eds., *Crimes Related to Taxation* (Beijing, China Procutorate Press, 1996), at 367.

10. Ye, et al., *supra* note 9, at 353.

11. He Gang, "Analysis of the Nature of Tax Exemptions Allowed by Tax Officials Without Legal Basis", *Zhongguo Shuiwu*, 1992, No. 5, at 23-24.

12. Transparency International Survey: 1995 and 1996.

13. Johnston and Hao, *supra* note 4.

14. Barbara Ettorre, "Why Overseas Bribery Won't Last", *Mgmt. Rev.*, 1 June 1994, at 20.

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and trade organizations, law enforcement agencies and tax and customs services.[15] 70 to 80 per cent of all banks and private enterprises were reportedly victims of extortion by government officials.[16]

Data on corruption in the tax administration is even more difficult to gather. There has been very little published literature on the subject of corruption in the tax system.[17] According to Transparency International, however, tax collection is one of the areas most vulnerable to corruption.[18] Corruption in the tax administration appears to be increasing as well. For example, in 1994 the Chinese tax administration investigated 1,857 cases of corruption (of which 460 were referred to the People's Procutorate for prosecution), 209 persons were convicted under the Criminal Law, 225 persons were deprived of the right to be a civil servant; and 340 were dismissed or demoted.[19] The number of cases increased by 11 per cent in 1995.[20]

Despite the difficulties in measuring precisely the amount of corruption, Transparency International's surveys and the official press reports in China and Russia seem to support the perception of widespread corruption in China and other transitional economies. From the perspective of preventing corruption in tax administration, the precise amount of corruption taking place is almost a secondary issue. The perception of corruption is as damaging to the tax system as corruption itself.

B. Damaging effects of corruption in the tax administration

Corruption in the tax administration is damaging. It reduces the efficiency of a tax administration, destroys public confidence in the tax system, ruins the morale of tax officials, and bleeds tax revenue.[21] Widespread corruption may derail the economic transition process.

1. Corruption reduces efficiency in tax administration

The efficiency of a tax administration can be measured by its performance in carrying out two main functions: revenue collection for the government and equitable treatment of taxpayers. Corruption makes a tax administration ineffective in carrying out these functions. With respect to revenue collection, corruption generally involves a taxpayer paying bribes to officials to reduce or avoid tax payments. The taxpayer and the officials both "benefit" from the transaction by dividing the tax savings between them at the expense of the government. Therefore, a portion of tax revenue flows into the pockets of the officials, rather than into the coffers of government. It is difficult to assess the amount of revenue lost as a result of corruption. Anecdotal evidence indicates that in some transitional countries, about 10 to 15 per cent of tax revenue cannot be collected because of corruption.[22] Corruption causes unequal treatment of otherwise similarly situated taxpayers. Honest taxpayers must incur expenses in terms of time and money to comply with tax laws, whereas dishonest taxpayers can bribe tax officials to avoid tax or obtain tax benefits that would otherwise be unavailable to them. Corruption generally subverts trust and cooperation among tax officials, encourages violations of rules and regulations, and intimidates and terrorizes honest officials into silence.[23] There is a corrosive quality to corruption. Many will commit acts of corruption out of the belief that others are corrupt. Dishonest officials may feel justified in their action. Honest officials may be impelled to choose one of two options: to apply non-corrupt standards and run the risk of being ridiculed or isolated, or to participate in corrupt practices. Most observers note that in corrupt bureaucracies the tendency is to hire corruptible individuals exclusively, regardless of their professional qualifications.[24] Such hiring practices perpetuate the corrupt "culture" of the administration.

2. Corruption destroys voluntary compliance

The *raison d'être* of any tax administration is to ensure compliance with tax laws. In an ideal law-abiding society, people would pay the taxes they owe, and the tax administration would amount to little more than the provision of facilities for taxpayers to discharge this responsibility.[25] No such country exists, or is likely ever to exist. Compliance with tax laws must be created, cultivated, monitored, and enforced in all countries, especially in countries with a short history of modern taxation.

Widespread corruption in the tax administration is considered an important factor influencing taxpayers' attitudes in complying with tax laws.[26] Actual or perceived corruption causes taxpayers to lose respect for tax laws and confidence in the tax administration. Facing the prospect of dealing with dishonest officials who will demand bribes or otherwise cause trouble for the taxpayer, the taxpayer will have little confidence that payments will be handled properly by the officials and that other taxpayers will be treated in the same way. The perception that dishonest taxpayers benefit from a corrupt system by avoiding taxes may encourage honest taxpayers to become dishonest. Such a spin-off effect will destroy a voluntary compliance system.

15. Associated Press, "Russia for Sale: Plenty of Takers", *Chi. Trib.*, 15 April 1993, at 8; Randolph Ryan, "Forum Explores Lawless Business Landscape in Russia", *Boston Globe*, 19 Nov. 1994, at 5.
16. Jefferey P. Bialos and Gregory Husisian, *The Foreign Corruption Practices Act: Coping with Corruption in Transitional Economies* (Dobbs Ferry, New York, Oceana Publications Inc. 1996), at 9-24.
17. Richard Bird and Milka Gasanegra de Jantscher, eds., *Improving Tax Administration in Developing Countries* (International Monetary Fund, 1992), at 8.
18. *TI Source Book*, *supra* note 5, Chap. 2. Other areas include public procurement, re-zoning of land, and government appointments.
19. *Zhongguo Shuiwu*, 1995, No. 6, 4-7, at 5.
20. *Zhongguo Shuiwu*, 1996, No. 5, 4-6, at 5.
21. See Gould, et al., *supra* note 1, at 25-26.
22. The gap between the revenue authorized by the law and the actual taxes collected is greater in developing countries than that in developed countries. For example, in New Zealand, 85 per cent of the tax authorized is collected, whereas in Russia, only 45 per cent of the tax authorized by law is actually collected.
23. Gould, et al., *supra* note 1, at 33-34.
24. Id.
25. Amaresh Bagchi, Richard Bird and Arindam Das-Gupta, "An Economic Approach to Tax Administration Reform", (International Centre for Tax Studies, 1995).
26. Bagchi, et al., *supra* note 25, at 15.

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3. Corruption undermines the process of economic transition

In transitional economies, taxation is used to raise revenue, to regulate the economy, and to redistribute income. Widespread corruption can defeat these objectives and make it difficult for the government to implement economic reforms.

Corruption in the tax administration weakens the government's ability to use taxation as a policy tool to promote economic development. Corruption favours taxpayers who, because of the special treatment they receive from tax officials, are able to reduce their tax liability. If the statutory tax system has been designed to be neutral, corruption will destroy the neutrality by giving a competitive advantage to some taxpayers over their competitors. If the statutory tax system has been designed to provide incentives to encourage investment in certain economic sectors, granting incentives to unqualified taxpayers as a result of corruption will defeat the purpose of the tax incentive programmes. Corruption also has a damaging effect on attracting foreign investment. Many transitional economies are short of capital, modern technology and management skills. As part of the solution to the problem, they encourage foreign investment. Systematic corruption may deter foreign investment as it increases the "hidden" cost of doing business and creates uncertainty in the tax system.[27]

Corruption distorts the redistribution of income. There is a growing gap between the "haves" and the "have-nots" in transitional economies. Where taxes are designed to facilitate the redistribution of income, if some taxpayers reduce their tax payments by bribing officials, corruption will neutralize the redistribution function of taxation.

Governments have an important stabilizing role to play in the process of economic transition. That role requires a reduction of the deficit and expenditures on various government programmes. Corruption in the tax administration reduces government revenue and raises the cost of tax collection. The revenue loss heightens the deficit problem and undercuts the government's ability to assume a stabilizing role. In some countries, there is lack of funding for social welfare programmes, education, and health-care programmes, investment in infrastructure projects, regional developments, and government staffing costs. This causes social unrest and other problems in society.

4. Corruption impedes the development of the rule of law

Endemic corruption ruins the efforts to establish the rule of law in transitional economies. The transition from a command economy to a market economy requires the establishment of a legal system and respect of the rule of law. Corruption breeds disrespect for law and order. Corruption also hinders a country's political development. It is likely to generate conditions of violence, social unrest, political instability, and regime change.[28] In transitional economies where there is a genuine attempt at developing the rule of law and "democracy", if corruption is not checked and controlled, it will undermine the whole process of reform.[29] Democracy depends on the confidence of the people in the integrity of their government.[30]

5. Is corruption always bad?

Some would argue that corruption can have beneficial effects. Bribes and pay-offs expedite transactions by helping overcome cumbersome rules and regulations.[31] In other words, corruption is a bit of grease that helps the wheels of government and business turn.[32] Some academics argue that bribery can be acceptable when there are irrational interventions by government in the economy. For example, if it takes two years to get licences and permits to sell one's crop, then a bribe that gets the deal done in two weeks may increase economic efficiency. However, counter-arguments are often more acceptable. Corruption leads to economic inefficiency and waste. Any gains obtained through corruption are unlikely to be transferred to the investment sector.[33] Moreover, the practice of giving "speed money" is actually often the cause of administrative delays. Civil servants may get into the habit of holding back papers from clients until some form of payment is made to them.[34]

C. General causes of corruption

There are many causes of corruption. Low salaries, social and economic factors, deficiencies in substantive tax laws and administrative procedures, and the lack of a system of accountability can be considered as main causes of corruption in the tax administration.[35] In transitional economies, the transition process itself also creates abundant opportunities for corruption.

27. See Paolo Mauro, "The Effects of Corruption on Growth, Investment, and Government Expenditure" (International Monetary Fund, Policy Development and Review Department, 1996).
28. Gould, et al., *supra* note 1, at 29-30.
29. See *TI Source Book*, *supra* note 5, Chap. 2; Johnston and Hao, *supra* note 4; Agnisezka Klich, "Bribery in Economies in Transition: The Foreign Corrupt Practices Act", (1996) Vol. 32 *Stanford Journal of International Law* at 121; Daniel McGrory, "Civilizing the Russian Underground Economy: Requirements and Prospects for Establishing a Civil Economy in Russia", (1995) Vol. 5 *Transnat'l L. & Contemp. Probs.* at 65; Louise Shelley, "Post-Soviet Organized Crime and the Rule of Law", (1995) Vol. 28 *Marshall L. Rev.* at 827; Csaba Varga, "Transformation to Rule of Law from No-Law: Societal Contexture of the Democratic Transition in Central and Eastern Europe", (1993) Vol. 8 *Conn. J. Int'l L.* at 487.
30. Corruption was a major impetus for the pro-democracy movement in Beijing in the summer of 1989; corruption and political reactions to it have been serious concerns for the Party leadership in China.
31. *Newsweek*, 4 November 1994, at 13.
32. Id.
33. *TI Source Book*, *supra* note 5, Chap. 2.
34. For example, in Columbia, tax officials would conveniently "lose" tax returns accompanied by cash, or alter amounts of payments reported on returns; McLure, "Improving the Administration of the Colombian Income Tax, 1986-88", in Bird, et al., *supra* note 17, at 134.
35. An individual's incentive to be corrupt will be minimal or absent if he is of strong moral character, if his colleagues are not corrupt, if he is more loyal to his organization and country than to his family and friends, if his wages are adequate, and if corruption is not condoned in his society.

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1. Low salaries

Low salaries have been found to be a major cause of corruption in many countries. An official might be forced to indulge in corrupt acts if he/she is not earning enough to maintain a decent living.[36] In transitional economies, the nominal monthly salary of tax officials is generally below USD 100. Rapid inflation in recent years has hit officials particularly hard. Their salaries have fallen even further behind the incomes (legitimate and otherwise) of the newly emerged entrepreneurs, some of whom were former colleagues or friends. Some officials may be motivated to trade tax favours for material advantage to themselves or their families.[37]

Low salaries may explain why some officials took bribes[38]– if they had a living wage they would not be as tempted. In many cases, however, perpetrators are high-salaried officials who commit acts of corruption out of greed or passion for luxury.[39]

2. Cultural traditions

Much of the research on the causes of administrative corruption has focused on the persistence of traditional values and customs that conflict with the requirements of modern bureaucracies. Parochial loyalties and kinship ties tend to influence the behaviour of bureaucrats. An official is faced with two sets of ethics: ethics toward the job, and ethics toward family and friends. The dominance of loyalty to family and friends over loyalty to the job may lead to corruption.[40]

In China, the entrenched social norm of seeking favours through connections (*guanxi* in Chinese) by appealing to nepotism, patrimonialism, and the like causes corruption. Such social norm is, to a large extent, derived from the feudal tradition of granting privileges to some and not to others. Chinese traditional culture attaches great importance to human relations. Values such as loyalty, mutual trust, and fulfilment of personal obligations are emphasized in the context of relationships. Consequently, personal networks based on traditional values are exploited in this fashion in order to surmount institutional barriers or to circumvent the legal rules. "China has always been marked by favours that soon become bribes, that in turn often are obtained by extortion".[41] When a former Minister of Railways was convicted of corruption, he defended himself on the grounds that (a) it would have been impolite for him to refuse gifts from friends, and (b) that once he had accepted their gifts, he had to do them favours in return.[42]

The Chinese traditional values emphasizing personal connections (*guanxi*) became further entrenched under socialism. In socialist China, where the allocation of goods and services was made under the centrally planned system, the work unit was the source of all basic things in daily life. The lack of viable alternatives meant that maintaining *guanxi* was essential to acquire scarce resources. At the work unit level, officials could use their power in distributing goods, services, and other benefits to exchange favours among themselves and to create loyalty from subordinates. *Guanxi* was cultivated with anyone who had the resources to satisfy a need. During the economic reforms, although market forces began to replace central planning in allocating resources, personal connections continue to play an important role in allocating certain resources. In the area of taxation, the taxpayer's needs are obvious: i.e. to reduce/avoid their tax liability. Good connections with officials will often mean that the officials will be more inclined to exercise their discretion in the taxpayer's favour.

Preferential treatment based on *guanxi* led to systematic corruption. Officials high and low feel comfortable applying the principle of *guanxi* in their day-to-day work, as it reflects a value system that is understood by everybody. The "regulated feel compelled to impart in the regulator a feeling of obligation by the giving of gifts or favours in exchange for special attention to their case; the regulator consequently comes to expect this sort of reward".[43] Thus, a system of normative behavioural expectations has been developed. "In such a structure the safest course is for everyone to insist that everything is always to operate just as it is supposed to."[44] Where officials in high positions are corrupt, it is very likely that local officials or citizens will follow suit. A Chinese proverb

36. One Thai official is reported as saying: "What you have called corruption, I call survival. My subordinates count on me to help them in any way possible. I like my job. I am supporting a large family. There may be other ways, but I don't see them and besides, I am not hurting anyone. You tell me what alternatives there are. Do you know my salary? I am not stupid. I know my duty and so does everyone else. Corruption is a problem in Thailand but there's no better way now. Besides, every person in this [section] has been involved [in corruption activities] for years". See Jon S.T. Quah, "Bureaucratic Corruption in the ASEAN Countries: A Comparative Analysis of Their Anti-Corruption Strategies", (1982) Vol. 13, No. 1 *Journal of Southeast Asian Studies*, at 153-77, and at 165 quoting from Clard D. Neher, "Political Corruption in a Thai Province, "*The Journal of Developing Areas XI*, 4 (July 1977), at 484-89.

37. Other factors contributing to corruption in many developing countries include high unemployment, widespread poverty, and widening social and economic inequalities. Poverty forces individuals not only to tolerate corruption, but also to initiate it where none exists and to take advantage of it where it is present. Sometimes favours are extended to other individuals, particularly relatives and friends, because of the desire to alleviate their poverty. At other times, favours may be extended with the objective of exacting certain future benefits from the recipients. See Gould, et al., *supra* note 1.

38. "Manual on Practical Measures Against Corruption Submitted to the 8th UN Congress on the Prevention of Corruption and the Treatment of Offenders", Havana, 17 August – 7 September 1990.

39. Low salaries could hardly be pleaded by Roh Tae Woo, former president of South Korea, indicted for reaping USD 365 million in bribes; or the former Italian prime minister's brother, charged for bribing tax inspectors for tax audit; or the African leaders who have stashed away in Swiss banks several billion US dollars; or the UK senior tax inspector in charge of special investigations who was jailed for taking a bribe of USD 90,000; see Guardian Weekly, 2 March 1997, Finance 19; *Tax Notes International*, 11 August 1994, at 155; The Christian Science Monitor, 29 November 1996, Friday, at 20.

40. Gael McDonald, Raymond Zepp and Pak Cho-kan, "Comparative Ethical Perceptions of Australian and Hong Kong Managers", in Geerhold Becker, et al., *Ethics in Business & Society: Chinese and Western Perspectives* (Berlin: Springer, 1995), Chap. 3; Vito Tanzi, "Corruption, Governmental Activities, and Markets", in Fiorentini & Peltzman, *The Economics of Crime* (Cambridge University Press, 1995).

41. L. Cheng and A. Rosett, "Contract with a Chinese Face: Socially Embedded Factors in the Transformation from Hierarchy to Market 1978-89", *Journal of Chinese Law*, 1991, No. 5, at 143, 178.

42. Editorial note, "Chinese Lawyers: the Search for Identity", *China News Analysis*, 1994, No. 1501, at 1, 8, citing *Guangming Ribao*, 7 April 1993. See also Peter Corne, *Foreign Investment in China: The Administrative Legal System* (Hong Kong: Hong Kong University Press, 1996), at 233.

43. Corne, *supra* note 42, at 228-9.

44. Cheng and Rosett, *supra* note 41, at 179.

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expresses this notion aptly, "*shangliang bu zheng, xialiang wai*" (in English, "if the upper beam is not straight, the lower ones will go aslant").

In many cultures, exchanging of gifts is a laudable social custom emphasizing the importance of personal relations in social life. Cultures differ widely as to what is reasonable and appropriate. In many cases, however, that tradition has been abused and used as an excuse for lavish gifting to officials in return for favours.[45]

3. Bureaucratic traditions

Bureaucratic traditions in a country may also be a cause of corruption. China is one of the oldest bureaucratic countries in the world.[46] Today's corruption is largely a continuance of the tradition of bureaucratic corruption, which is reflected in three aspects: (a) highly integrated powers to officials; (b) officials protect other officials; and (c) becoming an official is a road to wealth.

In imperial China (prior to 1911), supreme legislative, judicial, and executive powers were vested in the emperor. The emperor was above the law: he made laws, the laws were binding on all subjects, but he himself was not so bound and could alter the laws by decree at any time. Based on the Confucian value systems, checks on and division of power were hardly necessary as the emperor was the "son of heaven" and the government was believed to rest on the "rule of virtue".[47] At levels of government below the emperor, there was no formal separation of judicial powers from other powers, and no developed doctrine of judicial independence.[48] The local magistrate served both as chief administrator and judge. Local officials acted as "parent officials" (*fu mu guan*) over their "children citizens". Just as the power of the head of a family could not be challenged by the members of the family, the power of the "parent officials" could hardly be challenged by citizens. In case of abuse of powers, the officials were often protected by the system.

Bureaucrats were subject to a top-down management system. Under the vertical management system, where a subject brought an action against a local official, the appeal was adjudicated by higher officials responsible for supervising and scrutinizing the conduct of local officials. The alleged misconduct of the local official may reflect poorly on the judgment of the higher official in his appointment of the local official. In the meantime, the local official would activate his connections to influence the higher official in his decision. In the end, "officials protect other officials" and the abuse of powers went unchallenged.

Attached to the powers were high social status and privileges. Top bureaucrats stood high in the social order, well above the artisans, merchants and peasants, just below the emperor. The high social status meant not only glory but also personal wealth. Officials with high virtue provided government services and personal security for their "children citizens". In return, they received material rewards as well as deference and respect from the citizens. Corrupt officials used the power to assemble wealth through extortion of gifts and bribes and embezzlement. To the Chinese "s*heng guan fa cai*" ("get promotion and then become rich"). Corruption thus became an indispensable component of officialdom in imperial China.

The long bureaucratic tradition is accompanied by a history of corruption in China. It was stated that "the entire Chinese history was a history of embezzlement".[49] Recorded history of corruption goes back to 1027 B.C. Through dynasty after dynasty, corruption was not only a fact of life, but also a way of life for bureaucrats.[50] Widespread corruption contributed, if not caused, the downfall of some dynasties, including the nationalist government in 1949. The Chinese Communist Party came to power in 1949 with a strong idealistic and revolutionary agenda and was able for a while to rely on that revolutionary fervour to contain the spread of corruption. However, as that fervour began to dissipate, behaviour associated with corruption appeared and spread. When the economic transition began in the late 1970s, the effect of corruption was felt through most economic activities. Since then, the problem of corruption worsened year after year.[51] The stakes for corruption also increased: in 1980, cases involving more than 10,000 yuan accounted for less than 10 per cent of the total cases, whereas in 1993, it accounted for more than 57 per cent overall and 80 per cent in the more developed regions.[52]

4. Transition to a market economy

Economic transition involves a market economy replacing a command economy and the establishment of public institutions and legal systems to accompany the transition. In China and other transitional economies, some of the corruption in recent years has been caused by the process of this transition. During the transition, the society is doubly plagued by problems attributable both to central planning and to the market. The transition process opens new opportunities for malfeasance while the sources of corruption inherent in the planned economy continue to exist.

The transitional stage lacks both legal legitimacy and institutional strength as a result of fragile and poorly developed administrative and political structures. There is no adequate corruption control in place. Under the planned economy, the government was the largest employer, investor, and developer, and the bureaucracy was in a monopolistic position,

45. There is no cultural explanation, however, for lavish gift-giving in return for favours bestowed by government officials. Lavish gifting, usually done in secret, has in fact distorted the traditional practice into institutionalized bribery in the name of goodwill tokens. "I shudder at how an integral aspect of our culture could be taken as the basis for rationalizing otherwise despicable behaviour. In the African concept of appreciation and hospitality, the gift is usually a token. It is not demanded. The value is usually in the spirit rather than in the material worth. It is usually done in the open, and never in secret. Where it is excessive, it becomes an embarrassment and it is returned. If anything, corruption has perverted and destroyed this aspect of our culture." (*TI Source Book*, A, Chap. 2.)
46. Gong, *supra* note 4, at 37.
47. Id., at 38.
48. For example, a local magistrate served both as the chief administrator and the judge. Where officials took advantage of tax collection for personal gains or engaged in extortion, taxpayers had virtually no chance of protesting against the action.
49. Gong, *supra* note 4, at 37.
50. Id.
51. *Huasheng Yuebao*, 1996, No. 7, at 6.
52. Id.

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empowered with discretionary authority. There were opportunities for corruption.[53] Corruption did occur, but wise bureaucrats did not push it to excess because of the control system. In China, for example, during the Mao era (pre-1976), the system was built upon revolutionary ideology, a charismatic leader, and Party-state dominance. Corruption was regarded as individual deviance, and people were mobilized in periodic rectification campaigns to report wrongdoing and criticize decadent thoughts and behaviour. Such campaigns sent officials down to lower levels (countryside or labour camps) to remould their attitudes and behaviour. The perks and privileges conferred on such officials were withdrawn. The Party-state was able to detect and control officials' behaviour and corruption was controlled to some extent. During the process of economic transition, there is a political and economic "decentralization".[54] The Party-state system has not yet been replaced by a system of law and order to control corruption. In the meantime, economic reforms create uncertainty and generate many opportunities for officials to trade power for private gain.

Faced with temptations arising from the poor salary situation and a defective regulatory environment, a high-quality individual with honesty and self-discipline may "repeatedly walk along the beach without wetting his shoes".[55] Unfortunately, however, in transitional economies, there seems to be a widespread decline in social and public morality under the impact of reforms. Personal integrity and self-discipline are being swamped in a wave of "money-making fever" and "getting rich first". There has appeared a value vacuum; "some people have forgotten the most rudimentary sense of righteousness essential to a society and of professional ethics" (*sic*).[56]

5. The lack of rule of law

The rule of law contemplates a government conducting itself according to rules binding on all persons, entities, and organizations, including government agencies and is enforceable by the courts. Where the powers of government officials are not subject to meaningful controls by the public nor reviewable by an independent judiciary, corruption tends to be rampant.

Counteracting measures in China have failed so far because of the absence of a system based on the rule of law. In China, paramount rulers of imperial dynasties often put certain controls on bureaucratic behaviour, for fear that rampant corruption would lead to social unrest. These controls included: (a) recruiting officials through civil service examinations to minimize recruitment through personal connections; (b) requiring officials at lower levels to be accountable to their superiors; (c) avoiding assigning officials to their native places or recruiting relatives in the same government department.[57] These measures were ineffective. The examination system was corrupt in itself and provided opportunities for corrupt examiners. The system of accountability contributed to the development of organized corruption networks in which superiors demanded payments from their subordinates who sought protection. Similarly, the system of avoidance curbed nepotism, but was ineffective in controlling other forms of corruption.[58]

During the period of socialism and economic transition, the Chinese government and the Party have waged constant campaigns against corruption. During each campaign, the media publicize the results of the campaigns and the punishments of guilty officials. Although these campaigns have raised the public awareness of the problem and indicated the government's and the Party's disapproval of corruption, they have not been effective in fighting corruption. Investigations in such campaigns rarely proceed above a certain level of seniority in the government or the Party. Therefore, higher officials committing acts of corruption have rarely been brought to justice. The scapegoats are always less powerful administrators who do not have the necessary connections to protect themselves from prosecution, or are just unlucky. The anti-corruption campaigns do not change the underlying social norm; they merely reduce the corrupt behaviour until the campaign has blown over. Ultimately, they actually reinforce the recognition of the omnipotence of *guanxi* and the impotence of the rule of law. The Chinese experience illustrates three major hurdles in introducing the rule of law: (a) an over-concentration of power with the bureaucrats; (b) some people are above the law so that "the upper beam of the house is aslant"; (c) laws and penalties are not consistently and equally applied.

There is a lack of rule of law in other transitional economies. After decades of communist dictatorship, with law serving as an instrument of, rather than a check on, arbitrary state power, the rule of law is fragile and largely undeveloped in these countries. The popular acceptance of and respect for law is low. Enforcement structures and judicial systems have yet to be put in place.[59] While the governments are writing new anti-corruption laws and business regulations, these regulations contain significant gaps, and the development of institutions to implement and enforce these new laws is a long-term process.

53. Under the former public-ownership system, property belonged to the state, hence to every citizen, hence to no one. Profiting from public positions for private gains was not perceived to hurt anyone. Frequent shortages of goods and services encouraged people with power to use their power to gain access to such goods and services. The society was egalitarian on surface, classed underneath; self-help was justified. Many people would excoriate high officials for benefiting from their positions, but would not hesitate to engage in similar practices themselves, albeit on a much smaller scale. For further, see Andrei Schleifer and Robert Wishney, "Pervasive Shortages under Socialism", (1992) Vol. 23 *Rand Journal of Economics* at 237; Johnston and Hao, *supra* note 4.
54. In Russia and other former members of the Soviet Bloc, the economic transition has been accompanied by political liberalization. In China, although the Party remains in control, decentralization has weakened its control, especially over local officials.
55. Chinese terminology, used by Jiang Zemin, General Secretary of the Chinese Communist Party (CCP), in addressing a meeting of the CCP Central Discipline Inspection Commission on 23 January 1995, reported by NCNA, Beijing, 1 March 1995, and quoted in Gordon White, "Corruption and the Transition from Socialism in China", (1996) Vol. 23 *Journal of Law and Society* at 149, 157.
56. White, *supra* note 55, at 157.
57. Gong, *supra* note 4, at 40-41.
58. Id.
59. See Bialos and Husisian, *supra* note 16, at 13-14.

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6. Power and opportunities for corruption

Low salaries, societal attitudes and cultural influences are important causes of corruption, but they are generally not critical. For example, in some cases, perpetrators are high-salaried officials.[60] Similarly, societal attitudes and cultural influences contribute to corruption, but are not the driving forces behind corruption. The key cause of corruption in the tax administration seems to be the lack of the rule of law, resulting in unconstrained administrative powers and opportunities for corruption. Power corrupts; absolute power corrupts absolutely. Power corrupts the few, while weakness in the system corrupts many.

III. OPPORTUNITIES FOR CORRUPTION IN THE TAX ADMINISTRATION

In transitional economies, because of the nature of the transition and the short history of modern taxation, tax officials' powers are broad and are often subject to little meaningful control. This creates many opportunities for corruption. The combination of low salaries, high opportunities, and the lack of meaningful checks on the powers of officials is an open invitation for corruption. The Chinese tax system is discussed below to illustrate the dangerous combination.

A. Economic transition and evolution of the Chinese tax system

In imperial China, taxes took the form of levies on land, poll taxes, excises (on salt, tea, and tobacco), and customs duties. Business and income taxes were introduced early in the 20th century. Corruption in tax collection was widespread,[61] especially in places where "the mountain was high and the emperor was far away" ("*Shan gao huangdi yuan*").[62]

In 1949, the Communist government formed the People's Republic and initiated a socialist reconstruction of the economy. The reconstruction involved rebuilding the country from the ruins of economic and technological stagnation, massive social disorientation, and political chaos brought about by several decades of imperialist exploitation (such as the Opium War), external and civil wars, and the ineffective economic policies of the previous governments. One of the first acts of the government was to introduce the General Principles on the Implementation of National Tax Policy[63] and to establish the General Tax Bureau as a department in the Ministry of Finance. Major taxes introduced in 1950 and 1951 included deed tax, industrial and commercial taxes applicable to public enterprises, house property tax, land tax, slaughter tax, stamp duties, and commodity tax.[64]

From 1956 to 1978, a strict Soviet-type command economy was practised and the private sector almost vanished. Industry and commerce were completely controlled by publicly owned enterprises. State-owned enterprises delivered all their profits to the government and turnover taxes were generally used to facilitate the transfer of funds from enterprises to the government's coffer. At the peak of the political and economic turmoil during the Cultural Revolution (1965-76), law and order was in disarray, the role of taxation was disregarded, and the tax department existed only in name.[65]

The economic transition commenced in 1978, two years after the death of Chairman Mao Zedong. The new economic policy had two parts: opening up China to the outside world and reforming the domestic economic system. Establishing law and order and a modern tax system were considered key to the success of the policy. To facilitate the transition, a two-track tax system was introduced so that a Western tax system would apply to foreign firms and individuals and another system would apply to Chinese firms and citizens. In 1980 and 1981 income tax laws were introduced to apply to foreign individuals, Chinese-foreign equity joint ventures, cooperative joint ventures, wholly foreign-owned enterprises and other foreign entities doing business in China. In 1983 and 1984, state enterprises became subject to taxes – a reform which is commonly referred to in Chinese as *li gai shui* (taxation replacing profit delivery),[66] and new taxes were introduced to apply to the emerging collective and private enterprises. By the end of 1986, there were five turnover taxes (VAT, product tax, business tax, salt tax, consolidated industrial and commercial tax), six income taxes (individual income tax, Chinese-foreign equity joint venture income tax, foreign enterprise income tax, state-owned enterprise income tax, collective enterprise income tax, and private enterprise income tax), and numerous miscellaneous taxes on property and transactions. Taxation also assumed a new importance: whereas in the period of 1958-1978, tax revenue accounted for only 40 per cent of state revenue (mostly from turnover taxes), by 1986 this proportion had risen to more than 90 per cent.

The years following 1986 have seen the rationalization, consolidation, and reformation of existing taxes. In 1991, the separate Chinese-foreign equity joint venture income tax and the foreign enterprise income tax were consolidated into the Enterprise Income Tax on Foreign Investment Enterprises and Foreign Enterprises. In 1994, the five turnover taxes

60. *Supra* note 38.
61. Gong, *supra* note 4, at 39.
62. A Chinese saying.
63. Issued by the Executive Council of the Central People's Government on 1 January 1950 along with the Decision to Unify National Tax Policy.
64. See Jinyan Li, *Taxation in the People's Republic of China* (New York, Praeger, 1991), Chap. 1; Yao Meiyan, Hao Ruyu, eds., *Guide to the Application of China's New Tax System*, (Beijing, China Foreign Economic and Trade Press, 1994, at 109-20 (in Chinese).
65. Li, *supra* note 64.
66. Provisional Regulations on Levying Income Tax on State Enterprises, adopted by the Ministry of Finance on 29 April 1983. The first stage of reform commenced in 1983 in accordance with the Provisional Regulations on Levying Income Tax on State Enterprises. By the end of 1983, over 90 per cent of profitable state enterprises were paying income tax. At this stage, state enterprises were still required to deliver part of their "extra" after-tax profits to the State. The purpose of the reform was to give enterprise managers greater independence and control over the allocation of funds and with regard to investment decisions and, by permitting a substantial part of the profit to be retained, to provide an incentive for greater efficiency and to promote competition between enterprises. There was, however, a major obstacle to this. Due to the distortions caused by price controls and the unbalanced allocation of natural resources and capital investment, the level of after-tax profits among state enterprises did not necessarily reflect the level of management and productivity.

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were replaced by three new taxes (VAT, Business Tax, and Consumption Tax); the three domestic enterprise income taxes were replaced by a consolidated domestic Enterprise Income Tax; all taxes levied on personal income[67] were also consolidated into the new Individual Income Tax.

B. Broad powers of the tax administration

Under Chinese law, the boundaries between the constitutional powers of law-making, administration, and adjudication are blurred. The Chinese tax administration plays a pivotal role in all three aspects of the tax law.

1. Law-making powers

Tax legislation in China takes the form of "law" or "provisional regulations", supported by detailed rules for implementation:

- "laws" are formally promulgated by the legislature (the National People's Congress or its Standing Committee);[68]
- "provisional regulations" are formally introduced by the State Council[69] under the power delegated to it by the legislature;[70]
- implementation rules for "laws" are promulgated by the State Council; and
- implementation rules for "provisional regulations" are promulgated by the State Administration of Taxation (SAT) or the Ministry of Finance.

In practice, tax laws, regulations, and implementing rules are drafted by the SAT pursuant to a delegation clause in an enacting law or regulation, or under the direction of the State Council. Such delegation clauses are very general in nature and grant the SAT virtually unlimited rule-making discretion.

In addition to the delegated law making, the SAT also enjoys some inherent law making powers. The SAT is a department of the State Council. As such, the SAT is vested with inherent legislative power by the Constitution[71] and the Organic Law of the State Council.[72] This legislative power arises from the SAT's power to enforce tax laws and regulations, and is considered an intrinsic function of the SAT. Under this power, the SAT has introduced regulations concerning various aspects of tax administration, such as withholding of individual income taxes,[73] control of VAT invoices,[74] administrative appeals,[75] and regulation of tax agents. The exercise of such power is limited by the principle that legislation issued by the SAT cannot create rights and obligations that have not already been recognized by higher law, nor can it change the nature of rights and obligations in the higher law.[76] However, such limitation is ineffective as the higher laws, regulations, and implementing rules are broadly drafted with much discretion left to the SAT.

In exercising its administrative powers, the SAT also assumes a legislative role. Some of the interpretation circulars issued by the SAT are legislative in nature. Such circulars are generally issued when the law and regulations are silent on a particular issue, such as corporate reorganizations and the treatment of enterprise groups. The circulars provide substantive rules creating legal rights and obligations for taxpayers.

2. Statutory interpretation powers

The inherent flexibility of the legislation allows for a wide variation in its application. Statutory interpretation becomes vital. Unlike Western countries where the courts have the sole power of statutory interpretation, in China, interpretation of laws is separated into legislative, judicial and administrative interpretation.

Legislative interpretative power belongs to the legislature (Standing Committee of the NPC),[77] which performs both legislative and judicial functions. In practice, however, the legislature has never exercised its judicial function, and has delegated the power of legal interpretation to the Supreme People's Court and the Supreme People's Procutorate.[78]

Judicial interpretative power belongs to the Supreme People's Court.[79] With its inherent power and the delegated power from the legislature, the Supreme People's Court has the formal power to construe laws. However, in practice, the Supreme People's Court rarely hears cases because cases are generally not appealed to the Supreme Court. Courts of the second instance, usually the intermediate courts, render final

67. The Individual Income Tax (1980), Individual Income Regulatory Tax (1986) and Private Investors' Regulation Tax.
68. The National People's Congress (NPC) is the highest level of legislative authority under the Constitution. It is an elected body of about 3,500 delegates that has recently met once a year. It has the right to revise the Constitution and create major legal codes referred to as "basic laws".
69. The State Council is the head of China's executive and its members are elected by the NPC.
70. Resolution of the National People's Congress Standing Committee issued in September 1984 – the Resolution Concerning the Authorization of the State Council to Reform the Industrial and Commercial Tax System and Issue Provisional Regulations on Tax Collection.
71. Art. 90 of the Constitution provides that the State Council and its departments or ministries have the power to enact administrative regulations, measures, and rules within a specific mandate that arises from their natural or inherent powers of office.
72. Art. 10 of the Organic Law of the State Council provides that each department or commission of the State Council is empowered to introduce administrative measures.
73. For example, Interim Provisions concerning Withholding Individual Income Tax, 6 April 1995; Interim Provisions concerning the Collection and Administration of Individual Income Tax on Income from Construction and Installation Activities, 22 July 1996; and Interim Provisions concerning the Collection and Administration of Individual Income Tax on Income from Advertising Activities, 29 August 1996.
74. Detailed Rules concerning the Control of Invoices, issued on 28 December 1993; VAT Invoice Control Measures, Guo Shui Fa [1996] No. 166, 18 September 1996.
75. Tax Administrative Review Rules, issued on 6 November 1993.
76. For further, see Liu Ning, "Tax Legislative Power", *Zhongguo Shuiwu*, 1993, No. 2, at 19-21 (in Chinese); Corne, *supra* note 42, Chap. 2.
77. Constitution of the People's Republic of China, Arts. 62 and 67 and the Resolution on Strengthening the Legal Interpretation of Laws, passed by the Standing Committee of the 5th National People's Congress as an amendment to the 1955 Standing Committee Resolution on the Interpretation of the Law. See Corne, *supra* note 42, at 136.
78. See Liu Ning, "An Ignored Source of Chinese Law: The Gazette of the Supreme People's Court", 5 *Connecticut Journal of International Law*, 1989, No. 5, at 271, 276.
79. Organic Law of the People's Courts of the People's Republic of China (1983), Arts. 32 and 33; Organic Law of the People's Procuracy of the People's Republic of China.

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decisions. The Supreme People's Court functions almost exclusively as a law interpreting authority rather than a determiner of the litigants' rights. The Supreme Court has made no interpretation in respect of tax laws, except those related to the crimes of tax fraud. Because the courts have only a limited power of judicial interpretation, cases that go to court generally involve the assessment of tax penalties, rather than the assessment of tax liabilities based on the interpretation of tax laws.

Administrative interpretation is the most important form of interpretation. It is not only the most important mode of legal interpretation in China, it is in effect an authoritative supplement and accretion to legislation. Indeed, the principle of jurisprudence adopted in China is that only the enacting body or its representative or controlling organ is competent to interpret any piece of legislation in a manner that is generally binding.[80] The SAT's power of interpretation is conferred within the legislation itself. Since the SAT drafted such legislation in the first place, it is not surprising that it ensures that the SAT is allocated as much discretion as possible. This allows the SAT to define its position through interpretation or to change position through reinterpretation where necessary. The SAT's interpretation takes the form of circulars, or explanations, some of which are published.[81] Administrative interpretations are generally binding on the courts.[82]

Chinese tax laws confer broad discretion to the SAT. This approach seems suitable for the Chinese situation during the transitional stage; it is unrealistic to introduce Western style tax legislation in China because of the lack of familiarity with the concept and operation of taxation. As a consequence, tax laws are treated only as flexible guidelines that set the parameters within which administrative discretionary authority can be practised. The authority to specify and interpret tax laws is thus the source of enormous power, a power that can be easily abused.

3. Administrative discretionary powers

Chinese tax laws confer extensive discretionary powers to the tax administration in respect of assessing tax liabilities and penalties. For example, the Income Tax Law Applicable to Foreign Investment Enterprises and Foreign Enterprises provides that the SAT's approval is required where a taxpayer wants to:

- extend a tax holiday beyond the standard five-year period (Article 8);
- claim a tax refund for reinvestment in China (Article 10);
- pay no withholding tax or pay tax at a reduced rate on royalties (Article 19).

The implementation regulations for that law further provide that the SAT's approval is required in the following cases:

- where parties to a cooperative joint venture in the form of a partnership elect to have the venture taxed as one entity (Article 7);
- where a taxpayer adopts a fiscal period other than the calendar year as its taxation year (Article 8);
- to permit the deduction of interest incurred for purposes of production or operation (Article 21);
- to establish the basis of deduction for salaries and benefits paid to employees (Article 24);
- to permit the deduction of bad debts (Article 25);
- to permit the deduction of depreciation on a basis other than the straight-line method (Article 33);
- to allow accelerated depreciation (Article 40 and Article 41);
- to permit changes in the inventory valuation method (Article 51);
- to establish entitlement to tax incentives applicable to certain business profits (Articles 73-75); and
- when assessing penalties (interest and fines).[83]

Broad discretion creates opportunities for dishonest tax officials to take bribes, to extort or solicit bribes, or to commit other types of corruption. In China where traditional values emphasize personal connections, the existence of such broad discretion opens a window of opportunity for corruption. Detecting corruption is very difficult. For example, where the qualifications for tax exemptions are determined by local tax officials, and the rules for such exemptions lack specificity, these rules may be subject to different interpretations by different officials. The fact that officials have discretion over the granting of exemptions conveys the impression of a system of favouritism and one where connections are important, rather than one where the law is applied evenly among taxpayers. Such an impression may encourage taxpayers to compete in winning favours from officials, providing opportunities for officials to abuse their powers.[84]

C. Complexity and uncertainty in tax legislation

Complexity in the tax structure or substantive laws often cause confusion to both taxpayers and officials. Tax laws that are known to be impossible to administer invite taxpayers and officials to cheat in self-defence, knowing that everyone else is doing the same. This is a serious issue in transitional economies. Although the tax laws in transitional economies are simple in substance, the overall structure of the tax system tends to be complex, confusing, and sometimes nonsensical. To cope with rapid economic developments, tax laws in these countries are generally introduced on an ad hoc basis and are changed frequently.

In China during the 1980s, taxes were specific not only to each type of domestic and foreign investment enterprise, but also to the type of goods and services. Each of the taxes was

80. Cheng, J.Y.S., "The Constitutional Relationship between the Central Government and the Future Hong Kong Special Administrative Region Government", (1988) 20 *Case Western Reserve Journal of International Law*, at 65.
81. Jinyan Li, "China" in *International Guide to Advance Rulings* (Amsterdam: International Bureau of Fiscal Documentation, loose-leaf service).
82. In rare cases where the administrative interpretation goes too far and constitutes an abuse of power, the court may narrow the interpretation. See Corne, *supra* note 42 above, at 145.
83. Similar requirements are contained in other tax laws and regulations. In many cases, the approval is given by the tax authorities without issuing a formal ruling.
84. Some administrative measures have been introduced to prevent abuse of the granting of exemptions by tax officials. For example, checks and balances have been established by requiring that exemptions of given amounts must be approved at higher levels.

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assessed differently. Although the tax structure has been simplified after the 1991 and 1994 reforms, the system is still complicated. Tax administration was complicated by too many reporting requirements, numerous forms, and a variety of procedures. There was also a great deal of uncertainty in the tax system as a result of the frequent changes and the inconsistent treatment of different taxpayers.

D. Deficiency in structuring the tax administration

Two types of deficiencies in structuring the tax administration may contribute to corrupt practices: the coexistence of over-centralization and over-decentralization in management structure; and lack of functional specialization.

In general the rigidity of over-centralized decision-making structures and processes tend, in many cases, to delay official action, with the result that those seeking to expedite transactions may resort to bribes and pay-offs as a means of overcoming cumbersome regulations and indecision.[85] On the other hand, over-decentralization results in lack of control over local officials by the central government. In China, for example, under the pre-1994 structure, the tax administration was organized at several levels: the state tax bureau and tax bureaus at the provincial level, the municipal/district level, and the local level. The state tax bureau was part of the central government, whereas the tax bureaus at lower levels were part of the respective local governments. The state tax bureau set national goals or quotas concerning the amount of revenue to be collected in each province; local tax officials, who were employees of the local government, collected taxes. Local officials had some latitude in granting tax exemptions. Local tax officials were under the dual control of the local government in terms of administration, and the state tax bureau in terms of tax administration. Such dual lines of authority made uniform implementation of tax laws impossible as the state tax bureau could not closely monitor the actions of local tax officials.

Lack of functional specialization in the tax administration also contributes to corruption. Functional specialization refers to the organization of the tax administration by functional divisions, such as information processing, examination, audit and investigations, and collection. Such organization contains a built-in anti-corruption mechanism in that no single official has complete control over a taxpayer's tax situation. The checks and balances among tax officials improve efficiency and minimize corruption.

Until recently, China's tax administration was not organized based on functional specialization, but along the line of taxes. For example, each tax bureau had a separate department dealing with individual income tax, foreign-related enterprise income tax, domestic enterprise income tax, turnover tax and local taxes, and departments dealing with staff functions (such as personnel, training, internal inspection, etc.). Officials in one department performed all functions related to the payment of the taxes (i.e. collection, administration, and inspection). Although a certain degree of specialization was developed in respect of the particular type of taxes, there was little functional specialization. At the very local level, the primary management model used was to assign one tax official to a given number of taxpayers (based on locality or the nature of the taxpayer's business). That official (called a "designated tax official") was responsible for the assessment, collection, and audit of the taxpayers. The model was used to ensure the payment of taxes by large-size taxpayers, and as a means of providing taxpayer assistance. It was necessary at the beginning of the transition to the tax system as taxpayers had little experience. It became apparent, however, that the model gave one official too much authority and permitted taxpayers and officials to develop a closer relationship than was appropriate. In a culture where personal connections were overwhelmingly important and the tax officials had broad discretionary powers, such a management model provided fertile ground for corruption.[86]

E. Lack of accountability and transparency

Many transitional countries are in the process of introducing administrative procedures for reporting, collection, audit, penalties, and dispute resolution. In the meantime, the lack of such procedures present opportunities for corruption because the decisions of tax officials are subject to little accountability and control. Some local tax officials are called "lone wolves" or "kings".

F. Lack of computerization

The use of computers plays a critical role in modern tax administration. In many transitional countries, the tax administration has difficulties in gathering or utilizing the information collected. It does not have an adequate system of taxpayer identification numbers, nor a good record-keeping system. These failings contribute to the problem of corruption in that acts of corruption can be concealed. These problems cannot be resolved in most cases without computerizing the information system. Effective computerized information processing and record keeping will enable the monitoring of tax officials' actions and strengthen internal controls.[87] In China, for example, opportunities for corruption have been reduced greatly in places where computers are used to keep taxpayer information and for the initial selection of targets for audit. Some taxpayers even complained that they do not know whom to invite for dinner nowadays.

85. Bialos and Husisan, *supra* note 16, at 9-24; McLure, *supra* note 34.

86. It was reported that it was to the mutual benefit of both the tax official and the taxpayer to reduce tax payment for one year so that the tax quota for the following year would be reduced accordingly. Where the amount of taxes collected from the taxpayer exceeded the quota, both the tax official and the taxpayer could be rewarded. See Wang Qiyuan and Yan Chunlin, "New Management Model Brings Clean Administration and New System", *Zhongguo Shuiwu*, 1996, No. 7.

87. Bagchi, et al., *supra* note 25, Chap. 4. Computerization may, however, create new opportunities for crime involving the misuse of computer information.

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G. Ineffective internal controls

An internal control system generally consists of a set of behavioural guidelines and an inspection agency to enforce the guidelines, audit tax officials, and detect corruption. Many transitional countries lack such control systems. Corruption implies that an official has broken the law or rules of conduct. This requires that the rules and laws be clearly stated. In the absence of such rules, does accepting a gift on a national holiday, or having dinner with a taxpayer constitute an act of corruption? Does the answer to that question depend on the cost of the gift/dinner, the relationship between the taxpayer and official, the reason for the gift/dinner, and whether the official's decision with respect to the taxpayer is affected by the gift/dinner? Some transitional countries have set up internal control agencies, but the officials in the agencies are not yet well-trained and are ineffective in controlling corruption.

H. Weak external controls

Some degree of autonomous parliamentary, judicial, or even media supervision gives the state the means of reviewing or auditing the acts of the tax administration, thus providing safeguards against arbitrary or privately motivated decision making. Transitional countries generally lack a high-power, high-prestige, independent corps of auditors and inspectors, which makes detection of corruption difficult, if not impossible. There is also a general lack of an independent judiciary and lack of public awareness and respect for the rule of law.

IV. STRATEGIES FOR COUNTERACTING CORRUPTION IN THE TAX ADMINISTRATION

Systemic corruption in the tax administration, if uncontrolled, may derail or destroy the economic and political transition in China and other transitional economies. Corruption must therefore be conscientiously dealt with. Fighting systemic corruption, however, is no small feat. It involves removal of the main causes of corruption – a virtually impossible mission. If history is any indication, systemic corruption has been dealt with in different scenarios.

- One is an old-fashioned revolution, followed by the jailing or summary execution of the former leaders.[88] It often turned out that the new regime soon slumped into the practices of the old.
- Another scenario is to transform a society from top to bottom with a full package of civil service reforms. Such sweeping reforms are usually most feasible when they take place in the wake of a major shift in power and are undertaken by a new political establishment.[89]
- The third scenario is the "enclave" or "island of integrity" approach.[90] This approach "fences off" an area of government activity to address corruption in a manner isolated from the cross-pollination of other influences.

The last approach seems the most suitable for fighting corruption in the tax administration in transitional economies.

A. Creating an "island of integrity" in the tax administration

Is it possible to create an island of integrity in the tax administration in a country with rampant corruption? The answer is "yes" if the government has the political will. Governments of transitional economies must realize the damaging effects of corruption. They cannot turn a blind eye or a deaf ear to the issue. There is tremendous international effort in fighting corruption. Major international agencies and funding institutions are now actively involved in fighting corruption: the UN calls on countries to criminalize bribery in foreign commerce; the OECD recommends the removal of tax deductions for bribery payments; the World Bank and the IMF link financial aid with anti-corruption reforms; members of the Organization for American States have signed an agreement to essentially outlaw bribery in transactions between American states; the World Trade Organization has tried to tie corruption with trade issues; Transparency International, a new lobbying group based in Berlin, has given real visibility to the fight against graft.

If the government makes a long-term commitment to fight corruption, the tax department is a good place to start. It is one of the largest government agencies; it is vulnerable to corruption; and there is a "quick fix". From a technical perspective, changes in the organization of tax administration, in substantive tax laws, and in administrative procedures can be implemented in isolation from other areas of government activities. Furthermore, international experience in corruption control should be transferable to transitional countries. With the technical assistance provided by the OECD, the IMF, the BIFD and other international agencies, it is feasible to establish or strengthen anti-corruption measures in transitional economies.

B. Steps in counteracting corruption

Anti-corruption reforms should, at first, emphasize accountability measures and attitude change in the tax administration over substantive tax reforms. The reason is simple – it is a "quick win" situation. Tax administration's two main functions are collection of taxes, and providing services to taxpayers. Accountability measures include mechanisms that improve transparency in officials' decision-making. These measures help bring the public service closer to taxpayers and enhance its cost-effectiveness. Moreover, accountability measures can often be put into effect relatively quickly and can help create an environment where corruption is no longer tolerated by most officials and taxpayers. Finally, the techniques for introducing greater accountability in tax adminis-

88. The Communist-led revolution in China is of this category. See also *TI Source Book*, *supra* note 5, Chap. 5.
89. Uganda has adopted this approach: *TI Source Book*, *supra* note 5, Chap. 5.
90. *TI Source Book*, *supra* note 5, Chap. 5.

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tration are relatively well-understood and transferable between countries. By contrast, substantive tax policy reform is likely to be more difficult and time consuming. Such reform often intertwines with reforms in other areas and can only be introduced through legislation.

In the long run, however, substantive tax laws must be reformed to minimize administrative discretion or to specify the legal basis for exercising the discretion. Moreover, effective external controls by the courts, parliament, the press, or the public must be established.

There are some success models in corruption control. For example, Singapore's anti-corruption programme, consisting of both legal and administrative measures, has made it one of the most corruption-free countries in Asia and indeed the world.[91] In the United States, major corruption and embezzlement scandals involving top Internal Revenue Service (IRS) officials in the late 1940s resulted in a substantial reorganization of the IRS in 1952. The Inspection Services of the IRS was formed at the direction of President Harry Truman.[92] The Inspection Service and other integrity action programmes help to make the IRS one of the most efficient tax administrations in the world.[93]

C. Objective of anti-corruption reforms

The ultimate objective of anti-corruption reforms should not be absolute eradication of corruption, because it is a safe bet that corruption will never disappear. Efforts to eradicate corruption may be cost-prohibitive and make the government ineffective. For example, where tax officials' discretion and judgment are necessary for the job, such as in auditing, it is impossible to eliminate all possibilities of corruption. In the United States, according to one source, about 50 per cent of auditors in certain cities were involved in bribery.[94] Tax collection is a high-risk business. Anti-corruption reforms should aim at reducing corruption to a reasonable level.

V. CHINA'S RECENT INITIATIVES IN CORRUPTION CONTROL

The Chinese Government has not conscientiously singled out the tax administration as an "enclave" in terms of corruption control. During the past few years, however, the tax administration has gained more autonomy in implementing its programmes.

A. Salaries

In many countries, low salaries are a major cause both of corruption and of the drain of competent individuals away to the private sector. Paying a "living" salary to tax officials is an effective way of reducing corruption because an honest career in the administration becomes a reasonable choice for qualified people. Raising salaries for tax officials in transitional economies may be difficult, although not impossible. To begin with, the general salary level for government employees is low. The need for parity is often raised as a constraint on improving compensation for tax officials. As a rule, however, flexibility is possible through special pay, bonuses or rewards, accelerated promotions, posting to easy jobs, and other non-salary forms of remuneration.[95] The constraint is thus often more apparent than real.[96] Furthermore, paying higher salaries involves cost to the government. Whether it can afford paying higher salaries to tax officials must be examined in light of the potential loss of tax revenue caused by corruption. On a cost/benefit analysis, raising salaries for tax officials may result in a net revenue gain to the government.[97]

In China, tax officials' income levels are not low by Chinese standards. Their nominal monthly salaries are about USD 50, which is above the average income of Chinese citizens. In addition, tax officials generally receive subsidies for food, bonuses, and benefits in the form of free housing, uniform,

91. Id., Chap. 3; Jon S. T. Quah, "Singapore's Experience in Curbing Corruption", in Arnold J. Heidenheimer, Michael Johnston, Victor T. Levine, eds. *Political Corruption: A Handbook* (New Brunswick, Transaction Publishers, 1989), at 841-53.

92. The mission of the Inspection Service is to promote public confidence in the Internal Revenue Service by providing management with independent and professional internal audit and investigative powers that:
- promote the economic, efficient and effective administration of the nation's tax laws;
- detect and deter fraud and abuse in IRS programmes and operations; and
- protect the IRS against external attempts to corrupt or threaten its employees.

See Annual Report of Inspection Activities, Department of the Treasury Internal Revenue Service, Office of Chief Inspector.

93. "Problems in the Struggle Against Corruption in Tax Administration – Integrity: A Cornerstone of the US Tax System", a paper given at Inter-American Center of Tax Administrators (CIAT) 1995 General Assembly.

94. For example, even in the IRS, it was reported that in New York city in the 1960s "as many as 50 per cent of the agents doing office and field audits are involved in bribery". See David Burnham, *A Law Unto Itself* (New York: Random House, 1989), at 196.

95. Where possible, in addition to nominal salaries, the following compensation schemes can be considered:
- Bonus based on performance: Officers are paid a standard salary (esp. in countries like China that still has a pay scale prescribed by the government) and the amount of bonus depends on the performance of the officers. The evaluation of performance can be determined based on the nature of the job, the amount of extra revenue recovered, etc.
- Rewards to auditors and similar officers in proportion to the revenue raised due to their efforts. In practice, assessments often take a long time to complete due to appeals by the taxpayer, counter appeals and so on. To counter this, a partial reward could be paid immediately on the audit being completed. For assessments quashed on appeal, an amount greater than the reward initially paid out could be recovered from the officer. In practical terms, this could be implemented by a ledger account for each officer. There are many functions, typically staff and supervisory functions, which do not directly result in additional revenues but are essential for efficient administration. One way to preserve incentives may be for incentive pay to be pooled and shared proportionately among various units.
- Rewards may also be paid to officers who have performed well by allocating better housing and affording other non-monetary benefits.
- Better working conditions can also be used as positive incentives. (see Bagchi, et al., *supra* note 25, Chap. 9)

96. Intangible benefits for working in the tax administration (versus working in the private sector), such as work environment, hours, life style and family, job security, prestige, sense of "justice" – "on the right side", power and respect. It is difficult to put a dollar value on these intangibles. To many dedicated and competent tax officials, these intangibles are important and probably the reason why they remain in the tax administration rather than going to the private sector.

97. See Timothy Besley and John McLaren, "Taxes and Bribery: The Role of Wage Incentives", (1993) Vol. 103, *The Economic Journal* at 119-141.

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free transportation between home and work, subsidized meals, subsidized recreational activities, health care, medical insurance, and child-care.[98] High-ranking cadres are provided with chauffeur-driven automobiles. Directors of local tax offices are "parent officials", and are entrusted with the welfare of their subordinates. Some tax offices have their own farms, orchards, gardens, training/resort centres, and other profitable enterprises. The tax department is generally considered a prestigious and attractive place to work.

Low salaries may cause wide-spread corruption, but paying living wages is often not enough to control corruption. Even with an appropriate salary level, one still needs a system of accountability and a system that minimizes opportunities for corruption. Some officials are corrupt because of their greed and "passion" for wealth. Reducing opportunities for corruption can prevent corrupt practices or make them detectable.

B. Reorganizing the tax administration

Reorganizing the tax administration can reduce the deficiencies that cause opportunities for corruption, namely decentralization and lack of specialization and internal controls. Over the past several years, the Chinese tax administration has undergone several changes that assist in the control of corruption.

To deal with the problem of over-decentralization, the SAT was given more control over local tax offices. The tax administration at provincial and local levels (other than Shanghai and Zhejiang Province) was separated into state tax administration and local tax administration. Officials of state tax administration at provincial and local levels became employees of the central government and are under SAT's sole control. Officials of local tax bureaus remained subject to the dual control of both the SAT and local governments. With respect to counteracting corruption, the centralization in control enables the SAT to monitor the actions of officials of local SAT offices more closely, and reduces undue influence from local governments and taxpayers.[99]

The SAT has gradually introduced functional specialization. In 1991 a management model to separate some or all of the functions was introduced.[100] Under the new model, taxpayers are required to report their tax liability at newly established tax service centres and assessment, collection and audit of the taxpayer are conducted by different officials. If the official responsible for collection makes a mistake, especially if it is in the taxpayer's favour, the official responsible for auditing provides the check and corrects the mistake. Functional specialization appears to have reduced corruption for the following reasons:

- It has become more difficult for a taxpayer to bribe tax officials because he/she has to bribe more than one official. It is also more "risky" for the officials involved because they have to always act in common to avoid detection.
- More importantly, opportunities for corruption have been reduced under functional specialization because tax officials no longer maintain routine contacts with taxpayers. It is no longer "convenient" for taxpayers to develop close relationships with particular tax officials.
- Functional specialization generally requires officials performing different functions to document their decision. Thus, a paper trail is created, which enables management to detect improper conduct more easily.

The SAT has become more "professional". Some of the tax policy and drafting functions are being transferred from the SAT to the Ministry of Finance. The SAT is now focusing on tax collection and tax compliance. A civil service system has been gradually introduced in China. Should the system be implemented in the tax administration, recruitment and promotion of tax officials will be based on merit and corrupt personnel will more likely be kept out of the administration. The tax administration will be less influenced by "political" factors and will maintain a professional standard. The potential loss of job security will make some officials think twice before committing acts of corruption.

The tax staff have become more "professional" as well. They are specialized in one function, thus developing greater expertise and potentially higher productivity. Improved efficiency and accuracy in administration has gained taxpayers' confidence in the tax system. At local levels, new personnel management techniques have been experimented with, to improve "professionalism" in the tax administration. These techniques include: rotating officials between different positions or locations, separating functions in administration, group discussions and decision-making in respect of tax exemptions and reductions, and routine inspection by the internal inspection unit.

C. Administrative procedures – separation of duties and increased accountability

Until 1986, tax collection and administration in China were governed by rules contained in each of the substantive tax laws and the responsibilities of the tax administration and taxpayers were not clearly specified. Separate legislation on tax administration was first introduced in 1986 as "provisional regulations" and promulgated in the form of law in 1991.[101] Since 1994, more rules and procedures have been

98. At present, those benefits can only be enjoyed by government employees. About 80 per cent of the Chinese population live in the countryside where no such benefits are provided by the government.

99. The recent reform in separating SAT local offices from local tax offices has been accompanied by new problems. One of the new problems is an increase in the compliance burden for taxpayers. The assignment of responsibility for tax collections is incomplete, creating confusion for taxpayers and lack of cooperation between local tax authorities and state tax authorities.

100. Xiang Huaicheng, "Deepen and Push Ahead Tax Administration Reforms and Work Hard towards the Modernization of Our Nation's Tax Administration System", *Zhongguo Shuiwu*, 1996 No. 8, at 5-10 (in Chinese).

101. This law was first introduced on 21 April 1986 by the State Council in the form of provisional regulations; on 4 September 1992, it was upgraded to "law" promulgated by the National People's Congress Standing Committee; on 28 February 1995, the law was amended by the National People's Congress Standing Committee. Implementing rules for the law were introduced by the State Council.

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introduced to deal with invoice management,[102] tax administrative reviews,[103] tax audit,[104] internal inspection,[105] assessment of tax penalties,[106] and issues related to tax litigation.[107] Together with functional specialization, these rules have created some preliminary separation of duties and increased the accountability of officials.

1. Move towards self-assessment

At the beginning of the economic transition, it was necessary for tax officials to directly assess taxpayers' tax liabilities since taxpayers were unfamiliar with tax laws.[108] As the transition progresses there has been more reliance placed on taxpayer reporting. By 1994, a self-assessment system had been implemented and tax service centres had been created in most tax offices across the country. The move towards self-assessment has proven successful in China. Taxpayers are now responsible for determining their own tax liability and take initiatives in learning the tax laws. With the help of tax advisors, taxpayers now file tax returns at tax service centres. Tax collectors are no longer directly involved in establishing a taxpayer's tax liability. There is less "face-to-face" contact between taxpayers and the tax officials who assess their tax liabilities, and thus fewer opportunities for dishonest taxpayers and tax collectors to collude in cheating on the tax system.

To ensure the success of the self-assessment system, the tax authorities have introduced measures to improve taxpayer services, such as taxpayer education about tax laws and policy, making tax information (tax laws, regulations, administrative policies and tax forms) easily available to taxpayers, and answering taxpayers' questions. Tax officials are also required to "smile at taxpayers", offer a cup of tea to taxpayers when taxpayers visit the tax center, or just "be nice and polite to taxpayers by putting themselves in the shoes of taxpayers".[109]

2. Computerization

The move to self-assessment has been accompanied by computerization. Opportunities for corruption have been reduced greatly after the computerization of taxpayer records and initial selection of targets for audit. Most tax offices are equipped with computers. Tax returns and financial statements can be submitted electronically in some big cities.

3. Audit

A specialized audit function was established with the move to self-assessment. By the end of 1995, most tax offices had established an audit and examination department and the SAT has established an audit bureau. Previously, tax audit was conducted by taxpayers themselves and by tax inspectors.[110] That system was plagued with problems, such as unqualified auditors, lack of resources, random selection of targets for audit, and lack of guidance or control over auditors who had broad discretion in conducting the audit and were believed to engage in "trade" with taxpayers for money or personal favours.[111] Some of the problems are addressed in the Audit Procedures. According to the Audit Procedures, the main function of an audit is to investigate non-compliance with the law, to ensure collection of tax revenue, to maintain proper law and order in tax administration, and to encourage voluntary compliance.[112] Discretion and opportunities for corruption are controlled through separating audit functions and the establishment of a mechanism to ensure accountability.

With respect to the selection of files for audit, the discretion of an individual official is minimized. Selection is done by using a computerized screening and selection process, through random selection based on a percentage of taxpayers or based on information from the public. Cases that may involve tax evasion, fraud, or large amounts of tax owed must be automatically audited.

Officials who select targets for audit cannot conduct the audits. Cases involving serious tax evasion or having political or social implications must be audited by higher tax authorities.[113] An auditor must disqualify himself or herself from auditing a taxpayer if he/she is related to that taxpayer, has other interests in the taxpayer, or has a relationship that may impair his/her impartiality.[114] Audits must be conducted by a team of more than two auditors.[115] Auditors must properly document and keep any information and evidence gathered during the audit, explain to the taxpayer under investigation the results of the audit, listen to the taxpayer's opinion,

102. Rules on invoice management were introduced by the Ministry of Finance on 19 August 1986 and were reissued on 12 December 1993. Implementing rules were introduced by the State Administration of Taxation on 28 December 1993.
103. Issued by the State Administration of Taxation on 6 November 1993.
104. Issued by the SAT in December 1995.
105. These include Provisional Regulations on Tax Inspection, issued on 23 June 1995; Measures on the Hearing of Tax Inspection Cases (trial use), issued in 1995; Decisions of the SAT on Establishing Bodies of Disciplinary Inspection and Internal Inspection, issued in 1995; and Interim Measures on Specially invited Tax Inspectors, issued by the SAT in 1995; and Measures on Investigating Tax Inspection Cases, issued by the SAT in 1995. Full text of these rules is found in *Zhongguo Shuiwu Bao*, 15 and 22 November 1995.
106. Implementing Measures for Hearing Procedures in relation to Tax Administrative Penalties, issued by the SAT on 28 September 1996; Implementing Measures for the Separation of Investigation and Hearing Evidence from the Decision to Impose Tax Penalties, issued by the SAT on 28 September 1996.
107. These rules became effective on 1 January 1995.
108. In general, after tax registration with the local tax office, a taxpayer had to report to the tax authorities its production and business situation and fill out a tax appraisal form. After examining this form the tax authorities issued a tax appraisal certificate, which set out taxable items and quantities, applicable rates, and tax obligation, etc. When changes occurred in the taxpayer's business or in tax laws, a reappraisal was needed. In the case of large enterprises, the appraisal was made by the tax collectors responsible for that enterprise. The taxpayer would pay taxes based on the appraisal certificate. Since taxpayers did not have a strong idea of how to pay taxes or an understanding of the tax system, the tax appraisal process helped to establish the taxpayer's responsibility at the time of registration. All taxpayers were required to make tax declarations and submit tax returns, financial accounting statements, and other tax information to the tax authorities. The information declared might be used to assess the following year's tax appraisal.
109. Shenzhen Local Tax Bureau, "Strengthening the Service Function and Establishing Modern Tax Administration System in the Special Economic Zone", *Zhongguo Shuiwu*, 1996, No. 10, at 5; Zhang Zilu, Guo Fengxiao, Liu Xiaoqing, "Open a New Sky and Land", *Zhongguo Shuiwu*, 1996, No. 7, at 15-19.
110. Wang Shaoting, "Discussions of the Audit System under the Model of Administration", *Zhongguo Shuiwu Bao*, 3 June 1996, at 3.
111. Id.
112. Arts. 1-3 of the Audit Procedures, *supra* note 104.
113. Arts. 8-17 of the Audit Procedures, *supra* note 104.
114. Art. 20 of the Audit Procedures, *supra* note 104.
115. Art. 21 of the Audit Procedures, *supra* note 104.

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and keep an "audit original report".[116] Upon completion of an audit, auditors must prepare an "audit final report", consisting of information on the source of the audit, basic information about the taxpayer under investigation, the time and scope of the audit, main facts and methods of the taxpayer's non-compliance, measures taken during the audit, attitude of the taxpayer, and recommendation for reassessment. The audit report and other evidence must be delivered to the audit review section.

The audit review section is staffed with its own personnel and is charged to review the audit report and other information provided by auditors. The purpose of the review is to establish whether: (a) evidence and information obtained by the auditors is complete and accurate; (b) the law, regulations, or rules were applied correctly, (c) procedures were followed correctly, and (d) the reassessment suggested by the auditor is appropriate. The review section must prepare a review report and a decision report. In case of a big, important, or difficult case, the decision must be further reviewed by higher officials. Where the auditors suggest non-reassessment of a taxpayer, the review officials may accept that recommendation, or order a secondary audit by the original auditors or others.

These audit procedures have erected at least a "paper cage" for the "lone wolf" auditors by separating functions and increasing transparency. Whether the paper cage can become an iron cage will depend on how well these procedures are implemented. The shortage of qualified auditors to staff the different sections of the audit department is one of the difficulties.

4. Tax refunds

Processing refunds is an area vulnerable to potential corruption. Under the Chinese tax system, VAT refunds pose serious problems for the tax administration. Refunds of other taxes are either insignificant or fairly straightforward.[117] VAT refunds for both domestic sales and exports provide opportunities for dishonest officials to commit fraud. For example, a taxpayer may inflate the amount of VAT on inputs, and an official may be bribed to approve refunds for the inflated amount.

To control fraud and corruption in processing tax refunds, the SAT has adopted three main measures: invoice control, inspection, and computerization. In China, invoices have always been managed and controlled by the tax authorities.[118] Because of the importance of invoices for the implementation of VAT, special VAT invoices, designed and strictly controlled by the SAT, must be used by all taxpayers.[119] Any unauthorized sale of VAT invoices, the making or use of forged invoices, or the making of fraudulent entries on invoices is punishable by a fine or death penalty.[120] The invoice control centralizes management of VAT refunds.[121] In addition to routine audit, there is random inspections of export tax refunds.[122] Since 1995, the processing of VAT refunds has been computerized.[123] Taxpayers claiming export refunds must use an authorized software system to register with the tax authorities and complete all the required forms electronically. These forms must be reviewed and approved by the government agency in charge of foreign trade. The tax authorities then review the information and approve tax refunds. Local tax offices must file quarterly reports to higher tax authorities with respect to the amount of tax refunds, and information on taxpayers claiming refunds.

5. Tax penalties

The tax authorities have the power to impose civil penalties for failure to keep records and books of account, to pay taxes on time, to withhold tax, for tax evasion, and for other non-compliance with tax laws. These penalties are referred to as "administrative" penalties because they are imposed by the tax administration, as compared with those imposed by the Procutorate or the courts.[124] The Tax Collection and Administration Law and other tax laws generally set out a range of penalties for each type of non-compliance. For example, failure to keep proper books of records and accounts is generally punishable by a penalty not exceeding 2,000 yuan. In serious cases, the penalty can range from 2,000 to up to 10,000 yuan.[125] The exact amount is determined by the official based on the facts and circumstances of each case. Such discretion often provides bargaining power for the official and an opportunity for the taxpayer to commit corruption. Some checks on the scope of the official's discretion have been introduced in the new SAT Rules concerning the Separation of Tax Investigation and Imposition of Penalties, and rules on Hearing Tax Administrative Penalty Cases.[126] The rules provide that the officials responsible for determining the amount of penalties must be "detached from" those who conducted the investigations. Taxpayers are given an opportunity to present their cases before penalties are imposed. These requirements should theoretically reduce the arbitrary power of officials and improve the protection of taxpayers' rights.

6. Dispute resolution

In China as in many countries, there are two methods of dispute resolution: administrative reviews and judicial

116. Arts. 22-23 of the Audit Procedures, *supra* note 104.
117. As in the case of enterprise income taxes that are collected on the basis of self-assessment.
118. Invoice Management Measures, Ministry of Finance, 23 December 1993; Implementing Rules for Invoice Management Measures, SAT, 28 December 1993.
119. Rules on the Use of VAT Invoices (trial use), SAT, 27 December 1993.
120. Decision of the National People's Congress Standing Committee on Punishing the Crimes of Forging entries on VAT Invoices, Forging VAT Invoices and Unlawful Sale of VAT Invoices, and the Interpretation by the Supreme People's Court, 17 October 1996 and issued by the SAT to all tax offices, Guo Shui Fa [1996] No. 210, 15 November 1996.
121. *Supra* note 119.
122. SAT Notice on the Work of Export Goods Tax Inspection, issued in 1996.
123. Management Measures on Electronic Processing of Export Refunds, SAT, 10 May 1996.
124. Administrative Penalty Law of the People's Republic of China, promulgated by the Fourth Session of the Standing Committee of the Eighth National People's Congress, 17 March 1996. See Wang Yongqing, *Handbook on the Application of Administrative Penalty Law* (Beijing: Zhongguo Fangzheng Press, 1996).
125. Art. 37 of the Tax Collection and Administration Law, *supra* note 101.
126. Both were issued on 28 September 1996.

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appeals.[127] Administrative reviews are conducted by tax review committees established at each level of the tax administration. Because of the size of the country and lack of modern transportation and communication in some parts of the country, administrative reviews are handled generally by local review committees. Review decisions must be made within 30 days after the application for review is made.[128] If a taxpayer disagrees with the review decision, he/she may appeal to the People's Court. A large majority of the administrative review decisions are upheld by the court.[129]

In recent years, the Chinese courts have given more support to tax collection and administration. Courts at various levels make full use of trial functions to counter criminal activities of tax evasion and other tax law violations. Some cities have set up tax courts to hear civil tax cases. Such cases generally involve the assessment of tax penalties, characterization of facts for tax purposes, and unlawful actions of tax officials.[130] Appeals to the courts are governed by the Administrative Procedure Law.[131] Local tax offices are generally named as the defendant in civil cases. The SAT has issued guidelines to help local tax offices prepare for the defence, make arguments in court, file appeals, and enforce court decisions.[132]

Procedures for both administrative reviews and judicial appeals provide taxpayers with some process to voice their complaints. Although Chinese culture and the tradition of socialism discourage litigation, with the increase in private ownership and private wealth, the use of these formal procedures is expected to increase accordingly. The fact that taxpayers can invoke the process should effect some degree of control over the arbitrary decision-making of tax officials. China is considering the possibility of creating a specialized tax court.

D. Internal inspection

The SAT recently issued the Interim Provisions on Tax Inspection. According to these provisions, the SAT, state tax bureaus at local level, and local tax bureaus must establish a tax inspection unit and the number of personnel in the unit should be no less than two per cent of the total staff. The mandate of the tax inspection unit is to inspect actions of tax officials in violation of laws, regulations, policies, and codes of conduct. Tax inspection units must carry out their work independently and be free of interference from any agency or individual.[133] Cases under inspection include all forms of corruption in the tax administration.[134] Inspectors are given broad powers to carry out their mandate.

Who inspects the inspectors? There are some control measures. For example, inspectors are rotated every three to five years. If an inspector's decision against an official is not agreeable to the official, the official can apply to the same inspection unit and/or higher tax authorities for reconsideration or apply for judicial review. Severe penalties apply to inspectors who abuse their powers, use the power for private gains, are negligent in performing their duties, or disclose confidential information. Some tax bureaus invite members of the public as "special inspectors" to supervise and monitor the work of tax inspectors.[135]

The tax inspection unit is, in theory, helpful in fighting corruption in the tax administration. It can investigate and detect actions of corruption, which may not only result in the punishment of the corrupt officials, but also act as a deterrent. It also provides a channel for taxpayers or honest officials to report corrupt behaviour. In practice, it is difficult to ascertain the effectiveness of this mechanism. However, the traditional legacy of "officials protect officials" is still alive. It may be difficult for the inspection unit to act truly independently.

E. Integrity – the book of prohibition

The tax administrations in some Western countries have a code of ethics to assist tax officials in maintaining their reputation for integrity, and to give them a basis on which they can make the day-to-day decisions and judgments required of them.[136] In China, the SAT has issued a series of integrity or "clean administration" guidelines and published them in a pocket-sized handbook. These guidelines are intended to be "a ruler for tax officials to measure their conduct and a basis for the management to supervise and discipline the activities of tax officials".[137] Tax officials must "carry a copy of the book with them, compare their conduct with the rules in the book, exercise self-respect and self-discipline, keep the warning-bell ringing all the time, and never let their attention to these rules lax".[138]

The book contains numerous "don'ts" and consequences for non-observance. Some of the main "don'ts" include:

- don't accept taxpayers' invitations to banquets, celebrations or visits to foreign countries;
- don't accept taxpayers' gifts in cash, kind or marketable securities;
- don't claim reimbursement from subordinate units for personal expenses;

127. See Tax Collection and Administration Law and implementing rules, *supra* note 101 above.
128. Rules on Tax Administrative Reviews, SAT, Guo Shui Fa [1993] No. 119, 6 November 1993.
129. Yao Meiyan and Hao Ruyu, *supra* note 64, at 663-669.
130. Song Shuwen, Ma Xia and Kong Bing, eds, *Case Comments on Litigation between Citizens and Administrative Agencies* (Beijing, China Politics and Law University Press, 1992), at 146-52.
131. The Administrative Procedure Law of the People's Republic of China, adopted on 4 April 1989 at the Second Session of the Seventh National People's Congress.
132. Operational Guidelines on Responding to Tax Administrative Appeals, effective on 1 January 1995. See also Decision of the SAT on Several Questions Concerning Establishing Disciplinary and Inspection Offices, *Zhongguo Shuiwu Bao*, 15 November 1995.
133. Arts. 2 and 3 of the Interim Provisions on Tax Inspection, 23 June 1995.
134. SAT Measures on Investigating Tax Inspection Cases, *Zhongguo Shuiwu Bao*, 22 November 1995.
135. Interim Measures on the Work of Specially Invited Inspectors in Tax Administration, *Zhongguo Shuiwu Bao*, 15 November 1995; Lin Zhiqiang, "Clean or not, Ask Your Specially Invited Inspector", *Zhongguo Shuiwu Bao*, 17 July 1995.
136. For example, the IRS of the United States and the ATO, Australia.
137. Preface to the Handbook.
138. SAT, *Tax Officials' Clean Administration Handbook* (Beijing: China Tax Press, 1995), preface.

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- don't use one's position to buy goods at below-market prices;
- don't use one's position to borrow money or goods from taxpayers or use taxpayers' goods for no consideration;
- don't accept rebates or commissions;
- don't accept benefits under taxpayers' benefits programmes;
- don't take advantage of personal events (such as weddings, funerals, relocations, etc.) as an excuse to hold parties and make demands for gifts;
- don't delay in paying public funds;
- don't make excuses on behalf of family members, relatives or friends;
- don't buy and sell stock in violation of regulations;
- don't accept gifts from subordinates;
- don't use government-provided credit cards for personal use;
- don't use public funds to subscribe for club membership or pay for luxurious entertainment activities;
- don't engage in business activities or participate in profit sharing with taxpayers; and
- don't hold positions in any type of commercial entity (including honorary positions), except where special permission is granted and no remuneration is paid.[139]

Further "don'ts" are provided to specify prohibited activities involving banquets, entertainment, and gift-acceptance from subordinates.[140] In addition, the SAT has taken a positive approach to award and publicize "model" tax officials who can resist bribes and maintain a high moral and professional standard. These models are expected to inspire others to follow suit.

Administrative disciplinary sanctions are imposed against officials for non-observance of these "don'ts." In case of violations of tax laws or anti-corruption laws, the officials are also punishable under those laws. Administrative disciplinary sanctions have traditionally been a very effective method of punishing officials for dereliction of duty. They are generally more severe than administrative disciplinary action in Western countries. This is because the sanction will be included in the personal dossier (*dang an*) of the sanctioned official. As a direct or indirect employee of the Government of China (either as a civil servant, party member, or state enterprise), one cannot escape the contents of one's personal file. An administrative disciplinary sanction, once listed on one's file, has dire consequences in terms of prospects for promotion or seeking employment in other units. The allocation of privileges and promotion (such as better housing and social security) also depend on the state of one's personal file. Therefore, the threat of such measures is a powerful normative influence on those whose career lies in the bureaucracy, or any government employment.

Administrative disciplinary sanctions include:

- "warnings" (*jing gao*), which are the lightest form of sanction and are made against those who have committed an offending act for the first time;
- "black marks" (*ji guo*) or "big black marks "(*ji da guo*), which are normally imposed for: (a) approving tax exemptions without legal basis, and the amount of exemption is less than 50,000 yuan, (b) obtaining gains (less than 5,000 yuan) by buying goods from taxpayers at below-market prices, or (c) directly or indirectly engaging in commercial activities;
- "demotion to a lower rank", which is imposed for other forms of non-observance where the amount of personal gains or losses to the state is significant;
- "demotion to a lower post"; and
- "dismissal".

One cannot be promoted while any of the first two sanctions apply. The next three levels of sanctions all prohibit the offender from continuing to work in the same position. These sanctions can be imposed by the internal inspection unit or management of the tax administration. Before sanctions are imposed, there is generally a discussion in a public "hearing" and the person under investigation is required to state his/her case. Such hearings tend, however, to resemble more a public humiliation than an opportunity for natural justice. The names of offenders are often made public to generate a deterrent effect.

These sanctions can be effective in reducing corrupt behaviour in respect of abuse of powers and misuse of public funds. However, they will not be very effective in situations where the official has tax favours to "trade" with taxpayers, and especially where the tax laws or procedures are ambiguous and provide unconstrained discretion to the official. The reason is that the Chinese cherish personal connections. As long as there are tax favours to be traded, taxpayers and tax officials can find ways of trading favours for gifts or bribes. In the long run, developing a system of tax administration based on the rule of law is the only meaningful way to stop the "trade".

F. Substantive law reforms

Opportunities for corruption have been reduced to some extent through reforms to China's substantive tax laws. Although the tax administration still possesses enormous discretionary power, the range of discretion has been narrowed as a result of simplification in the structure of the tax system, greater detail and certainty in the legislation; and greater equity in the treatment of taxpayers.

The tax reforms of 1991 and 1994 resulted in rationalization of tax laws. The current tax structure consists of turnover taxes (VAT, Business Tax, and Consumption Tax) accounting for more than 50 per cent of the total tax revenue, enterprise income taxes accounting for about 40 per cent of total tax revenue, and individual income tax accounting for about 2 per cent of total tax revenue. Such a structure seems to suit China's current situation where administrative capabilities are limited and cultural attitudes toward taxation need to be cultivated. Both the turnover taxes and enterprise income

139. SAT, Several Provisions on Clean Administration and Self-discipline for Tax Officials, Guo Shui Fa [1995] No. 123, 5 July 1995.
140. Guo Shui Fa, [1995] No. 033, 17 February 1995; Guo Shui Fa, [1995] No. 067, 12 April 1995; Guo Shui Fa, [1995] No. 126, 4 July 1995.

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taxes are easier to collect than the individual income tax. The individual income tax is not significant in terms of generating revenue, but very important politically and socially. Collection of this tax depends on withholding at the source and, in most cases, the withholding tax is final. The 1994 reform simplified the system and made withholding more effective.[141] An effective withholding reduces opportunities for corruption, as taxpayers have virtually no need to deal with tax officials, and withholding agents have less financial incentive than taxpayers to bribe tax officials. Misconduct of withholding agents may be easier to detect as they are much smaller in number than the potential pool of taxpayers.

In addition to structural reforms to the tax system, the 1991 and 1994 reforms have also resulted in more certainty in the tax system. For example, from 1984 to 1993, the four turnover taxes and the state enterprise income tax were levied under regulations introduced by the State Council in a draft form. In the 1994 reform, the word "draft" was dropped, implying that these taxes would be effective for some time. Legislation governing each tax has become more "sophisticated" in substantive terms. For example, the legislation governing domestic enterprise income tax not only consolidated the three former taxes, but also contains more detailed provisions on the computing of income and taxable income, new transfer pricing rules, and fewer tax exemptions.[142]

G. External control and the development of the rule of law

Over the past decade or so, China has established some anti-corruption mechanisms. An anti-corruption bureau was established in 1995 within the Supreme People's Procutorate; special anti-corruption laws have been introduced; cadres in government and the Party have been required to disclose information on their (and their family members') housing, business dealings, foreign visits, and marriages to foreigners.[143] Because of the lack of truly independent media, an independent judiciary, and a legislature with democratically elected members, these anti-corruption laws have not been effectively and consistently enforced.

VI. CONCLUSION

Corruption is a cancer in a body politic. Corruption in the tax administration represents only part of the problem. In the long term, anti-corruption strategies in the tax administration work well if the systemic corruption problem is dealt with through political liberalization and the development of a system based on the rule of law.[144] The system should be such that whether eking out a humble living, making a lavish lifestyle more so, or doing favours for family and friends, individuals must reach the point of obeying the law without excuses. Governments need not only to pay civil servants a decent wage, to encourage whistle-blowers in the press and to develop an independent judiciary, but also to encourage a general sense of civic virtue. Unfortunately, this cannot be accomplished overnight.

141. Prior to that, personal income was taxed differently depending on the nationality of the individual and on the category of income. Withholding has become more effective because the reformed tax: (a) applies to both Chinese citizens and foreigners, (b) has integrated different sources of income, (c) has a simpler rate structure, and (d) has fixed deductions for personal exemptions and itemized expenses. With fixed deductions applied to taxable income, the withholding agent can easily calculate the amount of tax to be withheld. Withholding agents keep 2 per cent of the taxes withheld as "service fees".

142. For a discussion of this tax, see Jinyan Li, "People's Republic of China: Domestic Enterprise Income Tax", 49 *Bulletin for International Fiscal Documentation* 2 (1995), at 81.

143. Declaration of Important Personal Events of Cadres, issued by the Central Office of the Chinese Communist Party and the Office of the State Council on 23 March 1997.

144. White, *supra* note 35, at 165-66.

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INTERNATIONAL

TAX SIMPLIFICATIONS – A TALE OF THREE COUNTRIES

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I. INTRODUCTION

It is clear from a cursory examination that simplification is not a simple issue. In fact it is quite complicated. While the aim of simplification appears to command widespread support there does not seem to be agreement of how simplification can be achieved. This article will examine the simplification work in three countries (Australia, New Zealand and the United Kingdom) to determine if there are lessons for other countries wishing to embark on the task of simplifying their tax systems. First there will be some discussion on why tax systems become complex. This will be followed by a description of what each of the three countries has done to simplify their respective tax systems. From this lessons will be drawn for others.

II. CAUSES OF COMPLEXITY

Cooper has identified several levels and layers of complexity:[1]

- Complexity in the choice of tax system. For example, the choice of an income tax is likely to be far more complex than the choice of a poll tax.
  According to Cooper "a tax on income typically raises multiple questions and sources of dispute: what is income; how much is the income; what kind of income is it; when is it income; whose income is it..."[2]
- Complexity in the implementation of the tax. Cooper suggests that "one example of this kind of complexity arises from having too many rules and systems within the income tax dealing with the same thing.[3]
  In an Australian context several examples are given including multiple provisions dealing with depreciation, fringe benefits and foreign income.
- Complexity in the expression of rules. This, Cooper suggests, extends beyond the language used to express the tax rules. It also extends to "design and presentation of legislation as documents intended to communicate information to the reader".[4]

Several reasons can be cited for the complexity that exists in the Australian income tax system.

- "Since its introduction in 1936, the Income Tax Assessment Act (ITAA) has increased from 126 pages to over 5,000.[5]
- "The legislation has a very poor structure, making it difficult either to get an overview of the law or to find where particular concepts are dealt with;
  - over the years, important additions to the tax law have been "tacked on" to the existing legislation, further obscuring its structure;
  - most significantly, the language of the law has progressively adopted a style of such formality and precision that its true meaning is hard to find".[6]

There are, of course, other reasons why the law has become so complex including the complex business and social environment which the tax system has to serve, the vast array of complex financial products that exist, the flood of specific provisions introduced to stop tax avoidance opportunities and the apparent perceived need to make legislation comprehensive to ensure that judicial interpretative needs could be satisfied.

New Zealand's tax legislation suffered from almost the identical defects identified as inherent within the Australian legislation. The legislation was devoid of any coherent structure, its core provisions and their relationships with other provisions were indiscernible, and additions had been made over the years by way of "add-ons" without any concerted thought to their wider import. The language had not only failed to recognize changes in usage over the years, but its excessive formality and inconsistency had made interpretation a specialization for the expert:[7]

> The current Income Tax Act has not coped well with the demands placed on it in recent years. The numerous and major changes to tax law made over the past decade have resulted in the Act's length increasing by some 80 percent. These changes have added to the complexity of the Act. Such complexity has had a number of undesirable effects: the policy intent of the legislation has not been as clear as desirable, compliance costs for taxpayers and their advis-

1. G.S. Cooper "Themes and issues in Tax Simplification," (1993), 10 *Australian Tax Forum* at 417-460.
2. Id.
3. Id., at 434.
4. Id., at 441.
5. Tax Law Improvement Project, *The Broad Framework* August 1994, Canberra, at 6.
6. Id., at 8.
7. Valabh Committee, *Final Report of the Consultative Committee on the Taxation of Income from Capital*, 1992, Wellington, Valabh Working Party, *Working Party on the Reorganisation of the Income Tax Act* 1976, 1993, Wellington, and Organisational Review Committee, Organisational Review of the Inland Revenue Department, April 1994, Wellington, at 85.

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> ers have been higher than necessary, and sometimes the law has had unintended and unforeseen consequences.[8]

New Zealand's taxpayers faced an identical complexity burden to their Australian neighbours, and in a similar manner created the impetus for reform, see Section III. B. below.

Almost exactly the same situation developed in the United Kingdom. Although income tax was first introduced there in 1799, the situation regarding complexity deteriorated particularly in recent years. The result has been an increasing amount of criticism, for example from experts such as Beighton,[9] a former deputy chairman of the UK Board of Inland Revenue, and Williams.[10] As Munro informed a conference on tax drafting, recent Finance Acts in the United Kingdom have tended to be much longer than their predecessors. The four Finance Acts 1993 to 1996:

> ...have not introduced any major new taxes; indeed since 1980 the trend has been to abolish taxes. But the average length of each of these Acts has been 400 pages. And the reason for this is not hard to find. Although the total number of UK taxes has reduced, the taxes themselves have become much more elaborate and complex as a result of tax reform (for example, self assessment), the changing business environment, changes in the wider legal framework and a tendency to introduce more and more detail in order to make the provisions as all embracing and as certain as possible.[11]

The pressure for simplification in the United Kingdom has led to two initiatives, one by the Inland Revenue and the other by the Institute for Fiscal Studies, and these are summarized in Section III. C. below.

III. THE SIMPLIFICATION EXPERIENCES

A. Australia

In Australia simplification has taken the form of a complete re-write of the Income Tax Assessment Act 1936, as amended. The process has not been called simplification but the Tax Law Improvement Project (TLIP). This project, expected to take three years to complete, was conceived by the government in December 1993. Its funding approximately AUD 10 million (est.), commenced from 1 July 1994. By 1 July 1997 less than half the rewrite had been completed. This meant that in the 1997 Budget further funds had to be allocated to cover the cost.

The aim of the project is to restructure, renumber and rewrite the income tax law so that it can be more easily understood by those who need to read it.

The project team comprises over 40 people and is split between Canberra and Brisbane. It includes private sector representatives, involves consultation and invites public comment. Its goals include:

(i) A desire to reduce the time and effort expended by various people in using the tax laws;
(ii) A desire to reduce the complexity of the tax laws;
(iii) A desire to improve discussion of tax policy;
(iv) A desire to make it easier for taxpayers to understand their rights under tax law; and
(v) A desire to increase taxpayers' willingness and capacity to comply with tax laws.

TLIP's mandate is limited to improving the formulation of existing law and does NOT extend to making significant changes in tax policy. However, during the re-write process small changes in tax policy have, with the approval of the Assistant Treasurer, been made. Such changes have generally complied with the following criteria:

- no significant revenue impact is involved; and
- the need to clarify the law; or
- the need to bring the law into line with commercial or actual practice.

The first area of law to be re-written was the substantiation provisions. These provisions set out the basis in which claims for work related expenses and car expenses are to be substantiated if a valid claim is to be made in a taxpayer's returns. The provisions were chosen first because they affected seven out of every ten taxpayers. The bill introducing these provisions, the Tax Law Improvement (Substantiation) Bill was introduced into the parliament on 8 December 1994. It later became law and applied from 1 July 1994. Because the new framework for the new Act had not been established at this time the new law was appended to the old law by way of schedules.[12] It is also clear that the new tax law applied prior to the time it received Royal Assent. To this extent it involved an element of retrospectivity.

The second stage of the rewrite appeared in 1995, however, the bills lapsed when the parliament rose for the federal election. After a change of government the bills were reintroduced with only minor changes. For a time it was unknown whether the new government would proceed with the TLIP or whether it might have also wanted a fundamental review of tax policy. It seems to be proceeding according to the original intent but public debate is focusing on the tax structure rather than simplification, in particular the case for introducing a goods and services tax. For instance, in a statement made on 13 August 1997, the Australian Prime Minister announced the establishment of a Taxation Task Force to prepare options for tax reform. Of the five issues put before the Task Force not one was specifically directed at tax simplification.

8. New Zealand Government, *Rewriting the Income Tax Act: Objectives, process, guidelines – A discussion document*, December 1994, Wellington, at 3.
9. L.J.H. Beighton, "The Finance Bill: Scope for Reform?" (1995) *British Tax Review*, at 33-48.
10. D. Williams, "The Finance Act 1993: Incredible Drafting, Extraordinary Prose", (1993) *British Tax Review*, at 483-495.
11. N. Munro, Inland Revenue (UK), *Proceedings of the Tax Drafting Conference* 27-29 November 1996, Inland Revenue Department of New Zealand at 99.
12. Sec. 82KZBE in Subdivision GA of Pt III of the ITAA sets out the application of the "new law" (i.e. Sch 2A and Sch 2B). For the 1994-95 year of income only, Sec. 82KZBE provides for the operation of the "old law" (Subdivision F) if the new law prevents a person from deducting an expense for the 1994-95 tax year that they would otherwise have been entitled to deduct under the old law. Sec. 82KZBE(4) also gives the taxpayer the option to use the old law for the 1994-95 tax year if it will result in a greater deduction than under the new law. This prevents any disadvantage to taxpayers for the transitional 1994-95 year of income.

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The bills introduced into the parliament in 1996 had a variety of functions:

- The Income Tax Assessment Bill 1996 proposed to establish the structure and framework of the new legislation.
- The Income Tax (Consequential Amendments) Bill 1996 amended other Commonwealth Acts that contain references to the income tax law.
- The Income Tax (Transitional Provisions) Bill 1996 determined when and how emerging instalments of the new law will apply. Initially the second instalment was to apply from 1 July 1996 but this was changed to 1 July 1997 so that the law would not have retrospective effect.

These bills, as amended, were passed by both houses of the parliament and received Royal Assent on 17 April 1997. One of the bills gave rise to the new act, the Income Tax Assessment Act 1997. It contains the structure of the new legislation and is the first instalment of rewritten provisions, including those dealing with the core provisions, substantiation, losses, capital allowances and mining and quarrying. The Tax Law Improvement Bill 1997 which received Royal Assent on 8 July 1997 represents the second stage of the tax law rewrite. It contained provisions dealing with assessable income, recoupment of deductible expenditure, leased cars, deductions, gifts, entertainment, depreciation, exempt income, trading stock and capital allowances for primary producers. There is still much to be done.

Further instalments of the rewritten law are proposed to be introduced on, essentially, an annual basis. Each bill is preceded by Exposure Drafts which are available for public comment.

B. New Zealand

In similar vein to Australia, New Zealand's simplification process has taken the form of a complete rewrite of the Income Tax Act 1976 (as amended), and the Inland Revenue Department Act 1974 (as amended). Eventually this will extend to encompass the Goods and Services Tax Act 1985 and other revenue legislation.

The rewriting process must not be confused with a previous attempt at simplification, a process which resulted in two reports issued on over 170 ways in which the tax compliance and administration process could be made simpler. Tax policy had to remain unchanged and the recommendations had to be revenue neutral. Rewriting of the legislation was not part of the brief.[13] Simplification, as used in this study, is known as "Rewriting the Income Tax Act", under the auspices of the Working Party on the Reorganization of the Income Tax Act 1976. The Working Party recommended that the legislation be progressively rewritten over four to five years. This project was given governmental support in December 1994, evidenced by the release of the first of a series of discussion documents. To date, NZD 3.5 million (est.) has been appropriated to the project since the 1994/95 year. The project is now in its fourth year of a projected total of five for the rewriting of the Income Tax Act 1994, and later the Tax Administration Act 1994 and Taxation Review Authorities Act 1994.[14]

The aim of the project bears remarkable similarity to the TLIP in Australia; the rewrite is designed to reorganize, renumber and rewrite income tax (and related) law in order that it may be more easily understood by those who need to read it and that the associated costs of compliance will be reduced. A separate reporting division has been set up within the Legislative Affairs Directorate of IRD National Office, which is based in Wellington, to oversee the process. The Parliamentary Drafting Office will provide a final quality assurance check on draft legislation from the IRD's drafting unit. To assist the rewriting process, an advisory panel was also formed, comprising representatives from the Institute of Chartered Accountants of New Zealand and the New Zealand Law Society, together with senior officials from the IRD and the Treasury. The hallmark of the process is consultation and public comment.

The goals include:

(i) The desire to clarify the law in order to minimize the various costs faced by taxpayers and society generally because of the way the law is expressed.
(ii) The desire to improve the Act's structure, making the interrelationships between the parts of the Act explicit, and adopting a plain language style of drafting.
(iii) The commitment to address separately the policy issues that arise through the normal policy process; they are beyond the brief of the rewrite.
(iv) The desire to provide taxpayers with an opportunity to absorb the changes through a manageable progressively staged rewrite, with the draft legislation emerging from each stage open for consultation.
(v) While not specifically noted, there is a desire to both make it easier for taxpayers to understand their rights under the tax law and that taxpayers' willingness and capacity to comply with the tax laws increase.

The rewrite team's mandate does not extend to making significant changes to tax policy; small changes must be identified and approved by the government prior to inclusion in publicly disseminated draft legislation. Policy changes approved as part of the rewrite have complied with one of the same three criteria utilized for the TLIP, namely:

- no significant revenue impact is involved; the proposals should be revenue neutral; and
- the law needs to be clarified; or
- the law needs to be brought into line with commercial or actual practice, particularly as interpreted by the courts.

Examples of such changes include the comprehensive adoption of a gross/global approach to the calculation of income tax liability, revisions to the previous reorganization (relocation) of provisions, which itself led to potential changes in

13. Waugh Committee, *Tax Simplification: Consultative Document on Tax Simplification*, December 1989, Wellington and Tax Simplification Consultative Committee, *Tax Simplification: Final Report of the Consultative Committee*, September 1990, Wellington.
14. The time frame for completion of the rewrite process must necessarily exceed the five years originally intended since the majority of the Income Tax Act 1994 has yet to be rewritten.

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interpretation, and new purpose and interpretation provisions. Savings provisions are included to ensure that changes in terminology are not intended to change taxpayers' tax liabilities.

In contrast to the TLIP, the first step was the complete reorganization of the Income Tax Act 1976 and the Inland Revenue Department Act 1974 to form three new Acts: the Income Tax Act 1994, the Tax Administration Act 1994 and the Taxation Review Authorities Act 1994. Other revenue legislation was not directly affected, except for necessary consequential reference alterations. Rather than take a narrow focus as with the TLIP, the rewrite in New Zealand sought to immediately improve the entire income tax legislation with a reorganization, a process which itself would reveal further deficiencies in the existing legislation.

In December 1993, a discussion document was released by the government on the proposed reorganization process, following recommendations of the Working Party on the Reorganization of the Income Tax Act. Draft legislation was introduced into the parliament, passed on 8 December 1994 and assented to on 20 December 1994, with effect from 1 April 1995 for the 1995/96 income year. The old Acts were effectively repealed from that date, although they were specifically referred to in the savings provisions and relevant schedules of the reorganized Acts as a transitional arrangement. There was no obvious retrospectivity with this reorganization; indeed there were no significant wording changes, but only a reorganization of an ascending numeric style to a new alpha-numeric style with discrete but interrelated parts, each of which contained various subparts. For example, Section 104 (when deductions may be permitted) became Section BB 7 (part of the Part B, the core provisions).

The second stage of the process, the first rewriting component, was signalled by the release of a further discussion document in December 1994.[15] This discussion document set the framework for the remainder of the process; it outlined the stages of the rewrite (rewriting the core provisions (and necessary consequential provisions) and then the remainder of the Income Tax Act 1994); the objectives of the process; the scope of the rewrite in terms of policy and structural issues; and the drafting process and guidelines. The major area of contention was whether the rewriting process should be in one step rather than progressive steps; preference emerged for the latter.[16]

General acceptance from tax advisers on this discussion document led to a second discussion document, issued in May 1995. Specific proposals for the rewriting of the core provisions were included, accompanied by a summary of the problems with the current provisions and the implications of the new approach. Proposed draft legislation was also included for public comment.

Draft legislation and a comprehensive commentary on the Taxation (Core Provisions) Bill 1995 emerged in December 1995; the draft legislation was referred to the Finance and Expenditure Select Committee for the hearing of submissions. Legislation was eventually passed by the parliament on 16 July 1996, and assented to at the end of that month. While originally intended to take effect from 1 April 1996, delays within the parliamentary process and the desire to avoid the problems associated with retrospectivity, led to the rewritten core provisions in most instances only taking effect from 1 April 1997, although taxpayers with an early balance sheet date would be subject to the new provisions as early as 1 October 1996.

At present there are no bills before the parliament concerning the next stage of the rewrite; neither are there any discussion documents released from which draft legislation may emerge. Indeed there is no specific targeted output from the Inland Revenue Department in its forecast report for the year to 30 June 1997. A further complicating factor is the recent Mixed Member Proportional (MMP) election, which has resulted in a coalition government, comprising parties with essentially similar fiscal policy from the revenue perspective.

A recent government announcement has signalled that a discussion document should emerge in late 1997 which proposes the rewriting of Parts C (Income further defined), D (Deductions further defined) and E (Timing of Income and Deductions) of the Income Tax Act 1994. Further developments are expected in 1997 and 1998.

C. United Kingdom

Attempts at simplifying taxation in the United Kingdom have a long history. One of the earliest initiatives was the production of an early tax guide shortly after income tax was first introduced in 1799. It was entitled A Plain, Short and Easy Description of the Different Clauses of the Income Tax so as to render it Familiar to the Meanest Capacity.[17]

Since that time, the quantity and complexity of tax legislation has grown enormously – very much the experience of other countries. According to the Inland Revenue, and with respect to direct taxation only, there are now 6,000 pages of primary and secondary legislation plus tens of thousands of non-statutory documents, extra-statutory concessions and so on.[18] Increasingly the view of commentators has been that tax legislation in the United Kingdom has been excessively complex and sometimes poorly drafted.[19]

As in Australia and New Zealand, the most recent moves towards simplification have gravitated around the idea of simplifying the language of tax legislation, though the United Kingdom is still somewhat behind the other two countries in developing this approach. The Institute of Fiscal Studies set up a Tax Law Review Committee (TLRC) in the Autumn of

15. New Zealand Government, *supra*, note 8.
16. For further discussion see, A. J. Sawyer, "Two Significant Legislative Developments: Taxpayer Compliance, Penalties and Disputes Resolution and Taxation (Core Provisions) Bills Become Law", 50 *Bulletin for International Fiscal Documentation*, 10 (1996), at 440-447.
17. A. Farnsworth, *Addington: Author of the Modern Income Tax*, Stevens, 1951 at 15.
18. C. Davidson, "An Update on the Work of the Tax Law Review Committee", (1996) 17 *Fiscal Studies* at 103.
19. S. James, *Self-Assessment and the UK Tax System*, Research Board of the Institute of Chartered Accountants in England and Wales, London, 1995, at 16-19.

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1994 and in due course it has produced an interim report[20] and a final report.[21] The terms of reference of the TLRC are "To keep under review the state and operation of tax law in the United Kingdom". It does not seek to question government policy but rather whether that policy is being achieved in a satisfactory and efficient manner or how it could be better achieved. Almost in parallel with this initiative; the Inland Revenue issued its own approach to simplification[22] together with some further information[23] and followed this up with a consultative document.[24] The general conclusions are basically that tax legislation could be drafted in a more comprehensible style and the question then is how this might best be done.

Within that general approach, the TLRC developed four projects[25] i.e. tax legislation, tax appeals, Schedules D and E, and tax avoidance. The work on tax legislation echoes earlier work on simplification[26] but also recommended the provision of explanatory memoranda with each clause of the Finance Bill. The project on tax appeals is more fundamental in the sense that it is examining whether a more coherent and consistent system could be achieved. The project on Schedules D and E refers to the taxation of the self-employed and employees respectively, the differential treatment of which has been a cause for concern since the 1920s when the assessment of employees was almost arbitrarily transferred from Schedule D to the far more restrictive provisions of Schedule E. Tax avoidance is potentially a more complicated issue and it remains to be seen how far the work of the TLRC will result in significant progress in this area.

The immediate result of these reports has been the acceptance by the government of a need to rewrite tax legislation and this is going ahead. The head of the drafting unit in this process, Geoffrey Sellers, stated that:

> Our aim will be to redraft all the law in as clear and simple terms as we can achieve. We are not going to stop at the point where the tax is intelligible to the professionals. If we can go further we will. But equally we don't regard ourselves as committed to making every section intelligible to the man in the street.[27]

It is too early yet to assess the impact of these initiatives on tax simplification in the United Kingdom but they focus very much on the simplification of tax legislation rather than any attempt to reform the development of tax policy as a whole. As such they are unlikely to form the basis of a strategy which is likely to contain the pressures for complexity in modern society, pressures which are summarized at the beginning of the paper.

IV. LESSONS

A. Tax policy

In Australia major changes to tax policy were never part of the TLIP's mandate. Much of the criticism of the rewrite can be said to have arisen because tax policy has not been addressed. For its part the team would say that it might not yet have delivered anything if tax policy was first to be reformed before the legislation rewrite was to take place. Similar statements have been expressed over the New Zealand rewrite process, although the reasoning for leaving tax policy changes outside the brief has now been generally accepted. Exceptions include a deliberate attempt to have a consistent gross/global approach to the calculation of income, and modifications to the treatment of trading stock, especially for situations involving shares and land.[28]

A Joint Committee of Public Accounts which has reviewed the work of the TLIP has said that "[t]here is a clear sense of frustration in the tax profession that highly complex sections of the 1936 Act are being perpetuated in the new legislation..."[29]

Consequently, it concluded its investigation by saying that:

> The underlying complexity of the 1936 Act suggests that tax simplification and a reduction in compliance costs in Australia requires more than just a rewrite of the existing legislation...It requires a wide ranging review of tax policy and the administrative procedures that underpin the law...Only after such a review can compliance costs come down significantly.[30]

Thus one of the significant choices a legislature has to make is whether to simplify the way tax law is written or simplify both the way the tax law is written and tax policy. It is suggested that simplification of the words alone is unlikely to bring lasting benefits. In New Zealand, earlier administrative simplification measures,[31] coupled with specific simplification policy initiatives outside of the rewrite process (for example the disputes resolution process changes and the current proposal to simplify provisional tax and IR 5 Individual Tax Returns), have not, or are not expected to, introduce lasting benefits.

In the United Kingdom as well, the idea of radical reform was never really on the agenda in the first place. For instance, the interim report of the TLRC[32] stated explicitly that "the main factor in determining their [the Finance Acts'] length is the government's decision as to how many changes it wants to make to the tax code each year, and this is a policy matter outside our remit". A slight shift of approach was seen with respect to purposive legislation. The interim report of the TLRC doubted whether a move to purposive legislation

20. Tax Law Review Committee, *Interim Report on Tax Legislation*, Institute for Fiscal Studies, London, 1995.
21. Tax Law Review Committee, *Final Report on Tax Legislation*, Institute for Fiscal Studies, London, 1996.
22. Inland Revenue, *The Path to Tax Simplification*, HMSO, London, 1995.
23. Inland Revenue, *The Path to Simplification: A Background Paper*, HMSO, London, 1995.
24. Inland Revenue, *Tax Law Rewrite the Way Forward: A Consultative Document*, Inland Revenue, London, 1996.
25. C. Davidson, *supra* note 18.
26. For example, S. James, A. Lewis and F. Allison, *The Comprehensibility of Taxation*, Avebury, Aldershot, 1987.
27. G. Sellers, Inland Revenue (UK), *Proceedings of the Tax Drafting Conference* 27-29 November 1996, Inland Revenue Department of New Zealand at 97.
28. A discussion document has been released on proposed changes to the taxation of trading stock; although this document specifically excludes land from its ambit.
29. Report 345 "An Interim Report on the Income Tax Assessment Bill 1996, the Income Tax (Transitional Provisions) Bill 1996, and the Income Tax (Consequential Amendments) Bill 1996 at xiii.
30. Id., at 66.
31. See Waugh Committee, *supra* note 13.
32. Tax Law Review Committee, *supra* note 21, Executive Summary, at vii.

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would be an improvement. However, in its Final Report,[33] it revised its view and concluded that it would be possible to draft primary fiscal legislation in terms of general principles, but "in view of the need to change parliamentary procedures first", left this simply as a "longer term aim".

The same situation holds with respect to the Inland Revenue's proposals for tax simplification in the United Kingdom. The Inland Revenue undertook consultations and a senior official stated that:

> without exception all the major representative bodies have said we will not get very far unless we can simplify the underlying policy.[34] [However] We have ...made it clear in our discussions with the main representative bodies that we see their point and in general we [the Inland Revenue] accept it. But policy reform is not on offer now or in the foreseeable future. Almost all of them have accepted this. They welcome the rewrite for the benefits it will provide and they will continue their campaign for the bigger prize in other forums.[35]

Another problem that has become apparent in Australia is that the government of the day continues to have a thirst for new tax policy. In the 1996 Budget the following were some of the measures announced:

- increase in tax free thresholds for families;
- surcharge on superannuation contributions for high income taxpayers;
- restriction on the recoupment of losses by trusts;
- rules to deem certain dual residents as non-residents;
- extended capital gains roll-over relief for small business;
- rebate for private health insurance;
- capital gains exemption on sale of a small business upon retirement.

These undermine the efforts of the TLIP team to simplify the law. One way to allow taxpayers and tax practitioners to become more familiar with tax laws is to have a long term moratorium on changes to existing laws. If governments are serious about making the law more comprehensible they should resist changing it so often.

In contrast to Australia, remarkably few tax changes were announced in the 1996 and 1997 New Zealand Budgets. The two changes announced in the 1996 Budget were first, confirmation of the tax rate reductions (in two stages; the first took effect from 1 July 1996, the second has been delayed by the new government from 1 July 1997 to 1 July 1998 at the earliest); and second, a reduction in the amount of superannuation surcharge. Most changes were announced separately, accompanied by discussion documents. A remedial provisions bill was introduced and passed during 1996 which tidied up a variety of issues rather than introducing new policy initiatives. The 1997 Budget confirmed a postal ballot referendum will be held in September 1997 concerning a proposed compulsory superannuation scheme which, if endorsed, will attract compensatory tax rate cuts providing fiscal conditions permit. Other tax changes have generally been announced by ministerial notification and IRD publications.

A de facto moratorium to radical tax changes has been effected through the 1996 MMP General Election. The coalition government, formed on 11 December 1996, has stated that minimal change to the existing tax system may be anticipated over the next three years. Consolidating the widespread changes and allowing time to gauge their impact is important. Nevertheless, rewrites of all provisions other than the interpretation guidelines and the core provisions contained in Parts A and B respectively, are expected during 1997.

In the United Kingdom, the return of a new Labour Government in 1997 was soon followed by a Finance Bill designed to begin the implementation of its manifesto in opposition. Hence, as might be expected, proposals for a windfall tax and other measures took precedence over any overall strategy for tax simplification.

B. Delivery options

One of the important decisions in Australia was how the TLIP was to deliver the final product. The two main options were a staged introduction or a big bang. While the professional bodies favoured a big bang approach, the TLIP adopted the alternative approach. This was done so that work could be completed by particular dates. As it transpired the planned start dates were not achieved and commencement was deferred. In part this was due to the election but also the consultative and review processes appear to have slowed things down.

Debate before a Joint Committee of Public Accounts canvassed a third option for delivery, described as "warehousing".[36] This approach envisaged progressive enactment of new laws but a common start date. That is new laws would be warehoused as they were written and would not come into force until the last of them was enacted.

Such an approach was said to have the twin advantages of introducing the new law in manageable pieces and allowing for technical errors to be corrected.

New Zealand's rewrite process has followed an identical philosophy to the TLIP in preferring to adopt a staged introduction. The warehousing idea was raised in submissions but never received any credible support from the advisory committee or government. In a further case of déjà vu, the intended start dates were not achieved for the core provision rewrite; their implementation was 12 months later than originally expected, which is a result of the consultative and review process and the demanding legislative timetable placed on the select committee considering several major pieces of new draft tax legislation.

C. Structure

The Australian rewrite used a pyramid as a structure to arrange the content of the new law. The top of the pyramid

33. Id., Executive Summary, at viii.
34. *Supra* note 11, at 101.
35. Id.
36. Report 345, *supra* note 29, at 41-43.

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represents core provisions which deal at a broad level with how much tax taxpayers are required to pay. After the core follows, in turn, provisions which apply to large sections of the community (e.g. provisions dealing with income and deductions); then rules that deal with specialist groups (e.g. companies, trusts, partnerships). There is also a toolbox which contains definitions and other aids.

According to the Joint Committee of Public Accounts this structure has, generally, been well received.[37] The Specialist Tax Adviser to the Commonwealth Ombudsman suggested an alternative structure:

> the development of a series of fundamental propositions or principles which are agreed as being beyond debate – they are in effect "axioms" of the tax system. There would then be rules on how to apply these axioms in various contexts.[38]

While not formally applying the TLIP's pyramid structure, New Zealand's rewriting process has developed a structure within the new Act that mirrors a pyramid structure. After providing general interpretation provisions, the "top" contains the core provisions at a broad level, which in each subpart contain the letter to which the expanded details are contained in consequential provisions in the latter parts of the Act. Likewise, provisions that apply to large sections of the community follow (income and deductions further defined, and timing and apportionment of these items). Later, the rules that deal with specialist entities, the treatment of losses, and the tax liability calculation components are set out.

Loosely speaking, a "toolbox" containing definitions is provided at the end of the New Zealand legislation. Other aids to interpretation, such as flow charts and diagrams, are contained in the relevant parts of the act, especially in Part B containing the core provisions, so as to provide a visual road map of the interrelationships and structure of the Act.

D. Drafting style

One of the techniques used in Australia to improve readability was the introduction of clearer, shorter sentences and the use of plain English. For example, in the substantiation legislation sentence length was reduced from an average of 241 words to 37.[39] For the "depreciation provisions", the rewrite has reduced by half the 20,000 words that were used in the old legislation to express the law. An identical philosophy was adopted for the New Zealand rewrite.

The Australian legislation also contained other aids such as maps and graphics, tables, signposting and examples. Further it was directed at a reading age of someone with ten years of schooling (about 14-15 years old) rather than two years of university study.

While similar interpretation aids are provided with the New Zealand legislation to those introduced through the TLIP, there has been no conscious effort to reduce the reading age to the commendable goal of the TLIP. A policy of plain English drafting and the publicized drafting code make no reference to reducing the required reading ability from that of a person with a university degree.[40] Indeed, while the emerging legislation is easier to read than its predecessor, it remains complex and in places, tortuous. In the "Rewriting the Income Tax Act" discussion document, the government openly admits that complex tax policy, complex transactions and business organizations, and the elaborate and sophisticated transactions devised by taxpayers to circumvent the legislation, necessitates, in its view, complex tax law with the associated compliance costs.

Simpler style brings with it its own potential problems including:

(i) Possible lack of precision. Laws rewritten in simple language may contain unintended changes in tax policy. The rewritten laws may be clearly expressed and easy to understand but they may be different to the laws they replaced.

> Certainty or clarity may come not with the choice of words but the approach adopted in the legislation. In Australia (and in New Zealand to a lesser degree), a debate has existed over whether tax laws should be written in general terms (fuzzy law) or in intricate detail (black letter law). At present the old law in Australia (and New Zealand) contains a mixture of both and this is one of the problems faced by those seeking to interpret the provisions;[41]

(ii) Likely inapplicability of judicial decisions which have resolved the meaning of more complex words;

(iii) The likelihood that rewritten laws might also, inadvertently or otherwise, rewrite tax policy.

To counter unintended changes the new law in Australia contains a provision (Section 1-3) which, at paragraph 2, provides:

> (2) If:
> (a) [the old law] expressed an idea in a particular form of words; and
> (b) [the new law] appears to have expressed the same idea in a different form of words in order to use a clearer or simpler style;
>
> the ideas are not to be taken to be different just because different forms of words were used.

In submissions before the Joint Committee of Public Accounts, the accounting bodies expressed concern over this provision. In particular, they thought it placed the onus on taxpayers to determine whether the difference between the old law and the new law was one of style or a deliberate change in policy.[42]

This has then led to the suggestion that taxpayers should not be disadvantaged by the rewrite. That is, they should have the

37. Id., at 13.
38. Id., at 15.
39. P. Langenakker, "The Tax Law Improvement Project", Paper presented at the Australasian Tax Teachers' Conference Fremantle, 20 January 1995, at 3.
40. See L.M. Tan and G. Tower, "The Readability of Tax Laws: An Empirical Study in New Zealand", (1992) 9 *Australian Tax Forum*, at 355-372.
41. For a recent discussion of views from the tax drafters of Australia, New Zealand and the United Kingdom, see the *Proceedings of the Tax Drafting Conference*, IRD, 27-29 November 1996, Inland Revenue Department of New Zealand.
42. Report 345, *supra* note 29, at 21.

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option, at least for a transitional period, of being assessed under either the new or the old legislation. While this might suit some taxpayers it would make life miserable for the tax profession and would make a mockery of the simplification process.

For practitioners what Section 1-3 will mean is that they will have to have on their desks both the new and the old legislation so as to make comparison between the two and decide whether any differences were intended or not. How can this lead to simplification?

The New Zealand rewritten legislation contains a similar provision to Section 1-3 in Australia through the inclusion of Section AA 1, which provides:

> (2) The reorganization of the provisions and the changes of style and language carried out by this Act in relation to the provisions of the Income Tax Act 1976 are not intended to affect the interpretation or effect of those provisions as they are included in this Act.

This provision was part of the original reorganized Income Tax Act 1994 and remained as part of the rewritten core provisions. Furthermore, Nannestad,[43] a senior IRD solicitor, argues that when the new legislation [the reorganized 1994 Income Tax Act] is interpreted in the context of the overriding statutory interpretation principles applicable in New Zealand (including the scheme and purpose approach), the necessary conclusion is that the pre-existing law was unchanged by the 1994 Act. Insofar as the rewriting of the core provisions and necessary consequential provisions specifically change the 1994 reorganized form of the Act, then Section AA 1 has limited effect.

There has been no attempt to require tax practitioners in New Zealand to compare old and new versions of the legislation to determine whether differences in language were intended or not. Section AA1 and the IRD's interpretation of this section, have resolved the issue for the reorganized 1994 Act. However, this issue is far from resolved with the legislation arising as a result of the rewriting of the core provisions.

E. Tone

One of the unusual features of the Australian legislation is the tone of the legislation. The legislation addresses the taxpayer. For example, "To deduct a work expense you need to substantiate it by getting written evidence". This approach has been criticized because taxpayers generally do not read the legislation. It is read by accountants, lawyers and revenue officials who may not appreciate the use of this tone. It raises a basic question:

> "For whom should the tax laws be written?"

One of the debates in Australia, which affects the choice of drafting style, is over the target group for whom the laws should be written. The TLIP team looked at the compliance group. That is, if some laws are for wage and salary earners then those taxpayers should be able to read the law and determine their responsibilities. Particularly, now, when they lodge their returns under a regime of self assessment.

Of course those who previously prepared returns for this group have disputed the need for the ordinary taxpayer to read and understand tax laws. They believe that so long as tax return preparers understand the laws that should be enough. Perhaps what is behind the TLIP thinking is the desire to genuinely reduce compliance costs and this is best achieved if taxpayers themselves can lodge their tax returns without employing someone to do it for them.

This explains the change in drafting style in the substantiation provisions from the third person (the taxpayer) to the second person (you). This style is not to be adopted in all areas. For example, the mining provisions are likely to be directed to specialists in that industry.

Whether or not individual taxpayers actually use the new legislation remains to be seen. What is clear is that in the past individual taxpayers have not used the old laws. What they have used though, is the tax return forms and guides – principally TaxPack. The benefits of simplification will be lost unless these aids are also written in simple language. In Australia, simple language is generally used.

There are some curious simplifications. For example an "oyster"[44] has become an "aquatic mollusc".[45] This change apparently occurred as a result of industry representation.

The debate over whether the legislation should be written directly with the taxpayer as the reader by using "you" has not extended to the other side of the Tasman Sea. Tax legislation, like all other legislation in New Zealand, remains impersonal; it refers to the taxpayer, with the expectation that rarely will taxpayers read tax legislation themselves. Tax practitioners will normally be the target audience for reading legislation, while taxpayers will normally be content with user friendly tax guides and similar material, such as the IRD's Tax Information Bulletin. The continual advance towards comprehensive self-assessment appears to be creating no significant impact on this state of affairs.

F. Aids to interpretation

The old laws contained about 5,000 definitions.. These appeared throughout the legislation. The new law brings together all of these definitions at the end of the legislation. Most defined terms are identified by an asterisk. It is now the intention that each page of legislation, which contains a defined term, will have a footer telling the reader where the definition can be found.

The new law also contains a number of other aids to interpretation. These include diagrams, theme statements and tables of contents. While one would have thought that these would have gone without criticism, the NSW Law Society expressed some concern. It noted that there was "no authority...concerning the interpretation to be given to a diagram".[46]

43. A. Nannestad, "Reading the 1994 tax legislation", (1995) *CCH Tax Planning Report*, February, at 5-8.
44. See Sec. 6 of the old definition of "fishing operatings".
45. See Sec. 995-1 the new definition of primary production.
46. Report 345, *supra* note 29, at 30.

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With New Zealand's rewrite, an early decision was made to place definitions in one readily accessible location; in a separate part at the end of the legislation. Specific reference to this approach is made in Section AA 4(2) of the Act. Part O of the Income Tax Act 1994 is effectively a dictionary of words, terms and phrases used elsewhere in the Act. Following the rewrite of the core provisions, terms contained in the core provisions in Part B, which are defined in Part O, appear at the end of each section after the word "Defined"; the equivalent of the asterisk approach in Australia.

Aids to interpretation such as diagrams and lists of defined terms are provided in the Act; an innovative feature not present in other New Zealand legislation. Section AA 3(2) removes some of the uncertainty as to the legislative weight to be given to such aids:

> (2) Diagrams and lists of defined terms at the end of sections in this Act are included only as aids to interpretation, and
> (a) if there is a conflict between a diagram and a provision of the Act, the provision governs;
> (b) if a defined term is used in a section and is not included in the lists of defined terms for that section, the term is nevertheless used in the section as it is defined for the purposes of the Act.

While words overrule conflicting visual presentations the absence of a defined term will still require judicial interpretation as to how the term is defined for the purposes of the Act. Judicial assistance may also be necessary to resolve whether in fact there is any conflict between diagrams and words. Inclusion of this approach within the statutory framework would alleviate the concern expressed by the NSW Law Society over the authority for the interpretation of diagrams.

G. Numbering system

In Australia the numbering system adopted involves a two component number. The first component is the number of the Division. The second component is the number of the section, starting with the number 1 at the start of each Division.

It was clear some change was necessary as the former numbering system had run out of sensible numbering options. Sections, such as Section 159GZZZZA(2)(b)(iii)(B), had been used. While the new system will likely be an improvement it does have some disadvantages:

- those familiar with the old numbering system will be required to learn a new system;
- it is not clear how big the gaps in the new numbering system need to be to allow for subsequent changes to the law.

The alphanumeric numbering process in New Zealand's Income Tax Act has a three component number. The first component, a letter of the alphabet, refers to the Part of the Act. The second alpha character refers to the subpart. The third is the number of the section, starting with the number 1 at the start of each subpart. This approach is more radical than the Australian Division and section number style and avoids the nonsensical numbering options under the previous 1976 Act. It also has an advantage that it is less likely to suffer from insufficient gaps to allow for subsequent changes in the law as it offers three levels in the hierarchy rather than two (apart from the subsection and paragraph options within a section). Nevertheless it imposes a significant relearning obligation for a system that bears no resemblance to its predecessor.

H. Status of tax rulings

In Australia, as elsewhere, tax rulings have become an important aid used to interpret the tax law. Over recent years many public rulings have been issued. Most of these have been welcomed as assisting in the interpretation of the law. All of these rulings will need to be amended if only to reflect the new numbering system.

One of the "consequential amendments" that is being made is to ensure that rulings remain valid under the new law provided the new law expresses the same idea as the old! Again simplification may have the consequence of requiring taxpayers to know both the ideas expressed in the new and the old law. This can hardly be said to be a simple result.

Ultimately all rulings will need to be rewritten. This is likely to take longer than it took to rewrite the tax laws themselves. If a rewrite is to take place, there are other ways the ruling system can be amended.[47]

New Zealand revenue authorities and practitioners have been able to arrive at a practical compromise which has received government endorsement with respect to binding rulings. The core provisions, as the first stage in the rewriting process, have introduced significant changes to tax legislation. As provided in the binding rulings legislation,[48] 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) Act (in most cases 1 April 1997), public, 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) Act are not intended to change underlying policy, a simple transition process to restore certainty to taxpayers with a binding ruling was implemented.[49]

The process eventually agreed between the IRD, the Minister of Revenue and the Finance and Expenditure Select Committee to handle this situation encompasses the following:

(i) The Adjudication and Rulings Unit within the IRD will examine all private rulings and product rulings, issued before the enactment of the Taxation (Core Provisions) Act, which apply for the 1997/98 year onwards and which are potentially affected by the bill.
(ii) The IRD's review will be directed at determining whether the ruling in each case will terminate on the application date of this Act, and whether the ruling may be issued under the new legislation, or whether it needs to be altered because of policy changes in this Act.

47. See S. James and I.G. Wallschutzky, "Considerations Concerning the Design of An Appropriate System of Tax Rulings". *Revenue Law Journal*, Vol. 5, 1995.
48. See Sec. 91G Tax Administration Act 1994.
49. For further discussion, see Sawyer, *supra* note 16.

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(iii) 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, and a copy is sent to the person to whom the terminated ruling applied. Rulings in this situation will be reissued without cost to the applicant.

(iv) 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.

(v) 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 changes necessary to reflect substantive changes in the law. Taxpayers have the option of requesting a new ruling; indeed they may wish to 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 also 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.

The United Kingdom has considered introducing both pre-transactions and post-transactions rulings. The system of post-transactions rulings is being introduced but the government decided against a system of pre-transactions rulings. The Inland Revenue had "found that most of the people likely to be affected actually preferred the present informal arrangements to any formalized scheme, despite the element of uncertainty that may exist under the present system".[50]

I. Consultation

From the outset, the TLIP team in Australia believed consultation was essential for the success of the project. Apart from private sector representatives there was a consultative committee which contained a wide spread of backgrounds including academics, accountants, lawyers, trade unions and ethnic groups.

Draft bills have been made available for public comments and presentations have been made in most major cities. If this process fails it will not be for lack of effort on the part of the TLIP team but rather because of apathy on the part of users of the legislation. There is the view that, until the new law affects their practices, accountants and others are unlikely to invest the time needed to become familiar with it.

The consultation process has been less formalized in terms of efforts to include particular groups with the New Zealand rewrite, although the process has been open and comprehensive with several public discussion documents, the select committee submissions and hearings, and use of an advisory panel made up of public and private sector tax experts. However, the process has been centralized through Wellington and has not expanded to include presentations in the other major centres. Interested parties have had to make the effort to take their concerns to Wellington rather than have the rewrite team bring their proposals to the people as has been followed in Australia. In practice, however, "consultations" normally comprise written communications and telephone conversations rather than a physical meeting between the taxpayer's agent and the IRD rulings official.

J. Public awareness of changes

In October 1995 Cowdroy wrote of the Australian situation: "a large proportion of the business community and almost the entire general public is unaware that the tax law improvement project is being carried out."[51] Cowdroy argued that the benefits of improved legislation would be wasted if the public did not know about the changes. He argued that an extensive education programme was required.

During September and October 1996, in conjunction with the University of NSW's ATAX, the project team conducted presentations in ten cities across Australia. Curiously, these were for practitioners not the general population. Perhaps the latter are to be catered for later?

Awareness of the changes in New Zealand is at best on par with Australia; realistically the "average" taxpayer is unaware of the changes as they do not refer to tax legislation. Journalistic work in national and local newspapers and the occasional reference in IRD publications, would be the extent of opportunity for the general public to realize the scale of the rewriting process. There has been no effort to date to actively publicize the changes in the manner undertaken in Australia; perhaps there is a desire to leave taxpayers "in the dark for their own sake".

K. Removal of discretions

Another thing that the TLIP team in Australia did was to eliminate where possible, discretions which existed in the old law. For example, in some cases a provision may have offered a deduction "to the extent considered reasonable by the Commissioner of Taxation". While such provisions were tolerated under an assessment regime they did not sit well under self assessment, where the onus was on the taxpayer to "get it right".

50. Munro, *supra* note 11 at 100.
51. P. Cowdroy "Tax Law: Improvement or Impairment" (1995) 4(2) *Taxation in Australia*, October, at 94-104.

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The approach in Australia now is to use the expression "as is reasonable". It is then left to the taxpayer, or the taxpayer's adviser, to decide what is reasonable. Provided reasonable care is exercised,[52] the taxpayer is unlikely to be penalized just because a position different to that of the Commissioner is taken.

The New Zealand rewrite process has not specifically addressed the issue of whether discretions granted to the Commissioner should be removed. Rather, as a separate matter, there have been several attempts to remove discretions from the Commissioner where this improves overall certainty for taxpayers, such as making depreciation deductions mandatory according to a legislatively enacted schedule and the new fixed levels of expanded penalties due to take effect from 1 April 1997.

Nevertheless, while there has been a theme within the rewrite process to maintain flexibility in order to accommodate modifications and extensions, discretions have been left with the Commissioner where this is considered to enhance the administration function of the Commissioner with respect to the Act. The Commissioner's discretions will be revisited with a discussion document expected to be released in late 1997 as part of formalizing a self-assessment system for compliance with tax obligations in New Zealand.

V. CONCLUSIONS

What can be ascertained as the collective experience from the simplification exercises in Australia, New Zealand and the United Kingdom? Although the United Kingdom is somewhat behind the other two countries it appears to be treading very much the same path.

- Simplification is a process not an event. The experiences of Australia, New Zealand and the United Kingdom all attest to this.
- True simplification requires tax policy to be simplified as well as tax legislation. For Australia, New Zealand and the United Kingdom, this has been outside the brief of their respective simplification projects.
- Without a change in approach to tax policy, tax laws will never be simple. What is needed is general statements of policy not detailed statements of rules. The core provisions in New Zealand at least have made a gallant attempt to provide some general statements of policy, although essentially made within the bounds of the policy inherent in the 1976 Act. Purpose provisions have been included at the commencement of Parts A and B of the rewritten Core Provisions; these offer some guidelines as to the inherent policy behind the following provisions in each part. The exercise has not been attempted for the remaining parts of the Act (as yet). In the United Kingdom, the TLRC concluded in its final report that it was possible to draft satisfactory purposive legislation but relegated this to just a "longer term aim". The work currently being done by the Inland Revenue in rewriting tax law does not include such an approach.
- Simplification of tax laws alone may not help taxpayers reduce their compliance costs. Something also needs to be done about social security laws, superannuation, company laws, etc.[53] New Zealand's Legislature has simplified other important legislation, typified by the new Companies Act 1993. However, much remains to be done for the country's social security law, although at the time of writing possible changes to superannuation have been proposed by the coalition government through a referendum to be held during September 1997.

52. For cases involving a tax shortfall of AUD 10,000 taxpayers must also have a reasonably arguable position.

53. Australia has also simplified its company law. This did more than rewrite existing policy. For example The First Corporate Law Simplification Act 1995 abolished the distinction between "exempt" and "non-exempt" proprietary companies. Financial reporting, auditing and lodgement requirements previously based on this distinction are now based on company size. Small proprietary companies generally have reduced reporting requirements and need not prepare and lodge financial reports with the Australian Securities Commission.

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SINGAPORE

1997 BUDGET: A BUDGET FOR THE FINANCE SECTOR TO FURTHER DEVELOP SINGAPORE AS A REGIONAL FINANCIAL CENTRE

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I. INTRODUCTION

The Minister for Finance, Dr Richard Hu, presented Singapore's 1997 Budget in the parliament on 11 July 1997. The budget speech was comprised of three parts: a review of the economy; the financial year 1997 Budget; and revenue and tax changes.

The Minister reported that the growth rate of Singapore's economy slowed down to 7.0 per cent in 1996 after three years of above-potential growth. The slowdown eased the pressure of high growth but had not adversely affected the economic fundamentals.

On the outlook for 1997 the Minister was cautiously optimistic. He expected the global electronics industry to pick up towards the end of 1997 and revealed that the Ministry of Trade and Industry had forecast the economic growth in 1997 to be between 5 to 7 per cent.

The Minister realized that with a limited domestic market and few resources, Singapore had no choice but to be open and to compete in the world market to survive and prosper. He said staying competitive would not be easy. To meet the challenge as a nation, Singapore had to adapt to the challenges of the new operating environment.

The Minister announced that as a crucial exercise the government had set up an Economic Committee comprising representatives from the private, academic and public sectors to study the crucial issue of Singapore's longer term competitiveness.

On expenditure policy, the Minister said the government would continue to adopt prudence in its expenditure policy. As before the expenditure policy would focus on the delivery of essential public goods and services, consolidating the national economic infrastructure and channelling more resources to assist in the development of the people.

The Minister emphasized the importance of government's heavy investment in the development of the economic infrastructure and human resources. This investment was needed to maintain and improve Singapore's economic competitiveness in the face of growing competition from both the region as well as developed countries.

On infrastructure the Minister revealed that a major commitment was government's vision to build a world class public transport system.

In his announcement on proposed tax changes, the Minister explained that as the corporate tax and personal income tax rates had been reduced in 1996, there was no need to make further adjustment to these tax rates so soon after the last revision. However, the tax incentives would be fine-tuned to promote activities yielding high value-added with high growth potential.

II. TAX CHANGES FOR COMPANIES

A. Tax incentive for ACU activities

At present, income earned from Asian Currency Units (ACUs) activities is taxed at a concessionary rate of 10 per cent. Incremental income derived from certain high value-added activities is tax at a reduced rate of 5 per cent. To qualify, the taxable income of certain of these activities must each exceed SGD 10 million.

To further encourage the ACU activities, the 5 per cent tax on incremental income will be extended to income earned from all ACU activities if the taxable income from such activities exceeds SGD 50 million.

ACUs have the option of either the existing incentive for selected high-value activities or the new incentive which covers all activities.

The new incentive will be granted for an initial period of five years.[1]

1. With effect from year of assessment 1998.

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B. Tax incentive for the fund management industry

Currently, income earned by fund managers approved under the Tax Exempt Scheme from managing non-resident funds is taxed at a concessionary rate of 10 per cent.

For years of assessment 1996 to 2000, fund managers who manage more than SGD 5 billion worth of non-resident funds can enjoy a reduction in the tax rate to 5 per cent on incremental income earned.[2]

With effect from year of assessment 1998, fund managers who have substantial operations in Singapore will be exempted from tax altogether for income earned from managing non-resident funds. To qualify, the fund manager must manage at least SGD 10 billion of non-resident funds in Singapore, employ at least seven professional fund managers and analysts and have a track record of three years operation in Singapore under the Tax Exempt Scheme for Fund Management.

The new incentive will be granted for an initial period of five years.[3]

C. Tax exemption for managing IPOs of foreign currency shares

To develop the Stock Exchange of Singapore (SES) into a regional securities centre in line with the objective of developing Singapore into a regional financial market, the SES has been actively encouraging foreign companies with the necessary track record to list their foreign currency shares on the SES.

Income earned by banks and merchant banks from managing initial public offers of foreign currency denominated shares to be listed on the SES will be exempt from tax.

The exemption will be granted for an initial period of five years.[4]

D. Tax exemption for trading in foreign currency shares

Currently ACUs and Approved Securities Companies (ASCs) enjoy a concessionary tax rate of 10 per cent on income derived from the trading of foreign currency shares.

To further encourage the trading of foreign currency denominated shares, the income earned by ACUs and ASCs from the trading of foreign currency shares which are listed on the SES will be fully exempt from tax. The exemption will be granted for a period of five years.[5]

E. Extension of tax exemption scheme for syndicated offshore credit and underwriting facilities

Presently income earned by financial institutions and approved securities companies from the underwriting of syndicated offshore debt securities is exempt from tax. One of the conditions for granting the tax exemption is that the issue must be underwritten by financial institutions in Singapore.

In view of the borrowers' ability to raise funds on their own credit standing in the financial markets, without need for underwriting by financial institutions, the Minister announced that the requirement that the debt issues must be underwritten by financial institutions would be removed with immediate effect.

As a result of the change all fees earned by financial institutions in arranging offshore debt issues will be tax exempt irrespective of whether or not the issues are underwritten by financial institutions in Singapore.

F. Tax incentive for credit rating agencies

To encourage reputable credit rating agencies to set up operations in Singapore, a concessionary tax rate of 10 per cent will be granted in respect of income derived from providing credit rating services with respect to the issue of foreign currency denominated securities in Singapore.

To qualify for this incentive, the credit rating agency must satisfy the following conditions:

- have a track record in international credit rating of at least ten years;
- employ at least two qualified credit analysts in Singapore; and
- incur annual business expenditure of at least SGD 500,000 in Singapore.

This new incentive will be granted for an initial period of five years.[6]

G. Tax deduction for general provisions made by banks and merchant banks

Since the year of assessment 1992, banks and merchant banks have been allowed to claim a deduction in respect of general provisions up to a limit of 2 per cent of their loan and investment portfolios.

In view of the keen competition in the financial market and the banks' exposure to greater risks in their activities, the limit on tax deductible general provisions will be raised from 2 per cent to 3 per cent of qualifying loans and investments. This is to encourage banks and merchant banks to increase their level of general provisions to buffer against any unexpected losses.

The increase is effective from year of assessment 1998.

2. I.e. comparing the current with the previous year.
3. With effect from year of assessment 1998.
4. With effect from year of assessment 1998.
5. With effect from year of assessment 1998.
6. With effect from year of assessment 1998.

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H. Overseas enterprise incentive – onward payment of tax-exempt dividends out of qualifying income

The Overseas Enterprise Incentive (OEI) which provides for a tax exemption for a maximum period of ten years on income derived from approved overseas investments and projects was introduced in the 1993 Budget. The OEI also allows the flow-through of tax-exempt dividends for up to two levels of shareholding subject to a 100 per cent shareholding requirement.

Changes were made to the Income Tax Act in 1995 to allow the flow-through of tax-exempt dividends beyond two tiers of shareholding for foreign sourced income exempted under the Income Tax Act, provided that a 50 per cent shareholding requirement is satisfied.

To further encourage regionalization, the following changes will be made to the OEI:

- the reduction from 100 per cent to 50 per cent of the shareholding requirement for flow-through of tax-exempt dividends to the second tier of shareholding;
- the extension of the flow-through of tax-exempt dividends beyond the second tier of shareholding provided the 50 per cent requirement is satisfied. Holding companies at every tier of a corporate structure will be allowed to onward pay exempt dividends declared out of the qualifying OEI income;
- the waiver of the 50 per cent shareholding requirement in the dividend paying company for onward payment of exempt dividends on a case-by-case basis.

The above changes will apply to dividends received on or after 11 July 1997.

I. Tax incentive for satellite operations

To encourage companies in Singapore to launch their own satellites, the investment allowance incentive will be extended to satellite operators for approved capital expenditure which satisfies certain criteria.

At present, payments to non-resident persons for the use of satellites are subject to withholding tax at a rate of 15 per cent. To further boost the broadcasting and telecommunication industry, payments for the leasing of capacity on satellites operated by non-resident persons will be exempt from tax with immediate effect for an initial period of five years.

J. Industrial building allowances for logistics operators

To promote the growth of the logistics industry, Industrial Building Allowance (IBA) will be granted in respect of buildings which are owned and used for storage of goods and materials by companies providing logistics services, and which currently do not qualify for IBA.

Logistic services would include integrated logistics services covering warehousing, distribution, information management and other high-value-added logistics operations.

The change will apply to approved buildings with effect from year of assessment 1997.

K. Singapore Commodity Exchange Limited (SICOM)

The Singapore Commodity Exchange Limited (SICOM), formerly known as the Rubber Association of Singapore (RAS) was granted a five-year tax holiday when it was established in 1992. As the Exchange is still in its development stage, the tax holiday granted to SICOM will be extended for a further five years. In addition to existing income items which qualify for the tax holiday, tax exemption will be granted to new income items which have arisen from the Exchange's development, such as:

- fees for the quality assurance of physical commodities;
- registration fees for nominated warehouses;
- fees for the processing of applications for registered representatives and associated persons;
- annual subscription fees from registered representatives and associated persons;
- local membership processing fees;
- fees for processing of leases of seats on SICOM; and
- proceeds from the sale of trading permits.

III. TAX CHANGES FOR INDIVIDUALS

A. Income tax rebate

An across-the-board one-off rebate of 10 per cent of individual income tax will be granted in year of assessment 1997.

B. Income tax relief for dependents

1. Aged parents relief

Presently, there is a tax relief of SGD 3,500 for the maintenance of each aged parent. As a recognition to those who live with their elderly parents, a two-tiered relief for aged parents is introduced.

The relief for those who live with their aged parents will be raised from SGD 3,500 to SGD 4,500. For those who maintain their aged parents but do not stay with them, the relief will remain at SGD 3,500.

The two-tiered relief will be effective from the year of assessment 1998.

2. Wife relief

The allowable wife relief will be increased to SGD 2,000 from SGD 1,500.

3. Child relief

The allowable normal child relief will be increased from SGD 1,500 to SGD 2,000 for each qualifying child.

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4. Income ceiling condition

The income ceiling condition for eligibility of parent relief, wife relief, handicapped sibling relief and child relief will be relaxed. The respective reliefs will be allowed so long as the dependent has income of not more than SGD 2,000 a year (previously SGD 1,500).

All the above reliefs are effective from the year of assessment 1998.

C. Rebates on HDB service and conservancy and rental charges

Currently about 70 per cent of individuals do not pay income tax. In recognition of this group's contribution to the economy the government will grant rebates on HDB Service and Conservancy (S & C) charges and rentals to citizens staying in rented and owner-occupied Housing Development Board (HDB) flats.

The rebates on the S & C charges and rent will range from one to three months depending on the type of HDB flat in which they stay.

D. Rebates for revision in utilities rates

The government will grant rebates on the public utilities bills for Singaporeans living in one to four-room HDB flats. The rebate will range from SGD 50 to SGD 100 depending on the type of HDB flat in which they stay.

To further offset the water rate increase for lower income households, an additional S & C grant will be given to Singaporeans staying in one to four-room HDB flats ranging from SGD 3 to SGD 5.50 depending on the type of household.

The grant will be given for a period of two years from July 1997 to June 1999.

E. CPF Medisave Top-up Scheme

The government will pay SGD 100 into the account of every Singapore citizen aged between 21 and 59, and SGD.200 into the account of every citizen aged 60 and above.

The above payment will be made on 1 October 1997.

F. Pre-Medisave Top-Up Scheme

Having paid the first two instalments under the Pre-Medisave Top-Up Scheme in January 1996 and January 1997, the government will pay the third instalment in January 1998 as scheduled. The top-up grant will be paid into the CPF Medisave accounts of eligible Singaporeans, who are 63 years or older on 1 April 1997. For this third instalment, the co-payment required will be SGD 20. The government will match this SGD 20 with a contribution of SGD 100 to SGD 350 depending on the age group.

The Pre-Medisave Top-Up Scheme is to help older Singaporeans who retired before or soon after the introduction of Medisave to build up their Medisave accounts.

G. Voluntary contributions to CPF

Foreigners who are issued with an Employment Pass, Professional Visit Pass, or Work Permit on or after 1 August 1995 are not required to participate in the Central Provident Fund (CPF) Scheme. A grace period up to 31 December 1998 was given to foreign workers who jointly apply with their employers to the CPF Board to continue with the mandatory contributions provided the foreign employee remains with the same employer.

With effect from 1 January 1999 any CPF contributions made by a foreign employee or his employer voluntarily or any CPF contributions which are obligatory under a contract of employment will no longer be tax deductible for either the employer or the employee. Further, the employer's contributions will be taxable in the hands of the foreign employee.

However, the current tax exemption for Singaporeans posted overseas who make voluntary CPF contributions will continue to apply.

IV. OTHER TAX CHANGES

Concessionary tax rate for residential properties undergoing construction

Currently, home owners who demolish their properties for reconstruction pay property tax of 12 per cent on the annual value of the vacant land. With immediate effect home owners who demolish their houses for reconstruction for their own subsequent occupation will be eligible for the owner-occupier's rate of 4 per cent of the annual value during the period when their houses are undergoing reconstruction. All home owners who are presently rebuilding their homes will also be eligible for the concession.

V. CLOSING COMMENTS

The Minister pointed out that the world economy today is much more open. Investments and labour flow freely across borders. Competition in this new global environment is also keener. Singapore's continued success will depend on its ability to adapt and adjust to this new world economic order.

However, the Minister is confident that if Singapore continues to adopt far-sighted policies, remains alert to new challenges and opportunities, and stays nimble and fleet-footed, it will be able to succeed in the new global economy and thus continue to do well in the years ahead.

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VI. REACTION TO THE 1997 BUDGET

Some members of the parliament who participated in the parliamentary debates on the budget statement described the Budget as prudent and focused. However, many members voiced disappointment over its failure to address the pressing concerns of businessmen over the rising cost of doing business in Singapore. There were other members who commented that the Budget could have offered relief to manufacturers and small and medium enterprises (SMEs) and that the government rebates were inadequate. The public's reaction to the Budget echoed the feelings expressed above.[7]

7. In particular:
The manufacturing sector was disappointed that the Budget did not specifically address the issue of the rising costs of business operations.
The Small and Medium Enterprises felt that the government could have addressed the issues relating to their needs to face the challenges of the business environment and could have made available to them some appropriate and direct tax incentives. The SMEs also proposed the introduction of a two-tier corporate tax rate, such as 23 per cent for SMEs and 26 per cent for large corporations.
Whilst the finance sector welcomed the tax incentives for further developing Singapore as the regional financial sector, the public at large felt the Budget focused too much attention on the major players in the finance industry with very few benefits for the overall business sector.
Amongst individuals, there were mixed feelings. Some welcomed the tax changes and the rebates which would save them income tax over the next few years.

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ITALY

DYNAMICS OF CROSS-BORDER FLOWS OF MULTINATIONALS: THE ITALIAN TAX IMPLICATIONS

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This paper, originally presented by the author at the seminar organized by the Federation of Co-ordination Centres, Ghent, Belgium, on 22-23 May 1997, has been revised for the Ernst & Young International Tax Conferences to be held in New York, 11-12 November 1997, and Chicago, 13-14 November 1997.

I. INTRODUCTION[1]

This article examines from an Italian perspective the tax treatment of intra-group cross-border flows of income which include, among other things, dividend distributions and interest payments.[2]

II. "THE GROUP"[3] UNDER ITALIAN LAW

Italian legislation does not provide for a systematic regime nor for special provisions regarding a "group of companies". Furthermore, while the Civil Code outlines cases in which "control" may exist[4] it does not give a legal definition of the term "group".[5]

From a tax standpoint, consolidated balance sheets are not taken into consideration by the tax authorities, and each legal entity is regarded as a separate taxpayer.

As far as transactions between related parties are concerned, transfer pricing rules are contained in the Italian Income Tax Act, (hereinafter: ITA) Article 76, paragraph 5, according to which

> "the income components derived from transactions with companies not resident within the territory of the State and which directly or indirectly control the enterprise, or are controlled by it or are controlled by the same company which controls the enterprise, shall be valued on the basis of the normal value of goods transferred, of services performed, and goods and services received, determined in accordance with paragraph 2, [arm's length] if income is thereby increased. The same rule shall apply if income is reduced, but only in respect of agreements reached with the competent authorities of foreign countries following special mutual agreement envisaged by international treaties against double taxation."

III. INBOUND INTEREST

This section concerns the Italian tax aspects affecting the inflow of interest on loans extended by an Italian company to foreign entities of a multinational group. The provisions regarding withholding taxes on interest are also analysed.

Interest received by entities carrying on a trade or business activity is included in their taxable base as "business income" and taxed at the ordinary rate of 53.2 per cent (IRPEG 37 per cent plus ILOR 16.2 per cent).[6]

In a multinational group, determination of the taxable amount of the interest received by an Italian company from a foreign related company is affected by the transfer-pricing rules contained in Article 76 of the ITA. According to this provision the taxable amount of the interest paid to an Italian company by a foreign related company may be adjusted by the tax authorities, if the amount declared is not in line with the "arm's length principle", that is with the interest rate applied on loans entered into by independent parties. The position of the Ministry of Finance on this subject has been clarified by Ministerial Instruction 32/9/2267 of 22 September, 1980,[7] which states that the "relevant market" to be taken into con-

1. See Valente, "Profili fiscali delle 'International Holding Companies'", *Dir. Prat. Trib.*, 1/1997, III, at 20.
2. See Valente, "Gli interessi nella pianificazione fiscale internazionale", *Commercio Internazionale*, 14/1997, at 673.
3. See Ferrara jr.-Corsi, *Gli imprenditori e le società*, Milano, 1987, at 690; Schiano di Pepe, *Il gruppo di imprese*, Milano, 1990; Vella, *Le società holding*, Milano, 1993; Cassandro, "I gruppi aziendali", Bari, 1988; Valente-Valente-Vernassa, "Il gruppo di imprese", in "Le holding nella pianificazione fiscale internazionale", in *Commercio Internazionale*, 4/1996 annex.
4. Art. 2359 of the Civil Code provides that the following shall be considered controlled companies: (a) companies in which another company has the majority of votes to pass resolutions in regular meetings; (b) companies in which another company has votes sufficient to exercise a dominant influence in regular meetings; (c) companies which are under the dominant influence of another company by virtue of particular contractual relationships. Generally, the "control" is presumed when the controlling company holds at least 51 per cent of the participating interest of the controlled company.
5. See Cottino, "Diritto commerciale", I, *Padova*, 1994, at 772; Galgano, "Diritto civile e commerciale", III, *Padova*, 1990, at 155; Di Sabato, "Manuale delle società", *Torino*, 1988, at 337.
6. According to Law 662/1996 ILOR (rate: 16.2 per cent) will be replaced by a new tax, IRAP, which will be levied at a maximum rate of 4.5 per cent; in addition the regions have the possibility of adding 1 per cent on the basic rate. With reference to companies other than banking and other finance institutions, interest is not included in the taxable base for IRAP purposes (i.e. the interest is neither taxable nor deductible).
7. See Maisto, "Il 'transfer price' nel diritto tributario italiano e comparato", *Padova*, 1985.

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sideration to determine the "arm's length principle" is the market of the lender. Furthermore, the determination of the fair market value is based on a number of factors, such as:

(a) the amount of the loan;
(b) the duration of the loan;
(c) the legal title of the loan;
(d) the financial position of the borrower;
(e) the currency;
(f) the exchange risks;
(g) the warranties related to the loan.

IV. OUTBOUND INTEREST

This section outlines the main Italian tax aspects affecting loans extended to an Italian parent company by companies of the same multinational group located abroad. In particular it focuses on the withholding tax aspects imposed on interest paid by the Italian company and on the tax deductibility of that interest.

A. Withholding tax

Interest paid by an Italian company to a foreign entity without a permanent establishment in Italy is subject to a 15 per cent final withholding tax at source to be levied by the Italian company at the time of payment.[8] The withholding tax rate may be reduced in application of the tax treaty provisions. For the purpose of the application of the withholding tax, the duration of the loan is not relevant; consequently, the withholding tax is levied both on short and long term loans.

In cases where the foreign company has a permanent establishment in Italy and the interest is effectively connected with a loan granted by the permanent establishment, according to the provisions of the tax treaty between Italy and the state of residence of the head office, the interest on the loan is taxed as business income at the permanent establishment level and no withholding is levied at source on such income.

In the recent past the withholding tax was generally avoided through the use of tax planning techniques, such as the "back-to-back" loan. In this kind of transaction the loan to the Italian company may be channelled through a third entity ("conduit") located in either a country in which the tax treaty with Italy does not impose a withholding tax on interest payments (e.g. Bulgaria, Hungary, Mauritius, Kuwait and Czech and Slovak Republics), or in the same country of residence as the lender. The latter is, for instance, the case[9] where the loan is channelled through the foreign branch of an Italian bank.[10] Recent changes in the law have discouraged this extensively utilized technique.[11] Up until the enactment of these provisions such a structure permitted avoidance of the withholding tax on the interest payments made by the Italian company for the following reasons:

- generally speaking, no withholding tax is due on interest payments when the interest is to be considered as "business income" and not "income derived from the investment of capital". This occurs when interest is paid by an Italian company to another Italian company or to an Italian bank;
- a foreign branch of an Italian entity is not a separate legal entity;
- for the purpose of the application of withholding tax, payment of interest is treated as if the payment had been made to the Italian bank. Therefore, no withholding was levied on the interest paid by the Italian company to the foreign branch of the Italian bank.

Such a modus operandi is no longer convenient for avoidance of withholding tax because, based on the new law (Law 662/1996), a 15 per cent withholding tax is also imposed where the Italian borrower pays interest on a loan obtained from the (foreign) permanent establishment of an Italian lender. In this case, the withholding tax so deducted is creditable against the lender's Italian corporate tax liability if the interest is actually paid to the foreign branch. On the other hand, if the interest is actually paid through the branch to a foreign resident, the withholding tax is a final liability and is therefore not creditable.

B. Rules for the tax deductibility of interest payments

No anti-thin capitalization rule is provided for by Italian tax legislation.[12] Accordingly, the tax deductibility of interest payments is not linked to a certain debt/equity ratio. However, restrictions to the tax deductibility (for IRPEG purposes) of interest are imposed by Article 63 of the ITA.[13] The

8. The rate of the interest withholding tax on corporate bonds is 12.5 per cent. Interest on bonds issued by the Italian Treasury or by a company listed on an Italian stock exchange is not subject to withholding tax if the recipient is an Italian resident company. Individual and corporate investors resident in a country with which Italy has a tax treaty that contains an exchange of information provision (almost all the treaties) are exempt from withholding tax in Italy.
9. Frequently utilized in the past.
10. The funds are deposited by a foreign company in a foreign branch of an Italian bank. The foreign branch, in turn, would grant the loan to the Italian company.
11. Art. 7, para. 5 of Decree 323 of 20 June 1996, converted into Law 425 of 8 August 1996, as modified by Art. 2, para. 158 of Law 662 of 22 December 1996.
12. In Italian tax law the only provision relating capital to debts is Art. 95(2) of the ITA (which refers to Art. 43) which lays down that the presumption of the right to interest on capital loaned does not apply to payments by shareholders to a company by way of capital on each bond, provided that the payments have been made on the basis of a formal resolution.
13. Another provision which would limit the deductibility of expenses is contained in Art. 76(7-bis) of the ITA. According to this article, taxpayers are not allowed to deduct expenses (including interest) connected with transactions between resident undertakings and companies which have their fiscal domicile in a non-EU State (or territory) with a "privileged tax regime", whenever such companies directly or indirectly control the Italian undertaking, or are controlled by the latter, or whenever such companies are controlled by the same company controlling the Italian undertaking. Based on Art. 76(7-bis)(2) of the ITA a state (or territory) is considered as having a privileged tax regime whenever the income of companies fiscally domiciled therein is not subject to tax on income or is subject to tax on income in an amount lower than 50 per cent of the total income tax levied in Italy on income of the same kind. However, in the event that the undertakings resident in Italy prove that the main activity of the foreign company is of a business nature, or that the transactions do mirror a real economic interest and were actually performed, such expenses (including interest) are deductible (Art. 76-ter(1)). The burden of proof rests with the Italian resident undertakings claiming the deductions.

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general rule provides that interest paid is deductible in an amount not exceeding the ratio between taxable income and total income (including exempt income). In practice the interest deductibility is limited to the percentage resulting from the following formula: A : B = X : 100, where A is the taxable income, B is the total income (taxable and exempt) and X is the percentage of tax deductible interest. In calculating this ratio, capital gains are included only to the extent of the portion which is taxable in the tax period (i.e. at least one fifth of the capital gain).[14]

Foreign dividends and interest are included in the calculation, even if totally or partially exempt from taxation on the basis of a tax treaty or of domestic law. This provision is advantageous for holding companies whose income mainly consists of dividends, capital gains and proceeds from the sale of participations. Based on these provisions, Italian holding companies are allowed to deduct almost 100 per cent of the interest payable on the loans incurred for the acquisition of their shareholdings.[15]

The 1997 Budget gave the government the authority to introduce a new tax (IRAP), applicable on a regional basis, which will replace ILOR (Local Income Tax), the local tax currently levied at the rate of 16.2 per cent. For IRAP purposes (tax rate: not exceeding 4.5 per cent, plus a discretionary 1 per cent levied by each region) the interest paid by companies other than banks is not deductible from the taxable base. This provision is applicable also to interest relating to loans incurred for the acquisition of participations (as mentioned in a preceding note).

V. INBOUND DIVIDENDS

This section deals with the tax treatment of dividend distributions made by foreign subsidiaries to their Italian parent company.[16] The main issues are Italian taxation of dividends at the Italian parent company's level, the recoverability of withholding tax on dividend payments possibly levied at source by the state where the paying company is resident and the availability of a tax credit for taxes levied abroad on the same dividends.

According to the general rule, dividends are subject to IRPEG and not ILOR. Within the EU, the tax treatment of dividends is regulated by Directive 435/90 (the "Parent-Subsidiary" Directive), which has been implemented in Italian legislation by Legislative Decree 136 of March 1993. As far as the tax treatment of inbound dividends is concerned, the law[17] provides that only 5 per cent of an EU dividend received by an Italian company is subject to IRPEG (Corporate Income Tax) at the rate of 37 per cent, while the remaining 95 per cent is exempt from taxation. This results in a total tax burden of 1.85 per cent. Such a favourable tax treatment, however, is subject to the following conditions:

- the parent company must have held a participation of at least 25 per cent of the capital of the foreign subsidiary for a period of at least one year at the date of the board resolution;[18]
- the foreign subsidiary must have one of the legal forms listed in the annex to the Directive 435/90;
- the foreign subsidiary must be a resident of an EU Member State; and
- the foreign subsidiary must be subject to taxation in the state where it is resident (according to the list provided in annex A), without any exemption other than temporary or territorial.

Should the above mentioned conditions not be met, the foreign dividends would be subject to one of the following tax treatments, depending on the percentage of participation of the Italian parent:

- where the foreign subsidiary is an "affiliated" company (i.e. the Italian parent company holds at least 20 per cent of the foreign subsidiary's share capital):[19] 40 per cent of the foreign dividends are subject to IRPEG at the rate of 37 per cent, while the remaining 60 per cent is tax exempt. The tax burden in this case is 14.8 per cent;
- where the Italian parent company holds less than 20 per cent[20] of the subsidiary's share capital and in all other cases in which the foreign company is not a "controlled or affiliated" company within the meaning of Article 2359 of the Civil Code: no tax exemption is available and therefore, the dividends are fully taxed at the rate of 37 per cent.

Furthermore dividends distributed to an Italian parent company by a subsidiary resident in a "tax haven"[21] are fully taxed.

Whenever the more favourable EU tax treatment is not applicable, it would be worthwhile to consider the advisability of reorganizing the structure of the foreign investment by inter-

14. The proceeds derived from the transfer of participations are included only to the extent that they exceed the costs sustained in connection with the acquisition of the participations.
15. The rules mentioned above concern interest exceeding the amount of interest exempt from taxation derived from public and private securities acquired since 28 November 1984. Interest paid up to an amount corresponding to the amount of the exempt interest received is not tax deductible.
16. As regards outbound dividends, according to Art. 27(3)(1) of Decree 600 of 29 September, 1973, dividends distributed by a resident company to a foreign shareholder are subject to a final withholding tax of 32.4 per cent, subject to treaty provisions. The foreign shareholder may claim a refund of the tax paid in its country of residence on the dividend of up to two-thirds of the tax withheld in Italy (Art. 27(3)(2)), provided that the payment of tax on dividends be certified by the competent tax authorities of the foreign country.
17. Art. 96 bis of the ITA, introduced by Legislative Decree 136/1993.
18. According to a recent Resolution of the EC Court of Justice dated 17 October 1996, (cases C-283/94, C-291/94 and C-292/94,) the one-year period need not necessarily have elapsed at the date of the board meeting which resolves the distribution. No change has been made in the Italian law to comply with the *Denkavit* decision, neither has a Ministerial Resolution been issued. Thus it seems that the year holding period still has to be satisfied (unless the taxpayer is prepared to litigate). In the *Denkavit* case the ECJ denied the taxpayer the right to obtain compensation for the loss incurred in connection with the postponement of the profit distribution on the basis of the fact that the interpretation given by Germany (and other Member States) was not manifestly contrary to the Directive. However, considering that the ECJ has ruled on the issue Member States which breach the Directive on this point may well be held liable to pay compensation.
19. Generally, the same treatment also applies to "controlled" companies.
20. Ten per cent if listed on the Stock Exchange.
21. A list of countries deemed to have a "privileged tax regime" is provided by Decree of 24 April 1992.

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posing between the Italian parent and the foreign subsidiary a holding company located in an EU Country which allows, upon certain conditions, a total or quasi-exemption from taxation for foreign dividends. For instance, a Dutch holding company could be used as a vehicle to reduce the tax burden on foreign dividends, since dividends distributed to a Dutch holding by its foreign subsidiaries could be exempted from Dutch tax by virtue of the "participation exemption".[22] Afterwards the dividends, once repatriated to the Italian top-holding, could take advantage of the EC Directive 435/90.

The question of the availability of the provisions of the Directive in all those cases in which the dividends are not taxed at the distributing company's level (as in the case of dividends which are distributed from tax-exempt income under the "participation exemption" at the Dutch holding company's level) was discussed in the recent past, because it was uncertain whether in those cases the "subject to tax" requirement was to be considered as fulfilled or whether, on the contrary, the Italian tax authorities could, in light of a decision of the Italian Supreme Court,[23] deny the applicability of the Parent-Subsidiary regime. According to this decision the expression "subject to tax" (*assoggettato ad imposta*) requires a concrete and effective subjection to tax, while the potential liability to tax, rendered in English by the term "liable to tax", would be translated as "*assoggettabile ad imposta*".[24]

With respect to the interpretation of the "subject to tax" condition required by EC Directive 435/90, EU experts[25] have taken the view that the entities which are in principle "liable to tax" in their state of residence, but in fact are not "subject to tax" because they derive income which is exempt from tax under the participation exemption, can benefit from the EC Parent-Subsidiary Directive, since they are in principle subject to tax and the exemption only concerns specific income.

The Italian law which has implemented the Directive has extended the applicability of the Directive to companies which benefit from a domestic exemption regime, so long as such regime is temporary or territorially limited. Article 2(c) of the Directive 435/90, provides that in order to qualify for the EC tax regime, a company must be subject to one of the corporation taxes mentioned in the Directive, or to any other tax which may replace any of them, without the possibility of an option or of exemptions. According to Article 96-bis of the ITA, which has implemented the Directive into Italian law, the Directive is applicable to companies which are subject to the corporate income taxes listed in the Directive, without the possibility of benefiting from a regime of option or exemption (unless such regime of option or exemption is temporally or territorially limited). Therefore, the position taken by the EU experts seems to apply to the Italian case as well, particularly since Article 96-bis, has extended the applicability of the EC Directive.[26]

Dividends are in principle subject to taxation in the state of the beneficiary. However, the state of source can reserve the right to tax dividends, by imposing a withholding tax. The rates of the withholding tax may be reduced by the provisions of a tax treaty.

In Italy the withholding tax incurred abroad is recoverable under the provisions of Article 15 of the ITA, which states that final taxes incurred abroad can be recovered in Italy, up to the amount of the Italian tax rate corresponding to the ratio: foreign income/total income (domestic plus foreign). Normally, dividends distributed by a company resident in a Member State are exempt from withholding tax at source, as per the provisions of Directive 435/90. The Italian beneficiary can request the non-application of the withholding tax on those dividends or, alternatively, can ask for the refund of the withholding tax once applied.

With reference to foreign dividends subject to restricted Italian taxation (i.e. where the dividend is 60 per cent exempt, see above),[27] only 40 per cent of the withholding tax suffered abroad is recoverable in Italy.[28]

With regard to the availability of a tax credit for the underlying tax borne abroad on the dividends distributed to an Italian parent, some of the most recent treaties entered into by Italy and other EU Member States grant a taxpayer resident in one of the contracting states the right to receive directly from the Ministry of Treasury of the other contracting state the tax credit to which a resident of the latter state would be entitled, had he received the dividends. With respect to the availability of the tax credit, the tax treaties signed by Italy may be classified into four categories, as follows:

(1) treaties which grant the tax credit and/or the refund of an amount equal to the equalization tax paid by the distributing company[29](i.e. with France);
(2) treaties which grant only the refund of the tax credit (i.e. with the United Kingdom);
(3) treaties which grant only the refund of the equalization tax (i.e. with Germany and the Netherlands);
(4) treaties which do not grant the right to either tax credit or refund of the equalization tax (i.e. with Austria, Belgium, Denmark, Finland, Greece, Ireland, Luxembourg, Portugal, Spain and Sweden).

22. The participation exemption (*deelnemingsvrijstelling*) is available to Dutch companies, or foreign corporations with Dutch branches, holding investments in other companies (except portfolio investments).
23. Corte di Cassazione, Decision 4301, dated 8 April 1992.
24. See Marino, "New Dutch rules on group-financing and the participation exemption" – IFA joint meeting Netherlands–Italy, Lausanne, 30-31 August 1996.
25. See Dibout, "La directive communautaire du 23 juillet 1990 relative au régime fiscal commun applicable aux sociétés mères et filiales d'états membres différents", *Droit fiscal*, 1991, at 477; Schonewille, "Some questions on the Parent-Subsidiary Directive and the Merger Directive", *Intertax*, 1992, at 13.
26. See Marino, *supra* note 24.
27. I.e. in case of dividends distributed by an affiliate company in which the parent holds a participation of at least 20 per cent of the share capital, not qualifying for the exemption under EC Directive 435/90.
28. See Ministerial Instructions to the tax return of corporations (mod. 760); Circular Letter 50/1984, para. 24 issued by Assonime (National Association of Stock Companies) and Instruction 24.656 dated 28 May 1996, issued by the Regional Inspectorate of Emilia Romagna. Contra: Decision 423 dated 19 September 1995 of the Tax Court of Florence (1st degree).
29. The objective of the equalization tax is to assure that taxes paid by the company correspond to the amount of the tax credit available to the resident shareholder. The formula is 9/16 of the dividend, which corresponds to the underlying IRPEG of 36 per cent. Under Decree 41 of 23 February 1995, the IRPEG rate is increased to 37 per cent. This means that the "formula of 9/16" does not fully eliminate the double taxation and that 1 per cent of the tax paid is lost.

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It is worth describing briefly the effects of the implementation of EC Directive 435/90 on the treaty provisions concerning the above mentioned refunds. The procedure to be followed by an Italian parent company receiving dividends from a subsidiary located in one of the above states in order to obtain those refunds is detailed in Circular Letter 151/E issued by the Ministry of Finance on 10 August 1994.

The following is a summary of the taxation of dividends under some of the treaties Italy entered into. Furthermore, the main aspects of the refund procedure according to the various treaties and to Circular 151/E are outlined hereafter.

(a) Italy–France

The provisions of EC Directive 435/90 have been implemented in France by Article 24 of Law 91/1323 dated 30 December 1991, which has amended Article 119-ter of the *Code Général des Impôts* ("C.G.I."). Based on this article the withholding tax at source provided by Article 119-bis paragraph 2 of the C.G.I is not applicable to dividends paid to EC resident companies, provided that the following conditions are met. The parent company must:

- be the effective beneficiary of the dividends;
- have its effective management headquarters in an EC Member State;
- have one of the legal forms provided by the annex to EC Directive 435/90;
- have held at least 25 per cent of the French distributing company's share capital for a continuous period of at least two years;
- be subject to tax in the state where the effective headquarters of the company is located.

Furthermore, the parent company must not be allowed to benefit from the payment by the French Treasury of an amount corresponding to the tax credit (*avoir fiscal*) with respect to the dividends. Article 10 of the Italy–France treaty states that an Italian resident beneficiary has the right to the refund of the *avoir fiscal* on the dividend received from its French subsidiary. The amount of the refund depends on the percentage of participation:

- where the percentage of shareholding is less than 10 per cent: the Italian shareholder is entitled to the refund of the whole tax credit. Such a refund is subject to withholding tax at source at the rate of 15 per cent. The refund is subject to the condition that the dividend be subject to taxation at the Italian beneficiary company's level;
- where the percentage of shareholding ranges between 10 per cent and 25 per cent and the participation has been held for a period of at least 12 months: the refund is equal to 50 per cent of the tax credit, subject to a 5 per cent withholding tax at source;
- where the percentage of shareholding exceeds 25 per cent and the participation has been held for a period of at least 12 months: according to the tax treaty, the refund amounts to 50 per cent of the tax credit, subject to a 5 per cent withholding tax.

The tax regime provided by EC Directive 435/90 is an alternative to the tax treaty regime. Therefore, if the taxpayer asks for the non-application of the withholding tax under the EC Directive and subsequently applies for the refund of the tax credit, the withholding tax is levied on both, i.e. the dividends as well as on the refund (*avoir fiscal*).

As an alternative to the refund of the tax credit, the Italian shareholder can ask for a refund of the equalization tax (*précompte*), if this tax has effectively been paid by the French company. Such a refund is subject to a 5 per cent withholding tax where the participation has been held for a period of at least 12 months and does not exceed 10 per cent.

(b) Italy–United Kingdom

With regard to dividends distributed by companies falling within category (2) above, it is worthwhile pointing out that the 5 per cent withholding tax provided for by the tax treaty between Italy and the United Kingdom is levied both on the refund of the tax credit and on the dividend distribution.

The position of the UK tax authorities concerning the coordination of the tax treaty provisions regarding dividends with the EC provisions has been clarified by the Inland Revenue in a Circular Letter dated December 1991. This document points out that the purposes of the EC provisions are satisfied by the UK domestic legislation, which does not impose any withholding tax on dividend payments.[30]

The Italy–UK tax treaty (Article 10, paragraph 3) provides for a refund to the Italian shareholder of the ACT (Advance corporation tax) paid by a UK company on the dividend payments.[31]The amount of the refund depends on the percentage of participation:

- where the Italian parent company owns less than 10 per cent of the voting power of the UK company: the tax credit is totally reimbursed. The refund is subject to a 15 per cent withholding at source. The withholding is levied on both, the refund of the ACT and the dividend;
- where the Italian parent company owns at least 10 per cent of the voting power of the UK distributing company: the refund is equal to 50 per cent of the tax credit. Both, the refund and the dividend, are subject to a 5 per cent withholding.

With reference to the tax treatment of the dividend at the Italian beneficiary's level, according to Article 96-bis of the ITA, the dividend is 95 per cent exempt from taxation. The remaining 5 per cent is subject to IRPEG at the rate of 37 per cent. Consequently, the total tax burden amounts to 1.85 per cent of the dividend (37 per cent of 5 per cent = 1.85 per cent).

Article 10, paragraph 3(d) of the Italy–UK treaty states that the treaty provisions are not applicable if the beneficiary of the dividend and the tax credit is not subject to Italian taxation. The generally accepted opinion is that the Italian beneficiary cannot, in this case, be considered "exempt from taxa-

30. This position is contentious and may be challenged. See Dietz R. "ACT, Dividends and UK Withholding Tax: We Are Not Amused", 51 *Bulletin for Fiscal Documentation* 5 (1997), at 224. See also Bouzoraa D. "The Parent-Subsidiary Directive: *Denkavit*'s Lessons", 37 *European Taxation* 1 (1997), at 18.

31. When a UK company pays dividends it must account for tax (ACT), at a rate such that the tax amounts to the sum of dividend plus tax, multiplied by the basic rate of income tax.

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tion", as, in fact, the dividend is taxed, although at a reduced rate. Therefore, in the absence of an official clarification on this subject, the clause contained in paragraph 3(d) of Article 10 of the tax treaty should be satisfied, provided that the Italian tax on the taxable part of the dividend is effectively applied.

As far as the refund of the ACT is concerned, the internal law provisions do not say whether such a refund should be taxed in full at the Italian company's level; however it is a common opinion, based on a literal interpretation of Article 96-bis, that the quasi-exemption (95 per cent) of the dividend should not apply to the refund of the ACT, which is therefore fully subject to tax.

(c) Italy–Germany

The tax treaty (Article 10, paragraph 4) entitles the Italian shareholder to a refund of the equalization tax relating to the dividend distribution, if paid by the German company. The refund is granted to Italian resident shareholders, independently from the legal form and the percentage of participation in the German distributing company. Both, the dividend and the refund of the equalization tax are subject to withholding, which amounts to 15 per cent of the gross amount of the dividend. At the Italian parent company's level the dividends are partially exempt (95 per cent) from taxation.

(d) Italy–Netherlands

The tax treaty (Article 10, paragraph 3) entitles the Dutch resident shareholder to a refund of the equalization tax paid by the Italian subsidiary. Since the equalization tax does not exist in Dutch legislation no refund is given to the Italian shareholder. At the Italian parent company's level the dividends are partially exempt (95 per cent), based on Article 96-bis of the ITA.

INTERNATIONAL TAX PLANNING CONFERENCE

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Technical Speakers & Topics:

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Rashmin Sanghvi, Rashmin Sanghvi Associates, India	**International Tax Implications of Proposed Changes in the Exchange Control Laws in India**
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Tokyo, Ministry of Finance. 1996, pp. 367.
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(B. 116.480)

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(B. 116.529)

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(B. 116.410)

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Francisco Alfredo García Prats
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(B. 116.383)

Rechtspraak internationaal belastingrecht en Europese sociale zekerheid. Editors A.H.M. Daniels, A. Pleijsier and M.J. Weerepas.
Lelystad, Koninklijke Vermande B.V. 1996, pp. 518. NLG 39.50. ISBN: 90 5458 267 7.
Jurisprudence of international tax and European social security law. The book contains a complete overview of important EC jurisprudence in the field of tax matters and social security. An overview of the literature and useful comments on each case are given. Therefore, the book is very useful for practitioners, interested persons and students.
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This book contains a comprehensive overview of all rights and obligations in the area of social security. The European Directives as well as the national regulations of the various EC-Member-States are included. The book is especially useful for cross-border employees and for persons who intend to reside in another European Member-State.
(B. 116.405)

Bekkers, V.J.J.M.; Bonnes, J.M.; Moor, A.J.C. de; Voermans, W.J.M.
Brussel en Nederland: tegenliggers, spookrijders of reisgenoten? Implementatie van de EG-regelingen in de Nederlandse rechtsorde.
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(B. 116.392)

Todtenhöfer, F.
Die Übertragbarkeit der Grundsätze über Kapitalaufbringung und Kapitalerhaltung auf Genussrechte.
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If certain requirements are met enjoyment rights are equal to equity. It is uncertain whether the raising of a minimum capital and the maintenance of a minimum capital apply to enjoyment rights. The author investigates whether these regulations can apply in those cases and comes to the conclusion that they not only can but should apply to counteract constructions, i.e. the transfer of valueless loans into enjoyment rights.
(B. 116.393)

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Schaumburg, H.; Piltz, D.J.
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(B. 116.427)

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(B. 116.441)

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Troost, J.
Die steuerliche Abgrenzung zwischen typischen und atypischen stillen Gesellschaften.
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(B. 116.455)

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Managers and directors in international tax law (Income tax – net worth tax). The author describes the tax issues arising from being employed abroad. Devised as practical advice for the addressed group, whether working for a resident or a non-resident company, and their tax counsellors. 28 examples explain which country has the right to tax in a specific case. The amendments of the 1997 Tax Amendment Act relating to nationals of the EU or the EEA are included.
(B. 116.470)

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(B. 116.440)

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DEM 73. ISBN: 3 89012 522 0.
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(B. 116.395)

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DEM 67. ISBN: 3 406 41814 7.
Book of the German Research Institute for Tax Practitioners and Tax Representatives. A complete overview of the German Value Added Tax Act. Changes in the tax law are highlighted. The attachments contain a list of goods for which the lower tax rate applies and decrees for supplies in Germany of foreign entrepreneurs and decrees concerning NATO offices and soldiers resident in Germany The book is very useful for tax practitioners and students.
(B. 116.389)

UStR-krit 1996/97. Veranlagungszeitraum 1996. Voranmeldungszeitraum 1997.
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VAT Directives critically commented upon – for tax payments in the year 1997 and for the assessment of the fiscal year 1996. Examples, explanations, advice and critical comments as to the application of the VAT directives by the tax authorities. Related statutes and an index are annexed.
(B. 116.462)

Kraeusel, J.
Das neue Umsatzsteuerrecht 1997. 5. Auflage.
Bonn, Stollfuss Verlag. 1997, pp. 674.
DEM 63.80. ISBN: 3 08 313605 6.
The new 1997 VAT Law. The author considers all changes to the VAT Law and to the VAT Directives introduced by the 1996 Tax Law.
(B. 116.472)

Weinmann, N.
Das neue Erbschaftsteuerrecht 1997.
Munich, Verlag C.H. Beck. 1997, pp. 193.
DEM 48. ISBN: 3 406 42326 4.
The book provides a comprehensive overview of the new provisions in the area of the inheritance and gift tax. It contains an explanation of an important decision by the German Supreme Court on which the legal changes are based. Furthermore, the book mentions all legal changes in the Tax Act 1997 which are of importance for the inheritance and gift tax. Finally all changes in the Valuation Tax Act and in the Inheritance and Gift Tax Act are explained, especially, the valuation of real estate, the rates and the tax free amounts. The book is of great interest for practitioners and students.
(B. 116.248)

Handzik, P.
Die neue Erbschaft- und Schenkungsteuer. Gesamtdarstellung mit allen Änderungen durch das Jahressteuergesetz 1997.
Bielefeld, Erich Schmidt Verlag. 1997, pp. 172. DEM 39.80. ISBN: 3 503 03591 5.
The book provides a comprehensive overview of the inheritance and gift tax and the Valuation Law Act. All changes are explained by means of useful cases. The complete regulations are included in the book.
(B. 116.302)

Konzernabschlüsse '95. Ausweis – Gestaltung – Berichterstattung.
Düsseldorf, IDW Verlag GmbH. 1997, pp. 306. DEM 148. ISBN: 3 8021 0734 9.
1995 Consolidated financial statement. Results of an examination and evaluation of 100 big corporations and firms in Germany showing tendencies in the commercial and fiscal balance sheets, e.g. with respect to the treatment of permanent establishments abroad, inflation adjustments etc.
(B. 116.391)

Iceland

The economy of Iceland.
Reykjavik, Central Bank of Iceland. 1997, pp. 51. ISSN: 1024 0039.
A survey on recent developments and economic prospects. Includes information on foreign trade and balance of payments, financial markets, public finance and foreign debt.
(B. 116.484)

Italy

Fernando Serrano, Antón.
La terminación convencional de procedimientos tributarios y otras tecnicas transaccionales.
Madrid, Asociación Española de Asesores Fiscales, Montalbán, 3-6 dcha. 28014-Madrid, Spain. 1996.
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ISBN: 84 89025 07 X.
Conventional termination of tax procedures and other methods of transactions. This book describes the different methods of ending a procedure between the taxpayer and the tax authorities. It also compares the Spanish regime with the Italian and German ones.
(B. 116.340)

Come è cambiato e come cambierà nel '97 il fisco italiano.
Rome, Ministry of Finance. 1997. La Guida del Contribuente, No. 15, pp. 59.
Booklet describing the changes to the Italian tax system for 1997. Information current to 30 January 1997. Includes information and rates table of the extraordinary levy for Europe and details of the forfeitary tax regime for small taxpayers.
(B. 116.354)

Permanent establishments: comparison in some European countries.
Lugano, Fidinam Trust Company Ltd. 1996, pp. 35.
The concept of permanent establishment in Italy in the context of the Italian Fiscal Code is discussed. Includes a comparative overview of the definition of a permanent establishment in Belgium, Germany, France, the United Kingdom, Luxembourg, the Netherlands and Austria.
(B. 116.480)

Liechtenstein

Hier, K.J.
Die Unternehmensstiftung in Liechtenstein.
Vaduz, Liechtenstein Verlag AG., Postfach 133, FL 9490 Vaduz, Liechtenstein. 1995, pp. 167. CHF 90. ISBN: 3 85789 101 7.
Enterprise foundation in Liechtenstein. Comprehensive information (company law, organization and administration, taxation and various other topics) on the Liechtenstein foundation set up for business purposes.
(B. 116.439)

Luxembourg

Warner, Philip J.
Luxembourg in international tax planning.
Amsterdam, IBFD Publications BV. 1997, pp. 410. NLG 245. ISBN: 90 70125 96 X.
This book provides a practical in-depth study of Luxembourg in international tax planning. It is divided into five parts, i.e.: an introduction to Luxembourg as a country and financial centre; fully-taxable resident businesses, including the calculation of profit taxes, other taxes, and the taxation of non-residents; fully-taxable "special purposes vehicles", including analysis of the banking and reinsurance sectors, holding company, SOPARFI; tax exempt vehicles, with reference to the 1929 holding company and investment funds; and the taxation of corporate reorganizations.
(B. 116.401)

L'utilisation de la nouvelle convention Suisse–Luxembourg; The Switzerland–Luxembourg tax convention: a practical guide.
Lugano, Fidinam Trust Company Ltd. 1996, pp. 33.
(B. 116.481)

Netherlands

Haan, P.M. de; Perik, R.G.M.; Scheijndel, M.P. van.
Winstdrainage en concernfinanciering.
Deventer, Fed. 1997, pp. 118.
ISBN: 0 6002 722 1.
This book contains a complete and clear description of the main changes to the Corporate Income Tax Act including an overview of the legal regulations which in the Netherlands are in force at 1 January 1997. Special attention is drawn to important rulings of the Supreme Court which led to the introduction of the legislation on the limitations of interest deduction, the treatment of currency results and the new facility for group finance companies. The book is very useful for practitioners and researchers.
(B. 116.422)

Bakker, J.R.; Bos, E.; Geld, J.A.G. van der; Nus, D.J. van; Smit, P.M.; Dool, R.P. van den.
De nieuwe regels in de vennootschapsbelasting.
Deventer, Kluwer. 1997.
Fiscaal actueel, pp. 106. ISBN: 90 200 1928 7.
This book provides a comprehensive overview of the amendments to the corporate income tax. Main items are the possibility to report taxable income in foreign currency, limitations of the deduction of interest for certain intragroup transactions and reorganization, the financial risk reserve, changes in the participation exemption and measures for an alternative calculation of non-deductible interest on loans to acquire shares to which the participation exemption applies.
(B. 116.309)

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Schuit, S.R.; Janssen, J.E.
M&A in the Netherlands.
The Hague, Kluwer Law International. 1996, pp. 280. NLG 75. ISBN: 90 411 0319 8.
Comprehensive and practical description of the legal and tax aspects of mergers, acquisitions, takeovers and joint ventures in the Netherlands.
(B. 116.451)

Laman, B.; Dijkstra, K.
Alles over stichtingen en verenigingen. Wat iedere bestuurder moet weten. 3rd Edition.
The Hague, Delwel Uitgeverij BV, Alexanderstraat 26, P.O. Box 19110, 2500 CC The Hague. 1997, pp. 154. NLG 45.
ISBN: 90 6155 800 X.
This book deals with the financial and fiscal situation of societies and foundations. The book contains a complete overview of the most important fiscal aspects. Special attention is drawn to accounting practice and the risks and liabilities of managers of those entities.
(B. 116.415)

Fiscaal memo 2.
Deventer, Kluwer. 1997, pp. 332.
ISBN: 90 200 1860 4.
Booklet containing updated information on relevant regulations in Dutch tax law as of 1 January 1997.
(B. 116.357)

Reuvers, M.R.
Het inkomen van buitenlandse belastingplichtigen. 8th Edition.
Deventer, Fed. 1997.
Fed Fiscale Brochures, pp. 94. NLG 51.
ISBN: 90 600 2735 3.
Updated and revised edition of a monograph explaining the limited tax liability of non-resident taxpayers under the Dutch income tax law (both individual and corporate) and related tax aspects.
(B. 116.476)

Bouwman, J.; Vries, M. de.
Ouders en studerende kinderen. 2nd Edition.
Deventer, Kluwer. 1996.
Kluwer Belastingwijzers, No. 19, pp. 148.
ISBN: 90 200 1848 5.
Revised and updated edition of the monograph dealing with taxation aspects arising from the financial relationship between parents and children.
(B. 116.467)

Pensioengids 1997. Vraagbaak voor pensioenen.
Deventer, Kluwer. 1997, pp. 364.
ISBN: 90 6002 725 6.
Updated practical guide for what a pension, supplementary-, and early retirement pension is, how it is built-up and for whom it is intended. Attention is also paid to life insurance and saving schemes for employees. International tax and financial aspects of pensions are also outlined.
(B. 116.358)

Aronowitz, A.A.; Laagland, D.C.G.; Paulides.
Value added tax fraud in the European Union.
Amsterdam, Kugler Publications BV., P.O. Box 11188, NL-1001 GD Amsterdam. 1996, pp. 150. ISBN: 90 6299 136 X.
This research aims to fill the gaps in knowledge concerning organized crime by highlighting one specific phenomenon, that of EU cross-border VAT fraud. This publication provides insight into: the effectiveness of the present VAT control system and the vulnerability of legitimate business to organized crime. This research examines the control systems of Belgium, Germany, the Netherlands and the United Kingdom, and fraud cases in those countries as well.
(B. 116.443)

Elsen, E.H. van den.
Onroerende zaken: BTW-constructies en economische eigendom. De gevolgen van de reparatiewetgeving. (1)
Lelystad, Koninklijke Vermande B.V. 1997, pp. 126. NLG 45. ISBN: 90 5458 294 4.
Real estate VAT avoidance schemes and bare ownership. The book gives a complete overview of the changes in VAT to counteract VAT avoidance schemes and schemes to avoid transfer tax. The book explains the effects on the exploitation and rental of real estate.
(B. 116.363A)

Dielwart, V.C.E.
Kernboekje BTW plus 1997.
Deventer, Fed. 1997, pp. 227. NLG 49.
ISBN: 90 6002 732 9.
An overview of the most important rules concerning value added tax in the Netherlands, including decrees of the Ministry of Finance and the most important court decisions.
(B. 116.421)

Elsen, E.H. van den.
Onroerende zaken: BTW-constructies en economische eigendom. De gevolgen van de reparatiewetgeving. (2)
Lelystad, Koninklijke Vermande B.V. 1997, pp. 84. NLG 45. ISBN: 90 5458 294 4.
Real estate VAT avoidance schemes and bare ownership (part 2). This second part deals with implementing orders and changes to the former proposals.
(B. 116.363B)

Paulus, A.
The feasibility of ecological taxation.
Antwerp, Maklu Uitgevers, Somerstraat 13-15, 2018 Antwerpen, Belgium. 1995, pp. 315. BFR 1950. ISBN: 90 6215 502 2.
The book provides an overview of the possibilities and difficulties of using taxes directly or indirectly for ecological purposes. Ecological taxes are presented, analysed and discussed within the context of two different approaches of ecological taxation: the "double dividend" approach and the "ecological concerns" approach.
(B. 116.381)

Bos, G.; Kauer-Van Dijk, M.; Verhaegh, P.H.F.G.; Vrede-Pompe, C.J.S.
Elsevier schenken & erven almanak 1997.
Amsterdam, Bonaventura. 1997, pp. 408.
NLG 59.50. ISBN: 90 6882 301 9.
The 1997 edition of the monograph on marriage, gifts and inheritances law. Text of the Dutch Succession Law 1956 is appended.
(B. 116.547)

Hund, D.; Lucas Luijckx, B.J.J.M.
Internationaal fiscaal memo.
Deventer, Kluwer. 1997, pp. 290. NLG 47.
ISBN: 90 200 1901 5.
Annual pocket edition containing relevant data on double taxation treaties concluded by the Netherlands. Summaries of the 35% ruling, tax treaties, social security contributions and other domestic tax laws are appended.
(B. 116.376)

Kromhout, A.J.; Mierlo, T.C.M. van; Tuk, P.J.B.
Praktijkboek belastingrecht voor accountants, administrateurs, controllers, bedrijfseconomen.
Lelystad, Koninklijke Vermande B.V. 1997, pp. 848. NLG 85. ISBN: 90 5458 306 1.
Practitioners book for accountants, administrators, controllers and business economists. The book contains a complete and clear overview of the most important aspects of Dutch tax law. Furthermore, the actual changes, such as the new regime for substantial shareholders and the counteracting of base erosion and the measures to strengthen the fiscal position of the Netherlands are explained.
(B. 116.362)

Klaassen, J.; Zevenboom, G.H.
De nieuwe jaarverslaggeving. 7th Edition.
Deventer, Fed. 1997, pp. 217. NLG 55.
ISBN: 90 6002 669 1.
Comprehensive analysis of the main accounting requirements. The book contains an overview of a balance sheet, a profit and loss account, consolidated group accounts, the publication requirements and accountant control. Moreover, each chapter contains practical cases.
(B. 116.423)

Caminada, Koen.
De progressie van het belastingstelsel.
Amsterdam, Thesis Publishers Amsterdam, Prinseneiland 305, 1013 LP Amsterdam. 1996, pp. 21. NLG 42.50. ISBN: 90 5170 387 2.
Progression of the tax system. The book contains a good quantification of the developments in tax progression, by taking into account developments in tax rates and deduction possibilities and the effects on tax revenues. It is especially useful for students.
(B. 116.375)

Sociale dialoog en sociale rechten. Uw sociale zekerheid wanneer u zich verplaatst in de Europese Unie.
Brussels, European Community. 1997, pp. 230. ISBN: 2 827 5610 6.
This book contains a comprehensive overview of all rights and obligations in the area of social security. The European Directives as well as the national regulations of the various EC-Member-States are included. The book is

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especially useful for cross-border employees and for persons who intend to reside in another European Member State.
(B. 116.405)

Bekkers, V.J.J.M.; Bonnes, J.M.; Moor, A.J.C. de; Voermans, W.J.M.
Brussel en Nederland: tegenliggers, spookrijders of reisgenoten? Implementatie van de EG-regelingen in de Nederlandse rechtsorde.
Zwolle, W.E.J. Tjeenk Willink BV. 1993, pp. 225. ISBN: 90 271 3740 4.
A comprehensive overview of problems arising in the area of the implementation process of EC-regulations, especially the backlog. The book focuses on the national and community factors which impede the implementation of EC-regulations. The juridical criteria and the mechanisms used in the implementation process are analysed. Finally, some solutions are mentioned to resolve the existing problems. The book contains a lot of useful information for juridical and public administration education and for practitioners of Community law.
(B. 113.214)

Behnisch, U.R.
Die Umstrukturierung von Kapitalgesellschaften: national und grenzüberschreitend. Eine rechtsvergleichende Studie.
Basel, Verlag für Recht und Gesellschaft AG. 1996.
Die Eidgenössischen Steuern, Zölle und Abgaben, Band 8/1996, pp. 484. CHF 152.50.
This book deals with all civil, competition and fiscal law aspects of a restructuring of a limited company in Switzerland, the United Kingdom and the Netherlands. The book especially focuses on the realization of hidden reserves and a description capital gains and profits. The existing system is explained by constitutional and financial arguments. Finally the book investigates whether the existing laws applying to a restructuring result in distortions and discrimination.
(B. 116.228)

Poland

Mastalski, R.
Wprowadzenie do prawa podatkowego.
Warsaw, Wydawnictwo C.H.Beck. 1995, pp. 122. ISBN: 83 7110 061 2.
Introduction to the Polish tax law and legal system.
(B. 116.420)

Das polnische Recht der Rechnungslegung und Prüfung.
Düsseldorf, IDW Verlag GmbH. 1997, pp. 307. DEM 65. ISBN: 3 8021 0732 2.
This book provides a comprehensive overview of all laws and decrees in Poland concerning accounting and controlling practice. The book is especially of interest for practitioners.
(B. 116.367)

Spain

Fernando Serrano, Antón.
La terminación convencional de procedimientos tributarios y otras tecnicas transaccionales.
Madrid, Asociación Española de Asesores Fiscales, Montalbán, 3-6 dcha. 28014-Madrid, Spain. 1996.
Monografias No. 9, November 1996, pp. 130. ISBN: 84 89025 07 X.
Conventional termination of tax procedures and other methods of transactions. This book describes the different methods of ending a procedure between the taxpayer and the tax authorities. It also compares the Spanish regime with the Italian and German ones.
(B. 116.340)

Cipriano Muñoz Baños
Infracciones tributarias y delitos contra la hacienda publica.
Madrid, Editoriales de Derecho Reunidas. 1996, pp. 478. ISBN: 84 7130 866 5.
Tax infringements and offences against the Treasury. The book deals with aspects related to tax infringements and offences against the Treasury in Spain. In particular, it covers the different types of infringement (minor and major), tax sanctions (and enforcement mechanism) and their imposing procedure and penalty surcharges on late payment of tax.
(B. 115.886)

Francisco Alfredo García Prats
El establecimiento permanente. Análisis jurídico-tributario internacional de la imposición societaria.
Madrid, Editorial Tecnos S.A. 1996, pp. 504. ISBN: 84 309 2820 0.
Permanent establishments. Overview of the tax treatment and other issues concerning permanent establishments. The book describes the origin, legal background, concept, types and taxation of PE. It also covers specific matters like the agent's clause, the meaning of business activity, the non-discrimination principle, function of the PE and European Union issues related to PE.
(B. 115.921)

Rosembuj, Tulio.
El fraude de ley y el abuso de las formas en el derecho tributario.
Madrid, Marcial Pons, Ediciones Juridicas S.A. 1994, pp. 331. ISBN: 84 7248 182 4.
Tax fraud and the abuse of forms in tax law. This book analyses the legal qualification of tax fraud and other forms of abuse of the tax law. In particular, the author examines the general anti-abuse provisions contained in the General Tax Law and specific cases related to tax avoidance. Contains extensive bibliographical references.
(B. 115.465)

Switzerland

L'utilisation de la nouvelle convention Suisse–Luxembourg; The Switzerland–Luxembourg tax convention: a practical guide.
Lugano, Fidinam Trust Company Ltd. 1996, pp. 33.
(B. 116.481)

Behnisch, U.R.
Die Umstrukturierung von Kapitalgesellschaften: national und grenzüberschreitend. Eine rechtsvergleichende Studie.
Basel, Verlag für Recht und Gesellschaft AG. 1996.
Die Eidgenössischen Steuern, Zölle und Abgaben, Band 8/1996, pp. 484. CHF 152.50.
This book deals with all civil, competition and fiscal law aspects of a restructuring of a limited company in Switzerland, the United Kingdom and the Netherlands. The book especially focuses on the realization of hidden reserves and a description of capital gains and profits. The existing system is explained by constitutional and financial arguments. Finally the book investigates whether the existing laws for a restructuring result in distortions and discrimination.
(B. 116.228)

United Kingdom

Interim report by the Tax Law Review Committee on the tax appeals system.
London, IFS The Institute for Fiscal Studies. 1996, pp. 122. ISBN: 1 873357 62 1.
Recommendations on certain aspects regarding the UK tax appeals system.
(B. 116.293)

Chennells, L.
Labour's windfall levy.
London, IFS The Institute for Fiscal Studies. 1997.
IFS Commentary, No. 59, pp. 19.
ISBN: 1 873357 65 6.
The Labour Party has made a pledge that, should they be elected in 1997, they would impose a one-off windfall levy on the excess profits of the privatized utilities. This commentary discusses the background to the policy, presents the economic arguments for and against the levy, and examines some of the issues about how the levy (or tax) might actually operate in practice.
(B. 116.339)

Simon's direct tax service. Finance Act 1997 handbook.
London, Butterworths. 1997, pp. 180. GBP 20.
ISBN: 0 406 89509 0.
The provisions relating to income tax, corporation tax, capital gains tax and inheritance tax with explanatory notes.
(B. 116.364)

Ferrier, Ian; Sherring, Tony.
Tolley's UK taxation of trusts. 6th Edition.
Croydon, Tolley Publishing Company Ltd. 1996, pp. 239. ISBN: 1 86012 296 5.
The book has been fully revised and updated to include the changes brought about by the Finance Act 1996, and in particular its effect on agricultural and business property reliefs and offshore trust planning. New material

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includes: a further-expanded chapter on self-assessment, references to the Inland Revenue's Trust Manual, the forms 31 and 32 (1996) and commentary on significant new cases.
(B. 116.196)

Maas, Robert.
Tolley's anti-avoidance provisions. 2nd Edition.
Croydon, Tolley Publishing Company Ltd. 1991, pp. 579. ISBN: 0 85459 519 8.
This book contains a full exposition and analysis of UK anti-avoidance law and practice. The book is topic based but follows closely the related legislative framework. Most major taxes are covered.
(B. 116.200)

Grundy, M.; Field, J.; Briggs, J.
Asset protection trusts. 2nd Edition.
London, Key Haven Publications PLC., 7 Crescent Stables, 139 Upper Richmond Road, London SW15 2TN, United Kingdom. 1993, pp. 95. GBP 90. ISBN: 1 870070 94 1.
This book details the law relating to asset protection trusts from the standpoint of settlor, creditors and beneficiaries. The book contains a discussion of the legal status of pre-bankruptcy settlements in England and the United States as well as an overview of recent asset protection trust legislation in a number of offshore jurisdictions. Extracts from relevant laws are appended. There is a brief discussion of tax issues and drafting. The law is stated as at 31 March 1993.
(B. 116.211)

Venables, Robert; Kessler, James.
Tax planning & fundraising for charities. 2nd Edition.
London, Key Haven Publications PLC., 7 Crescent Stables, 139 Upper Richmond Road, London SW15 2TN, United Kingdom. 1993. GBP 140. ISBN: 1 870070 84 4.
This book contains a detailed explanation of the law together with a discussion of the practical problems faced by charities and donors to charity. While the main emphasis is on taxation of charitable income, attention is also given to other taxes. Each form of fundraising is separately covered including covenanted payments, gift aid and gifts. There is a separate part dealing with issues such as tax efficient organizational structuring, corporate acquisitions, tax avoidance, double taxation treaties and trusts. The law is stated as at 1 January 1994.
(B. 116.209)

The Ernst & Young's tax saver's companion 1996.
Chichester, John Wiley & Sons, Inc. 1996, pp. 298. GBP 9.99. ISBN: 0 471 96105 1.
A pocket size book containing concise descriptions of fundamental tax issues as well as practical guidance and planning ideas. The focus is on individual taxation but also extends to business taxation.
(B. 115.873)

Maas, R.
Taxation of employments. 4th Edition.
Croydon, Tolley Publishing Company Ltd. 1995, pp. 396. ISBN: 1 86012 044 X.
A comprehensive guide to the tax and case law relating to Schedule E including the provisions of the Finance Act 1995.
(B. 116.198)

The taxation of ministers of religion.
London, The Churches Main Committee, Fielden House, Little College Street, London SW1 3JZ. 1996, pp. 12.
Circular No. 2 of 1996 dealing with the main aspects of income tax and capital gains tax which are peculiar to ministers of religion by virtue of their office.
(B. 116.503)

Venables, R.; Hardy, A.
Inheritance tax planning. 3rd Edition.
London, Key Haven Publications PLC., 7 Crescent Stables, 139 Upper Richmond Road, London SW15 2TN, United Kingdom. 1997, pp. 718. ISBN: 1 870070 99 2.
This book is a compilation of five separate works on estate and gift tax planning by this acknowledged specialist practitioner. The books focuses on tax on inheritance, tax on gifts, trusts and agricultural property. The book provides detailed planning techniques, legislative background as well as non-resident issues. The law is stated as at 1 January 1997.
(B. 116.231)

Kessler, J.; Vaines, P.
Tax planning for the foreign domiciliary. 2nd Edition.
London, Key Haven Publications PLC., 7 Crescent Stables, 139 Upper Richmond Road, London SW15 2TN, United Kingdom. 1996, pp. 155. GBP 140.
ISBN: 1 870070 98 4.
This book deals with the practical problems which arise when a foreign domiciliary comes to live in the United Kingdom and, in particular, the steps which can be taken to reduce or eliminate UK taxes (including inheritance tax). The law is stated as at 1 April 1996.
(B. 116.205)

Venables, Robert.
Non-resident trusts. 6th Edition.
London, Key Haven Publications PLC., 7 Crescent Stables, 139 Upper Richmond Road, London SW15 2TN, United Kingdom. 1995, pp. 431. GBP 175.
ISBN: 1 870070 87 9.
The first part of this book sets out in a practical manner the answers to key questions relating to the creation, life and termination of a non-resident trust. The second part analyses the relevant legislation and case law, with a focus on capital gains tax issues. The law is stated as at 1 August 1995.
(B. 116.207)

Thornhill, A.; Randall, P.
Employee trusts and approved employee share schemes. 2nd Edition.
London, Key Haven Publications PLC., 7 Crescent Stables, 139 Upper Richmond Road, London SW15 2TN, United Kingdom. 1994, pp. 150. GBP 90.
ISBN: 1 8700070 86 0.
This book describes the background to employee share schemes, contains a detailed examination of the conditions for approval of share option schemes, discusses alternative types of scheme including employee trusts, profit sharing and savings related option schemes. Describes the law and practice as at January 1993.
(B. 116.208)

Blundell, R.; Dearden, L.; Goodman, A.; Reed, H.
Higher education, employment and earnings in Britain.
London, IFS The Institute for Fiscal Studies. 1997, pp. 77. ISBN: 1 873357 67 2.
This study examines the impact of higher education on individuals' employment prospects and wages in the medium to longer term.
(B. 116.429)

Jones, A.; Posnett, J.
Individual giving and the impact of tax.
London, Charities Aid Foundation. 1997, pp. 4.
Brochure investigating the determinants of charitable giving in the United Kingdom and analysing the impact of tax deductibility on giving by covenants.
(B. 116.505)

Nock, R.S.
Stamp duties for property transactions. 2nd Edition.
London, Key Haven Publications PLC., 7 Crescent Stables, 139 Upper Richmond Road, London SW15 2TN, United Kingdom. 1996, pp. 700. GBP 120.
ISBN: 1 870070 89 5.
This book contains a detailed description of stamp duties relating to property transactions. In addition to the traditional forms of transaction such as conveyances and leases, other issues are covered such as financing and securitization, unit trusts. There is also a chapter on industrial and intellectual property. The interaction between stamp duties and V.A.T is also discussed. Particular focus is given to the interpretation problems arising from the Finance Act 1994. The law is stated as at 31 October 1996.
(B. 116.206)

Blow, L.; Hall, J.; Smith, S.
Financing regional government in Britain.
London, IFS The Institute for Fiscal Studies. 1996, pp. 66. GBP 7.50. ISBN: 1 873357 59 1.
Official data on territorial and regional spending.
(B. 116.336)

Matthews, Paul.
Trusts: migration and change of proper law.
London, Key Haven Publications PLC., 7 Crescent Stables, 139 Upper Richmond

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Road, London SW15 2TN, United Kingdom. 1997, pp. 107. GBP 95. ISBN: 1 870070 97 6.
Practice oriented book covering the essential questions surrounding changing the residence of UK trusts or changing the proper law governing trusts, including specific drafting points. The UK legislation on trust recognition as well as the non-implemented provisions of the Hague Convention are appended.
(B. 116.325)

Parliamentary procedures for the enactment of rewritten tax law. Report of a working party of the Tax Law Review Committee.
London, IFS The Institute for Fiscal Studies. 1996, pp. 30. GBP 12.50.
(B. 116.334)

Johnson, P.; Disney, R.; Stears, G.
Pensions: 2000 and beyond. Volume 2: analysis of trends and options.
London, Retirement Income Inquiry, 31 Great Peter Street, London SW1P 3LR; London, IFS Institute for Fiscal Studies. 1996, pp. 159. GBP 10.50. ISBN: 0 9527479 1 X.
The book outlines current pension provision in the UK and looks at trends in pensioner incomes, SERPS, the effects of some options on a range of individuals, and examines policy options for first-tier provision and some aspects of private sector provision.
(B. 116.343)

Behnisch, U.R.
Die Umstrukturierung von Kapitalgesellschaften: national und grenzüberschreitend. Eine rechtsvergleichende Studie.
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(B. 116.418)

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releases 14 and 15
Boston, Warren Gorham Lamont.

Conference diary

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NOVEMBER

Taxation, Legislation and Accounting in the Czech Republic, the Slovak Republic, Slovenia, Croatia, Bulgaria and Romania, Hotel Don Giovanni, Prague, the Czech Republic, 5-7 November 1997 (English):

Central & Eastern European Department, IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-453 2707, Fax: 44-171-631 3214, E-mail: georgina.grant@ibcuk.co.uk

Minimising Tax on International Business Profits, The Swallow International Hotel, London SW5, 17 November 1997 (English):

Centaur Conferences, 50 Poland Street, London W1V 4AX, Tel.: 44-171-434 3711, Fax: 44-171-287 8706.

Transfer Pricing Audits, Amsterdam, the Netherlands, 20-21 November 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

Onshore & Offshore Tax Planning for Advisers to the Wealthy, Four Seasons Hotel, London, 27 November 1997 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-673 4383, E-mail: juliet.neckar @ibcuk.co.uk

DECEMBER

International Tax Planning Conference, Taj Mahal Hotel, Mumbai, India, 5-6 December 1997 (English):

Bombay Management Association, 9 Podar House, A Road, Churchgate, Mumbai – 400 020, Tel.: 91-22-204 7650 / 204 9698, Fax: 91-22-202 4743, E-mail: roy@itpa.org

The Optimal Use of Tax Treaties in International Tax Recovery, The Café Royal, London, 8 December 1997 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-673 4383, Fax: 44-171-453 2036.

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International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

School of Transfer Pricing, The Berners Hotel, Berners Street, London, the United Kingdom, 11-12 December 1997 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

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TREATY MONITOR

Editorial

Welcome to the December special issue of the *Bulletin* which is devoted to the theme of tax treaties. This issue is designed to celebrate the birth of a new section in the *Bulletin* the "Treaty Monitor" which is intended to be published at approximately three-monthly intervals. The "Treaty Monitor" will examine various important issues affecting the application of tax treaties. A review of significant events and a list of recently signed treaties will also be included. The next "Treaty Monitor" is scheduled to appear in the March *Bulletin*.

TREATY NEWS

Barry Wachtmeester
Tax Treaty Department, IBFD, Amsterdam

India

India is well known for its policy of protecting its right to tax passive source-income at relatively high rates in its tax treaties. For example with respect to royalties; many Indian tax treaties concluded before 1995, particularly with OECD member countries, contain withholding rates of 15 per cent or more. This policy reflected India's response to being a capital importing country. However, over the last few years India seems to have shifted its policy towards lower treaty withholding rates. The Germany–India treaty, signed on 18 June 1995 and already effective, and the Sweden–India treaty, signed on 24 June 1997 and not yet in force, provide for a maximum withholding rate of *only* 10 per cent for dividends, interest and royalties. This shift towards the OECD Model is also interesting for countries which have negotiated most-favoured-nation (MFN) clauses into their tax treaties with India. These clauses might lead to a reduction in withholding rates to 10 per cent on Indian source passive income. The following countries included MFN clauses in their treaties with India: France, Israel (royalties and technical service fees only), the Netherlands, Norway (royalties and technical service fees only), Spain (royalties and technical service fees only) and Switzerland. Except for the treaty with Switzerland, the lower rates will be applied automatically.

Germany

Not only tax treaties contain MFN clauses. Commercial, investment protection and friendship agreements might also incorporate such clauses concerning taxes. In German literature a debate is now going on regarding the application of an MFN clause in the friendship treaty with the United States signed on 29 October 1954. One of the issues arising there for example is, whether it is possible to apply the exemption from dividend withholding tax under the Parent-Subsidiary Directive for dividend distributions to a US parent company, instead of the 5 per cent rate under the income tax treaty. The application of these MFN clauses in non-taxation treaties is still highly questionable; however, further research in this field might become rewarding.

Netherlands–Malaysia

The protocol of 4 December 1996 between the Netherlands and Malaysia was not given automatic approval in the Netherlands. The protocol therefore has to be discussed in parliament. The discussion will most likely focus on the denial of tax treaty benefits to so-called Labuan offshore companies (LOCs) which are considered to be tax haven companies (i.e. 3 per cent corporate income tax under LOBATA). It appears that the denial of treaty benefits contains some overkill (i.e. double taxation) with respect to profits derived from permanent establishments in Labuan which are (partly) taxed at the normal rate in Malaysia and also with respect to interest and royalties derived from LOCs. The question then is whether the Netherlands unilateral decree for the avoidance of double taxation can be applied in these cases. However, even if the unilateral decree is applicable, this will not eliminate the double taxation regarding interest and royalties derived from LOCs; under this decree the Netherlands will only grant a credit if the interest or royalties is derived from a developing country. For the purposes of the unilateral decree, Malaysia is not regarded as a developing country. Another interesting point is the following: under certain circumstances, the exclusion of treaty benefits to LOCs under the new protocol seems to be ineffective with respect to the routing of dividends through Malaysia. According to a Malaysian decree of 12 December 1995 (the Income Tax (exemption)(No. 31) Order 1995), Malaysian companies are in certain circumstances granted an exemption in respect of foreign source dividends. Together with the absence of a Malaysian withholding tax on dividends this may result in a taxation treatment effectively similar to LOCs. Now, the question is whether the Malaysian decree falls under the scope of the protocol provision regarding LOCs. The protocol also denies treaty benefits to any law substantially similar to LOBATA. Is this decree substantially similar?

Netherlands–Argentina

Another issue is the term "financial lease" under the treaty between Argentina and the Netherlands. The treaty provides

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that financial lease payments are not considered royalties but business profits. The term itself is not defined in the treaty. However, the Dutch explanatory note refers to a memorandum of understanding in which the term is explained. According to this memorandum the term "financial lease" follows the definition under Argentinian domestic law. Further, Argentina is allowed to change this definition unilaterally. Peculiarly this is made public; not by publication of the memorandum of understanding itself but through the Dutch explanatory note (which is only available in the Dutch language). It is not clear what legal force can be ascribed to the memorandum.

Hong Kong

After the resumption of Chinese sovereignty over Hong Kong on 1 July 1997, China announced that it will not extend the benefits of its tax treaties to Hong Kong. All official statements published by China's treaty partners agree that Hong Kong is not to be considered as a part of China for treaty purposes. So far, statements are available from the following countries: Australia, Belgium, France, Japan, the Netherlands, Sweden, the United Kingdom and the United States. It is likely the other 30 or so treaty partners will reach the same conclusion.

RECENT TREATIES

Countries	*Date of Conclusion*
Canada–Netherlands (protocol)	25 August 1997
Lesotho–Mauritius	29 August 1997
Luxembourg–Ukraine	6 September 1997
Belgium–Indonesia	16 September 1997
Malaysia–Sri Lanka	16 September 1997
Canada–Denmark	17 September 1997
Kazakstan–United Kingdom (protocol)	18 September 1997
Croatia–Turkey	22 September 1997
Iceland–Netherlands	25 September 1997

All these treaties are not yet in force.

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CHANGES TO THE OECD MODEL TREATY AND COMMENTARY SINCE 1992

Klaus Vogel

I. INTRODUCTION

In 1991 the OECD Committee on Fiscal Affairs decided that the Model Tax Convention on Income and Capital (hereinafter "MC") and its official Commentary (hereinafter "MC Commentary") which since their original enactment in 1963 had been revised only once, in 1977, should from that time on be updated periodically in much shorter intervals.[1] Such updating was done in 1992, 1994 and 1995. A 1997 update was recently passed by the OECD Council and will be published shortly. Apart from adding to the Model a new, second loose-leaf binder which will contain an overview of the positions of certain non-OECD countries to the individual Articles and paragraphs of the MC and, in addition, a number of earlier OECD reports which were out of print, the changes to the Articles of the MC are "very minor" those to the OECD Commentary "relatively minor".[2] To prepare for the new amendment it is useful to look back and sum up what was achieved by the former three revisions.

In the second section of this article amendments to the text of the MC will be reported together with their explanation by the Commentary. The third and final section highlights some major amendments to the Commentary which were not motivated by a revision of the text of the MC.

II. AMENDMENTS TO THE TEXT OF THE MODEL TREATY

A. Interpretation by reference to domestic law

One of the most discussed provisions of the OECD MC is its Article 3(2) governing interpretation of treaty terms which are not defined by the treaty. The article sets down that, unless the context otherwise requires, both contracting states shall interpret such terms according to their domestic law. The 1995 update rephrased the provision to clarify two issues: first, whether Article 3(2) refers to the domestic law in force at the time at which the treaty was concluded ("static reference") or to the law in force at the time when the treaty is applied ("ambulatory reference"), and second, what to do when the legal usage of the state applying the treaty attaches more than a single meaning to a term. The new text answers the first question clearly, with regard to the second there is less clarity.

1. "Static" vs. "ambulatory" reference

Until the early 1980s it was generally assumed that Article 3(2) referred to the law as it currently stood at the time of the treaty's application.[3] However, in 1982, in the *Melford* case the Canadian Supreme Court confirmed a decision of the Court of Appeals according to which the law at the time at which the treaty was signed was controlling.[4] This led to an extensive discussion in which the majority criticized the Canadian rulings and supported an "ambulatory" rather than a "static" approach.[5] Moreover, in Canada a specific statute on the interpretation of tax treaties was enacted[6] to overrule the Supreme Court's decision.

The OECD Fiscal Committee was reluctant at first to commit itself to a clear-cut solution. In its 1992 update, it left the text of Article 3(2) unchanged and only mentioned the problem in a few brief addenda to the Commentary. Here it started by saying that the ambulatory approach "should prevail" (paragraph 11), but immediately qualified that statement by some rather obscure observations regarding the influence of the context on interpretation (paragraph 12).[7] Moreover by adding that two conflicting objectives were involved: on the one hand to have a durable, lasting rule, on the other hand one which is practicable confused matters further. According to the Commentary the original wording of Article 3(2) provided "a satisfactory balance" between those two interests (paragraph 13). In view of the controversy over what the clause really meant this conclusion was difficult to comprehend.

In 1995, however, the Committee resolved to take a definite step, viz. to amend the text of Article 3(2). It now reads "As regards the application of the Convention *at any time* by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has *at that time* under the law of that State ..." This is clearly in favour of an ambulatory interpretation. Paragraphs 11 to 13 of the Commentary were not changed, but in view of the new text their reservations lost some of their weight and their lack of clarity became less important. The conclusion that "the

1. OECD, Model Tax Convention on Income and Capital, loose-leaf binder, updated September 1995, Introduction, paragraph 9.
2. According to the statement of an OECD official at the 51st IFA congress 1997 at Delhi.
3. See, e.g. R. Lenz, (1960), "L'interprétation des Traités de Double Imposition", General Report, *Cahiers de Droit Fiscal International XLII*, at 294 and 297.
4. *The Queen v. Melford Developments Inc.*, 35 DTC 5020 (1981), 36 DTC 6281 (1982).
5. In particular: J.F. Avery Jones, et al., (1984), "The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD-Model", *British Tax Review*, at 14. For further references see: *K. Vogel, On Double Taxation Conventions*, 1997, Introduction, marginal no. 124 b et seq.
6. Income Tax Conventions Interpretation Act, 20 Dec. 1984, *Canadian Gazette* Part III 863 (1984).
7. See the criticism by K. Van Raad, "1992 Additions to Articles 3(2) (Interpretation) and 24 (Non-Discrimination) of the 1992 OECD Model and Commentary", *Intertax*, (1992), at 671.

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wording of paragraph 2 provides a satisfactory balance" became correct, though it was not changed, because it now refers to another wording.

2. Tax law vs. other branches of law

In addition, the domestic law – or better: the legal terminology – of the state applying the treaty to which Article 3(2) refers was determined by a new formula. The article originally read: "... the meaning which it [= the undefined term, K.V.] has under the law of that State concerning the taxes to which the Convention applies". The new wording goes: "... under the law of that State for the purposes of the taxes to which the Convention applies", and it continues: "any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State". The words "for the purposes of the taxes" appear to be slightly more precise than "concerning the taxes", but convey no different significance: it is *the tax law* of the state in question to which Article 3(2) refers, more precisely the law of taxes on *income and capital*, for those are the taxes to which according to Article 2 MC "the Convention applies".[8] Consequently, if the treaty term the meaning of which is unclear is not used by the tax law of the state in question, but by other branches of law (e.g. the law of treaties or the commercial law), or if it is used only in the context of other taxes than those on income and capital, then the rule of Article 3(2) cannot apply.[9] The newly added phrase that a meaning in tax law prevails over meanings in other branches of law does not lead to a different conclusion, for it presumes that the term in question *has* got a meaning in tax law.

So much for what is to be gleaned from the new MC text. Some difficulty is raised, however, by a simultaneous amendment to the Commentary, a new paragraph 13.1 destined to explain the new text. It reads: "For purposes of Paragraph 2, the meaning of any term not defined in the Convention may be ascertained by reference to the meaning it has *for the purpose of any relevant provision* of the domestic law of a Contracting State, *whether or not tax law*" (emphasis added). This is evidently in contradiction to the text which it purports to elucidate. We have to ask, therefore, whether in view of such contradiction the text of the MC prevails over the Commentary or vice versa. In general, it is recognized that among OECD member states provisions which are identical or similar to the MC should be interpreted according to the view expressed in the Commentary, for it can be presumed that those states in adopting the MC wording wanted to follow the Commentary. The Commentary in such cases establishes either a "special meaning" of the words of the treaty as supported by H.G. Ault[10] or even their "ordinary meaning" as I tend to think in agreement with Rainer Prokisch.[11] But all this is not conclusive when there is such a striking disaccord between the MC and its Commentary as in the present case.

Paragraph 13.1 appears to be all the more mysterious by saying that the meaning "*may be* ascertained ..." "May be" implies a certain latitude, a power of discretion,[12] whereas according to Article 3(2) MC the term "*has* the meaning ..." which is uncompromising. It seems that the best way to harmonize both statements is to assume that they refer to different situations, paragraph 13.1 applying when a treaty term is not used by the law on "the taxes to which the Convention applies" and, therefore, Article 3(2) is not applicable. But I admit that this is just an attempt to retain an acceptable meaning for the paragraph which otherwise would have to be discarded as being in flat contradiction to the clause that it should explain.

B. Leasing

Royalties under the 1963 and 1977 versions of the MC included "payments of any kind received as a consideration ... for the use of, or the right to use, industrial, commercial or scientific equipment" (Article 12(2)). Thus leasing payments were royalties and as such under the MC were taxable only in the state of residence of the lessor (Article 12(1)). The only question which bothered the 1977 Commentary in this respect was how to distinguish leasing rents from sales proceeds.[13] It is well known, however, that many countries in their tax treaty negotiations request the right to levy a withholding tax on royalties which in particular is a permanent demand of developing countries. Therefore, the UN Model provides for such withholding tax in the same way as the MC does for dividends and interest and many tax treaties follow that example.

It is equally known, however, that the trouble with withholding taxes lies in their being levied on gross receipts. If the profit margin is narrow, the withholding rate may well equal or even exceed the actual profit so that the income received may be taxed at 100 per cent or more. This can particularly happen in the leasing business where, as the lessor is normally not in a monopolistic position, profit margins typically will be lower than profits from licensing patents or the use of know-how. The UN Model took this into consideration by not including leasing in their royalty definition. In 1992 the OECD followed and deleted "equipment" from the definition of royalties in Article 12(2). In treaties that follow the UN and the new OECD version leasing proceeds, therefore, are not treated as royalties, rather they belong to the "profits of an enterprise" which are governed by Article 7. In other words, even if the country of the lessee under the treaty retains the right to levy a withholding tax on royalties, this no longer applies to leasing proceeds; these are taxable in the

8. According to Art. 24(6) this article as an exception applies to taxes "of every kind and description". But it is not "the Convention" which applies to these other taxes, and the words "to which the Convention applies" in Art. 3(2) would be meaningless if they would refer to all other taxes as well.
9. In this case general considerations regarding the interpretation of treaties apply. They may lead to the same result as Art. 3(2), but the reference to domestic law is not mandatory. See K. Vogel, loc. cit. (*supra* note 5) marginal nos. 95 et seq.
10. H.G. Ault, (1993), "The Role of the OECD Commentaries in the Interpretation of Tax Treaties", in: H.H. Alpert, and K. Van Raad, (eds.), *Essays in International Taxation. To Sidney I. Roberts.*, at 61, also in *Intertax*, (1994), at 144.
11. R. Prokisch, "Fragen der Auslegung von Doppelbesteuerungsabkommen", 4 *Steuer und Wirtschaft International*, (1994), at 52. The resolution of the OECD Council on the 1997 update obligates the tax administrations of the OECD member countries to follow the MC Commentary, in applying their countries' tax treaties.
12. Compare MC Commentary Art. 23 para. 7.
13. See 1977 MC Commentary Art. 12 para 9.

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lessee's country only if the lessor has a permanent establishment there and the equipment leased is part of the assets of that establishment.

C. The 183-day rule

When an employee resident in a contracting state receives wages etc. for work exercised in the other contracting state, under the 1963 and 1977 MCs taxation remained with the residence state as long as the employee's presence in that other state did not exceed 183 days within the fiscal year concerned. This rule which still can be found in many existing treaties leads to problems when the employee's presence exceeds 183 days but not in one fiscal year, starting, e.g. in mid-July and ending next year in early June. If the tax rate in the state where the activity is exercised is higher than in the state of residence, employers and employees might be tempted to structure a working stay in the other state so as to make it less than 183 days in each of two connecting years. On the other hand, if the tax rate in the state of the activity is lower than in the state of residence and if the state of residence under the treaty exempts income from employment in the other contracting state, the splitting up of the period of presence in the other state may well be disadvantageous to the employee.[14]

The 1992 update, therefore, following a suggestion made by an OECD report from 1984[15] undertook to solve this problem by slightly changing the text of Article 15(2)(a). According to the new version taxation remains with the residence state if the 183 days are not exceeded "in any 12-month period commencing or ending in the fiscal year concerned". For computing whether this requirement is fulfilled, a number of short stays has to be aggregated. Thus, starting from the initial arrival, the periods of presence for employment purposes in the state where the work has to be performed have to be added up in any 12-month period to see whether they amount to more than 183 days. And if they do, the state of the activity may tax the wages or salary, otherwise it may not. If at the end of the 12-month period the employee is still present and continues to exercise his activity, a new period of 12 months starts for which again it must be calculated whether the periods of presence add up to more than 183 days. If the employee is not present at that time, a new 12-month period will start when he or she next arrives to perform his/her employment activities.

Under the former wording of Article 15(2)(a) it was controversial whether in case of a continuous stay of more than 183 days in one fiscal year – maybe even a stay during the whole fiscal year or several years – but not more than 183 days during the last fiscal year, the exemption from source state tax applied for that last term. It was argued that in such case the presence was not a "temporary" one and that, therefore, the state of the employment was entitled to tax the wages received during that last period.[16] With regard to the new, updated version the same view might be held in cases when after one or several 12-month periods the final phase amounts to less than 183 days. It is indeed not quite satisfactory that in such cases the state where the activity was exercised should not be allowed to tax the activities during that last phase. However, there is nothing in the wording of Article 15(2)(a) which would suggest a restrictive interpretation and, in addition, the OECD Report "The 183 Day Rule" from 1992 made it unmistakably clear that the clause is meant to be read according to its strict wording, even if the activity abroad as a whole is not one of short duration.[17]

For the calculation of the 183-day period the MC Commentary following the report just mentioned pronounces itself in favour of what it calls the "days of physical presence method"[18] arguing that physical presence can easily be ascertained and proven, if necessary. "Under this method the following days are included in the calculation: part of a day, day of arrival, day of departure and all other days spent inside the state of activity such as Saturdays and Sundays, national holidays, holidays before, during and after the activity, short breaks (training, strikes, lock-out, delays in supplies), days of sickness (unless they prevent the individual from leaving and he would have otherwise qualified for the exemption) and death or sickness in the family.... It follows from these principles that any entire day spent outside the State of activity, whether for holidays, business trips or any other reason, should not be taken into account".[19]

D. Minor changes

The "beneficial owner" clause of Articles 10 and 11 was slightly changed in 1995 through replacing the words "if the recipient is the beneficial owner of the dividends" (resp. interest) by "if the beneficial owner of the dividends is a resident of the other Contracting State". The Commentary explains that this amendment was made to clarify that, when an intermediary is interposed between the beneficiary and the payer, the limitation of tax in the state of source is available only when the beneficial owner is a resident of the other contracting state.[20] This is in accordance with Article 1 MC under which the beneficial owner is entitled to treaty protection only if he is a resident of a contracting state. Moreover, if he is a resident of the state of the payer, to grant him the tax limitation would be against the underlying policy of Articles 10 and 11. Further, the former version might have led to the conclusion that in cases where the recipient and the beneficial owner are different persons the reduction of withholding tax

14. The MC Commentary, Art. 15 para 4, pays attention to the possibility of tax avoidance only.
15. Taxation Issues Relating to the International Hiring-out of Labour, in: OECD, (1985), Trends in International Taxation.
16. K. Locher & W. Meier & R. Siebenthal, *Doppelbesteuerungsabkommen Schweiz/Deutschland*, 1971 and 1978, loose-leaf, B. 15.2 Nr. 2; M. Popp, "Besteuerung von Arbeitnehmerentsendungen ins Ausland", *Der Betrieb*, (1976), at 2081.
17. The 183 Day Rule: Some Problems of Application and Interpretation, In: OECD, Model Tax Convention, Four Related Studies (Issues in International Taxation, No. 4), 1992, para 19.
18. MC Commentary Art. 15 para 5 (the paragraph was originally inserted into the Commentary in 1992, it was amended, but not in substance, in 1995). See, too, The 183 Day Rule (*supra* note 17) paras. 13 et seq.
19. K. Vogel & R. Prokisch, Article 15, marginal no. 22b, in K. Vogel, *supra* note 5.
20. MC Commentary Art. 10 para 12, Art. 11 para 8.

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would have had to be denied even if the beneficial owner was a resident of the "other" (seen from the payer) contracting state. The new wording thus is in fact an important clarification. Article 12 did not need a similar clarification because it already under MC 1977 had a similar wording in paragraphs 1 and 3.

In Article 17 the word "athlete" was substituted in 1992 by "sportsman" (surprisingly not gender neutral whereas the former term was). This is, of course, no substantive change, the Fiscal Committee certainly did not mean to exclude sportswomen from the provision. In contrast, in 1995 a substantive change was made to the article which, surprisingly, is not reflected in the article's text. Its rule was extended to sportsmen and -women in government service to whom it was not applicable before by inserting an inconspicuous "17" into Article 19(2) where the exceptions to the "state of the fund principle" of Article 19(1) are listed. Thus Article 17 now prevails over Article 19 which it did not do before. There was no intention to deceive anybody, it was just the simplest way to carry out the intended amendment. But as a consequence the change might easily escape attention.

The remaining changes to the MC are more of a linguistic type. Maybe the rephrasing of Article 25(4) in 1995 in so far as it concerns a competent authority consultation by way of establishing a joint committee and the simultaneous replacement of the words "involved in" by "concerned with" in Article 26(1) may have a very slight substantive effect. But the insertion of "only" into the tiebreaker rules of Article 4(2)(a), (b), and (c), carried out in the same year, is nothing more than a clarification, the transposition of the definition of "national" from Article 24(2) to Article 3(1)(f) in 1992 only improves the MC's systematics and the replacement of "any" by "all" in that definition is merely stylistic. Finally, the replacements of the terms "diplomatic agents" and "consular officers" by "members of diplomatic missions" and "members of consular posts" put into effect in 1994 adapts the MC's terminology to that of the two Vienna Conventions on Diplomatic Relations and on Consular Relations.

In addition, the MC loose-leaf edition at the end of the "History" sections of Articles 1 and 3 mentions that in 1995 a long-term project, first, to improve the drafting of the MC and its Commentary without changing their meaning and, second, to harmonize more closely the English and French versions was started and that in this context changes to the title as well as to Articles 1 and 3 and their Commentaries were made without being documented in the MC's publication. One year before in the course of the 1994 review, changes such as substituting "if" for "when" – of course not everywhere – "that" for "which" etc. had been made without having ever been mentioned. Though of minimal impact, people who have to apply those texts and the treaties which are based on them should know about these actions. And although the improvements attained certainly deserve approbation it is unfortunate that they were not published. For though they were not intended to change the content of the MC or its Commentary, nobody knows in advance whether a different meaning may be attributed to the revised version by a court when a case is contested. And in that case it may be important at what time and how the revision was made.[21]

III. AMENDMENTS TO THE COMMENTARY NOT INDUCED BY A CHANGE OF MC

A. Conduit companies and base companies

In 1987 the OECD had published two reports concerning conduit and base companies, respectively.[22] When the Commentary was revised in 1995 what seemed to be essential from these reports was integrated into the discussion of "Improper Use of the Convention" at Article 1 paragraphs 7 et seq. and of dividend taxation at Article 10 paragraphs 37 et seq. The Commentary considers several ways to withdraw treaty benefits from such companies, but in view of the numerous differences of legal provisions and factual situations in OECD member countries makes no strict recommendations. It discusses, *inter alia*, a look-through approach comparable to the US-advocated "limitation on benefits" clause, an exclusion of certain types of tax-exempt companies to be defined in the treaty from treaty benefits, general subject-to-tax provisions, and a "channel approach" intended to define conduit companies and to exclude them from treaty benefits. On the other hand, the Commentary emphasizes the necessity of phrasing the provisions in such a way that they do not interfere with bona fide business activities. To avoid this it again considers several different solutions including a general bona fide proviso, an activity proviso etc. Further, the Commentary discusses the applicability of general substance-over-form rules to tax treaties which do not include an explicit rule of this type.[23] Whereas in former statements the OECD Fiscal Committee seemed reluctant to adopt such a general approach, the 1992 Commentary states that by that time "[t]he large majority of OECD Member countries" did approve it.[24] But still there was no unanimity.

In the context of Article 10 the 1992 Commentary further examines the treaty consequences of a Subpart-F type approach to base companies. It affirms that Article 10(5) does not ban such approach because this paragraph is confined to taxation at source and has no bearing on taxation by the residence state. Unfortunately the Commentary is less clear with regard to the question of how the income of the subsidiary when attributed to the parent should be dealt with under the treaty. Whether such notional income falls under the definition of dividends (Article 10(3)) so that an affili-

21. See for more argument K. Vogel, "Reflections on the Future of the OECD Model Convention and Commentary", 50 *Bulletin for International Fiscal Documentation*, 11/12 (1996), at 527 and 529.
22. Double Taxation Conventions and the Use of Base Companies and Double Taxation Conventions and the Use of Conduit Companies, in: OECD, International Tax Avoidance and Evasion – Four Related Studies (Issues in International Taxation), No. 1, 1987, 60.81.
23. For this problem see in more detail K. Vogel, (*supra* note 5) Article 1 marginal nos. 77 et seq.
24. MC Commentary Art. 1 para 23. This change of opinion is criticized, *inter alia*, by D.H. Ward, "Abuse of Tax Treaties", *In: Essays in International Taxation* (*supra* note 10), at 397, also published in *Intertax*, (1995) at 176.

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ation privilege provided by the convention would be applicable is called "doubtful" (but not "incorrect"), the Commentary goes on to say that the country of residence "may face th[at] allegation".[25] And when it comes to the question whether a withholding tax on a subsequent distribution of dividends by the subsidiary should be creditable against the former tax on the notional dividend the Commentary again does not dare to give a strict answer ("one might argue", "on the other hand", "would suggest").[26] Evidently the Fiscal Committee was divided on these questions and, therefore, took refuge in those very weak phrases.

B. Allocation of income

The attribution of income to permanent establishments was the subject of a report which the OECD adopted in 1993.[27] The results of this report were transferred into the 1994 update to the Commentary.[28] The basic principle of Article 7, paragraphs 2 to 4, that the profits of a permanent establishment should be computed as if the permanent establishment were a distinct and separate enterprise is elaborated by these amendments in much more detail than it was before and a number of questions of doubt are discussed. The addenda refer, in particular, to the evaluation of transactions between the head office and the permanent establishment or between permanent establishments of the same enterprise, further to the realization of hidden reserves when assets are transferred to a permanent establishment abroad, and finally to the transfer of bad loans between permanent establishments in international banking. These considerations are of considerable practical value, but they may shortly be superseded, when, as it is intended, the problem of transfer pricing between head office and permanent establishments is addressed by a special chapter of the OECD's transfer pricing guidelines.

In contrast, the Commentary's comments concerning the central transfer pricing rule which is Article 9 MC are relatively few in number and so are the updates.

This may be felt to be surprising at first sight. But it seems that it is a paradoxical consequence of the subject being so broad. If transfer pricing between associated, though legally independent enterprises were examined in the Commentary in such detail as other questions are (not all of them that would have deserved such discussion, it is true), the Commentary's balance would be gravely impaired. Therefore, for a discussion of transfer pricing the 1992 revision of the Commentary confined itself to referring to an OECD report published as early as 1979;[29] it refrained from integrating that report into the Commentary though it did so with most other OECD reports that had been published on MC questions since 1977. The Transfer Pricing Guidelines continue that tradition and by their sheer size they confirm that it would have been impossible to publish them as a part of the Commentary to Article 9, which systematically they are. It is for this reason that the 1992 updates to the comments on Article 9 only refer to some small questions of procedure.[30]

C. Thin capitalization

Following another OECD report[31] the Commentary to five MC articles was amended in 1992 to deal with the problems of thin capitalization. First, it was stated that Article 9 does not prevent the application of domestic rules providing that a loan may be considered equity and, that therefore, interest paid on that loan may be treated as dividends in certain situations as long as the arm's-length criterion is observed.[32] In a later context examples are given of factual situations which may justify such requalification.[33] Further, the Commentary asserts that participating bonds or convertible bonds do not normally fall under the examples given, therefore as a rule the proceeds from such bonds is interest under the MC unless the loan effectively shares the risk of the debtor company and thereby, under a substance over form approach, it proves to be equity.[34] Moreover, the Commentary asserts that the lender's state of residence is obliged under Article 23 to give credit for taxes withheld in such cases of thin capitalization from payments treated as dividends in accordance with the convention.[35] And finally, two brief observations refer to the application of Article 24 to thin capitalization rules.[36]

D. New financial instruments

Regarding "non-traditional financial instruments" a brief observation was inserted in 1995 that payments under such instruments are not normally covered by the definition of interest in Article 11(3) MC.[37] However, the Commentary goes on to say, that that definition would apply "to the extent that a loan is considered to exist under a 'substance over form' rule, an 'abuse of rights' principle, or any similar doctrine". It is not clear whether this means principles of domestic law of the contracting states (and of which of the two contracting states?) or of public international law. If the Fiscal Committee intended to refer to principles of domestic law, it is doubtful whether *any* doctrine of domestic law, even if it was adopted after the conclusion of the treaty in question, can modify the treaty's definition of interest. But here is not the place to discuss this.

To the extent that proceeds from non-traditional financial instruments are not interest they may be "other income" falling under Article 21 MC.[38] In this respect the Commen-

25. MC Commentary Art. 10 para. 38.
26. MC Commentary Art. 10 para. 39.
27. OECD, Model Tax Convention: Attribution of Income to Permanent Establishments (Issues in International Taxation, no. 5), 1994.
28. MC Commentary Art. 7 paras. 11 et seq.
29. OECD, Transfer Pricing and Multinational Enterprises, 1979.
30. MC Commentary Art. 9 paras. 4, 6, 10, and 11.
31. OECD, Thin Capitalization – Taxation of Entertainers, Artists and Sportsmen (Issues in International Taxation, No. 2), 1987.
32. MC Commentary Art. 9 para. 2.
33. MC Commentary Art. 10 para. 25.
34. MC Commentary Art. 11 para. 19.
35. MC Commentary Art. 23 paras. 67 et seq.
36. MC Commentary Art. 24 paras. 56 and 58.
37. MC Commentary Art. 11 para. 21.1.
38. Subject to the factual or legal situation Arts. 7 or 13 may be applicable as well. See B.A. Elvin, "The Re-Characterization of Cross-Border Interest Rate Swaps: Tax Consequences and Beyond", *Florida Tax Review*, (1995), at 631.

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tary shows concern that the convention might be abused by agreeing on non-arm's length payments where there is a special relationship between the parties involved. A 1995 update to the Commentary, therefore, suggests a special paragraph to be added to the Other Income article which would be similar to Article 11(6) MC,[39] yet would differ from it in so far as for the excessive amount on which would remain subject to double taxation.[40] As Article 21 MC covers all income not dealt with in the preceding articles the same would apply to the suggested new paragraph, but the Commentary considers it unlikely that a situation for which this suggested paragraph could become relevant might arise outside of those financial instruments for which the provision is intended. Evidently the Committee or Sub-Committee in charge did not realize that Article 21 does not only cover income the class or type of which is not dealt with in the preceding articles. Rather it covers income, too, the type of which is dealt with in those articles, but only in so far as it arises in the *other contracting state*. To such income Article 21 applies when it arises in and is received from a *third state*,[41] thus to income from immovable property (Article 6(1)), dividends (Article 10(1)), interest (Article 11(1)), royalties (Article 12(1)), capital gains from the alienation of immovable property or permanent establishments (Article 13(1) and (2)), dependent personal services (Article 15(1), second sentence, and (2)), director's fees (Article 16), income of artistes and sportsmen or -women (Article 17(1)), and to income from government service (Article 19). In contrast to what the Commentary maintains, the suggested paragraph 3 to Article 21 would, therefore, apply not only to new financial instruments. Rather, it would be a provision of broadest application which is particularly undesirable because the provision *upholds double taxation*.

E. Triangular cases

The problem of permanent establishments receiving profits, in particular, dividends, interest, or royalties, from a third state, but not protected by the treaty between that state and the state of the permanent establishment because permanent establishments are not "persons", has been discussed extensively, *inter alia*, by a report from the OECD.[42] The results of this report were incorporated into the Commentary on Article 24 MC in 1992.[43] Agreement is affirmed that the double taxation which arises in such situations should be eliminated. It is stated that this can be achieved by adequate provisions of the domestic law of the state concerned. If there is no such provision, the Commentary recommends to incorporate into Article 24(3) after its first sentence a clause according to which the state of the permanent establishment is obliged to give credit for withholding taxes of the third state on dividends, interest and royalties subject to the usual tax credit limitation. For other triangular situations the Commentary refers the states involved to bilateral negotiations.

F. Software

The treatment of computer software in the international tax field was studied by the OECD in another report[44] which like those mentioned before was integrated into the MC Commentary in 1992.[45] As with leasing (*supra* II.B) the Fiscal Committee's tendency here was also to limit source state withholding. The Committee did not consider it necessary, however, to change the MC text for the benefit of software taxation. According to the Commentary, Article 12 still includes software licences for industrial development or use. With respect to licences which are exclusive for a certain area or period the same would follow from the MC's text, the Commentary, however, seems to be in favour of characterizing income from such licences as enterprise profits under Article 7. In any case, the transfer of software ownership does not fall under Article 12 (even if the remuneration is current and variable) and neither do software licences for personal use of the licensee: here the transaction is economically equivalent to the sale of tangible goods.

G. Amendments of minor importance

A number of other smaller amendments were made in 1992 as well. Considering that under the more limited definition of royalties introduced that year the leasing of containers falls under Article 7 MC instead of Article 12 the question as to under what conditions such activity could lead to the constitution of a permanent establishment became relevant; for this the Commentary refers to another OECD report discussing this particular type of business.[46] Further, the explanation of the diverging systems of corporate income tax, in particular integrated and non-integrated systems, and their role in international taxation was rewritten in part.[47] Moreover, the comments concerning the provision on excessive interest (Article 11(6)) were amended. Following a report on the hiring-out of labour[48] a reference to the problems involved here was inserted.[49] Some other minor amendments were made with respect to the taxation of artistes and sportsmen.[50] The discussion of the mutual agreement procedure was revised in several respects with the intention of simplifying that procedure and improving the taxpayer's rights.[51] Regarding admin-

39. MC Commentary Art. 21 paras. 7 et seq.
40. MC Commentary Art. 21 paras. 10.
41. D.A. Ward, et al., "The Other Income Article of Income Tax Treaties", 38 *Canadian Tax Journal*, (1990) at 233, reprinted in 44 *Bulletin for International Fiscal Documentation*, 8/9 (1990), at 415; K. Vogel & M. Lehner, Article 21 marginal no. 13, in K. Vogel, *supra* note 5.
42. Triangular Cases, in: OECD, Model Tax Convention, Four Related Studies (Issues in International Taxation, no. 4), 1992, 27 et seq.
43. MC Commentary Art. 24 paras. 51 et seq.
44. The Tax Treatment of Computer Software, in: OECD, Model Tax Convention, Four Related Studies (Issues in International Taxation, no. 4), 1992.
45. MC Commentary Art. 12 paras. 12 et seq.
46. The Taxation of Income Derived from the Leasing of Containers, in: OECD, (1985), Trends in International Taxation.
47. MC Commentary Art. 10 paras. 40 et seq.
48. Taxation Issues Relating to International Hiring-Out of Labour, in: OECD, (1985), Trends in International Taxation.
49. MC Commentary Art. 15 para. 8.
50. MC Commentary Art. 17 paras. 3 to 10 and 12 to 14.
51. MC Commentary Art. 25 paras. 8 to 10, 22, 23, 30, 34, 40, 48.

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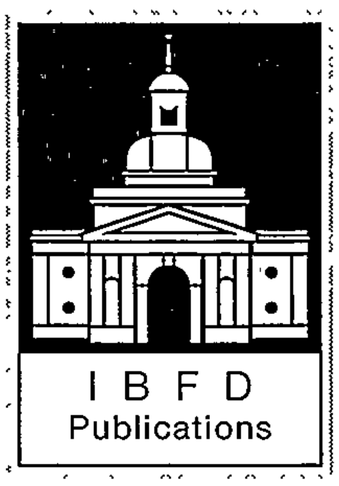
istrative assistance in tax matters the Commentary referred to the relevant Convention drawn up within the European Council.[52]

The 1995 updates to the Commentary which have not yet been mentioned include a discussion of the application of the tie-breaker rules (Article 4(2)) applying where a taxpayer is a resident of both contracting states for only a part of the taxable period. Logically they in this case apply only for that period in which he or she was so dual resident.[53] For artistes and sportsmen the comments regarding taxation of orchestras, teams etc. and, on the other hand, certain avoidance schemes were supplemented.[54] The interaction of the mutual agreement procedure with the dispute resolution mechanism provided by GATS was studied.[55] And, finally, the Commentary now explicitly states that under Article 26 information may not be disclosed to authorities that supervise the general administration of the Government, where these authorities are not involved specifically in tax matters.[56]

52. MC Commentary Art. 26 para. 3.
53. MC Commentary Art. 4 para. 10, sentences 3 to 6.
54. MC Commentary Art. 17 para. 11.
55. MC Commentary Art. 25 paras. 44.1 et seq.
56. MC Commentary Art. 26 para. 12.1.



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THE THEORY OF THE INTERPRETATION OF TAX TREATIES, WITH REFERENCE TO DUTCH PRACTICE

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I. INTRODUCTION

The aim of this article is to give (with special reference to Dutch practice) an overview of the principles applying to the interpretation of double taxation conventions. We pay special attention to the preparatory work, which in our opinion should have a more prominent place in the interpretation process (section II). In section III we argue that for the application of Article 3, paragraph 2 OECD Model Convention (hereinafter OECD MC) the formal aspects of a treaty term (the sign) do not literally have to coincide with the sign in national law. We also argue that fictions in national law have effect for treaty interpretation through the mechanism of Article 3, paragraph 2 OECD MC. In section IV the position of the Commentary in the Netherlands is discussed. It will be shown that the question whether the most recent version of the Commentary is to be used or the one current at the conclusion of the treaty is not answered unequivocally in Dutch case law.

II. VIENNA CONVENTION ON THE LAW OF TREATIES

Sinclair[2] classifies the traditional approaches to the interpretation of treaties as the objective (determining what the text reads), the subjective (determining the intentions of the States concluding a treaty) and the teleological approaches (first determine the purpose and tenor of the treaty). The Commentary to Articles 31 and 32[3] of the Vienna Convention on the law of treaties of 23 May 1969 (hereinafter: Vienna Convention) makes the same tripartition.[4] The Vienna Convention has put an end to any dispute on the preferable approach by favouring a synthesis of the three. Synthesis, though the text has supremacy and the intention is the weaker part, i.e. the wording is supposed to reflect the intention of the parties. The interpretation therefore starts with the letter.[5] Although the focus nowadays has shifted to the text with respect to its purpose and tenor (Article 31 Vienna Convention), the conditions under which the intentions of the parties to the treaty may also be investigated as a factor independent of the wording, are so extensive that the intention of the parties may just as well play a part.

The Vienna Convention was effected on 27 January 1980 after the ratification and accession of the 35th State. The provisions have been applicable to the Netherlands since 9 May 1985: the 30th day after the filing of the instrument of accession. In the meantime not all States have joined, not even the most important States. Though the United States only signed, and has not yet filed an instrument of ratification or accession with the depository, this does not mean that the interpretation articles do not have persuasive authority in the United States.[6]

Article 4 Vienna Convention states that the convention only applies to treaties concluded after the Vienna Convention has come into effect for the States in question. This implies that the articles of interpretation (31 and 32 Vienna Convention) only apply to treaties concluded after the coming into effect of the Vienna Convention, as far as the Netherlands is concerned to treaties concluded after 9 May 1985. However, a different outcome results if Articles 31 and 32 are nothing but a codification of customary law or if they have become customary law in the meantime, since international customary law applies even without the Vienna Convention.[7] According to influential authors[8] the rules of interpretation of the Vienna

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2. I.M. Sinclair, *The Vienna Convention on the Law of Treaties*, Manchester, (1973), at 70. He follows similar earlier divisions, compare G.C. Fitzmaurice, "The law and procedure of the International Court of Justice; treaty interpretation and certain other treaty points" *British Year Book of International Law 1951*, at 1-28. With respect to this, see also C. van Raad, "Interpretatie van belastingverdragen" *Maandblad Belastingbeschouwingen*, (1978), no. 2/3, at 50-51.
3. Before renumbering Arts. 27 and 28.
4. R.G. Wetzel and D. Rauschning, *The Vienna Convention on the Law of Treaties; Travaux Préparatoires*, [hereinafter referred to as *Dokumente*] Frankfurt am Main 1978 [Dokumente Band 44], at 250.
5. "The article ... is based on the view that the text must be presumed to be the authentic expression of the intentions of the parties; and that, in consequence, the starting point of interpretation is the elucidation of the meaning of the text, not an investigation *ab initio* into the intentions of the parties." (*Dokumente*, at 252)
6. P.H. Blessing, *Income tax treaties of the United States*, [hereinafter referred to as *Blessing*] Boston, loose-leaf edition, at I-60. Footnote 246 sets forth that the State Department regards these articles as codifying international law.
7. Compare Art. 38, para. 2(b) ICJ Statute.
8. Sir Ian Sinclair at the IFA congress of 11 September 1985 in London, summarized in: "Interpretation of tax treaties" 40 *Bulletin for International Fiscal Documentation*, 2 (1986), at 75; K. Vogel (Generalbericht), *Cahiers de droit fiscal international, Vol. LXXVIIIa*, at 32. Also compare H.F. Köck, *Vertragsinterpretation und Vertragsrechtskonvention; zur Bedeutung der Artikel 31 und 32 der Wiener Vertragsrechtskonvention 1969*, Berlin 1976, at 95: "... dass es sich als eine getreue Konsequenz aus den herrschenden Auffassungen über die Auslegung völkerrechtlicher Verträge darstellt und somit der traditionellen Methodologie gefolgt ist". M.N. Shaw, *International law*, (1994), at 561 also argues (by referring to the *Lithgow* case, *Golder* case *Bretagne* case and *Beagle Channel* case) that the rules of interpretation are codified customary law.

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Convention are indeed part of the international customary law. Consequently, the rules of interpretation also apply to Dutch tax treaties that have been concluded before 9 May 1985.

A. Article 31, paragraph 1 Vienna Convention

The central interpretation rule is Article 31, paragraph 1 Vienna Convention: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose". This rule combines the grammatical ("ordinary meaning"), teleological ("object and purpose") and systematic ("context") methods without giving preference to any one method. The starting point will be the grammatical reference, but this does not have priority: the final result will also have to be supported by context and purpose.

Ordinary meaning is nothing more than an assumption as is shown from Article 31, paragraph 4 Vienna Convention. In case of deviation the special meaning supersedes, however the burden of proof rests on the advocate of the special meaning.[9] Although it can be assumed that the special or technical meaning can also be deducted from the context, eventually a separate provision was incorporated regarding this in Article 31, paragraph 4 Vienna Convention.[10] The issue whether the ordinary meaning is to be found in common usage or whether a meaning from a specific jargon is to be preferred, is solved in favour of the ordinary meaning, which, in our opinion, means the lexical meaning. The literature[11] assumes, for that matter, that an expression is to be understood as the meaning of the expression adhered to at the time of concluding the agreement.[12] There seems to be some tension with regard to the dynamic interpretation accepted for the application of Article 3, paragraph 2 OECD MC.

The ordinary meaning is to fit the context. The context incorporates the surrounding text in the first instance (Article 31, paragraph 2 Vienna Convention), including the preamble and annexes. The context is extended to (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty, and (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

The Dutch *Nota's van Toelichting* (Explanatory Memoranda) on treaties cannot be included as part of the context of the treaty, nor should the Senate Foreign Relation Committee Reports, the Treasury Technical Explanations etc. in the United States, nor similar documents elsewhere. These documents are not approved by both contracting states and should not be relied upon. The Dutch Explanatory Memoranda are merely instruments used to inform the Dutch Parliament – that has limited authority regarding treaties – about the treaty in question. The documents are and remain a unilateral instrument in default of acceptance by the other state concluding the treaty. However, in the general practice of the treaty interpretation the Explanatory Memoranda are referred to repeatedly.[13, 14] According to the Dutch State Secretary of Finance the Explanatory Memoranda are an accurate reproduction of the discussions between the contracting states.[15] This opinion must be seriously questioned. For example on one of the subjects discussed in the Explanatory Memorandum on the Netherlands–Turkey treaty (rate of the Turkish branch profits tax), the literature evidences the fact that the Turkish authorities have a totally opposite point of view to their Dutch counterparts. The State Secretary of Finance's view therefore must rather be seen as an attempt to counter the growing demands of taxpayers to have access to the preparatory works of treaties (see further below).

While pursuing the meaning of an expression by means of the rules of the Vienna Convention, the traditional principles of explanation remain valid, such as the *ejusdem generis* principle[16] and the principle of the *expressio unius est exclusio alterius*.[17] The *ejusdem generis* principle requires the interpretation of general words within the setting of special words in the special context. The *expressio unius est exclusio alterius* principle expresses that mention of one specific term rules out other terms.

The treaty is to be explained in good faith. Although vaguely defined this criterion is fundamental to the interpretation of tax treaties. After all, an interpretation based on the text only can result in unreasonable consequences. We derive a fine example from Grotius: "The Locrians, then, availed themselves of a stupid evasion in their perfidy; for they took oath that they would keep the agreement as long as they should stand on that ground and should bear heads on their shoulders; they then threw away the earth which they had placed in their shoes, and the heads of garlic which they had laid on their shoulders, as if in that manner they could free themselves from the religious obligation." [18, 19]

One of the maxims for interpretation of treaties has always been the principle of *effective interpretation ut res magis valeat quam pereat*. According to this principle, a treaty is to

9. "Legal Status of Eastern Greenland", *P.C.I.J.* 1933, Series AB, No. 53, at 49. I. Brownlie, *Public International Law*, [hereinafter referred to as *Brownlie*] Oxford 1990, at 629.
10. *Dokumente*, at 254.
11. D.P. O'Connell, *International Law*, Vol. I, [hereinafter referred to as *O'Connell*] London 1970, at 258, *Brownlie*, at 629, J.G. Starke, *Introduction to International Law*, [hereinafter referred to as *Starke]* London 1989, at 479.
12. Rights of US Nationals in Morocco, I.C.J. Rep., 1952, at 176 and 189; South West Africa cases (*Ethiopia v. South Africa*; *Liberia v. South Africa*), (Phase 2), I.C.J. Rep., 1966, at 6 and 23.
13. For example Supreme Court 11 October 1978, 18 579, *BNB* 1978/300; Supreme Court 24 June 1981, 20 216, *BNB* 1981/236; Supreme Court 28 June 1989, 25 731, *BNB* 1989/286.
14. *Xerox Corp v. United States*, 41 F3d 647 (Fed. Cir. 1994); *Taisei Fire & Marine Ins. Co. v. Com.*, 104 TC 27 (1995); *Clayton v. United States*, 33 Fed CI 628 (1995); *Burghardt v. Comm.*, 80 TC 705 (1983) and many more in the United States.
15. His answer of 18 August 1997 to parliamentary questions on the Dutch treaty policy.
16. For a practical example see e.g. S.I. Roberts, "The Agency Element of Permanent Establishment: The OECD Commentaries from the Civil Law View (Part Two)", *Intertax* (1993), at 501.
17. *Brownlie*, at 629.
18. Hugo Grotius, *De jure belli ac pacis*, Libri tres, Chapter XVI [On Interpretation], Translated by F.W. Kelsey, Oxford/London 1925, at 409.
19. Another good example is to be found in L. Oppenheim, *International Law; a Treatise*, Vol. I, London etc. 1947, at 858, note 3.

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be interpreted in such a way that it has the intended effect. When drafting the Vienna Convention, the *effective interpretation* was not incorporated separately, for it was expected to be incorporated in the doctrine of *good faith*: "When a treaty is open to two interpretations, one of which does and the other does not enable the treaty to have appropriate effect, good faith and the objects and purpose of the treaty demand that the former interpretation should be adopted".[20, 21] In the literature the effective interpretation is still used as a maxim.[22]

Restrictive interpretation[23] has not been incorporated in the canon of the Vienna Convention. Restrictive interpretation means that in areas in which the sovereignty of the State is limited, the treaty is to be interpreted in such a way that sovereignty is violated as little as possible.

Object and purpose. The expressions of the treaty are also to be interpreted in the light of the object and purpose of the treaty. Object and purpose can mostly be found in the target phrasing of title[24] and/or in the preamble[25] of treaties. In practice this rule is followed frequently.[26]

Article 31 Vienna Convention does not create an hierarchy between the grammatical, teleological and systematic interpretation methods shown therein,[27] at the most there is some logical order, in which the text of the treaty is the logical starting point. An interpretation ensuing from a combined application of the methods of Article 31, paragraph 1 Vienna Convention must be the aim of the process. This becomes apparent from the phrasing of the said paragraph, as well as from the singular form of the head of the article "General Rule of Interpretation". The result of the interpretation is made by combining the three methods in which the grammatical meaning is by no means dominant.[28, 29] However, Starke sees the grammatical method as predominant and believes that there is only room for the influence of context and object and purpose in case of doubt.[30]

B. Supplementary means of interpretation

Thus, the linguistic, teleological and systematic interpretation methods do not have a hierarchical relationship. For the connection between Articles 31 and 32 however, subordination is to be noted.[31] The supremacy of Article 31 becomes apparent from the fact that Article 32 cannot be used to deny the interpretation resulting from Article 31: Article 32 solely speaks of "confirm". This supremacy can also be deduced from the expression "supplementary" shown in the head of Article 32. On the other hand, the Commission states that a rigid dividing line between Article 31 and 32 Vienna Convention is not to be drawn: "The fact that Article 28 admits recourse to the supplementary means for the purpose of "confirming" the meaning resulting from the application of Article 27 establishes a general link between the two articles and maintains the unity of the process of interpretation".[32]

In his dissenting opinion in the judgement on Interpretation of the 1919 Convention Concerning Employment of Women During the Night[33] Judge Anzilotti concluded that no right interpretations exist as long as the intention of the parties has not been determined. What is *clear*, is, for that matter, only known after the hermeneutic process has been gone through. A word in itself does not have any value, according to his opinion, except for conveying the party's intention. Therefore, he thinks it wrong to limit access to the *travaux préparatoires* (preparatory work): he believes every text – whether clear or unclear – is to be examined on the basis of the *travaux préparatoires*. O'Connell also turns his back from the idea that a term can be clear in itself: "... it may be doubted whether a clear and unambiguous clause has ever been devised".[34] Vattel's words[35] that if interpretation is not required, interpretation may not be applied, therefore is to be received reservedly in our opinion.[36] We advocate a much wider use of the preparatory work. In this respect it can be noted that the US Courts show no hesitation to resort to such materials, as for example in *Air France v. Saks*, 470 392 (1985): "In interpreting a treaty it is proper, of course, to refer to the records of its drafting and negotiation".[37]

Article 32 Vienna Convention provides the treaty interpreter with other methods of interpretation as additional instruments. The reference to the preparatory work of the treaty in particular facilitates interpretation with a view to the intention of the parties. Article 32, however, can only be used in three cases: to confirm the meaning resulting from the application of Article 31, to determine the meaning when the interpretation according to Article 31 leaves the meaning ambiguous or obscure, and to determine the meaning when the interpretation according to Article 31 leads to a result which

20. *Dokumente*, at 251.
21. It appears as if *O'Connell* missed this, at 255. With respect to this, also see the criticism of Sinclair, *supra* note 2, at 74.
22. *Starke*, at 480, *Brownlie*, at 631.
23. H. Lauterpacht, "Restrictive Interpretation and the Principle of Effectiveness in the Interpretation of Treaties" *The British Year Book of International Law*, (1949), at 48-85.
24. With respect to this, for example: "Convention ... for the avoidance of double taxation and the prevention of fiscal evasion".
25. With respect to this, for example from the Poland–Netherlands tax treaty: "The Government of the Kingdom of the Netherlands and the Government of the Polish People's Republic desiring to further develop their economic relationships, and to conclude to that end a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital".
26. With respect to this, for example in Rights of US Nationals in Morocco, I.C.J. Rep. 1952, at 176 and 196.
27. "[The Commission] considered that the article, when read as a whole, cannot properly be regarded as laying down a legal hierarchy of norms for the interpretation of treaties." (*Dokumente*, at 252).
28. "The Commission, by heading the article "General rule of interpretation" in the singular and by underlining the connection between paragraphs 1 and 2 and again between paragraph 3 and the two previous paragraphs, intended to indicate that the application of the means of interpretation in the article would be a single combined operation. All the various elements ... could be thrown into the crucible, and their interaction would give the legally relevant interpretation" (*Dokumente*, at 251-252).
29. *Brownlie*, at 255.
30. *Starke*, at 478-479.
31. Sinclair, *supra* note 2, at 73.
32. *Dokumente*, at 252.
33. Permanent Court of International Justice, PCJI-Publications (1932), Ser. A/B, no. 50.
34. *O'Connell*, at 253.
35. M. de Vattel, *Le droit des gens ou principes de la loi naturelle* [1758, Chapitre XVII De l'interprétation des Traités], Washington 1916, at 461.
36. Sinclair, *supra* note 2, at 72.
37. For further references *Blessing*, at I-64, footnote 270.

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is manifestly absurd or unreasonable. Although these limitations might seem to imply a limited role for Article 32, the three situations are described so broadly that in principle the article can play a part in many interpretative matters.

The *travaux préparatoires* of a treaty are defined as the documents that form the basis for the establishment of a treaty. These are documents or oral statements (which could be made later, e.g. in *Hunter Douglas*,[38]) that contain information on the course and the content of the treaty negotiations (designs, agendas, consulted documents, minutes), the standpoints of parties on certain subjects, the differences in opinion about the apparent ambiguity of the treaty text, etc.[39]

The Dutch courts in the field of international tax law have only rarely considered the preparatory work. See Supreme Court 16 December 1959, 14 083, *BNB* 1960/50. In this judgement, both the Court and Supreme Court relied heavily on a letter written to the Dutch Government on 27 November 1948 (the treaty was concluded on 30 December 1949) by the French Minister of Finance and Economics.

The limited use of the preparatory work in Dutch case law can be easily explained by the current inaccessibility of the preparatory work: the documents are in the offices of the Ministry and are not published. The readiness of the Dutch Government to supply the documents is not to be overrated. This is partly explained because the preparatory work discusses the interests of individual taxpayers mentioned by name.[40] Publication could be a violation of the statutory obligation of secrecy. However, in the Netherlands anonymization of administrative decisions (case law in the field of public government concerning rulings) is considered an adequate means to avoid these problems and for that reason publication has been argued for.[41] We believe that the publication of the preparatory work would greatly facilitate the attaining of the ultimate goal of double taxation conventions: avoidance of double taxation.

The Dutch State Secretary of Finance Willem Vermeend is of another opinion. In his recent answers to questions from the parliament he states that publication could endanger the openness of the representatives of the other state. This of course makes no sense in the light of the obligations contained in Article 32 Vienna Convention. Apart from that, this statement obviously tries to blur the practice of the Ministry of Finance. Again, we refer to the above-mentioned judgement Supreme Court 16 December 1959, 14 083, *BNB* 1960/50. This case shows that the tax administration is capable of gaining access to the preparatory work and also uses this if required. (The letter of the French supported the Dutch tax authorities' view of course.) Quite apart from the obligations of the Vienna Convention, to ensure a fairer application of the law either both taxpayers and the tax authorities should have access to the preparatory work, or neither of them should have.

III. ARTICLE 3, PARAGRAPH 2 OECD MC

A. Theory

The expression *term* is to be explained according to the rules of Articles 31 and 32 Vienna Convention. According to the dictionary this expression means *word*. A *word* is a combination of form (*sign*) and content (*concept*).[42] The question now is how to interpret *term*: is the mechanism of Article 3, paragraph 2 OECD MC not triggered if the treaty sign does not literally coincide with the law sign? Or, if the stress of the reference is on the concept aspect of the term, can Article 3, paragraph 2 OECD MC do its work if the signs differ, but refer to similar concepts? This question has only been casually dealt with in the international literature: Van Raad and Ward in the IFA congress report of 1985 define *term* as being inclusive of *content*, whereas Vogel does not.[43] Avery Jones raised the question again in 1993[44] and Van Raad recently signalled that this problem is still waiting to be solved.[45] In 1996, the matter has led to controversies in Dutch literature. Pijl defended with an appeal to the treaty effectiveness the conceptual explanation, whereas Van Scheijndel defended the explanation according to the sign.[46]

In Dutch case law a preference for the conceptual explanation can be found. Court 's-Hertogenbosch 6 June 1975, 488/1974, *BNB* 1975/278 considered the treaty term "employee's pay for labour" equivalent when applying the *lex fori* provision to the term in the legislation "earned income". In Supreme Court 27 November 1985, 22 717, *BNB* 1986/47 guidance regarding the meaning of the treaty term "compensation of loss" was obtained from the legal term "settlement of losses". In Supreme Court 4 July 1989, 25 660, *BNB* 1989/274 the question was raised whether the treaty term "pensions ... paid by virtue of the statutory social insurance of another State" included AAW and the WAO

38. *Hunter Douglas v. MNR* 1979, DTC 5340.
39. Vogel believes that the preparatory work would only involve documents "an deren Ausgestaltung beide Vertragsparteien beteiligt waren, in denen also ein gemeinsamer Wille beider zum Ausdruck kommt" (*Generalbericht*, at 41). H. Pijl, "Aantekeningen bij de *lex fori* bepaling in belastingverdragen", *Weekblad voor Fiscaal Recht* 1995/6164, at 1262 argues that relevant conclusions can also be drawn from documents which lack a common intention. Whatever the extent of the preparatory work to be taken into consideration, the fact is there are such works.
40. J.F. Avery Jones, "The interpretation of tax treaties with particular reference to Article 3(2) of the OECD", *British Tax Review* 2 (1984), at 99, does not assign the preparatory work with much practical interest, because this material does not exist in his opinion, that is to say he believes the negotiations between both States are confidential.
41. See *supra* note 39, H. Pijl, at 1262.
42. With respect to this, compare for example John Lyons, *Introduction to theoretical linguistics*, Cambridge 1968, at 55 who describes a word as "the relationship between 'form' and 'meaning' (between expression and content)".
43. "Interpretation of tax treaties" 40 *Bulletin for Fiscal Documentation* 2 (1986), at 85. With respect to this, also see M.R. Reuvers in his national report, *Cahiers de Droit Fiscal International Vol. XVII* (1960), at 231.
44. J.F. Avery Jones, "Article 3(2) of the OECD Model Convention and the Commentary to It: Treaty Interpretation", 33 *European Taxation* 8 (1993), at 257.
45. C. van Raad, "Tax Treaty Issues – Current and Future Developments", 36 *European Taxation*, 1 (1996), at 4.
46. See *supra* note 39, H. Pijl, at 1254-1265; M.P. van Scheijndel, "Voor een beter begrip van de term 'uitdrukking' in Art. 3(2), OESO-Modelverdrag", *Weekblad Fiscaal Recht*, 1996/6190, at 409-410 with an epilogue by H. Pijl.

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(allowances of the Dutch social security system). In principle, the Supreme Court in this case did not object to linking the term in question through Article 3, paragraph 2 OECD MC with the entirely differently formulated term in Dutch law, but at the end did not do so because the content of the statutory and treaty term did not coincide.

Meaning is also subjected to the articles of interpretation 31 and 32 Vienna Convention as a treaty term. As with other treaty expressions the ordinary meaning is to be found. Lexically it means "content of a word or a compound of words".[47] To apply Article 3, paragraph 2 OECD MC the text does not require a real definition of the expression in national law. The way in which national law assigns meaning to the term is irrelevant. It may thus imply the explanation that is given to the term in the legislative history or in case law.[48] In a more general sense, this means that the national rules of explanation will be part of the treaty interpretation, by means of Article 3, paragraph 2 OECD MC. The text of this article does not require that the national legislation actively *assigns* meaning to the expression, but only that the meaning can be *derived:* the broad scope of the phrase "under the laws" cannot be explained otherwise in our opinion.

In general, Dutch case law assumes the same. We refer to a decision of Court 's-Hertogenbosch.[49] The Court tried to find a corresponding term for the treaty term "to carry on an enterprise" in the national legislation and found it in Article 2, paragraph 1(d) Corporate Income Tax Act. However, the definition required further clarification. The Court subsequently assigned content to this expression by appealing to case law that had been established with respect to this article.[50]

The Netherlands law uses formulations such as "y is considered under x", "x is considered as y" and "x is considered to be y". From these formulations, one may deduct that the legislator believes that x is "actually" different from y , but y is equivalent by fiction to x only for the sake of legal consequences. However justified this approach may be, in our opinion it cannot result in another treatment of these fictions than the "real" meaning of x for the purpose of treaties. Our arguments will be presented below.

In the Dutch literature the question has been raised whether the fictions in national legislation permeate Dutch treaties by virtue of Article 3, paragraph 2 OECD MC. The majority of authors are of the opinion that this is the case.[51] Regarding this pervasion, a number of arguments can be pleaded. In the first place it can be argued that an expression does not have a generally valid fixed meaning. A meaning is established in certain settings and for the benefit of a specific situation. If this setting implies that an expression does have a certain meaning, then this is the meaning applicable to this situation. In connection with this, the term "fiction" is misplaced: by using formulas with considered, deemed etc. the meaning itself is stipulated for the part that the expression plays. Moreover, adopting a difference between "real" meaning and "fictions" would lead to a highly complicated (philosophical and etymological) analysis of the "real" meaning of an expression.

Secondly, the Commentary states that specific fictions in national legislation are accepted in treaty interpretation. The following instances illustrate this point:

> *Commentary 3(4)*: "The question whether an activity is performed within an enterprise or is deemed to constitute an enterprise in itself has always been interpreted according to the provisions of the domestic laws of the Contracting States".
>
> *Article 6, paragraph 2 OECD MC*: "The term 'immovable property' shall have the meaning which it has under the law of the Contracting State in which the property in question is situated". From Commentary 6(2) of this article it can be deducted that a legal fiction is also meant here: "The paragraph ... specifically mentions the assets and rights which must *always be regarded* as immovable property or not".[52]
> *Commentary 4(8)*: "[The definition] also covers cases in which a person is deemed, according to the taxation laws of a State, to be a resident of that State ..."

From Court Amsterdam 11 April 1989, 3310/87, *BNB* 1991/68 it becomes apparent that the Dutch courts also accept the pervasion of national fictions into the treaty, albeit that the pervasion of the national fiction (of course) is limited by the context which may require otherwise. The taxpayer (Dutch resident) lived separated from his wife (German resident). The wife enjoyed income from immovable property situated in Germany and interest from German bank accounts. Based on the Dutch legislation the wife's income was allocated to the husband. It was questioned whether this fiction was to be applied for the purpose of treaties as well. The Court: "The parties concluding the treaty cannot have intended by Article 2, paragraph 2 of the treaty, to respect all national fictions. The purpose of the treaty and the relation between the sentences of the Articles 4 and 14 of the treaty require otherwise." Because the wife was the person receiving the income under the treaty, Article 20, paragraph 1 of the Netherlands–Germany treaty was applicable to her income and therefore remained outside the Dutch basis of levy.

When explaining a term used in the treaty, there are two contradictory objectives: to strive for a collective meaning in both states (for this purpose the context is to be the primary factor) and the relative ease with which the treaty interpreter

47. Oxford English Dictionary, Oxford 1989, part IX: "The signification, sense, import; a sense, interpretation. Also, the intent, spirit as apart from the "letter" (of a statement, law, etc.)".
48. B. Klebau, "Einzelprobleme bei der Auslegung von Doppelbesteuerungsabkommen", *Recht der Internationalen Wirtschaft* (1985), at 128; H. Pijl *supra* note 39, at 1260; J. Sasseville, "Interpretation of Double Taxation Conventions in Canada; An Update", 48 *Bulletin for International Fiscal Documentation*, 8/9 (1994), at 375.
49. Supreme Court 23 March 1994, 29 084, *BNB* 1994/192.
50. In *Estate of Charlotte Burghardt v. Commissioner* (80 Tax Court 705 (1983)) a similar path is taken. For the expression 'specific exemption' the tax court applied a law historical method, by applying a law that had already been replaced before signing. For insecurities with respect to this judgement see H. Shannon, "United States income tax treaties: Reference to domestic law for the meaning of undefined terms", *Intertax* (1989, No. 11), at 455.
51. P.H.G. Albert, "Dubbele woonplaats en vaste inrichting in het verdrag met de Verenigde Staten" *Weekblad Fiscaal Recht*, 1995/6146, at 549 and 550; H. Pijl *supra* note 39, at 1259. C. van Raad, "The national law when explaining treaty provisions", *Van Wet naar recht; opstellen aangeboden aan prof. mr P. Scheltens*, Deventer 1984, at 166. Deviating: C.J.A.M. van Gennep, "Dual resident BV", *Maandblad Belastingbeschouwingen* 11 (1994), at 378.
52. Our emphasis.

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can deduct the meaning (for this purpose national legislation is to guide the interpreter initially). The opinions of international experts differ regarding the relation between context and meaning pursuant to the national legislation. Dutch literature generally presumes (in accordance with the international opinion on this[53]) that the meaning in national legislation supersedes the meaning according to context.[54] On the basis of the text of Article 3, paragraph 2 OECD there seems to be little room for another opinion: any term not defined shall, unless the context otherwise requires, have the meaning that it has under the law of that state. Apparently, the reference to the context has been formulated as the exception here and the main reference is to the national law. Yet there are dissenting voices in the Netherlands. According to the Explanatory Note to the US treaty, the context supersedes national meaning.[55] Peeters also has this standpoint.[56] In Germany, this *völkerrechtsfreundliche* or autonomous theory is generally supported:[57] a treaty is first to be explained from its own context and only if this does not succeed, by means of referring to national law. The theory is founded on the idea that a treaty is to be considered as a closed legal system with its own nomenclature, and is supported by the *Bundesfinanzhof*.[58] The theory admittedly has its advantages: if an expression of a treaty is first explained from its own context, the risk of deviating interpretations and positive or negative qualification conflicts caused by this is smaller. However, the text of Article 3, paragraph 2 OECD MC must prevail and therefore, also in Germany, the *völkerrechtsfreundliche* theory has not remained undisputed.[59]

B. Dutch practice

The *lex fori* provision is generally taken seriously in Dutch case law.[60] Supreme Court 15 June 1955, 12 374, *BNB* 1955/279 has been as far as we could work out, the first judgement in the Netherlands in which the *lex fori* provision was explicitly incorporated by the Supreme Court in its dictum. In this case Article II, paragraph 2 of the Netherlands–US treaty 1948 however was ultimately not applied since the treaty itself contained the definition of the term in question. In the Supreme Court's very carefully considered judgement of 7 October 1959, in 13 997, *BNB* 1959/368, the grammatical analysis is confirmed by the *lex fori* provision. Supreme Court 23 June 1965, 15 412, *BNB* 1965/206 (Netherlands–Germany treaty) dealt with the explanation of "income from claims which ... by means of a mortgage ... has been secured with immovable property situated in another State". The interested party had revalued the mortgage claims downward in the past, and revalued these upward in the year concerned. It was in dispute whether this revaluation upward might be considered income allocated to Germany. The Hof interpreted income with an appeal to the *lex fori* provision Article 2, paragraph 2 of the treaty and excluded the changes in value from this. A remarkable decision is Court Amsterdam 29 April 1971, 688/1970, *BNB* 1972/108 in which the explanation of the term "entire income" (Article 20, paragraph 2 the Netherlands–Germany treaty) according to Dutch law was rejected. In this, the court assumes a static point of view. The link to national law is not possible "because during the time the treaty was concluded, the Income Tax Decree 1941 was in force, in which the latter term did not appear". The court apparently is of the opinion that there is to be a strictly similar expression in the act involved, and also assumes that the expression in the act in force during the conclusion of the treaty is to be looked for. Neither one of these opinions is supported by us. Interesting is Court 's-Hertogenbosch 28 May 1984, 1827/1981, *BNB* 1984/250. This case dealt with the meaning of "any claims secured by mortgage" (Article III, paragraph 1 the Netherlands–Canada treaty of 1957). The *lex fori* provision Article II, paragraph 2 of this treaty refers to acts in general, not to tax legislation in particular. The Court therefore considered investigating the meaning in the civil legislation, since there was no tax act with a description of this term. However, given the fact that the Dutch civil law also includes the rules of Dutch international private law, and given the fact that this latter source appoints the Canadian law as decisive, the meaning was eventually found in the Canadian civil law. Special attention should also be paid to Court 's-Hertogenbosch 6 June 1975, 488/1974, *BNB* 1975/278, in which the Court with an explicit appeal to the *lex fori* provision of Article II, paragraph 2 of the 1957 Netherlands–Italy treaty found the meaning of the treaty term (Article XI) "employee's pay for labour" in the legal term "earned income". From this, the willingness of the Dutch court to interpret the *lex fori* provision in a more comprehensible manner (term as concept) may be deducted, as we have noted *supra*. The Court Amsterdam 21 March 1986, 1781/84, Vakstudie Nieuws 1987, at 299 interprets the term "salaries, wages and other similar remunerations" (Article 17 of the Netherlands–Israel treaty) according to the meaning of "wages" in the national law with reference to Article 3 of that treaty. In Court Leeuwarden 12 August 1988, 440/86 E II, FED 1988/710, the Court seeks advice in vain from Dutch national law for the meaning of the term fixed base. (This term is not found in Dutch law.) In Court Amsterdam 11 April 1989, 3310/87, *BNB* 1991/68 the limitation inherent in

53. J.F. Avery Jones, see *supra* note 40, at 107,; K. Vogel, "La clause de renvoi de l'article 3(2) Modèle de Convention de l' OCDE", *Réflexions offertes à Paul Sibille*, Brussel (1981), at 962; *K. Vogel on Double Taxation Conventions*; K. Vogel and R.G. Prokisch, *Generalbericht, Cahiers de Droit Fiscal International, Vol. LXXVIIa* (1993), at 49.

54. E.A. Brood, *Compendium van het Nederlands internationaal belastingrecht* (Deventer: 1992) at 28; C. van Raad see *supra* note 2, at 52; H. Pijl *supra* note 39, at 1254-1255; M. Romijn, *Internationaal belastingrecht*, 1991, at 115.

55. "In the second paragraph of Article 3 it has been established as usual, that every expression not defined in the treaty is to be interpreted within the context of the treaty and according to the national law of the States, if the context is not decisive", *Vakstudie Nieuws* 1993, at 2114.

56. J.B.J. Peeters, *Internationaal belastingrecht in Nederland*, Amsterdam 1954, at 138.

57. For example H. Debatin, "Auslegungsmaximen zum internationalen Steuerrecht" *Aussenwirtschaftsdienst des Betriebsberaters*, Dezember 1969, Heft 12, at 480.

58. BFH 15, Januar 1971 III R 125/69 *BStBl*, II 1971, at 379; C. Gloria, "Die Doppelbesteuerungsabkommen der Bundesrepublik Deutschland und die Bedeutung der *Lex fori*-Klausel für ihre Auslegung" *Recht der Internationalen Wirtschaft*, December 1986, nr. 12, at 978.

59. W. Diehl, "Qualifikationskonflikte im Aussensteuerrecht", *Finanz-Rundschau*, 23 November 1978, at 517.

60. Other examples: Court 's-Gravenhage 26 February 1982, 16/81 M III, *BNB* 1982/132; Court 's-Hertogenbosch in Supreme Court 4 April 1990, 26 075, *BNB* 1990/157; Supreme Court 10 June 1981, 19 934, *BNB* 1981/242; Supreme Court 4 July 1989, 25 660, *BNB* 1989/274.

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the *lex fori* principle was again highlighted. In this case a fiction from the national law was left outside of consideration. Sometimes the *lex fori* provision is not applied at all and the use of this provision is not even considered, as in Supreme Court 23 November 1994, 29935, *BNB* 1995/117. The term "pay" in the provision concerning State pensions (Article 12, paragraph 2 of the Netherlands–Germany treaty) is actually found in the Dutch legislation (Article 38 Individual Income Tax Act) and is considered in case law. In its dictum the Supreme Court, made no reference to the national law and stated somewhat dogmatically: "what [matters] is where the pension build-up was made. Only then the distinction between State pensions and private pensions which is of the essence here, is done justice". In our opinion, the non-application of Article 3, paragraph 2 OECD MC in a situation like this, where all circumstances allowed the application of the *lex fori* provision, was incorrect.

IV. THE ROLE OF THE OECD COMMENTARY

A. The judicial status of the OECD MC and Commentary

As stated therein, the OECD Model Convention and the associated Commentary, do not have binding power as they are only a recommendation: with regard to this see the *General Remarks on the Model Convention* from the Committee on Fiscal Affairs report of 1977 that accompanied the Model of 1977. In the present Introduction there is a remark similar to the one in the former General Remarks: "... the Commentaries are not designed to be annexed in any manner to the conventions to be signed by Member countries, which alone constitute legally binding international instruments ...".[61] In our opinion, nothing concerning the status of the Model can be deducted from this. It is, for that matter, a paradox if the non-binding Commentary proclaims its own status of being non-binding. There is nothing which makes it clear that the above-mentioned text supersedes (the rest of) the Commentary and makes a meta-statement.

The Commentary is, however, indeed in no way binding under international law, according to the conventional framework the Model treaty has been embedded in: the treaty pursuant to the Organisation of Economic Co-operation and Development of 14 December 1960. To realize its objectives, among other things, the OECD can take decisions and make recommendations (Article 5 OECD Convention 1960). The binding decisions ("except as otherwise provided") that serve as the starting point, are only really binding on a Member State if that Member State has satisfied the demands of its constitutional procedures. Because conversion into national law is not compulsory, the decisions are characterized to a large extent as containing no obligation, and in this respect it must also be mentioned that concrete decisions are seldom taken. Van Meerhaeghe remarks with blatant irony after reviewing a listing of vague OECD activities that the OECD (in his opinion a "huge publishing house") "demonstrates remarkable activity but one searches in vain for concrete decisions".[62] The Convention does not include any remarks about recommendations. Recommendations only oblige the Member State according to Article 18(c) of the rules of procedure of the OECD[63] to investigate whether the recommended measure is opportune.

The Model Convention, including the Commentary, therefore has a weak status. It is a mere appendix to a recommendation accepted by the OECD Council on 23 July 1992, in which Member States are advised to conclude new treaties and to adjust existing ones on the basis of the Model Convention presented in combination with the Commentary. The status of being non-binding with regard to international law is established by this. The Model Convention is not a convention, it is a draft, which can serve as a starting point for entering into real treaties. The Model Convention is therefore no supplementary convention which is to be taken into account according to Article 31 paragraph 3(a) Vienna Convention ("every agreement between parties realized at a later time").

B. The status of the Commentary in literature

The question is to be asked whether the Commentary may only be used in the last instance (in case of ambiguities, obscurities or absurdities in the meaning that has been established in a different manner) or also when establishing the meaning itself. This discussion takes place with regard to the articles of interpretation 31 and 32 of the Vienna Convention. The question arises to which category the OECD Commentary belongs, to the context or to the preparatory work. As described above, for that matter, the context is always considered together with the establishment of the meaning, while the preparatory work only is a supplementary means (Article 32 Vienna Convention).

Van Raad bases the value of the Commentary on the fact that it has been realized in common consultation with the Member States which could have made reservations. Therefore he believes that it is a contextual document in the sense of Article 31, paragraph 2(b) Vienna Convention.[64]. The opinion of Van Raad is doubted by Avery Jones:[65] firstly, the Commentary is not a report on a multilateral treaty. Secondly, although

61. General Remarks no. 26 and Introduction no. 29.
62. M.A.G. van Meerhaeghe, *International economic institutions*, Dordrecht 1985, at 221.
63. Quoted in *Vogel on Double Taxation Conventions*, Introduction (80). On judicial aspects H.J. Hahn and A. Weber, *Die OECD, Organisation für wirtschaftliche Zusammenarbeit und Entwicklung*, Baden-Baden 1976.
64. David A. Ward, "Principles to be applied in interpreting tax treaties", XXV *Canadian Tax Journal. Vogel on Double Taxation Conventions*, Introduction (80) also derives from the circumstance that reservations and observations are being made that these are more than a recommendation. We believe that the possibility to make reservations and observations does not change the legal status of the OECD Model Convention and Commentary. Against Vogel's statement that high qualified official experts have stated their opinion in the OECD Commentary, Nooteboom has justly argued that this cannot justify the preferential position of the Commentary. A. Nooteboom, "De invloed van de OECD-modelbelastingverdragen terzake van inkomen en vermogen van 1963 en 1977 op de rechterlijke oordelen in Nederland gepubliceerd in de *BNB*'s in de jaren 1981-1993", Lelystad 1994 (last lecture on 2 July 1993 University Groningen).
65. J.F. Avery Jones, see *supra* note 40, at 92.

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it is a document pertaining to the treaty, it is not a document made in connection with concluding a treaty.

In our opinion Article 31, paragraph 3(b) Vienna Convention offers more possibilities to justify the use of the Commentary. In connection with the content, "any subsequent practice in the application of the treaty which establishes the agreement of the Parties regarding its interpretation" is to be taken into consideration as well. In our opinion, this text can be broadly interpreted as comprising the interpretational activity itself, such as the use of the Commentary. It is not required that agreement is realized by common practice: we believe it is satisfactory if one of the parties practices and the other party does not object. This may also become clear from the Commentary to the Final Draft of the articles of interpretation of the International Law Commission: "The text provisionally adopted in 1964 spoke of a practice which "establishes the understanding of all the parties". By omitting the word "all" the Commission did not intend to change the rule. It considered that the phrase "the understanding of the parties" necessarily means "the parties as a whole". It omitted the word "all" merely to avoid any possible misconception that every party must individually have engaged in the practice where it suffices that it should have accepted the practice". [66]

C. The Commentary in Dutch practice

With regard to the interpretation of treaties the Commentary was first used in the judgement of Supreme Court 24 March 1976, 17 812, *BNB* 1976/121. In his appeal, the State Secretary of Finance uses the OECD Commentary to support his opinions about the negative list in the permanent establishment article (Article 2 paragraph 2(b) Germany treaty). It is significant that the State Secretary referred to the OECD Commentary of 1963 when dealing with a treaty originating from 1959. For that matter, the State Secretary motivated his appeal to this Commentary by referring to the preliminary publication of this article in the Fiscal Committee Report in 1958. With respect to this, see further the State Secretary in Supreme Court 10 March 1982, 20 933, *BNB* 1982/127 and Supreme Court 15 June 1988, 24 881, *BNB* 1988/258.

In the Advocate-General's conclusions, as a rule, the Commentary is always quoted when appropriate. Occasionally, the relevance of the Commentary in question is considered in more detail, for example when it is clear from the accompanying documents (the Dutch Explanatory Note or its foreign counterpart) that a certain treaty has been inspired by the OECD MC. See for example Supreme Court 22 July 1988, 25 075, *BNB* 1989/2.

The courts have made use of the Commentary, see for example Supreme Court 2 September 1992, 27 252, *BNB* 1992/379 and in the Court's judgement in Supreme Court 25 May 1994, 28 959, *BNB* 1994/219. Because of the relevance, the consideration of the Supreme Court in *BNB* 1992/379 is cited: "... it is to be assumed that in the Agreement (the Netherlands–Ireland treaty) as appears from both its text and the explanatory note supplied to the Dutch Senate and the Parliament by the Dutch Government... that the OECD Model Convention of 1963 is followed to the best possible extent and that the English version of Article 8, paragraph 9, of the Agreement is almost literally similar to the English text of Article 10, paragraph 5 of the above-mentioned Model Convention, as a result of which, as rightfully argued..., the Commentary to the latter provision referred to is of "major importance" for the interpretation of Article 8, paragraph 5 of the Agreement, and does not offer, to quote the Court's words, "something to go on".[67]

Which version of the Commentary is to be used is a vexed issue: is it the Commentary current at the conclusion of the treaty or the Commentary at the time of the dispute? From the above cited *BNB* 1992/379 it appears that the Supreme Court follows the version of the Commentary as it was current at the time when the treaty was concluded: after all, the Supreme Court followed the Commentary of 1963 for the Netherlands–Ireland treaty of 1969. This method was also used in Supreme Court 28 June 1995, 29 435, *BNB* 1996/108, in which the Court (judging in 1993) with regard to the Netherlands–United Kingdom treaty of 1980 followed the Commentary under the OECD MC of 1977.

The OECD itself recommends that the most recent Commentary is followed.[68] For its interpretation of the Netherlands–Austria treaty of 1970, the Court in Supreme Court 4 July 1989, 25 660, *BNB* 1989/274 with explicit reference to the Introduction to the Commentary uses the 1977 Commentary. The Supreme Court approved this. The same happened with regard to the Netherlands–Indonesia treaty of 1973 in Supreme Court 12 June 1991, 27 310, *BNB* 1991/312: the Court consciously followed the Commentary of 1977, by recognizing the recommendation of the Introduction.

In the above-mentioned, the concrete treaty was realized under one of the versions of the Commentary. Does the Commentary, however, also play a part in interpreting if it cannot have been part of the treaty negotiations historically? From the statement in the Introduction (29) that the Commentary in general "can be of great assistance ... in particular, in the settlement of any disputes", it can be deducted that this may be the case. In Dutch case law this is incorporated in the interpretation of the Netherlands–United States treaty of 1948. In Supreme Court 20 April 1983, 21 047, *BNB* 1983/204 the Supreme Court sanctioned the relation to the Commentary sought by the Court, even though the Commentary did not exist at the time when the treaty was being concluded.

66. *Dokumente* at 254.
67. In Supreme Court 11 October 1978, 18 759, *BNB* 1978/300 the Commentary was also followed, now explicitly because the treaty in question – the Netherlands–Belgium treaty – had been derived from the OECD MC to a large extent, as appeared from its text and the unilateral explanations of the contracting states. Without additional comment, we also refer to Supreme Court 17 May 1961, 14 458, *BNB* 1961/196; Supreme Court 24 June 1981, 20 216, *BNB* 1981/236; Supreme Court 28 June 1995, 29 435, *BNB* 1996/108; Court 's-Hertogenbosch 19 September 1975, 728/1974, *BNB* 1976/103; Court 's-Gravenhage 26 March 1984, 22/84 M I, *BNB* 1984/249.
68. Introduction (33-35).

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ARTICLE 23 OF THE PROPOSED UNITED STATES–IRELAND TAX TREATY

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I. INTRODUCTION

On 28 July 1997, Ireland and the United States signed a new tax treaty, to replace what is probably the oldest US tax treaty currently in force. Like all recent tax treaties entered into by the United States, it contains, at Article 23, a Limitation on Benefits (hereinafter "LOB") article.[1] This concept has evolved considerably since its first appearance in Article 16 of the US 1977 Model Convention, probably reaching a peak of complexity in Article 26 of the Netherlands treaty. The LOB article in the proposed United States–Ireland treaty, (referred to throughout this article as "the Treaty")[2] although quite complex, is far more succinct. It nevertheless contains some interesting additional material reflecting the evolution of the US negotiators' position since 1993 that may be of broader international interest.

This article analyses Article 23 of the Treaty and compares its terms with versions of the corresponding article in the recent treaties between the United States and the Netherlands, Luxembourg and Portugal (referred to in this article as "the other treaties").[3] This selection, although apparently arbitrary, is not entirely so.[4] All four countries have special corporate tax regimes, set within ostensibly normal tax systems.[5] They therefore represent ideal targets for the refinement by the US Treasury negotiators of their anti-treaty-shopping weapon – the LOB clause. In most cases,[6] diplomatic delicacy has prevented explicit references to the regimes targeted by the United States. The bilateral nature of tax treaties also necessitates the use of "two-way" language, which further hinders clear drafting and interpretation of LOB clauses, which primarily reflect the concerns of the US negotiators. The result is a set of 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. These tests are supplemented by discretionary relief provisions that require a subjective analysis involving the imputation of a principal purpose. If treaty abuse motives are not regarded as the principal purpose of a transaction or structure, treaty access may be permitted. This familiar pattern is followed in the Treaty.

II. QUALIFIED PERSONS

Article 23(1) grants all the benefits of the Treaty to a resident of a contracting state who is a "qualified person".[7] There are six categories of qualified person:

(a) an individual;
(b) a qualified governmental entity, as defined;
(c) a person other than an individual, at least 50 per cent owned by qualified persons or residents or citizens of the United States, where that person meets a detailed "base erosion" test;
(d) a unit trust listed and traded on a recognized stock exchange or at least 50 per cent owned by qualified persons or residents or citizens of the United States;
(e) a company having its shares substantially and regularly traded on one or more recognized stock exchanges, or at least 50 per cent owned by such publicly traded companies, or by qualified governmental entities, their subsidiaries or by any combination of these;
(f) a pension trust, certain employee benefit trusts and any charitable or other exempt organization.

1. However, only the most recent contain the LOB article in its present highly evolved form. Earlier US treaties with 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 contain LOB provisions following either the 1977 US Model Treaty or the 1981 Proposed US Model Treaty.
2. Except where it and another treaty or treaties are being listed for purposes of contrasting their provisions with those of other treaties surveyed in this article. In these cases, the term "US–Ireland" treaty is used.
3. Or, where referred to singly, as the Netherlands, Luxembourg or Portuguese treaties respectively.
4. By coincidence, two of the four are also countries with which the author has had considerable first-hand experience.
5. These are, in Ireland the International Financial Services Centre, in the Netherlands the favourable holding company and finance company regimes, in Luxembourg the 1929 holding company and Soparfi regimes, and in Portugal the tax exemptions available to activities licensed in designated islands in the archipelagos of Madeira and the Azores.
6. The exception is Art. 17(6) of the Portuguese treaty. Both sides were saved much drafting effort when Portuguese negotiators accepted an express reference to the Madeira and Azores Free Zone. The paragraph excludes from the benefits of the treaty any companies enjoying the benefits applicable to these parts of the two Autonomous Regions of Portugal, which include no tax on corporate profits until 2012 and no withholding tax on out-payments of dividends, interest or royalties. This wording could have unintended scope, depriving Portuguese banks with branches in Madeira of all treaty benefits, even in respect of fully taxable income.
7. The Netherlands treaty uses the term "qualified resident". The Luxembourg and Portuguese treaties avoid the use of either term.

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The detailed requirements applicable to each category of qualifying person are examined in the paragraphs that follow. Categories (c), (d) and (e) above are considered together.

A. Individual

The term "individual" is the only one not requiring definition or qualification.

B. Qualified governmental entities

The definition here is quite detailed. It extends more clearly than the other treaties to entities that are owned by the government, although in practice there will be very few that fall within the definition contained in Article 3(1)(j):

(i) any person that constitutes the Government or a Department of Government of a contracting state, or a political subdivision or local authority of a contracting state;

(ii) a person that is wholly owned, or the beneficial interest of which is wholly owned, directly or indirectly, by a contracting state or a political subdivision or local authority of a contracting state, provided (A) it is organized under the laws of the contracting state, (B) its earnings are credited to its own account and (C) its assets vest in the contracting state, political subdivision or local authority upon its dissolution; and

(iii) a pension trust or fund of a person described in subparagraph (i) or (ii) that is constituted and operated exclusively to administer or provide pension benefits described in Article 19 (Government Service), provided the income of the entity does not inure to the benefit of a private person and the entity does not carry on commercial activity.

There are several Irish state-owned commercial enterprises in the transport, utilities and telecommunications sectors. Because these carry on a commercial activity, they are not "qualified governmental entities" under the above definition. However, for as long as they remain in public ownership, they may qualify for treaty benefits under the other ownership tests described below.

C. Persons meeting certain ownership or other requirements

The wording here is similar to that of the other treaties, but also deals specifically with unit trusts.

1. Ownership

(a) *Ownership by qualified persons or US citizens or residents*

Under this test, at least 50 per cent of the beneficial interest in the entity (or in the case of a company at least 50 per cent of the aggregate vote and value of the company's shares) must be owned, directly or indirectly, by qualified persons or residents or citizens of the United States. This ownership test is not satisfied in the case of a chain of ownership unless it is satisfied by the last owners in the chain.

Of the other treaties, only the Luxembourg treaty contains a similar test.

(b) *Ownership by the public via a recognized stock exchange*

A company is a qualified person where:

(i) the principal class of its shares is substantially and regularly traded on one or more recognized stock exchanges; or

(ii) at least 50 per cent of the aggregate vote and value of its shares is owned directly or indirectly by companies in (i) above, or by qualified governmental entities or by companies more than 50 per cent of the aggregate vote and value of which is owned by qualified governmental entities or any combination of these.

A fund is a qualified person if:

(i) the principal class of units in it is listed on a recognized stock exchange located in either contracting state and is substantially and regularly traded on one or more recognized stock exchanges; or

(ii) the direct or indirect owner of at least 50 per cent of the beneficial interests in it is a person referred to in (i) or whose principal class of shares is substantially and regularly traded on one or more recognized stock exchanges.

The term "units" is defined in Article 23(8)(c) as "including shares or any other instrument, not being a debt-claim, granting an entitlement to (i) a share in the assets or income or (ii) receive a distribution from it. This inclusion of funds represents an additional category, not included in the Netherlands, Portuguese or Luxembourg treaties. It provides considerable scope for using IFSC-managed variable capital companies to invest in the United States and enjoy the benefits of reduced US withholding tax.

Recognized stock exchanges are also more extensively defined in the Treaty than in the other treaties. They include the NASDAQ System, any stock exchange registered with the US Securities and Exchange Commission, the Irish stock exchange, the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, London, Madrid, Milan, Paris, Stockholm, Sydney, Tokyo, Toronto, Vienna and Zurich, and any other stock exchange agreed upon by the competent authorities. The Luxembourg stock exchange is not included. The equivalent definition in the other treaties includes only NASDAQ and one (or, in the case of Portugal, two) national exchange(s) and can be extended only by agreement between the competent authorities. In the case of closely held companies, NASDAQ is excluded from the term "recognized stock exchange" in the Netherlands and Luxembourg treaties. In the case of Luxembourg, closely held companies listed on the Luxembourg Stock exchange are also excluded. The concept of closely held company does not arise in the United States–Ireland or Portuguese treaties.

The term "regularly and substantially traded" is defined in the United States–Ireland and Luxembourg treaties. Both treaties require that the aggregate number of shares[8] of that class traded on such stock exchange or exchanges during the previous fiscal year is at least 6 per cent of the average number of shares or units outstanding in that class during that tax-

8. Or, in the case of an Irish unit trust, units of that class.

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able year. The Treaty goes further, however in imposing a frequency as well as a volume test, and requires that trades in such class are effected on one or more of such stock exchanges other than in *de minimis* quantities during every quarter. It also addresses the problems faced by newly listed shares or units by deeming the 6 per cent volume test to be met if the class was not listed on a recognized stock exchange in the previous fiscal year.

The unique position of Irish Building Societies, which are usually owned by their depositors,[9] is addressed by deeming them to be a company the principal class of shares in which is listed on the Irish Stock Exchange, and which in any fiscal year is substantially and regularly traded on such exchange.

2. Base erosion

This test follows the pattern established in the other treaties. A person is not a qualifying person where amounts paid or accrued by that person during its fiscal year, which are tax deductible expenses for that fiscal year to persons that are neither qualified persons nor residents or citizens of the United States, exceed 50 per cent of the gross income of that person for that year. Arm's length payments in the ordinary course of business for services or purchases or rentals of tangible property, as well as payments in respect of financial obligations to a permanent establishment of a bank in either contracting state are not taken into consideration in applying this test. The reference to payments in respect of financial obligations is not found in the other three treaties.

The base erosion test does not apply to quoted companies or funds.

D. Pension funds, charities and other exempt organizations

A pension trust and any other organization established in that state and maintained exclusively to administer or provide retirement or employee benefits that is established or sponsored by a person that is otherwise a resident under Article 4 (Residence) is treated as a qualifying person; as is any charitable or other exempt organization, provided that the use of the organization's assets, both currently and upon the dissolution or liquidation of such organization, is limited to the accomplishment of the purposes that serve as the basis for such organization's exemption from income tax.

The relevant paragraph is much more detailed than the corresponding ones in the Portuguese and Luxembourg treaties. The Irish negotiators were clearly at pains to ensure that pension funds established by Irish companies would qualify for treaty benefits in respect of income from investments that they might make in the United States. They did not, however, go as far as the Dutch negotiators, who also expressly included private foundations and trade unions. In Ireland, these would normally be "charitable or other exempt organizations" for tax purposes, and covered by that term in the Treaty.

III. NON-QUALIFIED PERSONS QUALIFYING FOR TREATY BENEFITS

Active trade or business

Under Article 23(3) of the Treaty, a non-qualified person may qualify for treaty benefits if it is involved in an active trade or business in its country of residence (other than the business of making or managing investments, unless such business is carried out by a bank or insurance company acting in the ordinary course of its business) and the item of income from the other contracting state is "connected with" or "incidental to" the trade or business in its country of residence. The Treaty contains the usual proviso that, if the income is connected with a trade or business in the country of residence and the resident has an ownership interest in the activity in the other contracting state that generated the income, the trade or business is "substantial" in relation to the income-producing activity. The requirement that the income arising in the other state be "connected with" and "incidental to" the trade or business in the country of residence is common to all four treaties.

For group treasury companies located in the IFSC, carrying on intra-group lending activities, the question arises as to whether the United States will regard their activities as "the making or managing of investments". In practice, these operations can be substantial, employing large numbers of financially trained personnel. Until the Technical Explanation by the US Treasury is available, this question cannot be answered, but if the precedent established in the Technical Explanation to the Dutch treaty is followed, these companies are likely to fail the "active trade or business" test.

1. Substantiality

The "substantiality" test is also common to all the treaties covered by this survey, but the definitions of the term are not identical. The United States–Ireland and Luxembourg treaties contain a subjective "all relevant facts and circumstances test" as well as an objective test based on relative asset values, gross income and payroll expense. Under this, in both treaties, the trade or business will be deemed substantial if, for the preceding fiscal year, or for the average of the three preceding fiscal years, the asset value, the gross income and the payroll expense that are related to the trade or business in the first-mentioned state equals at least 7.5 per cent of the asset value, the gross income and the payroll expense, respectively, that are related to the activity that generated the income in the other state, and the average of the three ratios exceeds 10 per cent.[10].

The Netherlands treaty uses the same percentages but contains a more extensive set of additional conditions and options. Under these, Netherlands residents may elect to

9. As in the United Kingdom, there is a trend towards the de-mutualization of these societies, which results in their conversion to publicly quoted companies.
10. Art. 23(3)(ii) of the treaty.

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apply a modified version of the above "three ratios rule", under which assets and activities relating to the business conducted in other EC Member States by the Netherlands resident or certain related parties or affiliates can be combined with the Netherlands assets and activities.[11] The Portuguese treaty does not contain any definition of the term "substantial" in this context.

2. Banking and insurance companies

The position of banks and insurance companies in the context of the "active trade or business" test is more clearly set out in the Treaty than in any of the other treaties. Paragraph 9 of the Protocol to the Treaty expands on the provisions of Article 23(3) with regard to banks and insurance companies. It states that, in any case, a bank will be considered to be engaged in the active conduct of a trade or business if it regularly accepts deposits from the public or makes loans to the public. A resident of a contracting state that, as of 28 July 1997, was licensed by the banking authorities in that state to engage in the business of banking satisfies this requirement. Similarly, an insurance company will be considered to be engaged in the active conduct of a trade or business if its gross income consists primarily of insurance or reinsurance premiums and investment income attributable to such premiums.

IV. INCOME FROM OPERATION OF SHIPS OR AIRCRAFT IN INTERNATIONAL TRAFFIC

This is dealt with in the context of LOB only in the United States–Ireland and Netherlands treaties. Article 8 of both treaties provides generally that profits derived from the operation of ships or aircraft in international traffic ("international transportation income") may be taxed only by the country of residence of the person that earns the profits. If a person that has international transportation income fails to qualify as a qualified person, and cannot satisfy the active business test, the person nevertheless will be entitled to treaty benefits in respect of that income if at least 50 per cent of the beneficial interest in such person (or in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) is owned directly or indirectly:

- by qualified persons or citizens of the United States or individuals who are residents of a third state; or
- by a company or combination of companies the principal class of shares in which are substantially and regularly traded on an established securities market in a third state, provided that such third state grants an exemption under similar terms for profits referred to in Article 8 of this Convention to citizens and corporations of the other state either under its national law or in common agreement with that other state or under a convention between that third state and the other state.

This provision reflects the "reciprocal exemption" provisions of the Internal Revenue Code with regard to international transportation income. Under these provisions, income derived by a foreign corporation from the international operation of ships, aircraft or rail roads is exempt from US income tax if the country of incorporation grants an equivalent exemption to US corporations and certain other requirements are met.[12] In both treaties, the wording conforms closely to that of US domestic tax legislation, but neither mirrors it exactly.

V. DERIVATIVE BENEFITS

The concept of derivative benefits extends treaty benefits to non-qualified persons – companies that are controlled by persons who are not residents of the contracting states, but who meet other defined criteria. Some recent US treaties have imposed conditions that limit this facility, and the Treaty follows the Luxembourg and Netherlands treaties in this respect. All three treaties contain similar conditions with regard to dividends, interest and royalties, and impose as a condition of treaty access a requirement that the state of residence of the persons controlling the entity has concluded a tax treaty with the United States[13] providing at least as favourable treatment for the same type of income. The logic underlying this concept is that residents of third countries are unlikely to be engaging in "treaty shopping" by investing through an entity resident in one of the contracting states if they could obtain identical or more favourable treatment by investing directly from their own country. The Portuguese treaty contains no such conditions. Presumably, the exclusion of Madeira and the Azores from the benefits of that treaty reassured the US negotiators that third country investors were unlikely to use a normally taxed Portuguese company as a conduit for extracting income of this type from the United States.[14]

The Treaty provides[15] that a company is entitled to all of its benefits if at least 95 per cent of the aggregate vote and value of all its shares is owned directly or indirectly by seven or fewer residents of EU or NAFTA[16] countries and it meets the "base erosion test" described above. Residents of NAFTA countries and EU Member States are treated as "qualified persons" for purposes of that test in this context. There is no minimum Irish ownership requirement, and any combination of EU or NAFTA residents is permissible. This is more clearly expressed than in the Luxembourg treaty, which had given rise to doubts as to whether the seven or fewer residents of EU or NAFTA countries had all to be from either

11. For an extensive treatment of these and of the LOB article in the Netherlands treaty, see Philip H. Specter, 47 *Bulletin for International Fiscal Documentation*, 4 (1993), at 159.
12. Sec. 883(c) Internal Revenue Code.
13. For a commentary on the compatibility of the relevant provisions of the Netherlands–United States treaty with EU legislation see Helen Doyle "Is Article 28 of the Netherlands–United States Tax Treaty compatible with EU Law?" 35 *European Taxation*, 1 (1995), at 14.
14. However, an unintended opportunity for treaty-shopping may remain, since a Portuguese holding company (Sociedade de Participações Sociais – "SGPS"), whether located in Madeira or elsewhere in Portugal, is taxed at an effective rate of between 1.8 per cent and 1.98 per cent on dividend income from all sources. A two-tier structure, with a Madeira company owning a Portuguese SGPS, would therefore appear to provide a tax-efficient mechanism for extraction of dividend income from the United States at treaty-reduced withholding rates.
15. Art. 23(5)(a).
16. United States of America, Canada and Mexico.

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the EU or NAFTA. Both treaties grant a wider range of treaty access to eligible companies than the Netherlands treaty, which limits access to only four articles of the Treaty (Dividends, Branch Tax, Interest and Royalties). The Netherlands treaty also contains a joint ownership requirement[17] – more than 30 per cent of the aggregate vote and value of all the claimant's shares must be owned by certain residents of the Netherlands and more than 70 per cent by certain residents of the European Union. Unlike the United States–Ireland and Luxembourg treaties, it contains no mention of NAFTA countries.[18]

Throughout the treaty renegotiation process, financial institutions in the Dublin International Financial Services Centre ("IFSC") have been apprehensive about the possible impact of the LOB article. A significant part of their business involves the management of Agency Treasury Companies, which engage in cross-border lending to subsidiaries of multinationals. For many groups, particularly those based in countries without a tax treaty with the United States, access to the Irish tax treaties was a major attraction of companies established in the IFSC. The introduction by the United States of anti-conduit regulations in September 1995 reduced the scope for these non-Irish owned IFSC companies to lend to US borrowers and enjoy interest income free of US withholding tax. However, with appropriate capitalization of IFSC entities, it remained possible to avoid the impact of these regulations. The restrictions imposed by the LOB article impose additional obstacles on IFSC-based treasury companies owned by residents of non-treaty partners of the United States. They also affect investors in the IFSC who are resident in countries that have tax treaties with the United States – for example, Canadian and Italian-owned IFSC companies. The treaties between these countries and the United States contain less favourable provisions regarding source-country taxation of interest, causing Irish resident companies owned by residents of Canada or Italy to fail the "at least equivalent benefits" test in Article 23(5)(b). However, the impact of this is mitigated by the unusual transitional provisions – see below.

VI. LACK OF TREATY SHOPPING MOTIVE

The Treaty follows the other three in empowering the competent authority to extend the benefits of the treaty to persons who would otherwise not be eligible. Under it,[19] a resident of a contracting state that is not a qualified person shall, nevertheless, be granted the benefits of the Convention if the competent authority of that other contracting state determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention. This is stronger language than that contained in the Netherlands and Portuguese treaties, which merely require the competent authorities to use these motives as a guideline or as one of the factors to be taken into account in granting or denying treaty access. The comparable Luxembourg provision is remarkably short, and provides no guidelines for the competent authorities in reaching their decision and requires no determination by them of the absence of undesirable motives. The obligation contained in the Treaty for the competent authorities to consult each other before denying the benefits of the treaty to residents of the other state is absent from the Luxembourg and Portuguese treaties.

VII. FOREIGN BRANCH EXEMPTION

This is one of the rare instances of a treaty provision being drafted in "one-way" terms only.[20] It addresses the concern of the US negotiators that the United States may be conceding treaty benefits to US-source income that is exempt from tax in Ireland. Although there are many types of income that can be so exempt (e.g. royalties from patents on which the related work of research, planning, processing, experimenting, testing, devising, designing, developing or similar activity which was carried on in the state, stallion and greyhound stud fees, copyright royalties earned by authors, composers etc. in respect of works certified by the Revenue Commissioners as having artistic or cultural merit), the Treaty addresses only US-source income arising to a branch of an Irish resident company in a third country where that income is exempt from tax in Ireland. This "Foreign Branch Exemption" is relatively new.[21] Its acceptance by investors has so far been limited, with only two known instances of its application both involving US financial groups. For these, and those that may follow them, the Treaty provides for the denial of treaty benefits where the rate of tax applicable to the income is less than 50 per cent of the generally applicable tax that would be imposed in Ireland on an enterprise deriving such income directly from the United States. Any dividends, interest or royalties to which this paragraph applies will be subject to United States tax at a rate not exceeding 15 per cent of the gross amount.

These provisions do not apply if the income derived from the other contracting state is connected with or incidental to the active conduct of a trade or business carried on by the permanent establishment in the third state (other than the business of making or managing investments, unless these activities

17. Art. 26(4) of the Netherlands tax treaty.
18. More recent treaties (with Mexico and Portugal) also include NAFTA.
19. Art. 23(6).
20. The comparable (otherwise almost identical) provisions in Art. 24(5) of the Luxembourg treaty are drafted in the more usual bilateral terminology.
21. It was introduced in Sec. 29 of the 1995 Finance Act to encourage large international groups to establish regional operational headquarters in Ireland. 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.

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are banking or insurance activities carried on by a bank or insurance company).

VIII. ENTRY INTO FORCE

The Treaty in general enters into force on the exchange of instruments of ratification and its provisions have effect:

(a) for taxes deducted at source, for amounts paid or credited on or after 1 January following the exchange of instruments of ratification;
(b) for other taxes, in the case of the United States, for taxable periods, and in the case of Ireland, for financial years (corporation tax) and for years of assessment (income tax and capital gains tax) beginning on or after 1 January following the exchange of instruments of ratification.

It contains a one-year delay where the 1949 treaty would have afforded any greater relief from tax to a person entitled to its benefits than is afforded under the Treaty. In these cases, the old treaty continues to have effect for a period of 12 months from the date on which the provisions of the Treaty would otherwise have entered into force. Although the Luxembourg and Dutch treaties permit the taxpayer to elect to have the old treaty continue to apply, the Treaty contains no provision for such election. It is understood that the Irish authorities attach no particular significance to this omission, and regard the 12-month extension as optional for taxpayers.

The Treaty contains a unique delay mechanism in relation to the Derivative Benefits provisions of Article 23(5). The denial of treaty benefits to companies owned by residents of countries having a tax treaty at least as favourable (regarding dividends, interest or royalties) with the source country[22] shall not have effect for a period of 24 calendar months from the date on which the provisions of this Convention would otherwise have effect. This is in addition to the potential one-year deferral applicable in cases where the old treaty was more advantageous.[23] This means, for example, that if instruments of ratification are exchanged before the end of 1997, a Canadian-owned Irish company receiving interest from sources in the United States, and having a 31 December accounting year-end could continue to receive interest gross from the United States up to 31 December 2000.

It is not clear from the wording of the Treaty whether these provisions can operate selectively, continuing the application of the old treaty in respect of items of income where the old treaty affords greater benefits, while simultaneously applying the terms of the Treaty to other items of income or gain where the treatment is equal or more favourable under it. However, it is generally expected that taxpayers who elect for continued application of the existing treaty will continue to be covered by it in its entirety. If they do not so elect, the Treaty will apply in full from the date it enters into force.

IX. CONCLUSION

Overall, the provisions of the LOB article contain few surprises, and are particularly close to those of the Luxembourg treaty. The most radical difference is perhaps the additional two-year delay in the application of the Derivative Benefits provisions. The other differences relate primarily to matters of detail – a more precise definition of "recognized stock exchange", inclusion of some country-specific entities (building societies, unit trusts, state-owned) and exclusion of others (conduit companies, headquarters companies, holding companies).

The practical impact of the LOB article on international groups of companies will be limited. The vast majority of IFSC-based companies do not have US-source income, being already constrained from having US-source income by Sub-Part F and anti-conduit considerations. The large proportion of IFSC companies that are owned by US corporations will continue as before, enjoying deferral of US tax and the 10 per cent Irish rate of corporation tax on income from their international treasury, insurance, reinsurance or manufacturing activities in Ireland or "relevant trading operations" in Shannon and will be largely unaffected by the Treaty. Some will lose the benefit of the interest exemption under Article XV of the present treaty, but this was an unintended anomaly, and its removal has nothing to do with the LOB concept.

The main impact of the LOB clause will be to provide a three-year window of opportunity to Canadian and Italian groups to maximize the use of their existing IFSC structures, if any, and to encourage those who have not yet ventured into the IFSC to consider, establishing a short-term treasury function there for lending to the United States. Irish regulators are known to be hostile to the latter idea, and new applicants for IFSC licences are likely to face considerable scrutiny if they appear to be planning to channel Canadian or Italian funds to the United States via the IFSC.

In practical terms, therefore, the LOB article is likely to be of more interest to negotiators from countries that are in the process of negotiating/renegotiating a treaty with the United States, and to students of this aspect of tax treaties than to international businesses. Its effect will be preventive, rather than necessitating immediate reorganization of ownership structures or financing arrangements. In this, it has probably fulfilled the objectives of the US negotiators while having the Irish negotiators satisfied that they have concluded a treaty containing a state-of-the-art LOB clause that is no worse for residents of their country (and in some respects, better) than the corresponding provisions of other US treaties.

22. Art. 23(5)(b).
23. This interpretation accords with the Explanation issued by the US Joint Taxation Committee of Congress.

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CONTROLLED FOREIGN COMPANIES AND TAX TREATIES

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I. INTRODUCTION

One of the most problematic areas in the relationship between tax treaties and domestic law is where one contracting state treats a particular item of income as belonging to one payer while the other contracting state treats it as belonging to another. One area where this issue is highlighted is in the interaction between treaties and controlled foreign company legislation (CFC).[1] Specific legislation attributing the income of CFCs to resident shareholders was introduced in the United States in 1962. Similar regimes have been adopted since then by a large number of OECD countries and by certain other countries such as Brazil. Most CFC regimes, including that of the United Kingdom introduced in 1984, post-date the publication of the 1977 OECD Model Double Taxation Convention. It was only by way of amendment to the Commentary on Article 1 in 1992 that the official OECD Commentary referred to the inter-relationship between CFC type provisions and treaties.[2]

The Commentary deals with the issue in relation to Article 1 (personal scope) in the context of treaty abuse generally. It notes that the large majority of OECD member countries consider that CFC type measures are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. These rules are not addressed in tax treaties and are therefore not affected by them.[3] It does, however, note that the spirit of the Model Convention would be violated if a company ended up with no or almost no activity or income being attributed to it and the contracting states took divergent views on the subject with economic double taxation resulting therefrom, the same income being taxed twice in the hands of two different taxpayers.

The Commentary also points to a dissenting view which holds that CFC type rules are subject to the general provisions of treaties especially where the treaty itself contains provisions designed to counteract improper use. The United Kingdom has not entered any reservation in relation to this issue. The subject has attracted the attention of several writers.[4] In the concluding words of his book, Sandler noted that it was only a matter of time before the issue is tested in a domestic court.

The issue has come squarely before the UK courts recently in *Bricom Holdings Limited v. IRC*.[5] The facts of the case were straightforward and undisputed by the parties. Bricom Holdings Limited (the "Taxpayer") was a company resident in the United Kingdom. It owned 100 per cent of the shares of Spinneys International B.V. (the "Dutch company"). The Taxpayer was also one of several UK resident and incorporated companies forming a group of companies. The Dutch company was incorporated in and resident in the Netherlands. It carried on business as a restaurant operator through a branch in Singapore. After selling the branch, the Dutch company had surplus funds. Companies in the UK group borrowed substantial amounts of money from the Dutch company and paid interest to the Dutch company in respect of the loans.

Under UK domestic law, interest paid by the UK group company to the Dutch company was subject to tax under Case III of Schedule D. The Income and Corporation Taxes Act 1988 ("Taxes Act 1988") Section 349(2)(a) & (c) requires deduction of tax at source and Section 350(4) and Schedule 16 contain rules for accounting for the tax so deducted. However, Article 11(1) of the Netherlands–United Kingdom treaty (the "Treaty") provides that "interest arising in one of the States which is derived and beneficially owned by a resident of the other State shall be taxable only in that other State". There was no dispute that the UK payers were entitled to pay interest without deduction of tax as authorized by the Treaty.

The scope of the disagreement between the Taxpayer and the Inland Revenue was narrow, but significant. There was no dispute that the Dutch company was a CFC. The Taxpayer accepted that, but for the Treaty, as sole shareholder in the Dutch company it was potentially liable to apportionment of the whole of the chargeable profits, as well as creditable foreign tax of the Dutch company as a CFC in accordance with UK domestic law.

The Inland Revenue did not dispute that interest payable by UK resident companies to the Netherlands company was exempt from UK tax by virtue of Article 11(1) of the Treaty.

1. Another current example is in relation to hybrid entities. See for example Jonathan Schwarz, "Hybrid Entities and Financing Structures: A View from the United Kingdom" 51 *Bulletin for International Fiscal Documentation*, 6 (1997), at 265.
2. The issue was however raised in the OECD Committee on Fiscal Affairs Report: "Double Taxation Conventions and the Use of Base Companies" in International Tax Avoidance and Evasion – Four Related Studies (1987, Paris).
3. The only UK Treaty which deals with CFC rules is that with Canada in which Canada reserves the right to apply its equivalent domestic law provisions Art. 27(3).
4. For example, Daniel Sandler, *Pushing the Boundaries – the Interaction Between Tax Treaties and Controlled Foreign Companies Legislation* (Institute of Taxation/Institute for Fiscal Studies 1994); Michael Edwardes-Ker, Chap. 55 "Do Tax Treaties and CFC Provisions Conflict?", *Tax Treaty Interpretation*, (In-Depth Publishing).
5. [1996] STC (SCD) and [1997] STC 1179 (CA).

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It is particularly noteworthy that the Inland Revenue accepted that the effect of the Treaty was to exempt the interest from UK corporation tax and not merely the resident of the Netherlands who received it. They therefore acknowledged that the benefit of the exemption is capable of enuring to the Taxpayer company. The Inland Revenue argued that the Treaty did not apply to the CFC charge.

The issue in dispute was the correctness of assessments which included that part of the Dutch company's profits that comprised the interest it had received from the UK company.

II. CFC PROCEDURES

Under UK domestic law, the application of the CFC rules is not automatic. Taxes Act 1988 Section 747(1) gives the Board of Inland Revenue power to direct that the CFC provisions contained in Chapter IV of Part XVII of the Taxes Act are to apply. Such a direction may be made if the Board have reason to believe that the CFC regime is applicable.

The Board of Inland Revenue served several notices of direction applying the CFC provisions to the Taxpayer in respect of its ownership of the Dutch company and assessments apportioning the whole of the profits of the Dutch company to the Taxpayer followed.

The Taxpayer appealed against notices of direction and of assessment on the basis that they included amounts attributable to interest accruing to a Dutch resident company contrary to the provisions of Article 11 of the Treaty.

The decision both of the Special Commissioners and the Court of Appeal involved a close interpretation of the CFC provisions and the manner in which they operate.

The application of the CFC rules was analysed by the Special Commissioners as requiring three stages to be undertaken. This approach was endorsed by the Court of Appeal. The three stages are: ascertainment, apportionment and assessment.

Ascertainment, apportionment and assessment

Chargeable profits of the CFC are to be ascertained under Taxes Act 1988 Section 747(6)(a) and Schedule 24. Schedule 24 requires three assumptions to be made in determining the chargeable profits for an accounting period of the CFC. They are:-

- the CFC is assumed to be resident in the United Kingdom;
- the CFC is assumed to have become UK resident at the beginning of the first accounting period for which the CFC rules are directed to apply;
- the CFC has made claims for all reliefs available to companies within the charge to UK corporation tax.

In the view of the Inland Revenue, there was no basis for exclusion of the interest in ascertaining the chargeable profits. No part of the "chargeable profits" is interest derived or beneficially owned by the Dutch company. Chargeable profits for this purpose are a wholly notional amount, no part of which is paid to or received by anyone. The argument of the Taxpayer was that the CFC legislation did not change the nature of the income which is that of UK source interest received by a Netherlands resident. It retains its Treaty exempt character, even when brought into the computation of chargeable profits. It was thus argued that the chargeable profits were not purely notional amounts operating merely as a measure for apportionment purposes.

The Special Commissioners held that the interest lost its original character. They simply noted that once the amount had been determined in stage one, it would be apportioned to the UK resident shareholders at stage two. In the final stage, the UK resident shareholder, in this case the Taxpayer, is assessed. The assessment is not on "profits", as would have been the case if this was a charge to corporation tax, but on a sum equal to corporation tax. It is levied on the amount of profits apportioned to it, less creditable foreign tax apportioned to it.

The crucial issue said the Special Commissioners was whether at the end of the three stage process, Article 11 of the Treaty could exempt that part of the net sum assessable on the company, which is attributable to the interest obtained by the Dutch company from the UK group. The Special Commissioners considered that the interest element loses its character as such at the first stage of the process. By the time the assessment stage has been reached, Article 11 has no application because the amount actually assessed is not "income arising in one of the states which is beneficially owned by a resident of the other". It is simply a sum equal to tax computed on the statutory assumptions and apportioned from the beneficial owner to its UK resident shareholder. The CFC rules thus "deprived the chargeable profits of their real world status".

On appeal to the Court of Appeal,[6] the Taxpayer approached the manner in which the Treaty ought to be applied somewhat differently. It argued that the UK source interest income should be excluded from the computation of the CFC chargeable profits at stage one. On this basis, it would not be included in the amounts apportioned or assessed under stages two and three. The foundation for this argument was that the assumption in Schedule 24 that the CFC be treated as UK resident did not require the further assumption that the company was not resident in the Netherlands. It argued therefore that in ascertaining chargeable profits, the Dutch company should be treated as actually resident in the Netherlands, but assumed also to be UK resident. Dual residence is not uncommon and the Taxpayer argued that there is nothing in Schedule 24 to require the further assumption that there was no treaty between the United Kingdom and the Netherlands. As a dual resident, it would be entitled to the benefit of the Treaty. In argument, the Inland Revenue accepted that if this was the correct approach, UK source interest being exempt

6. A party to any appeal in England and Wales who has the right to appeal against any decision of the Special Commissioners to the High Court may instead appeal directly to the Court of Appeal if the conditions mentioned in Sec. 56A(2) Taxes Management Act 1970 are complied with.

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from UK corporation tax under the Treaty would fall out of the computation of the Dutch company's chargeable profits at stage one.

It was essential to the Taxpayer's argument that Schedule 24 operated on the assumption that the company which is *ex hypothesi* resident outside the United Kingdom is *also* resident in the United Kingdom. Millett LJ did not accept this and concluded that the assumption is that the company is *instead* resident in the United Kingdom.

He concluded that the nature of the assumptions were such that they required that the assumptions are to be substituted for the actual facts, not that additional assumptions be made in combination with the actual facts. Accordingly, profits had to be ascertained on the footing that the company was a UK resident instead of the actual residence of the company. Consequently, chargeable profits must be ascertained at stage one without reference to the Treaty.

The Taxpayer emphasized that at stages two and three, what is apportioned under the CFC rules is not an amount equal to the chargeable profits, but chargeable profits themselves. The court however ruled that it is not actual profits that are apportioned, but a notional sum which is the product of an artificial calculation. Thus, although the Court of Appeal upheld the result of the Special Commissioners, they did not entirely agree on the reasoning. The Court of Appeal did not agree that interest lost its character as interest by the end of stage one. It held, however, that interest received by the Dutch company should not be included in the sum apportioned to the Taxpayer on which tax is chargeable because the statutory process merely provides a measure by which an element in a conventional or notional sum is calculated. It is that conventional or notional sum which is apportioned to the Taxpayer and on which tax is charged.

III. CFC CHARGE AS CORPORATION TAX

The Taxpayer raised further arguments on the nature of the CFC charge which are relevant to the relationship between the CFC rules and treaty provisions. If the income which is exempt under the Treaty is nonetheless charged to tax under Section 747, is the tax so charged corporation tax? If it is not, then is it "substantially similar" to corporation tax? If it is corporation tax or substantially similar, is the income exempted from UK tax by Taxes Act 1988 Section 788 which authorizes the incorporation of treaties into domestic law.

The Court of Appeal regarded it as unnecessary to consider these questions. The failure to consider these questions does however leave key issues on the relationship between domestic law and the Treaty unanswered. Furthermore, this failure may reveal a fundamental flaw in the approach to this important issue. The analysis of the CFC provisions examined in detail on which the court relied, addressed more of the mechanical and computational aspects of the CFC charge than its essential character. It is suggested that the question as to whether the CFC charge is corporation tax should move to the top of the list of issues to be considered, rather than being a residual issue to be considered later on as it was in the *Bricom* decision. Only once this issue has been determined can the relationship between the specific treaty distributive rules and the mechanical aspects of the CFC charge be considered.

This is best illustrated if the starting point is the Treaty, rather than the UK domestic law. It goes without saying that the Taxpayer was within the personal scope of the Treaty under Article 1. The Treaty applies "to persons who are residents of one or both of the states". Article 11(1) states clearly that where interest arising in one of the states is beneficially owned by a resident of the other state, it is taxable only in that other state. According to Article 2(1)(a)(ii), the taxes which are the subject of the Treaty in the United Kingdom include income tax and corporation tax. The CFC charge is not specifically referred to. The Treaty also applies to "identical or substantially similar taxes" which are imposed after the date of signature of the Treaty in addition to or in place of the existing taxes (Article 2(2)).

The Inland Revenue argued that the sum assessed under Section 747 is not corporation tax. It is assessable not on the profit of a company assessed, but on a sum equal to corporation tax on a notional profit of the non-resident CFC. In substance, the charge is a fiscal impost *sui generis* introduced to cover a specific form of tax avoidance. It has nothing to do with the profits of the company assessed. Consequently, when the taxes that are covered by the Treaty in Article 2(1) are examined, the CFC charge is not one covered by the Treaty. The taxes referred to in Article 2(1) are income tax and corporation tax.

The Taxpayer argued that the CFC charge is corporation tax. Taxes Act 1988 Section 754(2) reads: "For the purposes of the Taxes Act, any sum assessable and recoverable under Section 747(4)(a) shall be regarded as corporation tax ...". The Special Commissioners were of the view that leaving aside this provision, the CFC charge is a tax but not corporation tax. It is a sum equal to corporation tax. It noted that the reliefs against corporation tax generally are not available and instead only those available against the particular tax found in Schedule 26 apply. The Special Commissioners rejected the Taxpayer's interpretation of the section which they ruled was limited to matters such as the period of assessments, the contents of the notice of assessment, and other mechanical matters of administration. It did not alter the *sui generis* nature of the CFC charge.

Although the Court of Appeal declined to decide the issue, Lord Justice Millett did note that there was force in the Taxpayer's argument that the conclusion that the charge is not a charge to corporation tax may fail to give full effect to Section 754(2) of the Taxes Act 1988 which provides that for the purposes of the Taxes Act, any sum assessable and recoverable under Section 747 shall be regarded as corporation tax.

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The approach by the Special Commissioners to this issue differs widely from that of the High Court in *Yates v. GCA International*,[7] where the question was whether a foreign tax "corresponds to" UK income or corporation tax for the purpose of double taxation relief. The Special Commissioners in that case noted that the tax imposed in Venezuela bears "all the hallmarks of a tax computed by reference to income" and corresponds to UK income or corporation tax. The mere fact that the tax was determined by reference to presumptive income did not change its essential nature. In considering this issue on appeal, Mr Justice Scott (as he then was) considered the structure of the Venezuelan income tax law generally, as well as the specific provisions dealing with presumptive income. In that case, in effect 90 per cent of gross income was deemed to be net profit. He concluded that to the extent that the relevant provisions of Venezuelan law sought to charge net profits to income tax, they served the same function as income tax and corporation tax serve in the United Kingdom.

The learned judge also noted that the word "correspond" is defined in several ways, including "to be similar to". The question, in that case, he said, was whether the Venezuelan tax was similar to, or does it serve the same function as, income or corporation tax. Similarly, the European Court of Justice has adopted a substance over form approach in examining indirect taxes to decide whether they are turnover taxes prohibited by Article 95 of the Treaty of Rome. Recently, in *Careda SA v. Administratiòn General del Estado* (Joined Cases C-370/95 and C-372/95) the ECJ held that for a tax to be classified as a turnover tax prohibited by Article 33 of the Sixth VAT Directive, it must exhibit the essential characteristics of VAT even if it is not identical in every respect. It would appear likely that the CFC charge is corporation tax and therefore one of the taxes which are the subject of the Treaty in accordance with Article 2(1)(a)(ii).

A. Substantially similar tax

The Special Commissioners did however "incline to the view" that the differences between the charge and corporation tax are not so great as to prevent it from being substantially similar to corporation tax. The differences noted by them are principally that it is charged only on UK resident companies having interests in CFCs, it is not charged on the profits of the UK company itself, but on profits of the CFC apportioned to it and only subject to specified reliefs set out in Schedule 26. The Special Commissioners considered that the tax base is the most important factor in determining similarity so that a tax computed on the same basis as corporation tax but charged on a specified class of company with some appropriate variations might well be substantially similar to corporation tax. On this basis, the charge would be covered by the Treaty as a "substantially similar tax". The application of the principles in *Yates v. GCA International* would also support this conclusion.

The consequences of a finding of this kind were significant according to the Special Commissioners. The provision that authorizes incorporation of treaties into domestic law in this respect[8] only refers to relief from "income tax" or from "corporation tax" in respect of income or chargeable gains. If the tax is not "corporation tax", then on a literal reading, in effect domestic law as set out in this provision, is defective because it does not permit the incorporation of Treaty provisions into domestic law insofar as they relate to "substantially similar taxes". The Special Commissioners noted that the position is unsatisfactory because a conclusion in this respect would place the United Kingdom in breach of the Treaty in not giving effect to it under domestic law.[9] They regarded this as not being necessary for their decision in any event.

The conclusions reached in this case are based on a highly literal reading of the CFC legislation and the legislation incorporating treaties into domestic tax law. Is such an approach in keeping with that of the House of Lords on interpretation of tax statutes expressed in the recent decision of *IRC v. McGuickian*.[10] Of particular importance are the views of Lord Steyn[11] that there has been a shift away from literalist to purposive methods of construction. The modern emphasis, he said, in that case is on a contextual approach designed to identify the purpose of a statute and to give effect to it. Furthermore, applying the logic of Lord Cook in the *McGuickian* case, the line between a conventional or notional sum and "profits actually chargeable to corporation tax" is necessarily somewhat artificial.[12] Indeed, the concept of profits even in accounting terms is somewhat artificial. On a literal and formalistic interpretation, the CFC rules give rise to a tax charged on a conventional or notional sum which exists only as the product of a calculation. A contextual approach to the CFC rules, the legislation incorporating treaties into domestic law and the Treaty itself may produce a different conclusion.

B. International law

A public international lawyer might come to an entirely different conclusion by reference to the Treaty itself. The terms of Article 11(1) of the Treaty are plain. Where interest arising in one of the states is beneficially owned by a resident of the other state, it is only taxable in that other state. This imposes a simple obligation on the United Kingdom in respect of income arising in the United Kingdom but derived and beneficially owned by a resident of the Netherlands. It must exempt such income from the taxes referred to in the Treaty, namely income tax and corporation tax. Article 26 of the Vienna Convention of the law of treaties provides that every Treaty in force is binding upon the parties to it and must be performed by them in good faith. Thus, the United Kingdom is bound in international law to give effect to the exemption

7. [1991] STC 157 ChD.
8. Taxes Act 1988 Sec. 788(3)(a).
9. The argument by the Inland Revenue that domestic law does not fully give effect to the Treaty is astonishing. As an executive act, it would appear to be a breach of international law itself: Art. 27 of The Vienna Convention on the Law of Treaties provides that "[a contracting state] may not invoke the provisions of its internal law as justification for its failure to perform a treaty".
10. [1997] STC 908 (HL).
11. At 915.
12. At 918.

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in Article 11(1). If the CFC charge is corporation tax or substantially similar to income or corporation tax, then the failure to give the relief claimed by the Taxpayer would be a breach of a Treaty obligation under international law.

Sandler notes[13] that when the CFC legislation was originally proposed, the Inland Revenue adopted a system of deeming income to belong to shareholders. This approach was replaced by the notional tax approach. Complexity of drafting was suggested as one reason and the possible need to renegotiate treaties was another. Sandler questions why this should make any difference. In his view, arguably the former approach is merely a more fundamental breach.

However, as noted by Professor Vogel,[14] avoidance in the Treaty context can be practised by contracting states as much as taxpayers. Treaties can be circumvented by drafting laws that avoid certain Treaty situations, although in substance the Treaty situation is present. Indeed, he cites CFC rules as a prime example of this.

Leaving aside the issues between the contracting states as a matter of international law, what ought a UK domestic court to make of the UK CFC rules in this light? Firstly, there is a presumption that Parliament intends to fulfil rather than break an international agreement.[15] Resolution of any doubt should if possible be in favour of that which is consistent with the provisions of the agreement.[16]

In *Bricom*, the arguments were finely balanced and the reasons given in the Court of Appeal and by the Special Commissioners were not identical. The application of a purposive approach combined with these principles on the manner in which Parliament's legislation is to be construed in the context of international obligations would lead to the conclusion that the CFC charge is corporation tax for the purposes of the Treaty or if it is not, that it is a substantially similar tax. Similarly, the enacting legislation should be read as including "substantially similar taxes" into the domestic law. It is only at this stage, in other words, after it has been determined that the Treaty applies to the CFC charge as a corporation tax, that the distributive rules in the Treaty are to be considered. In this case, it would result in exemption from UK tax. Thus, a priori if the CFC charge is corporation tax within the Treaty, its provisions will always be subject to any limitations imposed by the Treaty.

If the proper context for analysis of the application of CFC provisions therefore ought to be within the framework of the Treaty itself, limitation of benefits provisions may permit their application. Thus, for example, Article 11(6) of the Netherlands Treaty disapplies the benefits of Article 11 if the debt-claim in respect of which the interest is paid, was created or assigned mainly for the purposes of taking advantage of this article and not for bona fide commercial reasons. Therefore, in the context of Treaty obligations, it should be necessary to demonstrate that the taxpayer has fallen foul of this provision before the United Kingdom is released from its obligations under Article 11(1).

States can of course violate international laws by their domestic legislation and indeed do. The remedy in such circumstances would lie in the hands of the other contracting state rather than the taxpayer. Given the finely balanced arguments in the *Bricom* case, there is no reason why the courts should not favour an argument that upholds Treaty obligations, rather than breaches them. This approach was apparent in the decision of the Special Commissioners in the context as to whether the CFC charge was similar to corporation tax. The same conclusion might apply to an apparent circumvention of a treaty obligation. A contrary finding would have implications far beyond the tax charge on UK shareholders of CFCs. For example, it may bring into question the creditability of the CFC charge in other contracting states, whose residents owned UK companies which were subject to that charge.

IV. OTHER IMPUTED INCOME

Two other important UK provisions seek to tax UK residents in respect of the profits of non-residents. The CFC rules do not apply to capital gains. The Taxation of Chargeable Gains Act 1992 Section 13 imposes tax on UK resident shareholders where there has been a capital gain by a non-UK resident company, if that company would have been a "close company", had it been UK resident. The mechanism adopted is significantly different in that it apportions the gain to UK resident shareholders. There is no notional or conventional charge. The Inland Revenue have confirmed that where the non-resident company disposing of capital assets is resident in a suitable Treaty country, the gain will not be taxed in the United Kingdom.

The CFC provisions only apply to corporate shareholders. In the case of individuals, Taxes Act 1988 Section 739 deems the income of certain non-resident entities to be that of the UK resident transferor. The interaction of this provision with treaties was considered by the Special Commissioners in the case of *Willoughby v. IRC*.[17] Professor Willoughby made contributions to a retirement fund made up of personalized offshore single premium portfolio bonds issued by an Isle of Man insurance company. He argued *inter alia* that the income which was sought to be attributed to him was protected under the United Kingdom–Isle of Man treaty on the basis that it formed part of the industrial or commercial profits of a Manx enterprise and should not be subject to UK tax, because that enterprise had no permanent establishment in the United Kingdom. The Special Commissioners distinguished between actual income and deemed income. Deemed income, they reasoned, did not come within the business profits provision of the Treaty and was therefore not exempt by virtue of it. This aspect was not considered further on appeal.

13. *Supra* note 4 at 104.
14. *Klaus Vogel on Double Taxation Conventions* – Kluwer 1990 Paragraph 125.
15. See for example most recently *Garland v. British Rail Engineering Limited* [1982] 2 All ER 402 (HL).
16. *Quazi v. Quazi* [1979] 3 All ER (HL) 897 at 903.
17. [1995] STC 143 (CA).

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V. CONCLUSION

In the *Bricom* case, Lord Justice Millett expressed surprise that the issues had not previously come before the courts, given their fundamental nature and the fact that the CFC legislation had been in force for more than 12 years. The Inland Revenue claimed that this was because its understanding of the effect of the provisions is so obviously correct that no one had considered it worthwhile to challenge it before. The Taxpayer suggested that it was because the interest article in the United Kingdom–Netherlands Treaty was unusual and that in most treaties, the taxpayers' argument would not in any event succeed. While this is true in relation to interest articles which often provide for partial exemption only, similar principles may be applicable in relation to business profits and other income in particular. It remains to be seen whether the matter will be appealed further or whether a reference to the European Court of Justice will be sought.

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ARTICLE 17(2) OF THE OECD MODEL IN TRIANGULAR SITUATIONS

DOES ARTICLE 17(2) APPLY IF THE ARTISTE OR SPORTSMAN IS RESIDENT IN A THIRD STATE?

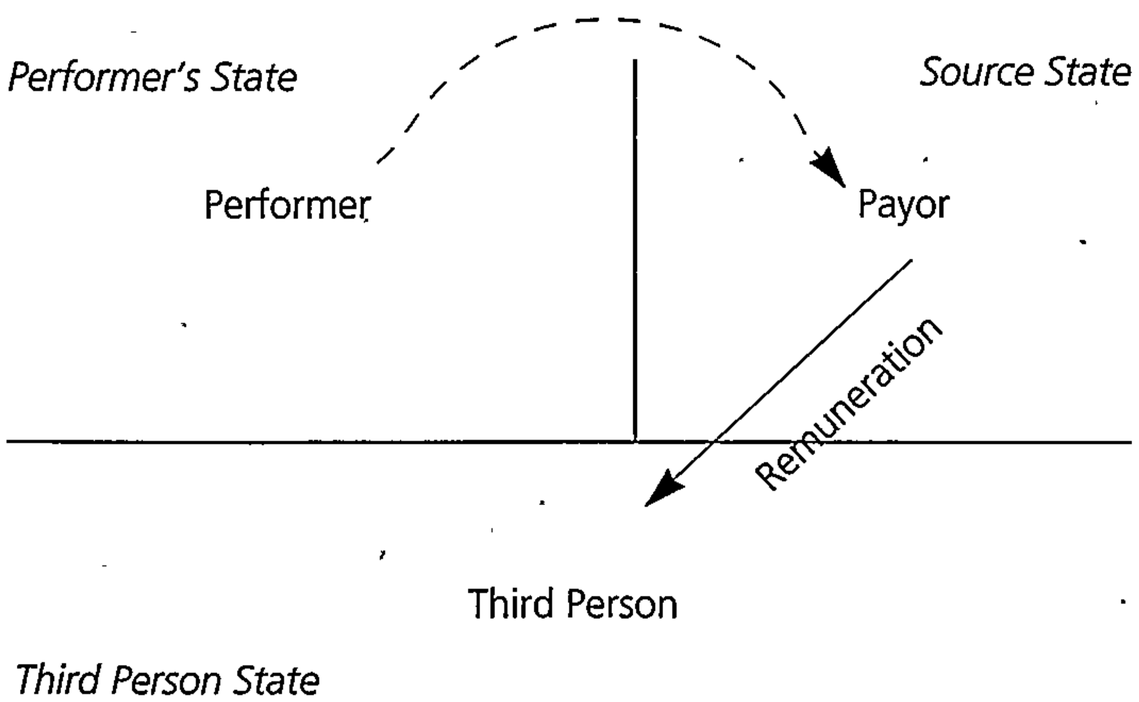
Rijkele Betten and Marco Lombardi

International Bureau of Fiscal Documentation

I. INTRODUCTION

In this article we examine the scope of Article 17(2) of the 1992 OECD Model Convention as amended in 1994 and 1995 (hereinafter the "OECD Model"). In particular, this article intends to investigate whether, if income covered by Article 17[1] does not accrue directly to the artiste or sportsman himself but rather to a third person, it is relevant that the tax treaty between the state in which the activities are exercised and the state where the third person is resident contains a provision similar to Article 17(2) of the OECD Model.

In this article the artiste or sportsman resident in a state ("Performer State") is sometimes simply referred to as the "Performer" so as to include generally the persons covered by Article 17 of the OECD Model. The state where the performance takes place is referred to as the "Source State" and the remuneration paid by a resident of the Source State in connection with the performance is referred to as the "Remuneration". Finally, the third person resident in a third state ("Third Person State") who receives the remuneration in connection with the Performer's performance is referred to as the "Third Person", irrespective of its actual legal form.



When dealing with Article 17(2) OECD Model it is essential to consider whether the state in which the activities are exercised taxes the income derived therefrom under its domestic legislation. Since tax treaties generally do not create an income tax liability which does not already exist under domestic law, the taxation of income that is paid to the Third Person rather than to the Performer himself has to be based on the domestic law of the Source State concerned. Broadly, states adopt two types of approach: (i) under the first approach, commonly referred to as the *look-through approach*, payments to a Third Person are considered to be made to the Performer himself; (ii) under the second approach, the Third Person itself is subject to tax on the income derived from the Performer's activities in the Source State.[2]

As clarified in the last sentence of paragraph 8 and in the second sentence of paragraph 11(c) of the 1992 OECD Commentary on Article 17, if the *look-through approach* is taken, the Source State may tax the Remuneration under Article 17(1) totally disregarding the Third Person and the circumstances related to it, including the state of residence of the Third Person. Thus, the Source State may tax the Remuneration regardless of whether Article 17(2) is incorporated into the relevant treaty.

Alternatively, if the domestic law of the Source State does not provide for a *look-through approach* but provides for taxation of a non-resident Third Person who receives income derived from performances rendered by the Performer, the issue is whether the presence of Article 17(2) of the OECD Model in the Source State/Third Person State treaty allows the Source State to tax the Remuneration even if the performance is rendered by a Performer resident in neither the Source or Third Person State. In this article we deal mainly with this last issue.

First we examine the historical development of Article 17 (Section II). In Section III we submit some observations based on the analysis contained in the preceding sections.

1. In para. 9 of the Commentary on Art. 17 of the 1992 OECD Model it is stated that Art. 17 covers income *directly and indirectly* connected to performances or appearances in the Source State, such as advertising or sponsorship income. Other royalties for intellectual property rights will normally be covered by Art. 12.
2. In some states (e.g. Italy) the domestic provision, although clearly dictated by anti-avoidance purposes, is drafted in such a way that it is not clear which of the two approaches is actually taken. See on this point A. Trivoli, "Taxation of non-resident entertainers – Profiles of the situation in Italy", in *Taxation of Non-Resident Entertainers*, IFA – Kluwer, The Hague – London – Boston, 1995, at 67-68.

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II. THE OECD WORKS

A. 1963 Draft

Article 17 of the 1963 OECD Draft Double Taxation Convention ("1963 Draft") reads as follows:

> Notwithstanding the provisions of Articles 14 and 15, income derived by public entertainers, such as theatre, motion picture, radio or television artistes, and musicians, and by athletes, from their personal activities as such may be taxed in the Contracting State in which these activities are exercised.

According to the Commentary to the 1963 Draft this provision stipulates that public entertainers and athletes may be taxed in the state in which the activities are performed. This rule should apply regardless of whether the activities are of an independent or of a dependent nature. Article 17 is an exception to the rules laid down in Articles 14 and Article 15(2).[3] According to paragraph 2 of the 1963 OECD Commentary on Article 17 the provision "makes it possible to avoid the practical difficulties which often arise in taxing public entertainers and athletes performing abroad."[4]

An example of the difficulties that arose at that time occurred in the case of the application of the 1931/1959 tax treaty between Germany and Switzerland.[5] This tax treaty did not contain a provision specifically dealing with the taxation of artistes and sportsmen. Therefore, originally, for the allocation by the tax treaty of the right to tax income derived by artistes from public performances it had first to be determined whether the artiste was conducting activities of a dependent or of an independent nature. In case of dependent activities the right to tax could under certain circumstances (e.g. a 183-days rule) be allocated to the state where the performance was rendered, but in case of independent activities the state where the activity was exercised could only tax the income of the artiste if there was a fixed base in that country. In practice, difficulties arose regarding the issue of whether the activities were of a dependent or of an independent nature and under what circumstances the presence of a fixed base had to be assumed.

A 1957 Supplementary Protocol to the Germany–Switzerland tax treaty dealt with these issues. The solution chosen was that with regard to professionally active actors (theatre, radio, television and movie artistes), professional sportsmen and other artistes, the condition that the presence of a fixed base was required before the state where a public performance was made could tax the artiste's income, was abolished. Under the 1931/1959 tax treaty *dependent* artistes could still claim application of the 183 days exception.[6]

The historical development of the 1931/1959 Germany–Switzerland treaty may help explain a potential reason for the inclusion of Article 17 in the 1963 OECD Draft: the application of other articles of the treaty did not function satisfactorily for the Source State. In other words, Articles 14 and 15 would rarely allow the country where a public performance was made to tax the income derived by the artistes or sportsmen from such an event.[7]

Therefore, Article 17 starts by expressing that Articles 14 and 15 do *not* apply. Consequently, income derived by "public entertainers and athletes"[8] from their personal activities as such may be taxed by the country in which the activities are exercised.

It is to be noted that Article 17 of the 1963 OECD Draft, unlike other Articles[9] of the 1963 Draft, did not stipulate where the entertainer or athlete had to be resident. The reference to Articles 14 and 15 may be implicitly understood as an indication that the artiste or sportsman should be resident in one of the contracting states. Otherwise, Articles 14 and 15 would not be applicable and there would be no need to exclude their application. The non-inclusion of the term "resident" in Article 17 could be accidental but can also be interpreted as an early, not-yet-explicit attempt to enable the Source State to tax the income in "conduit" situations.

Incidentally, it can be noted that another method for enabling the Source State to tax artistes and sportsmen performing within its territory is to provide that the supply by a non-resident enterprise of services of artistes and sportsmen constitutes a permanent establishment in the state where such services are rendered. For example, some tax treaties concluded by Brazil[10] contain a provision with the following (or similar) wording:

> An enterprise of a Contracting State shall be deemed to have a permanent establishment in the other Contracting State if it provides in that other State the services of artistes or athletes to whom Article XVII applies.[11]

Australia too has used this methodology, e.g. in Article 12(2) of its 1969 tax treaty with Japan. In addition, Article 4(4) of the 1977 tax treaty between Botswana and the United Kingdom also contains a similar definition.

B. 1977 Model

The OECD has not chosen this alternative PE route, which would have made unequivocal the OECD intention of covering triangular cases. Instead, the 1977 OECD Model Double Taxation Convention on Income and on Capital (hereinafter the "1977 OECD Model") included an amended Article 17. The text then read:

1. Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer,

3. Para. 1 of the 1963 OECD Commentary to Art. 17.
4. This paragraph of the Commentary deals also with cultural exchanges. This issue is not dealt with in this article.
5. This treaty is no longer in force, since it has as of 1 January 1972 been succeeded by the tax treaty between Germany and Switzerland of 11 August 1971.
6. The above two paragraphs are based on M. Kempermann in "Commentary to Article 17", Flick/Wassermeyer/Wingert/Kempermann, *Doppelbesteuerungsabkommen* Deutschland – Schweiz, Kommentar, Köln, Artikel 17.
7. See K. Vogel, H.A. Shannon, R.L. Doernberg, K. van Raad, *United States Income Tax Treaties*, Kluwer (Deventer – Boston) as at 1996, at 2 -Part II. Commentary Art. 17. These authors also point out that one of the main purposes of Art. 17 is to allow the Source State to tax workers with high levels of remuneration during a short stay in the Source State.
8. This is the phrase used in the 1963 OECD Draft Convention. In this article we will not discuss which particular artiste or athlete is covered by this definition, and/or other definitions.
9. See e.g. Arts. 14 and 15 of the 1963 OECD Draft Convention.
10. E.g. the treaties with Argentina (1980), Germany (1975) and Luxembourg (1978).
11. Art. 5(7) of the tax treaty between Argentina and Brazil of 17 May 1980.

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such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised.

Also, the title of the provision was amended to "Artistes and athletes". Hereinafter reference will be made to artistes and athletes, but we do not deal with who exactly is covered by the new and/or old definition.

The first paragraph of Article 17 now specifically refers to an artiste or athlete who is a resident of one contracting state who derives income from his personal activities that are exercised in the other contracting state. The latter state may tax such income.

Article 17(2) of the 1977 OECD Model deals with the situation where income accrues to another person. Notwithstanding the provisions of Articles 7, 14 and 15 such income may be taxed by the contracting state in which the activities are exercised. In comparison with Article 17(1), Article 17(2) also sets aside Article 7. This is necessary because if the "other person" receiving the income is an entrepreneur (whether a legal entity or an individual) then the state where the activities are exercised could only tax the income received by that other person if this had a permanent establishment in that state. Because Article 17(2) excludes the application of Article 7 to this income, the PE requirement does not apply.[12] Article 17(2) of the 1977 OECD Model does not state where the Performer should be resident.

With respect to the scope of Article 17 of the 1977 OECD Model, it may be argued that it is a better specification of the scope already contained in Article 17 of the 1963 Draft, the latter having simply been split into two paragraphs. If the interpretation of Article 17 of the 1963 Draft suggested above is correct, the latter did not specify in which state the entertainer or athlete should be resident, its function being to allow taxation in the Source State regardless of where the Performer was resident in conduit situations. Under this interpretation, the two paragraphs of Article 17 of the 1977 OECD Model are two independent provisions.

Conversely, it may be argued that the two paragraphs of Article 17 of the 1977 OECD Model cannot be read separately one from the other. As a result, since Article 17(1) of the 1977 OECD Model specifically requires that the entertainers or artistes be resident in one of the contracting states, Article 17(2) of the tax treaty between the Source State and the Third Person State is not applicable unless the Performer is also resident in one of the two contracting states. Following this reasoning, if the Performer is not resident in either the Source or the Third Person State, the Source State could only tax the Third Person if it is entitled to do so under other articles of the tax treaty between the Source State and the Third Person State. If the Third Person conducts a business or another independent activity, the presence of a permanent establishment or of a fixed base is required (and, normally, a connection between the income and the PE/fixed base); if the Third Person does not conduct a business it appears that the other income article would allocate the right to tax the income to the Third Person State.[13]

C. The 1987 OECD Study and the 1992 revision of the OECD Model Convention and Commentary thereto

In 1987 the OECD published its study on the Taxation of Entertainers, Artistes and Sportsmen (hereinafter the "1987 Study").[14] The Commentary (hereinafter: "1992 Commentary") to the revised 1992 OECD Model contained some amendments regarding Article 17.[15] The amendments were based on the 1987 Study.[16] Therefore the 1987 Study and the 1992 revision of the OECD Commentary to Article 17 will be jointly discussed.

Nothing was added to the Commentary to reflect the main principles behind the provision. The 1987 Study, however, included the following main principles:[17]

14. The main principle which underlines this report is that income from entertainment and sporting activities should be taxed in the same way as income from any activities. Exceptions to this principle should be kept to a minimum. (...)[18]

15. The second principle upon which this report is drafted is that artistes and athletes, are, as are other taxpayers, fully liable to tax in their country of residence, and, ideally, should be taxed accordingly. Whilst certain countries provide for exemption of foreign income, the amount of income earned abroad should be known when, under the general income tax, this affects the progressive rate that is applied to other income sources.

16. However, as is usually the case with itinerant activities, the country of residence has difficulty in identifying the activities of its residents abroad. It will therefore have to rely mostly on information provided by the country where the activities are exercised. For this reason, and also in order to avoid practical difficulties, it is felt that the principle on which Article 17 of the 1977 Model Convention is based should be followed. The main purpose of this report is therefore to help member countries to establish a system by which the income of artistes and athletes could effectively be taxed in the country of performance.

17. In taxing artistes and athletes, tax authorities encounter problems first in obtaining information about the performances taking place and secondly in the assessment of legal avoidance schemes.

12. If the other person does not conduct a business enterprise, then normally also the state where the activities are exercised may, at least according to the 1977 OECD Model, tax the income: Art. 21, allocating the right to tax to the residence state, is only applicable to items of income *not dealt with in previous articles* (Art. 21(1) of the 1977 Model).

13. Under this interpretation the other income article is applicable, because even if the treaty contains a provision similar to Art. 17(2) of the OECD Model, this is not applicable since the entertainer or artiste is not resident in one of the two contracting states. Compare with the previous footnote.

14. OECD, *Issues in International Taxation*, No. 2, 1987, 37-64.

15. The only amendment to Art. 17 of the 1992 Model, as compared to Art. 17 of the 1977 Model Convention, is the replacement of the term "athletes" with the term "sportsmen". In 1977 "entertainers" was replaced by "artistes".

16. For a more complete description of the study and the amendments to the Commentary, see Daniel Sandler, *The Taxation of International Entertainers and Athletes*, Kluwer Law International, The Hague, The Netherlands, 1995, 182-196.

17. At 40–41.

18. The remainder of this paragraph refers to "cultural exchange" events, which were already mentioned in previous OECD commentaries and are not dealt with in this article.

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When discussing possible improvements of the domestic legislation concerning the taxation of artistes and sportsmen, the following two fundamental questions are raised:[19]

1. How far should resident and non-resident artistes and athletes be treated alike or differently?
2. How far should artistes and athletes be treated differently from other performers of dependent, or independent, services?

In the Study it is suggested that the taxation of resident and non-resident artistes and athletes should be similar.[20] Regarding the second question, the suggestion is made to impose a withholding tax on all the self-employed and independent contractors.[21]

A first conclusion, which may be drawn from the 1987 Study, is that there is the feeling that income derived by artistes and sportsmen should be treated in the same or similar way as income from any other activity. It also appears, especially from paragraph 16 of the 1987 Study, that the state of residence has often difficulties in identifying activities performed abroad by its residents.[22]

One other addition to the 1992 Commentary that is worth noting is that whereas the 1977 Commentary only mentioned the purpose of Article 17(2) as being to counteract certain tax avoidance devices (in paragraph 4),[23] the 1992 Commentary also mentions two other situations where Article 17(2) may be applied: when there is a "management company which receives income for the appearance of e.g. a group of sportsmen (which is not itself constituted as a legal entity)",[24] and secondly when "the team, troupe, orchestra, etc, [] is constituted as a legal entity".[25]

D. Triangular situations

The 1987 Study contains three paragraphs dealing with triangular situations:

> 102. A number of difficulties experienced by countries involve three-country situations. One case is where the artiste resides in State A, performs in State S and is employed under an exclusive "slave" contract by a "shadow company" situated in a non-treaty country B (e.g. a tax haven) and which supplies the entertainer's services to a producer in State S against payment of a fee. The question then arises as to whether State S may tax remuneration in respect of the entertainer's performance. An affirmative answer should be given to this question since Article 17 of the convention between A and S, which applies to the artiste resident in A, confers on State S the power to tax, and furthermore this power is not circumscribed by any convention between A and B.
>
> 103. In another three-country situation, the artiste is resident in a third State B, while the "shadow company" is established in State A. Even if there is a convention between A and S, the "shadow company" in A could not argue that the remuneration paid to it by the producer of the performance in State S constitutes business income received without the intervention of a permanent establishment, since paragraph 7 of Article 7 stipulates that the Article does not apply to "items of income which are dealt with separately in other Articles of the convention between A and S.
>
> 104. Consequently, it appears to matter little where the performer resides since this will either be in a State that has signed a convention with State S (where the activity is performed), under the terms of which State S has the right to tax, or else in a State which has not a convention with State S, whose right to tax therefore cannot be limited.

In paragraph 103 it is stated that the shadow company does not need to have a permanent establishment in State S to be taxable there, because Article 7(7) of the OECD Model stipulates that it does not apply to items of income that are covered by other articles of the Convention. The question then is whether the item of income is covered by Article 17. Certainly not by Article 17(1), since the activities are not exercised by a resident of one of the contracting states. Therefore, ultimately, the issue is again whether Article 17(2) applies even if the entertainer is not resident in one of the two contracting states. Implicitly, the 1987 Study seems to suggest that Article 17(2) is applicable, since it concludes that the state where the performance is made may tax the income derived therefrom. Quite significantly, the above-mentioned paragraphs 102-104 have in the course of the 1992 revision of the OECD Model Convention *not* been included therein.

Some tax treaties show how treaty negotiators have dealt with this issue. For example, paragraph 2 of Article 17 of the 1979 treaty between Finland and Germany reads as follows:[26]

> 2. Notwithstanding the other provisions of this Convention, income which a resident of a Contracting State derives from the other Contracting State for services supplied by it and performed by a person as referred to in paragraph 1 in the other Contracting State may be taxed in the Contracting State where the services were performed, *even if this person is not a resident of a Contracting State* (emphasis added)."[27]

This Article 17(2) departs from the 1977 OECD Model in that it makes it explicit that it applies regardless of whether or not the Performer is resident in the other state. Also Article 17(1) of this treaty deviates from the 1977 OECD Model, since it lacks the specification that the Performer should be resident in a contracting state. Probably the specification in Article 17(2) was wanted by Germany (see its Observation to the OECD Commentary). The reason for including an Article 17(1) which deviates from the corresponding provision of the 1977 OECD Model is not clear. It may be that Article 17 of this treaty, which was signed in 1979, was drafted before the publication of the 1977 OECD Model. In this case this treaty provision is not relevant for the interpretation of Article 17 of the OECD Model. It may also be that the deviation of Article 17(1) was implemented to assure that Article 17(1) and 17(2) would have the same scope. Because of the uncertainties it does not seem right to draw general conclusions from this particular treaty provision.

As a result, the opinion expressed in some German literature that the reference to an artiste resident in a third state in Art-

19. Para. 60 of the Study.
20. Para. 61 of the Study.
21. Para. 63 of the Study.
22. However, the information aspect is outside the scope of our article.
23. In the 1992 Commentary still included, and slightly expanded, as para. 11(c).
24. See para. 11(a) of the 1992 Commentary.
25. See para. 11(b) of the 1992 Commentary.
26. Unofficial English translation, IBFD's Tax Treaty Data Base on CD-ROM.
27. Based on a search on the IBFD's Tax Treaty Data Base on CD-ROM, this is the only treaty that contains the italicized phrase. As mentioned, Art. 17(1) of this treaty is worded according to the 1963 Draft.

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icle 17(2) of the tax treaty between Finland and Germany is merely an illustration of how the interpretation should be for all German tax treaties that contain a similar provision cannot be shared completely.[28, 29] Nonetheless, as we discuss below, there are other arguments in favour of the applicability of Article 17(2) in triangular cases.

III. OBSERVATIONS

Based on the above discussion, we submit the following observations.

(a) Article 17(2) refers to income received by a "person" and excludes the application of Articles 7, 14 and 15 with respect to this person in case of income having an "artistic or sportive" character. The absence of any reference to where the artiste or sportsman should be resident can be interpreted as an implicit admission that they may as well be resident in a third state. In other words, Article 17(2) provides a special rule with respect to "tainted" (i.e. "artistic", "sportive", etc.) income of non-residents.

(b) This observation is not fully confirmed by paragraph 11 of the OECD Commentary on Article 17. The second sentence of paragraph 11 can be read in two different ways: either that paragraph 2 of Article 17 is, or that it is not, a provision independent from paragraph 1. If it is independent, in order for paragraph 2 to apply, the Performer does not have to be resident in one of the contracting states. If it is not independent, then it would seem that the Performer, as well as the Third Person, has to be resident in the other contracting state.

(c) As mentioned above, paragraph 103 of the 1987 Study was much clearer in indicating that the Performer *does not* need to be resident in the Third Person State and it is to be regretted that the same clarity has not been incorporated into the 1992 OECD Model.

(d) One of the unquestionable functions of both paragraphs of Article 17 is to tackle conduit situations. The OECD Commentary on Article 17 at paragraph 8 states that where a *look-through approach* is adopted by the Source State Article 17(1) applies in triangular situations.[30] Logically, the same conclusion should then apply also to Article 17(2).

(e) It appears to us that under the current version of the OECD Model (including Commentary), the question of the applicability of Article 17(2) to triangular situations cannot be given a general answer. We think that it is desirable that, where possible, a consistent interpretation of the OECD Model should be pursued. Accordingly, in our opinion, the Commentary should be amended so as to provide a clearer interpretation of Article 17(2). In particular, based on the analysis of the literal formulation of the provision, which is centred on two elements: the "tainted" income and the person receiving this income, it is our opinion that the Commentary should make it explicit that Article 17(2) applies also in triangular situations. This would eliminate the need of any specific Observations in the Commentary like the one currently added by Germany.

28. See Dörte Mody, *Die deutsche Besteuerung international tätiger Künstler und Sportler*, Nomos Verlagsgesellschaft, Baden-Baden, 1994, at 173.
29. Görl (in Vogel, *Doppelbesteuerungsabkommen Kommentar*, 3rd edition (in German), München 1996, Art. 17, Rz. 44b, 44c, 44e) is somewhat contradictory by specifying at another place (Art. 17, Rz. 48) that the tax treaty between Finland and Germany contains expressly an extended scope of application. It is certainly not indicated there that this is the general position to be taken, rather the formulation hints at the treaty being an exception.
30. Where a *look-through approach* is not adopted the scope of Art. 17(1) is restricted. It may, however, still apply to triangular situations where salary is paid from the Third Person to the Performer.

Conference diary

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

DECEMBER

Double Taxation Relief, Amsterdam, the Netherlands, 11-12 December 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

School of Transfer Pricing, The Berners Hotel, Berners Street, London, the United Kingdom, 11-12 December 1997 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

JANUARY 1998

Limitation On Benefits Clauses Compared, Vienna, Austria, 23 January 1998 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

FEBRUARY

Selected Issues in International Taxation, Amsterdam, the Netherlands, 2-6 February 1998 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

MARCH

Transfers of Technology, Amsterdam, the Netherlands, 5-6 March 1998 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

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TREATY ASPECTS OF THIN CAPITALIZATION

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I. INTRODUCTION

In the last decade, the thin capitalization problem has become more prominent.[1] In particular, several countries[2] have recently introduced regulations against the erosion of their tax basis by means of thin capitalization.

A clear cut definition of thin capitalization cannot be given. The OECD uses "... the expression 'thin capitalization' ... in its loose sense ... i.e. to describe the whole range of hidden equity capitalization".[3] In this respect the OECD argued that hidden capitalization (i.e. the use of hybrid financing instruments) as well as a high debt-to-equity ratio could both be seen as manifestations of thin capitalization.

National thin capitalization rules can be subdivided into two main categories: (1) the rules which reclassify the debt into equity or interest into dividends, and (2) the rules which just deny the deductibility of the interest.

In this contribution, the treaty aspects of national thin capitalization rules shall be discussed. The main question examined is whether a double tax convention (hereafter: DTC) protects the taxpayer from double taxation when the source country applies thin capitalization rules. Therefore, both juridical and economic international double taxation will be taken into consideration. The analysis will proceed by reference to the provisions of the OECD Model Convention.[4]

II. INTERPRETATION RULES IN DTCs

A. International public law

When interpreting treaty provisions under international public law, a distinction can be made between the method in which the real intentions of the treaty parties are reflected, the teleological method and the interpretation according to the wording of the provision.[5] The former method is based on a subjective approach. In order to find out what the intentions of the treaty parties were, an appeal could be made to the *travaux préparatoires*.[6] The latter method (or the objective approach) starts from the idea that the wording of a provision is the most clear expression of the intentions of the treaty parties.

The generally accepted principles on the interpretation of treaty provisions are codified in Articles 31 to 33 of the Vienna Convention on the law of treaties (hereafter: the Convention).[7] Article 31 of the Convention contains a general interpretation rule: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose". Article 31(2) of the Convention states that besides the treaty text itself the preamble, the annexes, as well as any agreement relating to the treaty or instrument which has been made by one or both treaty parties in connection with the conclusion of the treaty, belong to the context. This means that an interpretation according to the wording of the provision is the starting point. However, the more subjective interpretation approach can be used as a marginal test. This can be deduced from Article 32 of the Convention: "Recourse may be had to supplementary means of interpretation, ..., in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31 (a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable".

B. International tax law

According to Vogel,[8] international public law contains only a very general interpretation rule which cannot apply in the specific situations dealt with by DTCs. The OECD Model Convention (hereafter: OECD-MC) contains in Article 3(2) its own interpretation rule: "As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies". This provision seems to refer to the domestic law of the source country (*lex causae*). This approach would solve the problem of interna-

1. In 1987 the OECD published a Report on "Thin Capitalization", *Issues in International Taxation*, No. 2, Paris, OECD 1987; In 1996 the IFA-Congress discussed and agreed upon a resolution on this subject.
2. Amongst others Germany, Hungary and the Czech Republic.
3. Report on "Thin Capitalization", *Issues in International Taxation*, No. 2, Paris, OECD 1987.
4. From 1992 the OECD Model Convention (and particularly its Commentary) has been changed continuously. In this contribution I shall refer always to the latest version.
5. See, among others, Fitzmaurice, "The Law and Procedure in the International Court of Justice: Treaty Interpretation and Certain Other Treaty Points", *28th British Yearbook of International Law*, 1951; C. van Raad, "Interpretatie van Belastingverdragen", *MBB* 1978, nr. 2-3; A.J.M. Timmermans, "Interpretation of Double Tax Conventions", National Report, *IFA-Cahier 1993*; David A. Ward, "Principles to be Applied in Interpreting Tax Treaties", 34 *Bulletin for International Fiscal Documentation*, 12 (1980), at 545-551.
6. As *travaux préparatoires* are considered all working documents of the treaty parties. With respect to DTCs these documents are normally not made available to the taxpayer. This is the reason why, in my opinion, these documents cannot play a decisive role in the interpretation of DTCs.
7. The Vienna Convention on the law of treaties was concluded on 23 May 1969 and came into force on 27 January 1980.
8. K. Vogel, "Double Taxation Treaties and Their Interpretation", *International Tax and Business Lawyer* 1986, Volume 4:1, at 33.

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tional double taxation in the easiest way.[9] This approach, however, does not procure justice to most of the treaty provisions which allocate the right to impose tax.[10] In my opinion, according to Article 3(2) OECD-MC the definition of a term should first be found in the treaty itself. If a treaty definition cannot be found, the term should be interpreted according to the meaning in the domestic law of the country which applies the treaty (*lex fori*).[11] This interpretation should be checked with the context. The term 'context' as used in Article 31(2) of the Convention is not very helpful in DTCs. The intention of treaty parties to give away as few rights to impose taxes as possible does not justify a 'narrow' interpretation of the term 'context'. A broader interpretation is argued by referring to the UK approach where the history of the treaty is also taken into account. Beside the text of the treaty and any additional documents, Vogel[12] includes also the domestic laws of the treaty parties as well as the OECD Model Convention and the Commentary thereon as 'context'. However, the interpretation according to the *lex fori* approach might lead to international double taxation or non-taxation.

The reference to the domestic legislation can be either static or ambulatory. A static interpretation is given, if a country applies the internal laws which exist at the time the treaty was signed to define the meaning of terms. The ambulatory interpretation takes into account the internal law of a country at the moment the treaty is applied. Most countries seem to have accepted the ambulatory interpretation, which is in accordance with international law.[13] In literature[14] the application of the ambulatory interpretation has been limited to situations in which the internal laws have been changed without impairing the balance or affecting the substance of the treaty. Otherwise, the *pacta sunt servanda* rule[15] obliges the country to inform the other party.[16] This country can decide whether to accept the interpretation or to renegotiate the treaty.

III. DIVIDEND AND INTEREST IN DTCs

A. Dividend

In Article 10(3) OECD-MC the term dividend is defined as "... income from shares, ..., or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident." From the text of this provision as well as from the OECD Commentary, it can be deduced that this definition is not exhaustive. In the provision a general reference is made to the definition of the term dividend in the country of source. Whereas Article 10 OECD-MC mainly focuses on the imposition rights of the country of residence (recipient), this country has to follow the definition in the country of source (paying company).[17]

As a result of the various civil and fiscal definitions in the OECD member states, a *communis opinio* in drafting an exhaustive treaty definition of dividends was not possible and, therefore, a general formulation was added to the definition: "as well as income from other corporate rights which is subject to the same taxation treatment as income from shares". In the autonomous part of Article 10(3) OECD-MC an explicit exception is made with respect to profit sharing interest: "... other rights, not being debt-claims, participating in profits ..." A narrow interpretation, which starts with the definition of interest in Article 11(3) OECD-MC, limits the interpretation of the term 'corporate right' to shares and other incorporated rights. This interpretation, however, leaves the general formulated part meaningless; the intended rights are already mentioned explicitly in the autonomous part of the definition. Therefore, a broader interpretation should be followed. The OECD Commentary supports this view by using the term capital "when a loan or other contribution to the company does not, ..., come as capital under company law but when on the basis of internal law or practice ("thin capitalization", or assimilation of a loan to share capital), the income derived in respect thereof is treated as dividend under Article 10."[18] The question arises whether domestic thin capitalization rules can be seen as a corporate right. Vogel[19] describes a corporate right as "[Ein] Oberbegriff für sämtliche Rechtstitel, deren Erträge nach Abs. 3 als Dividenden anzusehen sind" (a general term for a group of legal rights remuneration of which according to Section 3 will be treated as dividends. E.g. participating bonds). In my opinion, the application of domestic thin capitalization rules cannot be hindered, as a debt instrument can be treated as a corporate right.

In the international literature,[20] the ambulatory interpretation method is usually accepted in order to determine the meaning of the term dividend. As discussed before, the ambulatory interpretation method is limited by the following phrase: "without impairing the balance or affecting the substance of the Convention".[21] The question arises whether domestic thin

9. John F. Avery Jones and others, "The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of The OECD Model", *British Tax Review*, 1984, at 14-54 and at 90-108.
10. K. Vogel, *Doppelbesteuerungsabkommen – Kommentar*, 3rd edition, Verlag C.H. Beck, München, 1996, Art. 3, Rz. 65.
11. C. van Raad, "Het nationale recht bij de uitlegging van belastingverdragen", in: *Van wet naar recht*, Kluwer, Deventer, 1984, at 159-178; M. Romijn, *Internationaal belastingrecht*, 4th ed., Tilburg, 1991, at 105.
12. K. Vogel, *supra* note 10, Art. 3, Rz. 72.
13. OECD Commentary to Article 3(2); See also Sir Ian Sinclair's comments in "Interpretation of Tax Treaties" (a seminar at the 1985 IFA congress), 40 *Bulletin for International Fiscal Documentation*, 2 (1986), at 75-83.
14. See e.g. John Avery-Jones, *supra* note 9, at 26-28 and K. Vogel, *supra* note 10, Einl., Rz. 124d.
15. Art. 31 of the Vienna Convention.
16. E.g. after German unification in 1989, the Ministry of Finance in Bonn wrote to all its treaty partners stating that it had the intention to apply the treaties concluded by the Federal Republic of Germany also with respect to the former German Democratic Republic territories.
17. K. Vogel, *supra* note 10, Art. 10, Rz. 186.
18. OECD Commentary on Art. 10, para. 15(d).
19. K. Vogel, *supra* note 10, Art. 10, Rz. 188.
20. K. Vogel, *supra* note 10, Art. 10, Rz. 199; rather balanced: John F. Avery-Jones, *supra* note 9, at 36; R. Pöllath/A. Rädler, "Die vorgeschlagene Erweiterung des § 8 Abs. 3 KStG – Voraussetzungen und Wirkungen nach innerstaatlichem und Abkommensrecht", *Der Betrieb* 1980, Beilage Nr. 8, at 16 as well as H.-M. Pott, "Die Vereinbarkeit des Entwurfs eines § 8a KStG (KStÄndG 1982) mit dem Völkerrecht", *StuW* 3/1982, at 223 and 228, doubt very much whether in case of a substantial change in the internal definition of dividend an ambulatory interpretation can still be applicable.
21. OECD Commentary on Art. 25, para. 34.

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capitalization rules upset the balance of the imposition rights in DTCs regarding the remunerations of shareholders. Both with respect to dividend and interest, the imposition right lies in the country of residence of the recipient whereas the country of source (paying company) has a limited imposition right. By reclassifying interest as a dividend, the balance of the imposition rights does not shift. The limited imposition right of the country of source, however, may, as far as the applicable rate goes, differ. This is in my opinion not sufficient to deny the ambulatory interpretation method in case of thin capitalization rules.

B. Interest

In Article 11 (3) OECD-MC, interest is defined as "... income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures". This is an autonomous definition which does not refer to any internal laws. It is interesting to consider the reason why internal laws are not referred to: "the formula ... ensures that conventions would be unaffected by future changes in any country's domestic laws".[22]

The definition of dividend excludes the definition of interest by excluding 'debt-claims'. This is emphasized with respect to domestic thin capitalization rules.[23] If the interest according to these rules is reclassified as a dividend, Article 11 OECD-MC will not apply.

Another important provision is stipulated in Article 11(6) OECD-MC: "Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payment shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention". The phrase "having regard to the debt-claim for which it is paid" refers, however, to the possibility to correct excessive interest rates due to the special relationship with the creditor rather than to the application of domestic thin capitalization rules.

C. Scope of application

By introducing thin capitalization rules, the domestic definitions of dividend and interest can differ from the treaty definitions. As regards the correction of profits according to Article 9(1) OECD-MC, the application of the domestic definitions does not seem to be hindered. Both Article 10(3) OECD-MC and Article 11(3) OECD-MC give definitions which apply only in these Articles: "The term ... as used in this Article means ..." In addition, Article 10(3) OECD-MC refers to interest which is *treated as* a dividend, rather than interest which is *deemed to be* a dividend. Both Articles, furthermore, refer to the balance of imposition rights at the level of the creditor only. The right to tax interest or a dividend is in principle given to the country of residence of the creditor, eventually a limited right to tax is given to the country of source. The treaty definitions of dividend and interest therefore, exclusively refer to the avoidance of international juridical double taxation (withholding tax).

D. Avoidance of international juridical double taxation

If the country of source (paying company) reclassifies interest into dividends, Article 10(3) OECD-MC prescribes that the country of residence (recipient) has to accept this treatment and, according to Article 23 OECD-MC, is obliged to give relief for double taxation with respect to the limited imposition right of the country of source (withholding tax). If the country of source prohibits the deductibility of the interest payments, in my opinion, Article 11 OECD-MC continues to apply. As a result, there is no danger of any international juridical double taxation.

IV. CORRECTION OF PROFIT (ARTICLE 9 OECD-MC)

A. Arm's length principle

At the heart of a DTC are the provisions which allocate the rights to impose taxation on certain income categories. These provisions may focus on the tax position of the recipient (in the cases discussed: the creditor). Article 9 OECD-MC differs in principle from this structure as it contains a provision which refers to the tax position of both the creditor and the debtor in different countries. Where the creditor and the debtor are related persons, Article 9(1) OECD-MC rules that – if transactions between them did not take place according to arm's length standards – the tax administration can correct the tax basis. This provision contains, in other words, an international profit allocation rule within a group of companies.

B. Thin capitalization as an 'arm's length' problem?

Article 9(1) OECD-MC states that:

> 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

22. OECD Commentary on Art. 11, para. 21.
23. OECD Commentary on Art. 11, para. 19: "In situations of presumed thin capitalization, it is sometimes difficult to distinguish between dividends and interest and in order to avoid any possibility of overlap between the categories of income dealt with in Article 10 and Article 11 respectively, it should be noted that the term 'interest' as used in Article 11 does not include items of income which are dealt with under Article 10."

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> 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.

The most important question is whether Article 9(1) OECD-MC constitutes a hurdle to the application of domestic thin capitalization rules. The Committee on Fiscal Affairs for the OECD (hereafter: the Committee) has the opinion that Article 9(1) OECD-MC does not hinder the application of thin capitalization rules which result in either the non-deductibility or the reclassification of the interest payments: "Article 9(1) allows the tax authority of a Contracting State *to adjust the taxable profit* of an enterprise of that State to include profits which have not accrued to it in its accounts but which would have accrued to it in the arm's length situation" [emphasis added].[24] Thus it can be deduced that any profit eliminated as a result of interest payments to a related company, to the extent that the payments exceeded arm's length payments, can be taken into account by the country of source.

Article 9(1) OECD-MC does not contain any definition of 'dividend' or 'interest'. In addition, it refers to profit allocation rather than to the determination of taxable profits. In my opinion, Article 9(1) OECD-MC does not interfere with domestic thin capitalization provisions which prohibit the interest deduction. These domestic provisions are part of the internal rules which determine the taxable profit.

With respect to domestic thin capitalization rules which reclassify interest payments as dividend distribution, in my opinion, the OECD view is not valid. The text of Article 9(1) OECD-MC refers explicitly to "conditions ... made or imposed between the two enterprises in their ... financial relations". This phrase makes the existing financial relations the starting point rather than the subject of Article 9(1) OECD. The term 'condition' has a rather limited meaning similar to the 'terms' of a contract;[25] The Commentary[26] states "no re-writing of the accounts of associated enterprises is authorized if the transactions between such enterprises have taken place on normal open market terms". In this narrow interpretation only the (excessive) remuneration can be changed by applying Article 9(1) OECD-MC. Bear in mind that with respect to excessive interest payments the OECD Model Convention has a special provision in Article 11(6). Only if a broad interpretation of the term 'conditions' is adopted, could Article 9(1) OECD-MC apply to these domestic thin capitalization rules.[27] The reclassification of the debt as equity should, therefore, be deemed as a 'condition' in the financial relation.[28] In my opinion, however, the text of Article 9(1) OECD-MC does not allow this broader interpretation.

Also the historical interpretation of Article 9(1) OECD-MC directs to a more restrictive interpretation. Article 5 of the League of Nations Model Convention 1933 was qua text to a large extent identical with Article 9(1) OECD-MC:

> When an enterprise of one Contracting State has a dominant participation in the management or capital of an enterprise of another Contracting State, or when both enterprises are owned or controlled by the same interest, and as the result of such situation there exist, in their *commercial or financial relations*, conditions different from those which would have been made between independent enterprises, any item of profit or loss which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise [emphasis added].

When this provision was implemented in 1933, thin capitalization was not an issue for tax authorities. Thus in his study Caroll[29] listed an interest free loan and a loan with excessive interest payments as examples of non-arm's length transactions but not excessive debt financing. The thin capitalization problem has been discovered relatively recently and is considered an important issue by some (but by no means all) countries. Article 9(1) OECD-MC has simply not been written with this issue in mind.

Another argument for the limited scope of Article 9(1) OECD-MC is that originally this provision was implemented in order to guarantee the independence of the parent company in relation to the subsidiary. Vogel[30] refers in this situation to the *Verteilungs-norm.*[31] This means that – with respect to the legal protection of the taxpayer – every correction of taxable profits can only be accepted if certain strictly formulated conditions have been met. This is made even more explicit by implementing in Article 9(2) OECD-MC a provision in which the other contracting state "... shall make an appropriate adjustment to the amount of the tax charged therein on those profits".

C. Restrictive or illustrative application?

A second important issue which has to be addressed is whether Article 9(1) OECD-MC limits any correction according to domestic thin capitalization rules to the arm's length profit? In this respect it is important whether Article 9(1) OECD-MC should be interpreted restrictively or illustratively.

A restrictive interpretation would mean that Article 9(1) OECD-MC prohibits any correction of profits which would lead to a higher taxable profit than the arm's length profit. An illustrative interpretation of Article 9(1) OECD-MC would, on the other hand, give the profit correction just a conventional framework. It does not prohibit the contracting states from correcting the taxable profits in excess of the arm's length profit.

24. Report on Thin Capitalization, *supra* note 1, para. 48-49. This opinion has been laid down in the Commentary on the OECD Model Convention, Art. 9(1), para. 2.
25. David W.M. Walker, *The Oxford Companion to Law*, Oxford 1980, at 268.
26. OECD Commentary, Art. 9, para. 1.
27. F.C. de Hosson and G.M.M. Michielse, "Treaty aspects of the 'thin capitalization' issue – A review of the OECD Report", *Intertax* 1989/11, at 480.
28. K. Vogel, *supra* note 10, Art. 9, Rz. 30, made a choice for this extensive interpretation: "Er [i.e. the term 'condition'] umfaßt neben den Voraussetzungen für das Zustandenkommen und die Abwicklung einer Leistungsbeziehung insbesondere die für die Wertbildung der Leistung maßgebenden Vereinbarungen und die Bewertung bzw. den Preis der Leistung selbst".
29. Mitchell B. Caroll, "Taxation of Foreign and National Enterprises – Methods of Allocating Taxable Income", *League of Nations*, 1933, No. 358.
30. K. Vogel, *supra* note 10, Art. 9, Rz. 10.
31. See also: H.-M. Pott, *supra* note 20, at 223-230.

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In the OECD Report on Thin Capitalization (hereafter: the Report),[32] the Committee has not reached *communis opinio* between the member states regarding the scope of Article 9(1) OECD-MC. The Committee, however, is of the opinion that the profit adjustment based on domestic thin capitalization rules should not result in taxable profit in excess of the arm's length profit. Thus, the Committee chooses in favour of the restrictive interpretation.

Three arguments can be put forward in favour of a restrictive interpretation.[33] First, that the restrictive character of the provision is based on its history. At the implementation of the text in 1933, the primary purpose of the provision was to protect the taxpayer from arbitrary profit corrections made by tax authorities. This purpose was reached by mentioning the circumstances under which tax authorities could correct profits. The Commentary on Article 9(1) OECD-MC repeated that "no re-writing of the accounts of associated enterprises is authorised if transactions between such enterprises have taken place on normal market commercial terms".[34]

A second argument is that there is a close relationship between the provisions of Article 9(1) OECD-MC and Article 7 OECD-MC: the profit allocation between headquarters and permanent establishment. In Article 7 OECD-MC the arm's length principle is formulated as follows:

> ... there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

This means that – at least in theory – the profit allocation has to be based on the separate entity approach. However, based on the Commentary,[35] some payments between head office and permanent establishment (e.g. interest and royalties) have to be disregarded in determining the taxable profit of the latter. Whereas both Article 9(1) OECD-MC and Article 7 OECD-MC have the same roots in Article 5 of the League of Nations Model Convention, it is not very likely that Article 9(1) OECD-MC permits a profit correction which would go beyond the arm's length profit.

The last and perhaps the most important argument for the restrictive interpretation can be found in the fact that it does not seem to be useful to conclude DTCs based on which contracting states could correct profits which go beyond the arm's length profit. In that situation, the risk of international economic double taxation would be maintained or even increased.

Meanwhile the Commentary on the OECD Model Convention explicitly expressed that the correction of profits based on domestic thin capitalization rules "normally [should] not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties".[36]

D. Subject of reference

Article 9(1) OECD-MC gives the tax authorities of the contracting states the possibility to adjust taxable profits by comparing the conditions made or imposed between two associated enterprises in their commercial or financial relations with those made or imposed with an independent third person. The subject of reference is thus an independent third person. There are two methods which may be used to determine whether this independent third person under identical circumstances would also have been granted a loan.

In the first approach the tax authority judges the facts and circumstances of the presented case. It considers many factors including: a high debt-to-equity ratio, the long-term need of the taxpayer to finance his business, the proportionality of the debt to the capital provided by the shareholder, the financing of a loss position, the possibility to convert the loan into share capital, the subordination of the repayment obligation, etc. All these elements should be compared with the conditions which an independent creditor would have imposed. Often it is suggested that a commercial bank might be just such an independent creditor. In my view, there are problems with using a commercial bank as an approximation to an independent creditor. The reasons for a parent company granting its subsidiary additional loans in order to protect its original investment, can easily interfere with the reference to an independent third party.

Another approach could be that the tax authorities reclassify the interest payments as dividend distributions if the financial structure of the paying enterprise exceeds a fixed debt-to-equity ratio. The fixed debt-to-equity ratio could be based on the normal ratio in the market. If this ratio can be seen as a "safe haven" and the taxpayer has the possibility to prove that the loan is at arm's length (i.e. an independent party would have also granted the loan), this approach would be acceptable. This view has been implemented in the OECD Commentary.[37] However, the taxpayer could be faced with a burden of proof which would be difficult to discharge. An extreme form of this approach can be found in the United Kingdom where interest paid to non-resident shareholders cannot be deducted automatically.[38] In its DTCs the United Kingdom has implemented the possibility of counter proof if the arm's length standard is met, the interest can be deducted. In my opinion, the burden of proof regarding its financial structure should not be with the taxpayer as there is no *communis opinio* about an arm's length financial structure. In addition, shifting the burden of proof to the taxpayer does not

32. Report on Thin Capitalization, 1987, *supra* note 1, para. 50.
33. F.C. de Hosson and G.M.M. Michielse, *supra* note 27, at 482.
34. OECD Commentary, Art. 9, para. 1.
35. OECD Commentary, Art. 7, para. 18: "The ... payments which under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. In such a case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits".
36. Commentary, Art. 9, para. 2(c).
37. OECD Commentary, Art. 9, para. 4.
38. ICTA 1988, Sec. 209(2)(e)(iv) and Sec. 209(2)(e)(v).

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match with the general domestic approach adopted in most countries.

V. RELIEF FOR INTERNATIONAL ECONOMIC DOUBLE TAXATION

A. Corresponding adjustment

Another problem is the question whether the correction of profits according to Article 9(1) OECD-MC will actually lead to international economic double taxation since it is highly uncertain whether the country of residence of the creditor will accept the corrections made by the country of source.

This problem is addressed by Article 9(2) OECD-MC:

> Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits.

The purpose of this provision is to avoid international economic double taxation, in the same manner as Article 23A OECD-MC and Article 23B OECD-MC protect against international juridical double taxation.

The phrase "... that other State shall make an appropriate adjustment ..." in Article 9(2) OECD-MC suggests an obligation to the country of residence to follow the corrections based on thin capitalization rules in the country of source. In the Commentary,[39] however, it is stated that the corresponding adjustment does not have to be given automatically by the country of residence. The country of residence is only obliged to give a corresponding adjustment if it agrees both in principle and amount to the corrections made in the country of source. This is precisely the weak spot of the provision. It assumes the same qualification of the facts and circumstances as well as the same interpretation of what is at arm's length. Since countries have various approaches to the thin capitalization problem, it is doubtful whether tax authorities will agree upon each others views. The Report[40] suggests that the country of residence should have an obligation to follow the correction of the interest payment in the country of source, if their thin capitalization rules are in line with Article 9(1) OECD-MC. This suggestion is in my view, not implemented in the 1992 Commentary. Such an obligation would have – even within the arm's length limitation – been an invitation to the countries of source to introduce the most strict debt-to-equity ratios. What remains to unwilling treaty partners, in that case, is either the abolition of the DTC or resignation to the fact that the DTC does not fully avoid international double taxation. In reality, countries of source will exercise with great care the implementation of a strict debt-to-equity ratio on penalty of a deterioration of their competitiveness (i.e. the danger of international economic double taxation).[41]

B. Methods of double tax relief (Article 23A OECD-MC and Article 23B OECD-MC)

Article 23A OECD-MC and Article 23B OECD-MC set out the alternative methods of double tax relief. The country of residence, which has to give a relief for double taxation for income that may be taxed in the country of source according to the OECD Model Convention (like business profit as a result of the non-deductibility of interest), may do so via an exemption (Article 23A OECD-MC) or via a credit (Article 23B OECD-MC). Where the country of residence chooses the exemption method for dividends received, the tax withheld in the country of source might not be creditable even though the withholding tax on interest payments would have been creditable. Likewise, where the country of residence chooses the credit method, the same problem might occur. Neither Article 23A OECD-MC nor Article 23B OECD-MC gives a general rule that the country of residence has to follow the reclassification in the country of source based on its domestic thin capitalization rules. Furthermore, the contracting states have the freedom to implement a special regime in which dividends received on a qualified participation can be (partly) exempt from taxable profits.[42]

According to the Committee, the above mentioned problem has to be primarily solved by interpretation of the individual treaty provisions or by the national legislation in the country of residence of the recipient. Two situations can be distinguished:

(1) where the equivalent provision to Article 23A(2) OECD-MC explicitly refers to the provision of Article 10 OECD-MC, the country of residence has the obligation to treat the interest which has been reclassified in the country of source as dividend accordingly. This applies only with respect to the relief which has to be given for withholding taxes in the latter country; or

(2) where the treaty provision does not refer to Article 10 OECD-MC, the country of residence should be also obliged to follow the classification in the country of source:
   - if the reclassification is in accordance with Article 9(1) OECD-MC; or
   - if the domestic thin capitalization rules apply in reverse order;[43] or
   - if the country of residence justifies the reclassification to the country of source.

In this way, one achieves the solution which is given by Article 9(2) OECD-MC.

The application in reverse order raises the question of the internal balance of domestic thin capitalization rules. These rules apply normally only to the tax position of the debtor. If

39. OECD Commentary, Art. 9, para. 6.
40. Report on Thin Capitalization, *supra* note 1, para. 65.
41. Germany, however, has even introduced a legal debt-to-equity ratio within the framework of the 'Standortsicherungsgesetz', which Act contains incentive schemes to strengthen the German economy.
42. See, amongst others, Article 20(2) third sentence of the DTC between the Netherlands and Germany.
43. I.e. that those rules should also apply regarding the tax position of the creditor and not only regarding the debtor.

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the country of residence of the creditor, however, also applies thin capitalization rules, in my opinion, it should apply those rules in reverse order. This means that – if these thin capitalization rules reclassify interest as dividend – an exemption or a credit for underlying corporate income tax should be given.

VI. OTHER TREATY INSTRUMENTS TO PROTECT AGAINST INTERNATIONAL DOUBLE TAXATION

Next to the provisions which give a direct relief for international double taxation, the OECD Model Convention contains two other instruments to avoid international double taxation: the mutual agreement procedure and the non-discrimination provisions.

A. Mutual agreement procedure

Article 25 OECD-MC contains a mutual agreement procedure. Individual taxpayers have the possibility to force the tax authorities in the country of residence to solve the international double taxation by mutual agreement with the source country's tax authorities (Article 25(1) OECD-MC). This situation occurs when it is argued that one of the contracting states does not levy tax according to the treaty provisions. This might happen if the countries qualify differently the facts and circumstances. This means that only classification differences between contracting states based on domestic thin capitalization provisions can be the subject of a mutual agreement procedure. In practice, however, some Ministries of Finance will also start procedures in case of international economic double taxation.[44]

It should be borne in mind that a mutual agreement procedure does not guarantee that the tax authorities actually find a solution (i.e. give relief for international double taxation). In addition, I doubt very much that consultations between countries will result in an acceptable solution. While an agreement on the application of a clear legal provision is highly unlikely, an agreement on facts (e.g. arm's length prices) is perhaps a possibility.[45] A country cannot 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". Finally, these mutual procedures are usually time consuming, which results in a long period of (fiscal) uncertainty.

B. Non-discrimination

Article 24 OECD-MC contains a general non-discrimination provision. Sections 4 and 5 of this Article are especially important to the thin capitalization issue.

1. Deduction non-discrimination provision

Article 24(4) OECD-MC states that:

> except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, ..., apply, interest ... paid by an enterprise of a Contracting State to a resident of the other Contracting State shall for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

This provision protects resident companies against domestic legislation which aims at the non-deductibility of certain business costs paid to non-residents. Notwithstanding this, however, it excludes the correction of profits based on the arm's length principle.

It is clear that once this provision has been implemented in a DTC, it directly influences the application of domestic thin capitalization rules. This happened e.g. with respect to the deductibility rules on intercompany interest in the United Kingdom which had to be withdrawn in most of the United Kingdom's tax treaties (see above). As argued before, domestic thin capitalization rules are neither covered by Article 9 OECD-MC nor by Article 11(6) OECD-MC. In that way, this provision could protect taxpayers against the application of thin capitalization rules. In practice, this provision is not very often implemented in DTCs. Usually, contracting states are just willing to implement a very general non-discrimination clause. Furthermore, domestic legislators are quite keen on drafting thin capitalization rules which in theory also apply to resident creditors.

2. Ownership non-discrimination provision

Next to Article 24(4) OECD-MC attention should be paid to Article 24(5) OECD-MC. The latter provision states that an "enterprise of a Contracting State, the capital of which is wholly or partly owned or controlled directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected." The question arises what constitutes a *similar enterprise*; in other words what is the subject of reference? This could be the company of which the shares are owned by residents of the same State or the company of which the shares are owned by residents of a third State. According to the Commentary,[46] it seems that the subject of reference is the first-mentioned: "Its [Article 24(5) OECD-MC] object therefore is to ensure equal treatment for taxpayers residing in the same State ..." The Report[47] also implies this view as it stated that Article 24(5) OECD-MC "aims broadly at preventing 'tax protectionism' – i.e. the deterrence by tax measures of investment from outside the country". Another hint for this interpretation can be found in the negotiations of the UN Model Convention. Some developing countries proposed an amendment to this provision in which an explicit reference to shareholders in third countries was made. This amendment, however, was heavily criticized by the developed countries. One could therefore believe that the

44. E.g. the Dutch Ministry of Finance.
45. I.e. an agreement on the application of the law is highly unlikely since it is not possible to accept only half of the consequences of the application. In contrast an agreement on the facts and circumstances can be achieved (one can find an arm's length price which is acceptable to both countries.
46. OECD Commentary, Art. 24, para. 57.
47. Report on Thin Capitalization, *supra* note 1, para. 66.

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reference made in Article 24(5) OECD-MC applies only to companies in the country of source whose shareholders are residents of that country.

This provision also protects taxpayers from application of domestic thin capitalization rules which are designed to prohibit interest payments to non-residents. The Report[48] concludes that the wording of Article 24(5) OECD-MC is so general, that Article 24(4) OECD-MC takes precedence in case of deductibility of interest payments (i.e. *lex specialis* takes precedence over *lex generalis*). The Report, however, takes the position that thin capitalization rules are covered by Article 9(1) OECD-MC.

Where the profit correction is not hindered by Article 24(4) OECD-MC, Article 24(5) OECD-MC cannot hinder it either. Although Article 24(5) OECD-MC is more general, attention should be drawn to the fact that it applies to payments to all creditors whereas Article 24(4) OECD-MC only applies to payments to shareholders/creditors. As a result, Article 24(5) OECD-MC can only apply, in the view of the OECD, if the thin capitalization rules also apply to non-shareholders. This is correct because thin capitalization rules which are drafted in line with the arm's length principle, by definition consider the non-shareholder as an independent third party.

VII. CONCLUSIONS

A. International juridical double taxation

Article 10(3) OECD-MC sets out for the purposes of this provision a definition of the term 'dividend'. This definition states that the reclassification of the interest payments in the country of source has to be followed by the country of residence. This implies that thin capitalization rules which reclassify debt or interest payments, with respect to the application of Article 10 OECD-MC should be followed by the country of residence. As a result, the country of residence has to give a relief for international juridical double taxation either by exemption (Article 23A OECD-MC) or by credit (Article 23B OECD-MC) for the tax withheld according to Article 10 OECD-MC.

Where the country of source has thin capitalization rules which prohibit the deductibility of interest payments, these payments will continue to be treated as 'interest' and covered by Article 11(3) OECD-MC. Although this treaty provision contains in Section 6 a special rule with respect to excessive interest, this rule does not apply in situations of thin capitalization. Also in these situations the country of residence is according to Article 23A OECD-MC (exemption) or Article 23B OECD-MC (credit) obliged to give relief for international juridical double taxation.

The definition of the terms 'interest' and 'dividend' given in Article 11 OECD-MC and Article 10 OECD-MC respectively apply to these provisions. In other words, these definitions are meaningless within the context of Article 9 OECD-MC. Therefore the international juridical double taxation has not yet been solved.

B. International economic double taxation

Based on the text and the Commentary, in my opinion, Article 9 OECD-MC does not apply to domestic thin capitalization rules. If such thin capitalization rules reclassify debt or interest payments, the wording of Article 9 OECD-MC does not allow such reclassification as a 'condition'. Even if the term 'condition', however, is interpreted broadly this would result in the danger of international economic double taxation. Any agreement based on Article 9(2) OECD-MC is unthinkable. In addition, the corresponding adjustment is not at all obligatory. Some countries (like Germany) have even made a reservation to Article 9(2) OECD-MC and are not willing to implement it in their DTCs.

If a thin capitalization rule prohibits the deductibility of interest payments, (this is occurring more and more often in practice), and should be qualified as a profit determination rule, Article 9 OECD-MC is not applicable at all. Article 9 OECD-MC refers exclusively to a correct international profit allocation between associated enterprises. The international economic double taxation occurs as a result of the different rules on profit determination in the country of source and the country of residence. This double taxation is not solved by any DTC.

C. Other instruments of treaty protection

The OECD Model Convention provides in Article 25 another possibility to avoid international double taxation. The Ministry of Finance can start a mutual agreement procedure to solve the double taxation situation. This provision, however, does not give any guarantee that an acceptable solution will be found. An acceptable agreement is hard to find. In case the thin capitalization rule prohibits the interest deductibility, in my opinion, an agreement is impossible as that will infringe the sovereignty of that country.

Another possibility might be found in the application of the non-discrimination clauses of Article 24 OECD-MC. Section 4 and Section 5 of this provision are relevant. Article 24(5) OECD-MC can be seen as a *lex generalis*; a resident company of which the shareholder is a non-resident may not be treated in a manner different or more burdensome than a resident company of which the shareholder is a resident (ownership non-discrimination). At first sight, this provision seems to forbid thin capitalization rules which apply to non-resident shareholders. Because *lex specialis* precedes *lex generalis*, any other specific treaty provision protecting the taxpayer from the application of thin capitalization rules should first be taken into account. Based on Article 24(4) OECD-MC a resident company which pays interest to a non-resident creditor should be treated tax wise in the same way as if the interest had been paid to a resident creditor. However, Article 24(4) OECD-MC makes an exception with respect to corrections of profit made according to Article 9 OECD-MC or Article 11(6) OECD-MC. As argued before, thin capitalization

48. Report on Thin Capitalization, *supra* note 1, especially para. 66(b) and para. 87(b).

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rules will never be covered by these treaty provisions and as a result the exception is not applicable. Domestic thin capitalization rules may therefore be contrary to these non-discrimination provisions.

In practice, however, tax treaties usually do not follow the OECD Model Convention on this point. They contain mostly a very general non-discrimination clause (like Article 24(1) OECD-MC). Thin capitalization rules will thus lead frequently to international economic double taxation. In my opinion, this is reprehensible as thin capitalization rules are drawn up by States in order to protect their budget (base erosion) and thereby create a vulgar fight between the tax authorities about the international allocation of the imposition rights on business profits. In order to solve the international economic double taxation problems which arise as a result of the application of domestic thin capitalization rules, the OECD has at the very least to rewrite Article 9(1) OECD-MC. Perhaps a more fundamental approach would be the introduction of a generally accepted debt-to-equity ratio which could be incorporated into DTCs and applied to both the country of source and the country of residence.[49]

49. G.M.M. Michielse, 'Thin Capitalization' in het fiscale recht, Diss., Kluwer, Fiscale Monografieën, Nr. 67, Deventer 1994.

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SPECIAL REPORT

THE UN MODEL IN PRACTICE

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This paper was written specially for the UN Ad Hoc Group of Experts on International Cooperation in Tax Matters, for presentation at the Group's eighth meeting in Geneva in December 1997. It summarizes the results of an extensive research project, carried out by the International Bureau of Fiscal Documentation, on the impact of the UN Model Double Taxation Convention Between Developed and Developing Countries.

The authors present this report in the knowledge that they cannot promise to have been complete but in the hope that their work will provide some new insights to the reader.

CHAPTER I

INTRODUCTION

The aim of this report is to assess the impact of the UN Model Double Taxation Convention Between Developed and Developing Countries (the UN Model) on current tax treaty practice. It is based on an extensive research project in which 811 concluded treaties were scrutinized in order to ascertain whether they adopt the distinctive provisions of the UN Model. These provisions were determined by comparing the UN Model with the OECD Model Tax Convention on Income and Capital (OECD Model) of 1977. The changes made to the OECD Model in 1992 and subsequently were not taken into account.

The research project was carried out using the IBFD Tax Treaty Database. It covered all comprehensive tax treaties concluded from 1 January 1980, the year in which the UN Model was published, to 1 April 1997, the date of the most recent version of the Tax Treaty Database. The treaties concluded by the former USSR and the former Republic of Yugoslavia that continue to be applied by a number of new states in that region of the world were counted only once.

For the purposes of this research project a distinction had to be drawn between developed and developing countries. Such a distinction inevitably carries an element of subjectivity, and so this invidious task was considerably simplified by reference to membership of the OECD when the UN Model was published. The 24 countries that were a member of the OECD in 1980 were regarded as developed countries and all other countries were regarded as developing countries, regardless of their actual stage of development. This meant, for example, that Mexico and Hungary, which joined the OECD only recently, were counted as developing countries.

In the first instance the research focused on the tax treaties concluded by developing countries with either a developed or another developing country. This group, referred to as Group A in this paper, comprised 697 treaties. The project also looked at the tax treaties concluded between OECD countries. This group comprised 114 treaties and is referred to as Group B.

The following provisions that are specific to the UN Model were scrutinized:

Art. 5(3)(a)	construction activities
Art. 5(3)(b)	furnishing of services
Art. 5(4)(a) and (b)	delivery of goods
Art. 5(4)(f) OECD	combination of activities
Art. 5(5)	stock agents
Art. 5(6)	insurance activities
Art. 5(7)	agents with one principal
Art. 7(1)	limited force of attraction
Art. 7(3)	management fees, interest and royalty payments
Art. 7(5) OECD	purchase of goods
Art. 8B	shipping profits
Art. 12(3)	radio and television broadcasting
Art. 13(4)	real property shares
Art. 13(5)	other shares
Art. 14(1)	additional criteria
Art. 16(2)	top-level managerial officials
Art. 18B(1) and (2)	pensions
Arts. 18A(2) and 18B(3)	social security payments
Art. 20(2)	equal treatment of students
Art. 21(3)	source state taxation of other income
Art. 25(4)	implementation clauses
Art. 26(1)	prevention of tax fraud/evasion, secret information and implementation

The provisions relating to the withholding taxes on dividends, interest and royalties were not examined, as the UN Model, unlike the OECD Model, does not recommend a particular percentage for these categories of income. In this respect any withholding rate, including the rates recommended by the OECD Model, is consistent with the UN Model. A more fundamental aspect that was not examined is the omission from the UN Model of the second sentence of Article 4(1) of the OECD Model, which limits the treaty concept of residence. The inclusion or omission of this provision is so intertwined with the rest of the treaty and the domestic law of the treaty partners that it would have been impossible to consider it without extending the project to Herculean proportions.

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Even the most cursory glance at a number of concluded treaties is sufficient to reveal the tremendous variety that can be achieved within the confines of a seemingly simple and rigid framework. The authors of this paper had no choice but to select the most important and commonly occurring variations for comment. Nevertheless, where it was felt appropriate, some provisions of particular interest are mentioned even though they are found in only a very limited number of treaties. Chapter II of this paper sets out the detailed results of the research and Chapter III summarizes the results in a schematic form.

CHAPTER II

Article 5(3)(a) Construction activities

1. The UN Model

Article 5(3)(a) of the UN Model reads as follows:

(3) *The term "permanent establishment" likewise encompasses*:
  (a) A building site, a construction, *assembly* or installation project *or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months*;
  (b) (...).

The relevant differences between the construction clause of the OECD and the UN Model refer to:
(a) the inclusion of supervisory activities, and
(b) the minimum period of six months.

2. Tax treaties

a. Supervisory activities

According to the OECD Commentary supervisory activities are explicitly subsumed under the construction clause provided the work is performed by the main contractor himself. However, supervisory activities performed by a subcontractor who is not engaged in the physical work do not constitute a permanent establishment. In this respect the UN Model departs from the OECD Model. According to the UN Model, supervisory activities may constitute a permanent establishment irrespective of whether they are performed by the main or subcontractor and irrespective of whether the contractor is physically involved in the work.

There are 449 treaties in which supervisory activities are included as one of the elements that may constitute a permanent establishment. Of these treaties 410 have been concluded by developing countries, with either a developed or another developing country (group A), and 39 have been concluded between developed countries (group B).

b. Minimum period

There are 513 treaties that prescribe a minimum period shorter than the 12 months recommended by the OECD Model. Of these treaties 484 have been concluded by developing countries, with either a developed or another developing country (group A), and 29 have been concluded between developed countries (group B). Of the 29 treaties in group B, 5 prescribe a 9-month period and 24 prescribe a 6-month period. The following periods shorter than 12 months are found in the treaties:

Number of treaties	Period in days	months
50	–	9
2	275	–
2	–	8
1	–	7
355	–	6
58	183	–
1	–	5
5	120	–
29	–	3
3	90	–
7	0*	0*

* No minimum period is included.

There are 298 treaties that prescribe a minimum period of 12 months or longer. Of these treaties 215 have been concluded by developing countries, with either a developed or another developing country (group A), and 83 have been concluded between developed countries (group B). All treaties in group B prescribe a 12-month period.

The following periods of 12 months or longer are found in the treaties:

Number of treaties	Period in days	months
2	–	36
4	–	24
3	–	18
289	–	12

For the sake of completeness it should be mentioned that a few treaties contain different limits for the various types of construction activity.

Article 5(3)(b) Furnishing of services

1. The UN Model

Article 5(3)(b) of the UN Model reads as follows:

(3) *The term "permanent establishment" likewise encompasses:*
  (a) (...);
  (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that

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nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period.

This provision is not specifically included in the OECD Model.

2. Tax treaties

There are 221 tax treaties with a specific provision for the furnishing of services. Of these treaties 219 have been concluded by developing countries, with either a developed or another developing country (group A), and 2 have been concluded between developed countries (group B).

The following periods are found in the treaties:

Number of treaties	Period in days	months
1	–	18
19	–	12
9	–	9
2	275	–
1	–	8
111	–	6
34	183	–
3	–	4
6	120	–
23	–	3
2	91	–
5	90	–
5	0*	0*

* No minimum period is adopted.

In 10 treaties concluded by developing countries (group A) a distinction is made between services performed for unrelated enterprises and services performed for related enterprises. In these treaties a minimum period applies to services performed for unrelated enterprises and no minimum period or a shorter minimum period applies to services performed for related enterprises. Seven treaties prescribe no minimum period in situations involving related parties and 3 treaties prescribe a shorter period than for situations involving unrelated parties (i.e. 30 days instead of 90 days).

The two treaties between developed countries (group B) prescribe the 6-month period recommended by the UN Model.

Article 5(4)(a) and (b) Delivery of goods

1. The UN Model

Article 5(4)(a) and (b) read as follows:

(4) Notwithstanding the preceding provisions of this article, the term "permanent establishment" shall be deemed not to include:

(a) The use of facilities solely for the purpose of storage *or* display *[]* of goods or merchandise belonging to the enterprise;

(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage *or* display *[]*; (...).

In this paragraph the term "delivery" as provided in the corresponding provisions of the OECD Model is omitted.

2. Tax treaties

There are 167 tax treaties that do not list "delivery" as one of the activities that do not constitute a permanent establishment. All these treaties are concluded by developing countries, with either a developed or another developing country (group A).

Article 5(4)(f) OECD Combination of activities

1. The UN Model

The UN Model does not include the provision contained in Article 5(4)(f) of the OECD Model which is formulated as follows:

"the maintenance of a fixed place of business solely for any combination of activities, mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character".

2. Tax treaties

In line with the UN Model, no provision for the combination of activities is adopted in 264 treaties. Of these treaties 233 have been concluded by developing countries, with either a developed or another developing country (group A), and 31 have been concluded between developed countries (group B).

Article 5(5)(b) Stock agents

1. The UN Model

Article 5(5)(b) of the UN Model reads as follows:

(5) Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 7 applies – is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such person:

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(a) Has and habitually exercises in that State an authority to conclude contracts .....; *or*
(b) *Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.*

This subparagraph (b) extends the concept of an "agent".

2. Tax treaties

There are 243 treaties with a specific provision for stock agents. Of these treaties, 234 have been concluded by developing countries, with either a developed or another developing country (group A) and 9 have been concluded between developed countries (group B).

These provisions differ in wording, albeit not in content. Thus, in 62 of these treaties reference is made to the fulfilment of orders or to the supply of goods rather than to the delivery of goods.

In addition to the provision for stock agents, 56 of these treaties include a specific provision for agents who habitually secure orders for the sale of goods or merchandise. Further, 30 of these treaties include a specific provision for agents who manufacture or process goods. An example of the first type of provision is:

(c) *he habitually secures orders for the sale of goods or merchandise in the first-mentioned State, wholly or almost wholly on behalf of the enterprise itself, or on behalf of the enterprise and other enterprises controlled by it or which have a controlling interest in it.*

An example of a provision for agents who manufacture goods is:

(c) *he manufactures, assembles, processes, packs or distributes in the first-mentioned State for the enterprise goods or merchandise belonging to the enterprise.*

Finally, in two treaties the specific provision for stock agents applies only in the case of abuse. This provision reads as follows:

(b) *(stock agent) ... The foregoing provision of this subparagraph shall apply only if it is proved that in order to avoid taxation in the first-mentioned State, such person undertakes not only the regular delivery of the goods or merchandise, but also undertakes virtually all the activities connected with the sale of goods or merchandise except for the actual conclusion of the sales contract itself.*

Article 5(6)
Insurance activities

1. The UN Model

Article 5(6) of the UN Model reads as follows:

(6) Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to reinsurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

This provision is not included in the OECD Model. The provision broadens the definition of permanent establishment by including the following activities carried on by insurance enterprises:
(a) the collection of premiums
(b) the insurance of risks

These activities qualify as a permanent establishment only if they are not performed through an agent of an independent status.

2. Tax treaties

There are 210 tax treaties with a specific provision for insurance activities. Of these treaties 184 have been concluded by developing countries, with either a developed or another developing country (group A), and 26 have been concluded between developed countries (group B).

It should be noted, however, that only in 137 treaties (5 of which belong to group B) are insurance activities deemed to constitute a permanent establishment as provided by the UN Model. In the remaining 73 treaties (21 of which belong to group B) the same result is achieved by adopting in Article 7 or in the protocol to Article 7 a provision stating that the provisions of Article 7 do not affect the application of domestic law regarding the taxation of profits from insurance business.

In 7 treaties in group A the right of the source state to tax profits from insurance activities is limited to 2.5 per cent of the gross amount of the premiums. In one of these treaties this limitation applies only to profits from reinsurance activities while the right to tax profits from insurance activities remains unlimited.

Article 5(7)
Agents with one principal

1. The UN Model

Article 5(7) of the UN Model reads as follows:

(7) An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. *However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not*

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be considered an agent of an independent status within the meaning of this paragraph.

The second sentence of this provision extends the scope of the permanent establishment concept by treating an agent who acts wholly or almost wholly for one principal as a dependent agent.

2. Tax treaties

There are 243 tax treaties with a specific provision for agents with only one principal. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

In 54 of these treaties the scope of this provision is limited to cases in which the transactions between the agent and the enterprise are not on an arm's length basis. An example of such an additional clause is: "*(...) if the transactions between the agent and the enterprise were made under conditions which differ from those which would be made between independent enterprises.*" In 5 of these treaties the taxpayer is given the possibility of demonstrating that the transactions were concluded in arm's length conditions.

In 22 of these treaties this specific provision not only covers activities performed by the agent on behalf of the enterprise itself, but also activities on behalf of associated enterprises. In that case the provision may be formulated as follows: "However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise *itself or on behalf of that enterprise and other enterprises controlling, controlled by, or subject to the same common control, as that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph.*"

Article 7(1)
Limited force of attraction

1. The UN Model

Article 7(1) contains a force of attraction rule which is limited as follows:

(1) 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.*

Clauses (b) and (c) strengthen the position of the source state by extending its right to tax to profits from business activities that are not carried out by an enterprise through its permanent establishment. The source state may attribute such non-p.e. profits to a permanent establishment of the enterprise if they are derived from the sale of goods or merchandise or any other business activity in the source state, provided that these transactions are similar to those concluded through the permanent establishment.

2. Tax treaties

There are 162 treaties with a limited force of attraction rule. Of these treaties 153 have been concluded by developing countries, with either a developed or another developing country (group A), and 9 have been concluded between developed countries (group B).

In 38 of these treaties (one of which belongs to group B) the enterprise may prove that the transactions or activities were genuinely carried out otherwise than through the permanent establishment. The wording of this provision differs in the various treaties. Two frequently recurring examples are:

However, the profits derived from the sales described in subparagraph (b) or other business activities described in subparagraph (c) shall not be taxable in the other State if the enterprise demonstrates that such sales or business activities have been carried out for reasons other than obtaining a benefit under this convention.

The provisions of subparagraph (b) and (c) shall not apply if the enterprise shows that such sales or activities could not reasonably have been undertaken by that permanent establishment.

In 19 of these treaties (5 of which belong to group B) the limited force of attraction rule applies only in cases of tax avoidance or abuse. In this case the burden of proof is on the tax authorities. An example of such a provision is:

The provisions of subparagraph (b) and (c) shall only apply provided that it is proved that the transaction concerned has been resorted to in order to avoid taxation in the Contracting State where the permanent establishment is situated.

In 12 treaties (3 of which belong to group B) the limited force of attraction rule applies only if there is some connection with the permanent establishment. An example of such a provision is:

The provisions of subparagraph (b) and (c) shall only apply provided that the permanent establishment has contributed in any manner in those sales or activities.

In 6 treaties in group A the scope of the limited force of attraction rule is restricted; the rule applies only to sales of goods or merchandise and business activities of the *same* kind as those sold or effected through the permanent establishment, not to *similar* sales and activities.

One treaty in group A refers only to sales, not to other business activities.

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Article 7(3)
Management fees, interest and royalty payments

1. The UN Model

Article 7(3) of the UN Model reads as follows:

(3) In *the determination* of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes *of the business* of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. *However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise by way of interest on moneys lent to the head office of the enterprise or any of its other offices.*

In this paragraph the principles laid down in the first sentence are defined and clarified in the second and third sentences.

2. Tax treaties

There are 201 treaties that include a clarification with respect to the determination of the profits of a permanent establishment. Of these treaties 195 have been concluded by developing countries, with either a developed or another developing country (group A), and 6 have been concluded between developed countries (group B).

Article 7(5) OECD
Purchase of goods

1. The UN Model

The UN Model does not include the provision contained in Article 7(5) of the OECD Model which is formulated as follows:

No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

2. Tax treaties

In line with the UN Model the above-mentioned provision is omitted from 45 treaties. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

Article 8 B
Shipping profits

1. The UN Model

Article 8 B(2) of the UN Model reads as follows:

Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ... per cent. (The percentage is to be established through bilateral negotiations.) (...)

This provision attributes to the source state a limited right to tax shipping profits, if the shipping activities in the source state are more than casual.

2. Tax treaties

There are 108 treaties providing for source state taxation with respect to shipping profits. Of these treaties 105 have been concluded by developing countries, with either a developed or another developing country (group A), and 3 have been concluded between developed countries (group B).

3. Deviations from the UN Model

A number of treaties contain provisions similar to, but deviating from, the UN Model. The most relevant deviating provisions can be summarized as follows:

- in 4 treaties in group A the taxing right of the source state is unlimited;
- in 101 treaties in group A and 3 in group B the right of the source state to tax is not dependent on the activities being "more than casual". Consequently, under these treaties it is irrelevant whether there is a scheduled or

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planned visit of a ship to a particular country to pick up freight or passengers;
- in 14 treaties in group A the scope of the provision is extended to air transport profits;
- 5 treaties in group A provide for a limited taxing right during the first 10 fiscal years after the entry into force of the treaty. After that period the source state loses its right to tax profits of shipping enterprises of its treaty partner.

In 3 treaties in group A the taxing right of the source state is limited to profits from the operation of ships between ports of the source state and ports of third states. Profits from operations between ports of the source state and ports of the treaty partner state are therefore not subject to tax in the source state.

4. Limitations to the taxing right of the source state

There are various types of limitation in the 104 treaties that provide for a limited right to tax in the source state. These limitations can be summarized as follows:
- 59 treaties in group A and 3 in group B provide for a reduction of the tax imposed by the source state by 50 per cent;
- 1 treaty in group A provides for a reduction of the tax imposed by the source state by two thirds;
- 5 treaties in group A provide for a reduction of the tax imposed by the source state of 50 per cent during the first 5 years after the entry into force of the treaty and of 25 per cent during the subsequent 5 years;
- 8 treaties in group A allow a withholding tax to be levied on the gross amount of the receipts derived in the source state. The withholding percentages vary from 1 per cent to 3 per cent;
- 5 treaties in group A provide for a maximum taxation in the source state equal to the lesser of 50 per cent of the tax imposed by domestic law and a certain percentage of the gross receipts derived in that state. The percentage varies from 2 per cent to 4 per cent;
- 13 treaties provide that the tax charged by the source state "*shall not exceed the lesser of: (a) 1.5 per cent of the gross revenue derived from sources in that State; and (b) the lowest rate of (name of one Contracting State) tax that may be imposed on profits of the same kind derived under similar circumstances by a resident of a third State*". In one of these treaties, the percentage in (a) is 1 per cent rather than 1.5 per cent;
- 10 treaties provide that (a) the tax imposed by the source state is to be reduced by 50 per cent and (b) the taxable profits are to be deemed not to exceed a certain percentage of the gross receipts. The percentage varies from 5 per cent to 7.5 per cent.

Article 12(3)
Radio or television broadcasting

1. The UN Model

The royalty definition of Article 12(3) of the UN Model reads as follows:

> (3) The term "royalties" as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, *or films or tapes used for radio or television broadcasting*, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

The OECD Model does not include in the definition of the term "royalties" payments made as a consideration for the use of, or the right to use, films or tapes used for radio or television broadcasting.

2. Tax treaties

There are 712 treaties that mention films or tapes used for radio or television broadcasting in the royalty definition. Of these treaties 610 have been concluded by developing countries, with either a developed or another developing country (group A), and 102 have been concluded between developed countries (group B).

It should be mentioned, however, that radio broadcasting is not mentioned in 39 treaties in group A and 6 treaties in group B. Further, 6 treaties in group A and 5 in group B include a generic reference to sound and video recording or to all means of reproduction of sound and image, while television and radio broadcasting are not expressly mentioned.

Article 13(4)
Real property shares

1. The UN Model

Article 13(4) of the UN Model reads as follows:

> *(4) Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State.*

This provision is not specifically included in the OECD Model.

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2. Tax treaties

There are 374 treaties with a specific provision for real property shares. Of these treaties 308 have been concluded by developing countries, with either a developed or another developing country (group A), and 66 have been concluded between developed countries (group B). In a number of these treaties real property shares are not dealt with in a separate paragraph, but together with gains on the alienation of real property in the first paragraph of the capital gains article.

In many treaties real property shares quoted on an approved stock exchange are excluded from this special regime. On the other hand quite a number of treaties specifically include interests in real property partnerships and/or trusts.

In 9 treaties the special regime for real property shares applies only if the participation exceeds a certain limit.

Article 13(5)
Other shares

1. The UN Model

Article 13(5) of the UN Model reads as follows:

> (5) *Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of ... per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.*

Under the OECD Model the right to tax capital gains on the alienation of shares is attributed to the state of which the alienator is resident, whereas under the UN Model this right is attributed to the state of which the company is resident (the source state).

2. Tax treaties

There are 384 treaties which more or less follow the recommendation of the UN Model. Of these treaties 322 have been concluded by developing countries, with either a developed or another developing country (group A), and 62 have been concluded between developed countries (group B).

In all these treaties the taxing right on capital gains on shares is explicitly attributed to the source state. It should be mentioned, however, that the same result may be achieved without such an explicit attribution. This is the case if, for example, the capital gains article does not contain a sweeping clause and there is no other income article, or there is an other income article that is in conformity with Article 21(3) of the UN Model. Such situations in which the source state can apply its domestic legislation are not included in the above-mentioned figures.

Further, it should be mentioned that the structure and wording of the regime for capital gains on shares in many treaties deviate considerably from the recommendation of the UN Model set out above. The complexity of this regime in many treaties makes it difficult to consider its elements in isolation rather than in their entire context. Nevertheless, a few general remarks can be made.

In many treaties the taxation right attributed to the source state is limited:

- in 82 treaties in group A and in 25 treaties in group B the source state has only the right to tax capital gains on shares derived by individuals who emigrated to the treaty partner state. In most of these treaties this taxation right is limited to a certain period after emigration;
- in 13 treaties in group A the tax that the source state may levy on capital gains on shares is explicitly limited to a certain percentage varying from 10 to 25 per cent;
- in 7 treaties in group A and 1 in group B the taxation right of the source state is limited by the exclusion of capital gains realized in the course of a corporate organization, reorganization, amalgamation, division or similar transaction;
- in 2 treaties in group A and 3 in group B the taxation right of the source state is limited to cases in which the shares are sold to a resident of the source state.

In 228 treaties in group A and 50 treaties in group B no minimum participation requirement is adopted. Of the remaining 106 treaties 44 have a participation requirement based on the shares sold and 62 have one based on the shares owned by the seller.

Article 14(1)
Additional criteria

1. The UN Model

Article 14(1) of the UN Model reads as follows:

> (1) Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State *except in the following circumstances, when such income may also be taxed in the other Contracting State*:
>
> (a) If he has [] a fixed base *regularly available to him in the other Contracting State for the purpose of performing his activities; in that case,* only so much of *the income* as is attributable to that fixed base *may be taxed in that other Contracting State; or*
>
> (b) *If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State; or*
>
> (c) *If the remuneration for his activities in the other Contracting State is paid by a resident of that Contracting State or is borne by a permanent establishment or a fixed base situated in that*

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Contracting State and exceeds in the fiscal year... (the amount is to be established through bilateral negotiations).

The principal differences between the independent personal services provisions of the OECD and the UN Models are to be found in the criteria based on:
(a) a length of stay of 183 days, and
(b) an amount of remuneration.

2. Tax treaties

a. The length of stay

In comparison with the OECD Model the source state's right to tax is extended by a provision that it may tax if a professional is present in that state for at least 183 days in a fiscal year, even if there is no fixed base.

There are 284 tax treaties with a length of stay criterion. Of these treaties, 264 have been concluded by developing countries, with either a developed or another developing country (group A), and 20 have been concluded between developed countries (group B).

The following periods are found in the treaties:

Number of treaties	Length of stay in days	months
225	183	–
1	182	–
2	180	–
1	–	6
17	120	–
2	91	–
36	90	–

There are no treaties between developed countries that prescribe a period shorter than 183 days.

The length of stay must be computed over the fiscal year, a period of 12 months or the calendar year. One treaty, however, provides for a length of stay (183 days) to be computed over two consecutive years.

No fixed base criterion has been adopted in 46 of these treaties, two of which have been concluded between developed countries. In one treaty in group A neither a fixed base nor a 183 days' presence in the source state is per se sufficient to attribute a taxing right to the source state, but both criteria must be met at the same time.

In two treaties in group A the right to tax is attributed to the source state if a fixed base is maintained in that state for at least 183 days. In this case, the existence of the fixed base is irrelevant if it is not maintained for a period of at least 183 days. On the other hand, the fact that a professional stays in the source state for more than 183 days is also not relevant in the absence of a fixed base maintained for the said period.

b. The amount of remuneration

In the UN Model the source state's right to tax is extended by a provision that the source state may tax any remuneration for independent personal services that exceeds a certain amount.

There are 45 tax treaties that include a criterion based on the amount of remuneration. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

No fixed base criterion has been adopted in 14 of these treaties; 2 of them also include no length of stay criterion.

Article 16(2)
Top-level managerial officials

1. The UN Model

Article 16(2) of the UN Model reads as follows:

(2) Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.

In this provision the principle applicable to the taxation of directors' fees is extended to the taxation of the remuneration paid to top-level managerial officials.

2. Tax treaties

There are 68 treaties dealing with remuneration paid to top-level managerial officials. Of these treaties 62 have been concluded by developing countries, with either a developed or another developing country (group A), and 6 have been concluded between developed countries (group B).

In 11 of these treaties (5 of which belong to group B) a definition is adopted of the term "top-level managerial function". According to this definition the term applies only to functions similar to those carried out by the members of the board of directors referred to in Article 16(1) of the OECD and the UN Models.

In 7 of these treaties (3 of which belong to group B), remuneration for the discharge of day-to-day functions is excluded from the scope of Article 16. In these treaties such remuneration is covered by Article 15 (Dependent Personal Services).

Article 18A(2) and 18B(3)
Social security payments

1. The UN Model

The provision recommended by the UN Model in Article 18A(2) and 18(B)(3) on social security payments reads as follows:

Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

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This provision is not specifically included in the OECD Model. It attributes an exclusive taxation right to the source state.

2. Tax treaties

There are 254 treaties with a separate provision for social security payments attributing the right to tax to the source state. Of these treaties 206 have been concluded by developing countries, with either a developed or another developing country (group A), and 48 have been concluded between developed countries (group B).

Most of these treaties prescribe an exclusive taxation right. Only in 31 treaties in group A and 20 treaties in group B is a non-exclusive taxation right attributed to the source state.

In 15 treaties in group A and 5 in group B the taxation right attributed to the source state is limited by the exclusion of social security payments made to an individual who is both a resident and a national of the treaty partner state. In one treaty in group A and one treaty in group B the taxation right of the source state is limited to social security payments made to nationals of the source state. Finally, in one treaty in group B the taxation right of the source state is limited by a maximum rate of 17.5 per cent.

Article 18B(1) and (2) Pensions

1. The UN Model

The provisions recommended by the UN Model in Article 18B (alternative B) (1) and (2) on pensions read as follows:

(1) Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment *may be taxed* in that State.

(2) *However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.*

The OECD Model does not attribute any right to tax to the source state. The UN Model attributes a non-exclusive taxation right to the source state.

2. Tax treaties

There are 295 treaties attributing to the source state a right to tax pensions. Of these treaties 259 have been concluded by developing countries, with either a developed or another developing country (group A), and 36 have been concluded between developed countries (group B).

Most of these treaties prescribe a non-exclusive taxation right. Only in 41 treaties in group A and 4 treaties in group B is an exclusive taxation right attributed to the source state. In one treaty in group B the exclusive taxation right of the source state applies only to the State's own nationals.

In 149 treaties in group A and 28 in group B the taxation right of the source state applies to annuities. It should be noted, however, that in 6 of those treaties in group A the source state taxation applies only to annuities and not to pension payments which are taxable exclusively in the residence state.

In 16 treaties in group A and 8 treaties in group B the taxation right of the source state is limited to lump sum payments, while all other pension payments are taxable only in the residence state of the recipient.

In a number of treaties the right of the source state to tax pensions is not specifically dealt with by a separate treaty provision. In 14 treaties in group A and 3 treaties in group B this taxation right is based on an "other income" article that is in line with the UN Model. In 6 treaties there is no "other income" article, which means that the source state can apply its domestic law.

In 34 treaties in group A and 6 in group B the taxation right of the source state is limited to a percentage that varies from 5 per cent to 20 per cent. Furthermore, 2 treaties in group B provide for a reduction of 50 per cent of the ordinary tax rate in the source state. In most of these treaties the limited flat rate does not apply in all cases. In some treaties the limited taxation right applies only to periodic payments, while lump sum payments are subject to ordinary taxation. In other treaties pensions are subject to a limited taxation right or, if lower, the tax which would be due by a resident of the source state on the pension payment and/or annuity. Further, there are treaties providing for different percentages for pension payments and annuities.

In 6 treaties in group A and 1 in group B the taxation right of the source state is limited to payments that exceed a certain amount per year. In 6 other treaties in group A the allocation of the taxation right to the source state is subject to the condition that the pension and/or annuity is borne, paid or deducted by an enterprise or a permanent establishment situated in that state.

In 9 treaties in group A and 2 in group B the taxation right of the source state is limited to pensions and/or annuities that are paid to a former resident of the source state.

In a number of treaties the taxation right of the source state depends in various configurations on the nationality of the receiver of the pension payment or annuity. A few other treaties contain a number of other additional conditions.

Article 20(2) Equal treatment of students

1. The UN Model

Article 20(2) of the UN Model reads as follows:

(2) *In respect of grants, scholarships and remuneration from employment not covered by paragraph 1, a stu-*

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dent or business apprentice described in paragraph 1 shall, in addition, be entitled during such education or training to the same exemptions, reliefs or reductions in respect of taxes available to residents of the state which he is visiting.

This provision is not specifically included in the OECD Model.

2. Tax treaties

There are 53 treaties with a specific equal treatment provision for students. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

It should be mentioned, however, that there are many treaties prescribing a greater exemption, relief or reduction than that recommended by the UN Model.

Article 21(3)
Source State taxation

1. The UN Model

Article 21(3) of the UN Model reads as follows:

(3) Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

This provision deviates from the OECD Model in that the source state may tax "other income" that arises in the source state.

2. Tax treaties

There are 343 treaties providing for source state taxation on "other income" arising in the source state. Of these treaties 308 have been concluded by developing countries, with either a developed or another developing country (group A), and 36 have been concluded between developed countries (group B).

It should be mentioned that there is no "other income" article in 38 treaties. Such situations in which the source state can apply its domestic legislation are not included in the above-mentioned figures.

Three of these treaties in group A provide for a withholding tax to be applied on the gross amount of "other income". The withholding rates are 10, 15 and 17.5 per cent. Three other treaties in group A attribute an exclusive taxing right to the source state rather than the non-exclusive taxing right prescribed by the UN Model.

Article 25(4)
Implementation clauses

1. The UN Model

Article 25(4) of the UN Model contains the following bilateral (second sentence) and unilateral (third sentence) implementation clauses:

(4) (...). The competent authorities through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure.

This provision is not specifically included in the OECD Model.

2. Tax treaties

There are 39 treaties that cover the implementation of the mutual agreement procedure. In 27 treaties only the bilateral implementation clause of the second sentence is adopted and in one treaty only the unilateral implementation clause of the third sentence is adopted. The remaining 11 treaties include both implementation clauses.

All these treaties have been concluded by developing countries, with either a developed or another developing country (group A). None of them has been concluded between developed countries.

Article 26(1)
Prevention of tax fraud/evasion
Secret information
Implementation clause

1. The UN Model

Article 26(1) of the UN Model reads as follows:

(1) The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention, insofar as the taxation thereunder is not contrary to the Convention, *in particular for the prevention of fraud or evasion of such taxes*. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. *However, if the information is originally regarded as secret in the transmit-*

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ting State it shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes *which are the subject of* the Convention. Such persons or authorities shall use the information only for such purposes *but* may disclose the information in public court proceedings or in judicial decisions. *The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning matters in respect of which such exchanges of information shall be made, including, where appropriate, exchanges of information regarding tax avoidance.*

2. Tax treaties

a. Prevention of tax fraud/evasion (first sentence)

There are 154 treaties that explicitly refer to the prevention of tax fraud or evasion. Of these treaties 146 have been concluded by developing countries, with either a developed or another developing country (group A), and 8 have been concluded between developed countries (group B).

There are only a few treaties the wording of which deviates from the recommendations of the UN Model.

b. Secret information (fourth sentence)

There are 50 treaties explicitly dealing with information that is secret in the transmitting state. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

c. Implementation clause (last sentence)

There are 65 treaties that cover the implementation of the exchange of information. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

A few of these treaties do not contain any reference to tax avoidance.

CHAPTER III

Summary

UN Model	Tax treaties group A	Tax treaties group B
Art. 5(3)(a):		
supervisory activities	410	39
period < 12 months	484	29
Art. 5(3)(b)	219	2
Art. 5(4)(a) and (b)	167	–
Art. 5(4)(f) OECD	233	31
Art. 5(5)	234	9
Art. 5(6)	184	26
Art. 5(7)	243	–
Art. 7(1)	153	9
Art. 7(3)	195	6
Art. 7(5) OECD	45	–
Art. 8 B	105	3
Art. 12(3)	610	102
Art. 13(4)	308	66
Art. 13(5)	322	62
Art. 14(1)(b)	264	20
Art. 14(1)(c)	45	–
Art. 16(2)	62	6
Art. 18A(2) and B(3)	206	48
Art. B(1)(2)	259	36
Art. 20(2)	53	–
Art. 21(3)	308	36
Art. 25(4):		
implementation clauses	39	–
Art. 26(1):		
prevention fraud/evasion	146	8
secret information	50	–
implementation clause	65	–
Tax treaties 1980/1997	697	114

EPILOGUE*

It can be seen from the table above that the UN Model has developed into an important instrument in the negotiation of tax treaties. Many developing countries, in shaping their tax treaty policy, have allowed themselves to be guided by its recommendations. But this is not all. It is equally apparent from the above table that the influence of the UN Model on the tax treaty policy of OECD members is far from negligible. The OECD can no longer ignore this influence, even though its model remains the greatest common denominator of OECD countries' tax treaty policy. The time has come for the OECD to adopt some of the UN recommendations in its own model and to discuss certain other UN recommendations in its commentary.

* This epilogue was written after the submission of the Report.

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