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CANADA

CANADA'S NEW TRANSFER PRICING RULES

Jack Bernstein

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I. INTRODUCTION

On 11 September 1997, Finance Minister Paul Martin and Revenue Minister Herb Dheliwal jointly released draft amendments to the Income Tax Act relating to Transfer Pricing measures announced in the 18 February 1997 Federal Budget. Also included in the release was the draft revision of Information Circular 87-2 which described Revenue Canada's administrative practice in the area of transfer pricing. It is anticipated that these measures will be included in a bill to be introduced in 1997. Canada has chosen to follow the revised (1995) transfer pricing guidelines of the Organisation for Economic Cooperation and Development (the "OECD").

The Income Tax Act currently provides in subsection 69(2) that where a taxpayer has agreed to pay to a non-resident person with whom the taxpayer was not dealing at arm's length a price, rental, royalty or other payment for the use or reproduction of any property or for other services, which is an amount greater than a reasonable amount, the amount is adjusted to be equal to the amount that the taxpayer would have paid to an arm's length party. Subsection 69(3) of the Income Tax Act applies in non-arm's length situations where a non-resident person has neither paid nor agreed to pay to a taxpayer as price, rental, royalty or other payment for or for the use of or reproduction of any property or for other services, an amount equal to or greater than the amount that would have been a reasonable amount in the circumstances. In that case the taxpayer would be deemed to have received a reasonable amount.

For taxation years that begin after 1997, subsections 69(2) and (3) are repealed as the consequence of the introduction of proposed subsection 247(2).

Section 247 will contain the legislation respecting transfer pricing. Subsection 247(2) applies to a transaction between a taxpayer, a partnership or a member of a partnership and a non-resident with whom the taxpayer, the partnership or a member of a partnership does not deal at arm's length. Where the terms of a transaction differ from those that would have been made between persons dealing at arm's length, any amount determined under the Income Tax Act may be adjusted to reflect amounts that would have been applicable if the parties were dealing at arm's length. If persons enter into a transaction that would not have been entered into between persons dealing at arm's length, the transaction may be recharacterized in order to determine the amounts that would have been applicable if the transaction had been entered into by arm's length parties. Subsection 247(2) applies to taxation years that begin after 1997.

If the adjustments made under subsection 247(2) for a transaction exceed a certain threshold, the taxpayer may be liable to a penalty under subsection 247(3). The penalty will be imposed if the taxpayer does not make reasonable efforts to determine and use arm's length transfer prices or allocations for the transaction. Subsection 247(4) and the draft Information Circular 87-2R provide guidelines as to when a taxpayer will be considered to have made reasonable efforts in these circumstances. Subsections 247(3) and (4) generally apply to adjustments made under subsection 247(2) for taxation years that begin after 1998.

The draft amendments to the Income Tax Act are designed to accomplish the following objectives:

- require a taxpayer who participates in cross-border transactions with non-arm's length parties to conduct such transactions on terms and conditions that would have prevailed had the parties been dealing at arm's length with each other;
- introduce documentation requirements which effectively require taxpayers to document their transfer pricing transactions and the steps taken to ensure that the terms and conditions of such transactions satisfy the arm's length principle; and
- impose a penalty, in certain circumstances, when a taxpayer fails to make reasonable efforts to determine and use arm's length transfer prices or arm's length allocations in respect of transfer pricing transactions.

The revised information circular will provide guidelines for taxpayers with respect to the following transfer pricing matters:

- the methods endorsed by the OECD to determine arm's length transfer prices or allocations for transfer pricing transactions and the considerations that enter into the selection of the most appropriate method in the circumstances of a particular transaction;
- special considerations regarding cost contribution arrangements, transfer of intangibles and intra-group services;
- the nature and extent of the documentation required to ensure that the taxpayer will be considered, under the proposed legislation, to have made reasonable efforts to determine arm's length transfer prices or allocations; and
- the application of the proposed penalty.

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Revenue Canada intends to devote more resources to the verification of cross-border transactions by multi-national enterprises and to increase the number of transfer pricing audits.

II. INFORMATION RETURNS

Section 233.1 of the Income Tax Act provides that every corporation resident in Canada or carrying on business in Canada at any time in the taxation year shall, within six months from the end of the year, file an Information Return for the year containing prescribed information regarding transactions with non-resident non-arm's length persons. A separate Information Return is required to be filed in respect of each such non-resident person. The prescribed form is Form T106. The section is being amended to extend the requirements to partnerships and individuals (including trusts). In the case of a non-resident or a partnership comprising non-resident persons, the new definition of a reportable transaction will be extended to include a transaction or a series of transactions that relates to a business carried on in Canada. Each non-resident person or partnership must file a separate Information Return.

A reporting person or partnership is not required to file an Information Return for a taxation year or a fiscal period, unless the total fair market value of the property or services that relate to the reportable transactions in which the reporting person or partnership and a non-resident non-arm's length person (or a partnership of which the non-resident person is a member) participated during the year or period, exceeds CAD 1,000,000. In determining the CAD 1,000,000 threshold, the value of property or services that relate to reportable transactions may be included. The rules contemplate tiered partnerships. A person who is a member of a partnership which in turn is a member of another partnership is considered to be a member of that other partnership.

III. PROPOSED SECTION 247

Proposed Part XVI.1 of the Income Tax Act contains new Section 247 and deals with transfer pricing for property or services purchased and sold in cross-border transactions, as well as the determination of amounts for tax purposes.

Subsection 247(2) will apply in situations where a taxpayer or a partnership and a non-resident person with whom the taxpayer, the partnership or a member of the partnership does not deal at arm's length or a partnership of which the non-resident is a member, are participants in a transaction or a series of transactions and the terms or conditions of the transaction or series differ from those that would have been made between persons dealing at arm's length, or the transaction or series would not have been entered into between persons dealing at arm's length. Where these conditions are met, Revenue Canada may adjust or recharacterize any amounts that, but for that subsection and the general anti-avoidance in Section 245, would have been determined for the purposes of the Income Tax Act in respect of the taxpayer or the partnership. Such amounts may be adjusted or recharacterized to reflect the quantum or source of the amounts that would have been determined if the participants had been dealing at arm's length with each other.

Section 245 of the Income Tax Act contains a general anti-avoidance rule. Basically, if a transaction is tax motivated, it may be recharacterized if it results in an abuse or misuse of the Income Tax Act.

A. Definitions

The terms "arm's length allocation", "arm's length transfer price" and "qualifying cost contribution arrangement" are relevant for purposes of the penalty provisions in subsection 247(3), as well as the transfer pricing adjustments under subsection 247(2). The definitions "transfer pricing capital adjustment" and "transfer pricing income adjustment" are relevant for the purpose of the penalty in subsection 247(3).

An "arm's length allocation" is defined to mean an allocation of profit or loss that would have occurred between participants in a transaction assuming that they had been dealing at arm's length with each other.

An "arm's length transfer price" means the amount that would have been a transfer price in respect to the transaction assuming that the participants in the transaction were dealing with each other at arm's length.

"Transfer price" is defined as an amount either payable or received or receivable by a participant in a transaction as a price, a rental, a royalty, a premium or other payment for, or for the use, production or reproduction of property or as consideration for services, as part of the transaction. Services include services provided as an employee and the insurance or reinsurance of risks.

A "qualifying cost contribution arrangement" refers to an arrangement under which the participants collectively make reasonable efforts to establish a basis for contributing to and to contribute on that basis to, the costs of producing, developing or acquiring any property, or acquiring or performing any services, in proportion to the benefits which each participant is reasonably expected to derive from the property or services as a result of the arrangement. *Interpretation Bulletin* IT-303, Know-how and Similar Payments to Non-residents, currently deals with Revenue Canada's administrative practice with respect to cost sharing arrangements.

Definitions are included for "transfer pricing capital adjustment" and "transfer pricing income adjustment". A "transfer pricing capital adjustment" consists of:

(a) 75 per cent of all reductions made under the proposed subsection 247(2) to the adjusted cost base of non-depreciable capital property or an eligible capital expenditure plus all reductions made in respect of the capital cost of the depreciable property of the taxpayer; or

(b) if a taxpayer is a member of a partnership, an amount equal to 75 per cent of all reductions made under proposed subsection 247(2) to the adjusted cost base of a non-depreciable capital property of the partnership or an eligible capital expenditure of the partnership plus all

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reductions made to the capital cost of depreciable property of the partnership. The new allocation is based on the taxpayer's pro rata share of the income or loss of the partnership for the period. If the partnership has no income or loss for the period, the new partnership is deemed to have income in the amount of CAD 1,000,000 for purposes of determining this calculation.

A transfer pricing income adjustment means the total of all amounts by which the taxpayer's income for the year would increase or the taxpayer's loss for the year from a source would decrease because of an adjustment under subsection 247(2).

B. Proposed penalty

If the "reduced" transfer pricing income and capital adjustments for the year exceed the lesser of CAD 5,000,000 and 10 per cent of the taxpayer's gross revenue for the year (determined without reference to the non-arm's length adjustment rules and the general anti-avoidance rule), the taxpayer is liable to a penalty for the year equal to 10 per cent of the amount of the "reduced" transfer pricing income and capital adjustments. The proposed penalty applies to adjustments made under the proposed subsection 247(2) for taxation years or fiscal periods that begin after 1998. Adjustments made in respect of transactions completed before the announcement date will not be subject to the penalty.

For the purposes of the penalty provisions, a taxpayer's gross revenue for the year as a member of the partnership is that proportion of the partnership's gross revenue for a fiscal period ending in the year (computed as though the partnership were a taxpayer and without any reference to any amount received or receivable from other partnerships of which the taxpayer is a member in the year), that the taxpayer's share of the income or loss of the partnership for its activities for the period is to the total income or loss of the partnership from its activities for the period. If the income or loss of the partnership for the period is nil, the partnership is deemed to have income in the amount of CAD 1,000,000 for the purposes of determining the taxpayer's share of the partnership income for that period. This provision will not apply with respect to transactions completed before the announcement date. It will apply for taxation years and fiscal periods that begin after 1998.

In the case of tiered partnerships, a member's share of the income or loss of the other partnership is deemed to be the amount to which it is directly or indirectly entitled. This applies for fiscal periods that begin after 1997.

A taxpayer's transfer pricing income and capital adjustments are reduced to the extent that they may be considered to relate to a transaction that is a qualifying cost contribution arrangement (defined above) and in which the taxpayer (or a partnership of which the taxpayer is a member) is a participant or a transaction in respect of which the taxpayer (or a partnership of which the taxpayer is a member) made reasonable efforts to determine arm's length transfer prices or arm's length allocations and to use those prices or allocations for tax purposes.

C. Documentation

A taxpayer will now be required to document the transactions which are governed by the proposed transfer pricing provisions in subsection 247(2). Otherwise, the taxpayer will be liable to a penalty (assuming that the taxpayer's transfer pricing income and capital adjustments exceed the penalty threshold set out above). The taxpayer will be deemed not to have made reasonable efforts to determine an arm's length price or allocation nor to have participated in a transaction that is a qualifying cost contribution arrangement, unless the taxpayer (or the partnership) makes or obtains certain records or documents within 60 days of the end of the taxation year (or fiscal period) in which the transaction is entered into. In other words there will be no reduction for purposes of calculating the penalty unless certain documentation requirements have been satisfied.

A taxpayer or a partnership should therefore maintain records or documents providing for a complete and accurate description of:

- the property or services to which the transaction relates;
- the terms and conditions of the transaction and how they relate to the terms and conditions of other transactions entered into between the participants;
- the identity of the participants and the relationship at the time the transaction was entered into;
- the functions performed, the property used or contributed and the risks assumed by the participants;
- the data and transfer pricing methods (for example, the comparable uncontrolled price method) considered and the analysis performed to determine the transfer prices or allocations of profits or losses or contributions to costs in respect of the transaction; and
- the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs in respect of the transaction.

Where the transaction spans more than one taxation year, the taxpayer or partnership must completely and accurately document any material changes occurring in the subsequent year or period to the matters listed above. The taxpayer or partnership will be required to make or obtain this information within 60 days after the end of the subsequent year or period.

The documentation required under this subsection must be provided to the Minister of National Revenue within 60 days of service, made personally or by registered or certified mail, of a written request thereof.

The reporting requirements apply and adjustments may be made under proposed new subsection 247(2) for taxation years that begin after 1998. A record or document made or obtained or provided to the Minister within 60 days of the end of the taxpayer's first taxation year (or the partnership's

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first fiscal period) that begins after 1998 is deemed to have been made or provided on a timely basis.

D. Other statutory provisions

Subsection 247(7) will exempt interest-free and low interest loans made by a corporation resident in Canada to a non-resident subsidiary it controls from the application of the transfer pricing provisions. It should be noted that a Canadian corporation that makes an interest free loan to any corporation other than a wholly owned subsidiary which uses the money in its business will be required to report an imputed return under Section 17 of the Income Tax Act.

Section 67 of the Income Tax Act contains a general limitation on expenses. It provides that no deduction may be made in respect of an outlay or expense except to the extent that the outlay or expense was reasonable in the circumstances.

Subsection 69(1) provides that where taxpayers acquired anything from a non-arm's length person at an amount in excess of fair market value, the taxpayer is deemed to have acquired it at fair market value. If the taxpayer has disposed of anything to a non-arm's length person for no proceeds or for proceeds less than fair market value, the taxpayer is deemed to have received proceeds of disposition equal to fair market value.

Subsection 69(1.2) provides that where a taxpayer has disposed of property for proceeds of disposition equal to or greater than fair market value, and there existed at the time an agreement under which a person whom the taxpayer was not dealing with at arm's length to pay as rent, royalty or other payment for the use of or for the right to use the property an amount less than a reasonable amount that would have been payable if the parties had been dealing at arm's length, then the proceeds of disposition of the property shall be deemed to be the greater of the actual proceeds and the fair market value of the property at the time of the disposition.

Where subsection 247(2) applies to adjust the quantum of an amount under the Income Tax Act, then Section 67 and subsection 69(1)(1.2) shall not apply to determine the quantum of that amount (subsection 247(8)).

There is an anti-avoidance rule intended to prevent taxpayers from artificially increasing their gross revenue for the purpose of the penalty provision. For the purposes of the gross penalty threshold and the determination of a partner's gross revenue, a transaction or a series of transactions is deemed not to have occurred where the purpose of the transaction or the series was to increase a taxpayer's gross revenue for the purpose of a penalty. This provision does not apply with respect to transactions completed before the announcement date. It will apply for taxation years and fiscal periods that begin after 1998 (subsection 247(9)).

Adjustments (other than adjustments that result in or increase a transfer pricing capital adjustment or income adjustment of the taxpayer for the taxation year) shall not be made unless the Minister considers that the adjustments would be appropriate in the circumstances (subsection 247(10)).

Subsection 247.1(1) provides that any penalty that is payable under these provisions must be paid before the end of the second month of the following taxation year. There is an interest charge on the portion of the penalty which the taxpayer failed to remit to Revenue Canada. These provisions apply for taxation years and fiscal periods that begin after 1998.

The provisions of the Income Tax Act relating to assessments, payments, penalties, refunds, objections and appeals will apply to Part XVI.1.

IV. DRAFT INFORMATION CIRCULAR 87-2R

The revised information circular sets out Revenue Canada's views on transfer pricing. It provides guidelines for non-arm's length transactions. The expression taxpayer, person or party will include a partnership.

The information circular reiterates that Canada and the OECD endorse the arm's length principle as governing the tax treatment of non-arm's length cross-border transactions. Taxpayers must conduct transactions with non-arm's length parties on the same terms and conditions that would have prevailed had the taxpayers been dealing at arm's length. A taxpayer that is a member of a multinational group and engages in non-arm's length transactions with members of the group, should pay substantially the same amount of taxes it would have paid had the members of the group been dealing with each other on an arm's length basis. It is a question of fact whether a taxpayer has satisfied the arm's length principle.

In July of 1995, the OECD issued the first part of its transfer pricing guidelines for multinational enterprises. The OECD issued further guidelines in March of 1996 dealing with intangible property and intra-group services. Revenue Canada supports and proposes to follow the OECD guidelines.

Paragraph 1.15 of the OECD guidelines states that the application of the arm's length principle is generally based on a comparison of the prices or margins used or obtained by non-arm's length parties with those used or obtained by arm's length parties engaged in the same or similar transactions. The economically relevant characteristics of the transactions being compared must be identical or at least sufficiently similar so as to permit reasonably accurate adjustments to be made for any differences in such characteristics.

Paragraphs 1.19 through 1.35 of the OECD guidelines indicate that a number of factors may influence the degree of comparability of transactions. These factors include the characteristics of the goods or services being purchased or sold, the functions performed by the parties to the transactions (taking into account assets used and risks assumed), the terms and conditions of the contract, the economic circumstances of the parties and the business strategies pursued by the parties. The importance of each of these factors in establishing comparability will depend upon the nature of the transaction and the pricing method adopted.

Business strategies are factors that can affect comparability as they influence the price that arm's length parties would

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charge for a product. Where an independent party attempts to introduce a product into a new market, it may be reasonable for that party to temporarily charge a price lower than it would otherwise charge, in an attempt to establish a market. It is unlikely that an independent party would maintain such a strategy for an extended period of time.

Prices should be set separately for each transaction entered into with a non-arm's length party. Where goods and services are to be provided, the price for the goods and for the services should be separately determined and identified. This is important because it is difficult for Revenue Canada to determine whether each component is reasonable. In addition, payment for services may not be subject to withholding tax where the recipient of the payment resides in a treaty jurisdiction. There may be situations where industry practice is not to separate the fee for a combination of intangible property and services.

Revenue Canada may seek to recharacterize a transaction where the substance of a transaction differs from its form. The OECD guidelines provide an example involving an investment by way of an interest bearing debt where arm's length parties would have structured their investment as a subscription of capital. However, where the thin capitalization rules contained in the Income Tax Act would apply to such a transaction, the transaction is unlikely to be recharacterized.

The Department may attempt to recharacterize a transaction that differs from that which independent enterprises behaving in a commercially rational manner would have entered into and the structure of the transaction makes it nearly impossible to determine an appropriate transfer price. An example in the OECD guidelines is a taxpayer who performs research and sells for a lump sum the unlimited entitlement to intellectual property it is developing. Arm's length parties would not have structured the transaction in this manner. Revenue Canada may attempt to recharacterize the transaction for tax purposes as a form of continuing research agreement.

V. TRANSFER PRICING METHODS

Revenue Canada will rely on the transfer pricing methods recommended in the OECD guidelines. These methods are divided into two groups:

(a) the traditional transaction methods, i.e. comparable uncontrolled price (CUP) method, the resale method, and the cost-plus method; and
(b) the transactional profit methods, i.e. the profits split and transactional net margin methods.

The traditional methods are preferable to the transactional profit methods and the transactional profit methods should be used only as methods of last resort. Revenue Canada follows the OECD guidelines in taking this position. The comparable uncontrolled price method is the favoured traditional method because it provides the highest degree of comparability.

The OECD guidelines do not express a clear preference for any transactional profit method. In fact, they discourage the use of such methods. Revenue Canada prefers the profit split method as providing a more reliable estimate of an arm's length result than the transactional net margin method.

The lack of reliable information necessary to apply a particular method may require the application of a lower-ranking recommended method for which adequate information is available. The taxpayer should select the recommended method that is most appropriate to its particular facts and circumstances. It will be the method that provides the highest degree of comparability between transactions. Once a taxpayer selects a particular method, the taxpayer is not required to make a determination under a lower-ranking method. Revenue Canada is under no obligation to accept a particular method used by a taxpayer unless, on an objective analysis of its application, it produces the most reliable measure of an arm's length result.

VI. TRADITIONAL TRANSACTION METHODS

A. Comparable uncontrolled price

The comparable uncontrolled price method provides the best evidence of an arm's length price. There are two possible sources of a CUP. First, the taxpayer may sell a particular product in the same quantities, under the same terms and in the same markets to parties with whom it deals at arm's length (an internal comparable). Second, other taxpayers may sell the same product, in the same quantities, under the same terms and in the same markets, to arm's length parties (an exact comparable uncontrolled price). Care must be exercised in using an internal comparable as the incidental sales of a product to third parties may not be indicative of an arm's length price for the product. Transactions may serve as comparables despite the existence of differences between those transactions and non-arm's length transactions provided the differences can be measured and appropriate adjustments made.

B. Cost-plus

Under the cost-plus method, the costs incurred for supplying a product or a service are known. An arm's length mark-up on the cost is determined either from the taxpayer's sales of the product or a similar product to third parties in comparable transactions, or from the mark-up realized by unrelated taxpayers in comparable transactions with third parties. Where the transactions are not comparable in all respects and differences have a material effect on price, adjustments should be made to eliminate the effect of those differences. This method may also be appropriate for the rendering of services. It is only appropriate where there are comparables.

It is important to properly determine the cost under this method. Where cost is not accurately determined, both the mark-up (which is a percentage of cost) and the transfer price (which is the total of the cost and the mark-up) will be misstated. Cost must be calculated in accordance with accounting principles that are generally accepted in Canada and that

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are appropriate to the industry, whether or not some other calculation of cost is used in the relevant foreign country. In determining the cost of a product, the Department does not recognize depreciation based on the replacement or current market value of capital property.

The cost base to which the mark-up is applied must be comparable to the cost base of the third party transactions which serve as comparables. Reference is made to paragraph 2.37 of the OECD guidelines where it is indicated that it may be necessary to make an adjustment to cost where one person leases its business assets while another owns its business assets.

C. Resale price method

The resale price method is similar in concept to the cost-plus method, in that it relies on comparisons of gross margins. Under the resale price method, the selling price to third parties is known and an expected return for the functions performed by the seller is established by reference to third party sales by the seller, or by reference to the return earned by persons performing the same or similar functions and selling the same or similar goods to the seller, to arm's length parties.

The arm's length price is determined by reducing the price realized on the resale of the property by the taxpayer to an arm's length party, by an appropriate gross margin. This resale margin represents an arm's length return for the functions performed and the risks assumed by the taxpayer. This method is most appropriate in a situation where the seller adds relatively little value to the product. The greater the value-added to the product by the functions performed by the seller, the more difficult it is to determine the appropriate resale margin. This is especially true where the seller employs an intangible property, such as a marketing intangible, in its activities.

VII. PROFIT METHOD

A. Profit split method

The profit split method may be applied where the operations of two or more non-arm's length parties are highly integrated, making it very difficult to evaluate their transactions on an individual basis and therefore, precluding the application of one of the traditional methods. The first step is to determine the total profit earned by the parties from their integrated operations. The profit to be split is generally the operating profit. In some cases it may be appropriate to split the gross profit. The profit is then split between the non-arm's length parties based on the relevant value of their contributions, considering the functions performed, the assets used and the risks assumed by each party. A detailed analysis of the functions performed by the parties must be completed and documented. It is not acceptable to merely provide each party with the same return on its respective assets.

Where the return on the functions performed can be established from comparable data, Revenue Canada prefers the residual profit split method over other types of profit split methods. A residual profit split is performed in two stages following the determination of the total profit. The first stage is the allocation of a return to each party for the readily identifiable functions (i.e. manufacturing or distribution), based on standard returns established from comparable data. The returns on these functions will therefore not account for the return attributable to an intangible property used by the parties. In the second stage, the return attributable to the intangible property is established by allocating the residual profit or loss between the parties. This is based on an analysis of the facts and circumstances indicating how this residual would have been divided between arm's length parties.

B. Transactional Net Margin Method ("TNMM")

The TNMM compares the net profit margin of a taxpayer arising from a non-arm's length transaction with a net profit margin realized by arm's length parties from similar transactions. TNMM is a method of last resort. It can only be used where the other methods do not produce a reasonable estimate of an arm's length price or allocation. The TNMM should be used only to determine the taxpayer's net return derived from non-arm's length transactions. Where the comparable party transacts with both arm's length and non-arm's length parties, care should be taken to isolate the net return attributable to the arm's length transactions.

As a result of its dependency on net margins, a high standard of comparability must be met in order to produce a reasonable estimate of an arm's length result. Several factors, other than transfer prices, may account for differences in net margins. Where possible, appropriate adjustments should be made in order to ensure a high standard of comparability. The failure to account for differences or to make a satisfactory adjustment may preclude the method from producing a reasonable estimate of an arm's length result. Differences may include differences in financing strategies or in the cost of financing. Other differences may be more difficult to adjust such as differences in age and productivity of plant and equipment, management ability or philosophies, and the business experience of the respective entities. Industry profit data rarely satisfy the standards of comparability required to implement the TNMM.

If there is a sufficient degree of comparability between products and functions, a taxpayer should be able to use one of the traditional transactional methods, instead of the TNMM.

As the TNMM is applied only to one of the members of a multinational group, it may produce absurd results because it fails to consider the relative contributions of all of the members to the profit of the group. It may result in the other members of the group having an unrealistic share of the total profits of the group.

C. Cost contribution arrangement

A cost contribution arrangement (CCA) is a written arrangement whereby two or more parties share the costs and risks of

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producing, developing or acquiring new property, or acquiring or performing services, in proportion to the benefits which each participant is reasonably expected to derive from the property or services as a result of the arrangement. Each participant's benefit or compensation for its respective contribution to a CCA is to be derived from exploiting the results of the CCA individually, and not from the actual activities of the CCA. Such an arrangement may be concluded for the joint development of an intangible property, with each participant receiving a share of the rights in the developed property. However, participants must also pool their resources to acquire any type of centralized services i.e. accounting, computer, technical support, human resources or the development of an advertising campaign common to the participants' markets.

Each participant's contribution must be consistent with that which an independent party would have agreed to contribute under comparable circumstances given the benefit it would have reasonably expected to derive from the arrangement. The expectation of mutual benefit is fundamental to the acceptance by independent parties of an arrangement for pooling resources and skills without separate and immediate compensation. Only persons who can reasonably be expected to derive a benefit from the results of a CCA can be considered participants.

The value of each participant's contribution should be consistent with the value that arm's length persons would have assigned to that contribution in comparable circumstances. The contributions may be in the form of services and associated operating costs. However, where participants make long-term contributions of tangible or intangible assets, it is unlikely that the cost of the assets would be used by arm's length persons as the basis for determining their respective entitlements to future benefits. For example, where two parties intend to be equal participants, with the first party contributing property having a fair market value in excess of its cost and the other party contributing cash, cost would not be an appropriate measure of the first party's contribution.

Where the participants perform all or part of the activities in a separate company that is not a participant (whether or not it is an affiliate of a participant), an arm's length charge would be appropriate compensation for the separate company. Where a separate company performs activities on behalf of the participants, it does not bear the major risks associated with those activities. The arm's length charge for such a company would be determined under the general principles including consideration of functions performed, assets used and risks assumed. Any mark-up included in an arm's length charge would reward only the agency role performed by such a company.

A participant's share of the overall contribution must be in proportion to the share of the overall benefits it expects to derive from the arrangements. Each participant's share of the benefits may be determined by directly estimating the anticipated additional income that each participant is expected to generate, or its estimated cost saving, as a result of its participation in the arrangement. The participants may use an allocation key or basis such as sales, units used, produced or sold, gross or operating profit, the number of employees or capital invested, etc. to indirectly estimate the additional income to be derived from the arrangement.

Where a particular component is developed within a CCA and the component is used by the participants in a variety of end products which differ significantly in price, the projected sales of the end-products would be an inappropriate allocation key. The differences in the prices of the end-product will distort this method. A better measure of the expected benefits would be the extent to which the component is used for each participant. When a participant's contribution is not consistent with its share of its expected benefit, a balancing payment may be required between the participants to adjust their respective contributions.

Under the arm's length principle, participants that transfer a part or all of their interest and the results of prior CCA activities (such as intangible property, work-in-progress or the knowledge obtained from past CCA activities) to a new participant should receive arm's length compensation from the new participant for that property (a buy-in payment). The amount of the buy-in payment should be determined based upon the price an arm's length party would have paid for the rights obtained taking into account the proportionate share of the overall expected benefit.

These principles also apply to determine the value of a buy-out payment when a participant disposes of part or all of its interest in the CCA. The contributions by a taxpayer will be treated, for tax purposes, as though they were made outside the scope of the CCA to carry on the activities of the subject of the CCA (i.e. to perform research and development or purchase a capital asset).

A contribution to a CCA does not constitute a royalty for the use of intangible property to the extent that the contribution is for the acquisition of a beneficial interest in the property.

D. Intangible property

It is appropriate to use the CUP method to determine the arm's length price for the sale or license of an intangible property such as a patent, trademark or know-how where the same or a comparable intangible property has been sold or licensed to arm's length parties, or where there have been genuine offers from third parties for the intangible.

Where the intangible property is highly valuable or unique, a comparable property may not be available. The cost-plus method would not be acceptable because it may not bear any relationship to the successful development of an intangible. It may not be possible to use any of the traditional pricing methods or the TNMM. The profit split method may be the most reliable.

Where a royalty rate is being established, the following items should generally be considered:

- prevailing rates in the industry;
- terms of the licence, including geographic limitations and exclusivity rights;

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- singularity of the invention and the period for which it is likely to remain unique;
- technical assistance, trade-marks and know-how provided along with access to the patents;
- profits anticipated by the licensee; and
- benefits to the licensor arising from sharing information on the experience of the licensee.

It is not appropriate to use hindsight in determining the value of intangibles. An agreement which is in substance the same as one into which independent parties would have entered would not normally be subject to adjustment as a result of subsequent events. Therefore, it is inconsistent for a tax administration to require or accept an adjustment solely on the basis that the income streams or cost savings differ from those initially estimated. Revenue Canada may consider the factors that a reasonable person with some knowledge of the industry would have taken into account at the time the valuation was made.

It is important to consider the terms and conditions that arm's length parties would insist upon to protect their respective positions in valuing an intangible. Where the value of the intangible is uncertain, it is unlikely that an arm's length party would permit the long-term exploitation of the intangible by a third party for consideration that might prove to be grossly inadequate. The transferor would normally insist on an agreement for a relatively short term or one that includes a price adjustment clause. The transferor would also insist on an agreement that sets a variable royalty scale so that, if the exploitation of the intangible proves highly profitable, the transferor would enjoy a reasonable share of that financial success. Similarly, an independent entity wishing to exploit an intangible property would be unlikely to agree to unconditionally pay large amounts for the exclusive use of the property, particularly for a long period of time.

VIII. INTRA-GROUP SERVICES

The OECD guidelines regarding the provision of intra-group services provide a framework for determining whether a charge for a particular service is justified and if so, what the charge should be. It is first necessary to determine whether a specific activity performed by a member of the group for another member is a service for which a charge is justified. An entity would be willing to pay for an activity only to the extent that the activity confers on it a benefit of economic or commercial value. A simple test is whether the entity would have been willing to pay for the activity if it was performed by an independent party or if it performed the activity itself. If this is not reasonable, it is unlikely that a charge for the activity would be justified.

Certain costs are incurred for the sole benefit of shareholders and therefore should not be charged to other members of the group. For example, an independent entity would not bear the costs of a shareholders meeting of an arm's length corporation. Also, costs which relate to the legal structure or the reporting requirements of a group member should not be charged. Other costs, such as those involved in raising funds for the acquisition of an interest in a business, would generally not be attributable to another member of the group. Notwithstanding this, if the funds were raised on behalf of another member of the group that used them to acquire a new company, it may be appropriate to attribute those costs to that other member.

It would be unusual for a group member to incur a charge for a service performed by another member of the group if that activity is performed by the member itself or by a third party on the member's behalf. In some cases, there may be a business reason for duplicating a service. For example, an existing computer system may continue, for a brief period, to be operated concurrently with a new one to deal with unforseen difficulties. The OECD guidelines provide the example where a second legal opinion may be obtained in order to reduce the risk of error on a particular issue. In either case, there is bona fide reason for duplicating the function.

Where a charge for a service is justified, the arm's length price must be approached both from the point of view of the supplier and the recipient of the service. The arm's length charge is not only a function of the price at which a supplier is prepared to perform the service (or the cost of providing the service), but also a function of the value to the recipient of the service and therefore of the amount that an independent entity is prepared to pay for such a service in comparable instances.

Where a service is rendered by arm's length parties or the service provider renders the service for arm's length parties, the price charged in those circumstances is a good indication of the arm's length price. The CUP method should be used assuming sufficient data for its application is available. It presumes the services are identical both in terms of type and quantity or extent to which they are provided. It also assumes that the markets are similar and that the services are provided on comparable terms. Where the service provider renders the service for arm's length parties and those services are ordinary and recurrent activities, the fee charged to arm's length parties for such services may constitute a CUP.

Where the CUP method cannot be applied, the cost-plus method should be considered. This would be appropriate where the functions involved (including assets used and risks assumed) are comparable to those performed by the independent entities used in the comparison. The costs incurred by the service provider should be the same as those incurred in the comparable transactions and if not, appropriate adjustments must be made.

An arm's length charge does not necessarily include the profit element. The arm's length charge should depend on two factors: the costs incurred by the service provider in providing the services and the value that the recipient assigns to the services. There are instances where the amount that the recipient is willing to pay for the services does not exceed the cost of supply to the service provider. It would therefore be inappropriate under the cost-plus method to include a profit element in the charge for such a service.

In determining the profit element to which a service provider is entitled, an examination must be made of the services

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being provided. There is a distinction between a taxpayer who renders services for other members of the group and that of a taxpayer who acts solely as an agent on behalf of a group to acquire services from a third party (see paragraph 7.36 of the OECD guidelines). In the latter case, the arm's length compensation would be limited to rewarding the agency role of the taxpayer. This would be determined by reference to a mark-up on the cost of the services. It is a question of fact whether a taxpayer is providing a service or merely acting as an agent. The deductibility of the costs allocated to a particular taxpayer would be based on the provisions of the Income Tax Act.

A. Direct charge and indirect charge

There are two methods for determining a charge for services: the direct charge method and the indirect charge method. Under the direct charge method, a specific price is established for each identifiable service. Under the indirect charge method, an allocation, to a particular entity, of the value of a service provided to more than one entity is made by reference to a basis or allocation key that indicates the share of the total value of the service attributable to the particular entity.

Revenue Canada prefers the direct charge method over the indirect charge method. Where the services are the same as those rendered to arm's length parties or where the service provided to the members can be reasonably identified and quantified, the direct charge method should be used. There are situations where a service has been provided to a non-arm's length party and a portion of the value of the service directly attributable to each of the parties cannot be determined (i.e. where global market research is intended to benefit all related entities). In this case, the indirect charge method must be used. Where an indirect allocation is used, it should result in a charge that is comparable to that which independent enterprises would accept. The choice of an allocation key (i.e. sales, units used, produced or sold, or the number of employees) should be made giving consideration to the nature and use made of the service.

B. Penalty – reasonable efforts

As indicated above, if the adjustments made under subsection 247(2) for a transaction exceed a certain threshold subsection 247(3) of the Income Tax Act will impose a penalty of 10 per cent of the total of the transfer pricing income and capital adjustments that relate to transactions for which a taxpayer has failed to make reasonable efforts to determine and use arm's length transfer prices or arm's length allocations. A penalty may also arise if the transactions are not qualifying cost contribution arrangements. It is a question of fact whether a taxpayer has made a reasonable effort. This requires the application of a recommended method by the taxpayer. A taxpayer must take reasonable steps to ensure that its transfer prices or allocations are in conformity with the arm's length principle. The documentation required is that which the taxpayer would have prepared or obtained in respect of the transaction pursuant to principles of prudent business management. A prudent business person would attempt to weight the significance of the transactions in terms of its business with the additional administrative costs required to prepare or obtain such documentation. Therefore, the obligation to find comparable transactions is not an absolute one, but may take into account the cost and likelihood of finding such comparables relative to the significance of the transactions.

The obligation to comply with the arm's length principle and the documentation requirements should be taken into account by the taxpayer when establishing internal procedures and policies to document its transactions. Each transfer pricing method may require different internal and external information and different supporting documents. The taxpayer is deemed not to have made reasonable efforts under subsection 247(4) unless the taxpayer has prepared or obtained records or documents which provide a complete and accurate description of the items that are listed in that provision. These documents must be prepared within 60 days of the end of the taxation year or fiscal period in which a transaction is entered into. If it spans more than one taxation year, the documentation must be updated to reflect any material change. A taxpayer may be required to produce or retain the required documentation at the time the transaction is entered into.

In connection with a CCA, the documentation required would include:

- the identification of participants in the CCA and non-arm's length parties;
- the scope of the activities covered by the agreement;
- the duration of the agreement;
- the nature and extent of each participant's beneficial interest in the results of the CCA activities;
- the manner and basis upon which proportionate shares of expected benefits are to be measured;
- the form and valuation of each participant's contributions;
- the allocation of tasks and responsibilities;
- the procedures for entering or withdrawing from the arrangement and the consequences thereof; and
- the policies and procedures governing balancing payments.

All material changes to the arrangements are required to be documented. Comparisons of projected and actual benefits must be made to ensure that each participant's share of the actual benefits derived from the CCA corresponds to that participant's contribution.

Paragraph 5.16 of the OECD guidelines states that because of a variety of business scenarios, it is not possible to produce an exhaustive list of the documentation required to support a particular pricing method. The documentation required by subsection 247(4) includes foreign-based documents and information. These documents should be obtained by the taxpayer to the extent that they are relevant in the determination of arm's length prices. If any of the documentation submitted to Revenue Canada is not in English or in French, the taxpayer must provide an official translation within 30 days of request by the Department. Any information provided to

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Revenue Canada is subject to the normal confidentiality rules under the Income Tax Act and income tax conventions.

IX. CUSTOMS VALUATIONS

The methods for determining value for duty under the Customs Act are similar but not identical to those outlined in the Information Circular. There are differences and Revenue Canada is under no obligation to accept the value reported for duty when considering the income tax implications of a non-arm's length importation.

X. CONFIDENTIALITY OF THIRD PARTY INFORMATION

Where in the course of an audit, Revenue Canada has obtained information on comparable prices from third parties that forms the basis of an assessment, Revenue Canada may seek written permission from the third parties to disclose the information to the taxpayer under review. If the permission is not granted, Revenue Canada is precluded under subsection 241(1) of the Income Tax Act from disclosing the information. One exception is where legal proceedings have commenced with respect to the assessment issued and the taxpayer has filed a notice of appeal with the Tax Court of Canada. In that situation, subsection 241(3) permits the Department to release the details on the comparables to the taxpayer assessed.

XI. PART XIII WITHHOLDING TAX

For adjustments to be made under subsection 247(2) of the Income Tax Act, tax under Part XIII of the Income Tax Act may also be payable. For example, if royalty payments made to non-residents were increased, additional Canadian withholding tax may apply.

XII. COMPETENT AUTHORITY PROCEDURES

Canada has entered into over 60 bilateral income tax treaties with other countries with the objective of eliminating double taxation. Many of these treaties provide for the allocation of income in accordance with the arm's length principle. These rules are generally found in Article 9 of the relevant treaty and are often modelled after Article 9 of the OECD Model Convention.

Revenue Canada may not find it appropriate to exercise discretion under subsection 247(10) to make an adjustment under subsection 247(2) of the Income Tax Act where the taxpayer is entitled to request or has requested relief from double taxation under the mutual agreements procedures of the tax treaty.

Where a transfer pricing adjustment results in double taxation, a taxpayer may request competent authority consideration as provided under the mutual agreement article of Canada's tax treaties. Information Circular 71-17 discusses the procedures and acceptability of requests for competent authority consideration.

Taxpayers have a responsibility to clearly document their transactions with related non-residents, in default of which there may be disallowances or adjustments. Without proper documentation, competent authorities may not be able to resolve any disputes.

XIII. ADVANCE PRICING ARRANGEMENTS

The advance pricing arrangement ("APA") programme was introduced to assist taxpayers in determining transfer prices acceptable for the purposes of the Income Tax Act. This is an agreement or an arrangement between the taxpayer and Revenue Canada which stipulates the mutually accepted pricing method to be used on specified international transactions for a future period (usually three years) with provision to renew. Usually, a taxpayer chooses a bilateral APA under which a treaty partner also agrees to the terms. Information Circular 94-4, entitled International Transfer Pricing; Advance Pricing Agreements sets out further details.

When concluding an APA, a taxpayer and Revenue Canada establish an acceptable transfer pricing methodology for specified transactions.

As long as the APA remains in effect and the taxpayer complies with its terms and conditions, no transfer pricing adjustments should arise under the Income Tax Act with respect to transactions covered by the agreement. Without any transfer pricing adjustments, the penalty in subsection 247(3) of the Income Tax Act would not be applicable.

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NETHERLANDS

PERMANENT AGENT – WITH PARTICULAR REFERENCE TO DUTCH CASE LAW

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I. INTRODUCTION

The question of what constitutes a permanent agent has been raised to prominence[2] partly because the subject has not yet been totally defined in theory, and, partly because the commissionaire structure[3] offers attractive tax opportunities. The authors of this article pay attention to the theoretical aspects of the permanent agent. Sections I and II respectively outline the problems caused by the absence of definitions of the terms permanent establishment and permanent agent in Dutch law.[4] Section III deals with the interrelation between paragraphs 5 and 6, of Article 5 of the OECD Model Tax Convention (hereinafter OECD MC). Section IV discusses the concept of "person" and section V what constitutes an "authority to conclude contracts". Section VI investigates the scope of the authority and section VII deals with concluding contracts "in the name of". Section VIII examines when the enterprise is bound and section IX which rules of international private law are applicable. Sections X, XI and XII deal with legal independence, economic independence and the meaning of the phrase "ordinary course of business". The article concludes with the summary contained in section XIII.

In this article the problems related to a permanent agent are discussed with particular reference to Dutch case law. This, however, does not necessarily hinder the general applicability of our findings. In view of the uncertainties of international tax law, the approach adopted by a foreign jurisdiction – even if its rulings do not have official value in another state – may certainly serve as a source of inspiration.

II. DUTCH LAW

A non-Dutch resident is liable to pay taxes on his profits from a domestic enterprise. This profit includes the amount of the benefits gained by means of a permanent establishment or a permanent agent in the Netherlands.[5] The expressions "permanent establishment" and "permanent agent" are not defined in Dutch law. This hiatus is compensated for by means of referring to the permanent establishment provisions in Dutch tax treaties and the OECD MC. The Dutch courts have made several judgements on this basis.[6,7] Finally, the Explanation to the Decree for the Avoidance of Double Taxation[8] states that the OECD MC and its Commentary may be taken as a guideline for the interpretation of the term permanent establishment in this Decree.

Thus, although it is possible to consult a number of sources, things remain unclear within this framework.[9] For instance, which treaty sets the standard in a specific situation, the OECD MC or the applicable treaty in question? After all, the definition of permanent establishment differs from treaty to treaty. Moreover, can the negative list of Article 5, paragraph 4 OECD MC also be applied to non-treaty situations? As regards the permanent agent the question arises whether deviations from the OECD MC in a specific treaty are of influence to the position of a non-resident of the Netherlands. See for example Article 5, paragraph 6 United Nations Model Double Taxation Convention: insuring risks in a contracting state and collecting premiums by means of an employee results in the status of permanent agency. If the treaty in question is decisive, this would imply that Dutch law considers a permanent establishment to be present or not, depending on the terms of the relevant treaty. Currently case law does not provide a conclusive answer on this point.

1. The authors are tax lawyers with Arthur Andersen & Co., Amsterdam.
2. E.g. A. Pleijsier, "The Agency Permanent Establishment Under Revision?: 'Acting in the name of', or 'what's in a name?'!," *Intertax* 1997, at 247-254.
3. The commissionaire structure provides the opportunity to centralize risks, (divided over the group of sales companies in various countries,) in one country, the country of the principal. This implies that the compensation for these risks is also to fall on the principal, i.e. a more substantial part of the total group income will accrue to that entity. As a consequence, the commissionaire structure is very well suited to also bring together particular services (shared services). One may think of treasury, collection, stock control, direct shipment, etc. In addition, the structure may bring about tax benefits in other jurisdictions; for instance, the US Subpart-F legislation can be avoided insofar as it is based on internal sales transactions. Subpart-F refers to the "title pass" of goods and a commissionaire will never be granted this title: it is directly passed on from the principal to the third party.
4. From here on referred to as OECD MC.
5. Art. 49, para. 1(a) Individual Income Tax Act, also applicable to corporations.
6. E.g. Supreme Court 21 April 1971, nr. 16 528, BNB 1971/110, Court of Appeal in 's-Hertogenbosch 17 October 1980, nr. 1574/1980, BNB 1982/60 and Supreme Court 15 June 1988, nr. 24 881, BNB 1988/258, including note Van Brunschot.
7. Unsuccessful efforts were made to provide for a legal definition by means of referring to Art. 5 OECD MC: Legislative proposal 20 603.
8. Explanation to Art. 2, para. 5 Decree for the Avoidance of Double Taxation.
9. R.W.G. Rouwers, *Buitenlandse belastingplicht; drie inkomensbestanddelen in historisch perspectief* (Foreign tax liability; three income components in historic perspective), at 157 et seq. [Thesis, Leiden, the Netherlands, 1996].

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III. THE RELATION BETWEEN ARTICLE 5, PARAGRAPHS 5 AND 6 OECD MC

Article 5, paragraph 5 OECD MC in combination with Commentary 5(32) eighth sentence stipulates that a permanent agent is only present if the principal is bound to the third party. In literature, Article 5, paragraph 6 is regarded as an exception to Article 5, paragraph 5 OECD MC.[10] This view has been questioned by Roberts:"[11] in his opinion paragraph 6 is not to be regarded as an exception to paragraph 5, but is to be assigned a meaning independent to that paragraph. However, Dutch case law[12] confirms the main rule versus exception relation.

IV. PERSON AND PLACE OF RESIDENCE

It is generally thought that the term person (Article 5, paragraph 5 OECD MC) can be regarded in conformity with Article 3, paragraph 1(a) OECD MC.[13] The fact that Article 1 OECD MC only permits application of the Convention for persons residing in one or both contracting states is irrelevant for the person of Article 5, paragraph 5 OECD MC: i.e. the agent is not the person whose tax liabilities are regulated by the Convention. This person is just one of the "intermediaries" appearing in treaties (just as is the employer in Article 15 OECD MC[14]) by reference to which the tax liabilities of another person are determined.

Skaar[15] is of the opinion that a more than incidental presence in the source state is required. Travelling commercial agents who conclude contracts in the source state, even if this takes place on a regular basis, are in his view not to be regarded as a permanent establishment, unless a habitual abode is minimally present. However, this view is not supported by the Commentary, while, in our opinion, this conclusion is equally not to be drawn on the basis of the term "permanent" referred to in Article 5, paragraph 5 OECD MC. We believe that permanence relates solely to the criterion of habitually exercising the authority. In literature, the requirement of a habitual abode is also absent.[16] Therefore, the text "habitually exercises in a Contracting State an authority to conclude contracts", in our opinion, allows the assumption of a permanent agent if the agents merely travel in and out of a state: the length of the stay in the source state is not subject to particular requirements.[17] However, the historic sources of Article 5, paragraph 5 OECD MC do reveal that at one time a more permanent presence was required.[18]

The person is to habitually exercise his acts in the source state. Van Raad states, and rightly so, that it is not really relevant whether the function of agent is constantly performed by the same person: "the pivotal point is whether the foreign entrepreneur is regularly involved in the trade of the source state".[19] After all, it is unthinkable that the performance of one individual does bring about a permanent agent whereas this would not be so (assuming the same volume and nature of the acts) in the case of more employees acting as representatives. The legal basis for this lies in the definition of "person" which also includes "any other body of persons", a category which is to be regarded "as broad as conceivable.[20] Acts of a body of persons in cooperation are therefore regarded as a whole. Incidentally, the question with regard to partnerships in the Netherlands was answered in case law: in a number of cases the agent was held to constitute a partnership. This is only different in certain older treaties, compare the Netherlands–Germany treaty:[21] Article 2, paragraph 1(1) defines persons as both individuals and bodies corporate; including associations of persons which as such are subject to taxation. Thus, in the case of a partnership not subject to taxation one is not to look at the aggregated acts of the partnership but at the acts of the individual partners. (See also the Netherlands–France treaty).

V. AUTHORITY TO CONCLUDE CONTRACTS AND THE FACTS

If the agent eventually does not sign the contracts in the source state, this does not necessarily detract from the concept of permanent establishment, compare Commentary 5(33): "A person who is authorised to negotiate all elements

10. J.F. Avery Jones and D.A. Ward, "Agents as Permanent Establishments under the OECD Model Tax Convention", 33 *European Taxation* 5 (1993), at 175. E.A. Brood and E. Boomsluiter, "Vaste vertegenwoordiger of onafhankelijke ondernemer?", (Permanent agent or independent enterprise?), *Weekblad voor Fiscaal Recht* 1994, at 197 (hereinafter *Brood/Boomsluiter).*
11. S.I. Roberts, "The Agency Element of Permanent Establishment: The OECD Commentaries from the Civil Law View (Part Two)", *Intertax* 1993, at 500 *et seq.*
12. Supreme Court 21 April 1971, nr. 16 528, BNB 1971/110, Supreme Court 13 January 1971, nr. 16445, BNB 1971/43, Court of Appeal in Amsterdam 25 May 1994, nr. 92/1850, *Vakstudie-Nieuws* 1994, at 3112, Supreme Court 28 June 1995, nr. 29 435, BNB 1996/108, including Conclusion by Van Soest and note by C. van Raad.
13. E.g. *Klaus Vogel on Double Taxation Conventions*, (hereinafter *Vogel*) Deventer/Boston (1991), 5(136).
14. H. Pijl, "Loonbelasting in driehoekssituaties" (Wage withholding tax in triangular situations), *Loonbrief* no. 8/9 1994, at 19.
15. A.A. Skaar, "Permanent Establishment; Erosion of a Tax Treaty Principle" (hereinafter *Skaar*) Deventer/Boston (1991), at 485.
16. C. van Raad, "De vaste vertegenwoordiger en de bepaling van de daarmee behaalde winst" (The permanent agent and determining the profit attributable to this agent), *Gielebundel*, Deventer, the Netherlands (1990), at 513. J. Hustons and L. Williams, "Permanent Establishments; a planning primer", (hereinafter *Hustons/Williams*) Deventer/Boston (1993), at 81 and 82.
17. Neither can a permanent residence be derived from the use of the term "present" in the *Commentary to the United Nations Double Taxation Convention between Developed and Developing Countries* (1980), at 72.
18. E.g. in the report of the Fiscal Committee of the League of Nations: Report to the Council of the fifth session of the Committee, 12 June 1935, Annex I, Protocol 2(c): "The term "permanent establishment" includes ... agencies... When the term "permanent establishment: is used ... it includes all the permanent establishments, whatever their form, which are *situate[d]* within such State ... When a foreign enterprise regularly has business relations in a State through an agent *established there* who is authorised to act on its behalf, it shall be deemed to have a permanent establishment in that State... A permanent establishment shall for instance, be deemed to exist when the agent *established in the State*...[i]s a duly accredited agent... who habitually enters into contracts for the enterprise for which he works..." (Cited from: Legislative History of United States Tax Conventions; prepared by the staff of the Joint Committees on Internal Revenue Taxation. Washington 1962, volume 4, at 4255, our italics).
19. C. van Raad, *supra* note 16.
20. The fact that the so-called Artificial Eyes judgement (Supreme Court, 15 June 1955, nr. 12 369, BNB 1955/277) states otherwise, can be explained from the fact that this judgement did not relate to a treaty situation.
21. Supreme Court 13 January 1971, nr. 16 445, BNB 1971/43 and Supreme Court 17 May 1961, nr. 14 458, BNB 1961/196 including note A.J. van Soest.

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and details of a contract in a way binding on the enterprise can be said to exercise this authority in that State, even if the contract is signed by another person in the state in which the enterprise is situated". Negotiations as such are not sufficient: it is mandatory that the principal is actually bound. Things look different for example when no contract can be concluded without the prior examination and permission of the head office.[22] However, it is required that this becomes apparent in actual fact: the question for example arises whether the head office sometimes actually refuses the pre-contracts brought in by the agent, or whether it always accepts all contracts as a matter of course.

The question whether or not an authority is present, is adjudged according to the facts, not on the basis of the legal form. E.g. in the *Kunstdarmenuitspraak* (Artificial Intestines judgement),[23] an authority was not included in the employment contract between principal and intermediary, but in reality negotiations were carried on. The Court of Appeal decided: ".. that this [employment] contract in itself does not imply granting an authority by the interested party to B for the purposes of concluding agreements on its behalf; however, that in the opinion of the Court the presence of such an authority can be deduced from the factual conduct of B as has become apparent in the course of the events....". The provision in the employment contract "Die Gesellschaft in Z nimmt von Herrn B Aufträge entgegen und hat sie zu genehmigen. Sie selbst schliesst die Kauf- und Lieferungsverträge mit den Kunden ab" (The company in Z receives orders from Mr B and has to approve them. The company itself concludes the sales and delivery contracts with the clients".) was disregarded in view of B's authority to make price-fixing agreements.

VI. SCOPE OF THE AUTHORITY

The Commentary 5(16) (1963) stated: "The term 'general authority' which has been commonly used in bilateral Conventions has been abandoned and replaced simply by the term 'authority'. In practice, it seems unlikely that any independent agents have a completely unfettered authority to conclude contracts. In all cases the authority must be to some extent circumscribed". Nonetheless, less recent Dutch case law often uses the expression "general authority". However, this expression does not entail discriminatory consequences, for the authority can be restricted in many respects (i.e. geographically, as regards content and duration) and yet still constitute a permanent establishment. The authority was geographically restricted in the Artificial Intestines judgement:[24] the agent in the Netherlands was only granted authority for the Benelux yet was nevertheless held to be a permanent agent. A restriction as regards contents was found in the *Scheepsverzekeraarsarrest* (the Ship Insurer judgement):[25] In this case the intermediary was authorized to arrange insurances for coasters, for other ships, however, he was only allowed to cover the risk after he was granted permission by his principal. The Court of Appeal considered no authority to be present because the intermediary was not authorized in the entire field of activities. However, the Supreme Court rejected this quantitative view. If there is an authorization with regard to particular transactions, this is regarded as an authority and sufficient reason to assume a permanent establishment, provided that the other conditions are complied with. Thus, a qualitative approach is adhered to. The fact that restrictions as regards duration are of no importance in respect of the permanent agent issue, becomes apparent from the *Makelaararrest* (Broker judgement):[26] here the agreement between the broker in the Netherlands and the German owner of the apartment complex was set for a period of 3 years (with subsequent annual extensions).

The *Schipholarrest* (Schiphol judgement)[27] revolved around the question whether the absence of the authorization to negotiate insurance policies, which the insurance agent was authorized to issue, detracted from the authority.[28] The Court of Appeal decided that considering that the intermediary was authorized to conclude insurance agreements on behalf of the principal and that these agreements could be established without extensive negotiations, the absence of an authority to negotiate could not detract from the general authority. The Supreme Court followed the decision of the Court of Appeal. We are advocates of the general view that this decision was incorrect, because, according to the original text of the United States–Netherlands treaty, a permanent establishment was only deemed to be present if apart from the authorization to conclude contracts an authorization to negotiate was also included, quod non. In the treaties which have been concluded under the OECD MC, where an authorization to conclude contracts is present the absence of an authorization to carry on negotiations does not in itself preclude the presence of an authority: authority merely to sign documents is also regarded to be an authority. However, we believe that in those cases Article 5, paragraph 4 OECD MC eventually prevents the determination of the existence of a permanent establishment. (See section X)

VII. IN THE NAME OF

According to Article 5, paragraph 5 OECD MC a contract must be concluded in the name of the principal as a prerequisite to a finding that a permanent establishment exists. Thus, if an agent does not conclude contracts in the name of the principal, as is the case with a commissionaire under civil law, a permanent establishment will in principle not be

22. *Skaar*, at 489.
23. Court of Appeal in Amsterdam 20 June 1978, nr. 1106/190, BNB 1979/190.
24. Id.
25. Supreme Court 17 May 1961, nr. 14 458, BNB 1961/196 including note by A.J. van Soest.
26. Supreme Court 21 April 1971, nr. 16 528, BNB 1971/110.
27. Supreme Court 13 January 1971, nr. 16 445, BNB 1971/43.
28. In the year of this dispute (1963) the United States–Netherlands DTC in question had not yet been modified (1965). The original text stipulated that a permanent establishment required both a general authority to negotiate and an authority to conclude contracts.

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deemed to be present.[29] In civil law a distinction is made between direct representation, in which the principal is directly bound (the contract is concluded in his name) and indirect representation: the contract is established between the intermediary and the third party, and the principal is not legally involved, even if he is the interested party in an economic sense. This is different in common law: according to this law there is only one contract in case of an intermediary, by means of which the principal and the third party are directly bound. Here, it makes no difference whether the contract has been concluded in the name of the intermediary or in the name of the principal.

The formulation of Article 5, paragraph 5 OECD MC does not display this fundamental difference between civil and common law. The OECD MC intended to define the intermediary as the extension of the principal if the principal was directly bound, which was achieved for continental law by means of the phrase *in the name of*. The criterion in drawing up the article did not relate to the purely formal act of concluding contracts *in the name of*, but to *binding the principal*. This for instance becomes clear from the Commentary 5(32), sixth sentence: "In such a case the person has sufficient authority to *bind* the enterprise's participation in the business activity in the State concerned".

An agency contract under common law always involves the binding element between the third party and the principal. It would therefore have been logical if the OECD MC included the provision of the principal having a permanent establishment in the other state in such a situation. However, this is not the case when read literally, since the wording of the Convention requires that the contract is concluded *in the name of* the principal. In 1992, the United Kingdom therefore included the following Observation as Commentary 5(45): "The United Kingdom considers that an agent who is not an agent of independent status within paragraph 6 of this Article and who has the characteristics described in paragraphs 32 and 33 above will represent a permanent establishment of an enterprise if he has the authority to conclude contracts on behalf of that enterprise whether in his own name or that of the enterprise". In 1994, the OECD amended an eighth sentence to Commentary 5(32): "Also, the phrase 'authority to conclude contracts in the name of the enterprise' does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concluded contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise". This sentence provided sufficient reason for the United Kingdom to delete the earlier Observation, compare History Article 5(45): "an earlier Observation numbered paragraph 45 was deleted, as a consequence of the amendment made to paragraph 32". In respect of the Introduction (33) to the Commentary this amendment to Commentary 5 (32) may be deemed to be also applicable to treaties concluded before 1994.

VIII. BIND THE ENTERPRISE

According to the Commentary it is no longer relevant whether a contract has been concluded in the name of the principal or not, what matters is whether the principal is bound by the contract with the third party. The issue in question has thus been transposed from a criterion based on legal form to a criterion based on substance, both for the United Kingdom and all other countries. This section deals with the latter criterion in more detail. Where an intermediary concludes contracts with third parties on behalf of a principal, two contractual relations are at issue: the principal-intermediary contract (the internal relation), and the intermediary and/or principal-third party contract (the external relation). The principal/intermediary is only bound to the third party on the basis of the external contract: if the contract – in civil law terms – is concluded in the *name of* the intermediary the principal is thus bound, (assuming an authorization in the internal relationship or (implicit) confirmation by the principal). Where the contract is concluded in the name of the principal, the principal is always bound.

The name in which the agent acts (as in the case of a broker), hardly influences the coming about of the binding element between third party and principal. The nature of the acts performed by the intermediary are essential here. Whether the principal is bound depends on the actual events. Even if the legal definition of the acts of a particular person only allows for mediation (brokers in most jurisdictions), acts (binding) outside the scope of this mediation may be deemed to be present.

Some years ago, the Netherlands completely revised the commissionaire regulation. Article 76 of the old *Wetboek van Koophandel* (Dutch Commercial Code; hereinafter *WvK*), defined a commissionaire as "he who has as his business the concluding of contracts in his own name or in the name of the enterprise, ... by order and for the account of a third party". However, civil law also enabled the commissionaire to conclude contracts in the name of his principal, compare Article 79, paragraph 1 of the old *WvK*: "If, however, a commissionaire has acted in the name of his principal, his rights and obligations, also with regard to third parties, shall be covered by the provisions of the *Burgerlijk Wetboek* [Dutch Civil Code; hereinafter *BW*] under the heading of mandate".

This approach has now been laid down in Dutch law in a simplified version in Article 7:400 et seq. *BW* (mandate). The commissionaire as a legal category is no longer present in the *WvK*. In the case of mandate the mandatory undertakes to perform one or more legal acts for the account of the mandator (Article 7:400, paragraph 1 *BW*). The contract may oblige the agent to act in his own name or in the name of the principal (7:400, paragraph 2 *BW*). In the latter case an authority must also be deemed to be present (Article 3:60, paragraph 1 *BW*).

29. *Hustons/Williams*, at 100, Kroppen/Hüffmeier. "The German Commissionaire as a PE under the OECD Model Treaty", *Intertax* 1996/4, at 135 for German law; *Skaar* at 478-488.

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With regard to the issue of the permanent establishment in relation to mandate the new Article 7:421, paragraph 1 *BW* is of interest: "If the mandatory who has concluded a contract with a third party in his own name, fails to fulfil his obligations towards the third party or is declared bankrupt, the third party is entitled to exercise his rights towards the mandator after informing the mandatory and mandator by written notice, insofar as the mandator is bound towards the mandatory in a similar way at the moment of the notice". It therefore seems that even if the intermediary concludes a contract with a third party in his own name, the principal will nevertheless be bound under certain circumstances. Van der Grinten is of the opinion that this constitutes a shift towards direct representation.[30] This raises the question whether this shift partly implies that the commissionaire is directly bound to the third party by virtue of the new system and that the commissionaire even if he concludes contracts in his own name, becomes – under certain circumstances – a permanent agent of the principal. We believe this is not the case: after all, the binding element only comes into being under certain circumstances according to civil law and is not a direct consequence of the *authority to bind the enterprise* of Article 5, paragraph 5 OECD MC.

IX. INTERNATIONAL PRIVATE LAW

The legal system under which a contract has been established, is of importance with regard to its qualification for tax purposes. Dutch tax law, after all, refers to the legal relations, even if these relations have been based on a foreign system.[31] To a similar extent, the answer to the question whether the principal is bound towards the third party in specific cases is dependent on the applicable legal system. Which legal system is to be applied is regulated by the rules of international private law. Dutch international private law is determined by the *Haags Vertegenwoordigingsverdrag* (the Hague Convention on the Law Applicable to Agency; hereinafter *HVV*). For the sake of completeness, we will briefly discuss the rules as laid down in this Convention. The *HVV* was concluded on 14 March 1978 and was ratified by the Netherlands on 21 July 1992. France, Portugal and Argentina also signed the Convention.[32] Article 4 *HVV* stipulates that it is also valid in relation to other states. Thus, where the rules of the Convention designate the legal system of a non-contracting state as being applicable, these rules shall apply to the contracting state. Articles 5 and 6 *HVV* describe the main rules for the internal relation. The internal law as opted for by the parties, in principle governs the agency relation. If no law is opted for, the applicable law shall be the law of the state in which the agent has his place of business or his habitual place of residence. Article 11, paragraph 1 *HVV* provides the main rule for the external relation. The point of departure with regard to this is the applicable law of the state where the agent had his place of business when the activities in question were performed. If the agent acted in another state, the law of that state shall apply, provided that certain conditions are complied with, e.g. if the third party had his office there. In this regard, the parties may include their own specific conditions (Article 14).

X. LEGAL INDEPENDENCE

The 1994 Commentary requires that the agent is both legally and economically independent. The Commentary 1963 5(15) still seemed to state otherwise: "Persons who may be deemed to be permanent establishments must be strictly limited to those who are dependent, both from the legal and economic point of view". Thus, the old version of the Commentary only requires legal or economic independence in order to be regarded as independent. After the modification of 1977, the question arises which Commentary is applicable if the treaty has been concluded under the 1963 system. This was at issue in the Taisei case.[33] The United States–Japan treaty dated from 1971 and was thus contracted under the 1963 Model. The Tax Court, however, referred to the revised Commentary 5(31), fourth sentence since this represented the intentions of the parties more clearly. The requirement for independence thus comprised both economic and legal independence.

A more detailed description of legal independence is phrased in the OECD Commentary 1994 5(30), first and second sentence: "Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise". Whether or not legal independence is present, is a question of a factual nature which, in cases of doubt, is to be assessed by the court. Dutch case law has dealt with this issue.

In the *Cargadoorsarrest* (the Ship Broker judgement)[34] the Court of Appeal stated:[35] "... considering the contents of the contract concluded with [the principal], which apparently does not deviate from, nor is more detailed than a ship broker is in the habit of concluding with his principal, and which leaves him [the intermediary] enough room to determine the volume of his commercial activity on behalf of [the principal] himself, the Court of Appeal is of the opinion that [the intermediary] in his relation to [the principal] has maintained his position of independent ship broker". This decision is authority for the view that the criterion of legal independence requires sufficient freedom for the intermediary to determine the contents of the agency. In the *Cargadoorsarrest* the freedom with regard to the *volume* was regarded as sufficient for retaining independence.

In a more general sense the OECD Commentary prohibits "detailed or comprehensive instructions" from the principal

30. W.C.L. van der Grinten, *Lastgeving* (Mandate), Deventer, the Netherlands (1993), at 56 [Monografieën Nieuw BW B 81].
31. E.g. Dutch Court of Appeal in 's-Hertogenbosch 28 May 1984, nr. 1828/1981, BNB 1984/250 and Supreme Court 6 December 1989, nr. 25 373, BNB 1990/44, including note by P. Den Boer.
32. Worldwide acceptance therefore seems an overstatement.
33. *Taisei Fire and Marine Insurance Co., Ltd et al. v. Commissioner*, 104 TC 535 (1995), among others, dealt with in Dale L. Davison, *Taxes* February 1996, at 101-109.
34. Supreme Court 15 June 1988, nr. 24 881, BNB 1988/259, including note by Van Brunschot.
35. The judgement also considered the criterion of the ordinary course of business.

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on penalty of losing the required degree of independence. Thus, if an agency contract regulates *all* details of the agency, such as the way of approaching the client, number of transactions to be concluded, working hours, contents of the contracts to be concluded, etc., independence can not be present. However, it is difficult to generally define the precise range of these instructions: Skaar's criterion of the extent to which the principal interferes in the business of the intermediary[36] is hard to apply in practice. Vogel's distinction[37] between material independence and personal independence seems applicable in practice: every agent is materially dependent, for, obviously, he is to follow instructions. However, only where the intermediary is personally dependent, (e.g. in an employment relationship) is there no legal independence.

A restricted room for manoeuvring or complete absence of freedom may bring into question the existence of the independence referred to in Article 5, paragraph 6 OECD MC. However, we believe that this does not detract from the authority itself by virtue of which the intermediary can bind the principal as stated in Article 5, paragraph 5 OECD MC. The only criterion in Article 5, paragraph 5 OECD MC is constituted by the authority to *bind* the principal. This authorization is present both in the case of an authority in a broad sense (e.g. if this authority partly comprises the authorization to carry on negotiations) and in the case of the authority being granted under extremely detailed conditions and being restricted to merely adding a signature. In both cases the principal is bound by means of the authority granted to the intermediary. This can only be changed if Article 5, paragraph 4 OECD MC is complied with (Article 5, paragraph 5 OECD conclusion): an agent who only brings the final confirmation by means of his signature, can be regarded as a messenger. The intermediary in his capacity of communicator only performs activities of a preparatory or auxiliary character in the sense of Article 5, paragraph 4(e) OECD MC, compare the accompanying Commentary 5(23), which literally refers to the supply of information.

In Dutch literature this problem is usually considered from a more philosophical point of view: a permanent agent is to be left sufficient room for freedom of decision; there must be a substitute material presence of the entrepreneur in the source state.[38] If this presence is not there, a permanent establishment does not come into being. We believe this argument to be flawed since a mere signature can constitute the required authority. The legal position, in our opinion, is determined by the reference to auxiliary activities. Where a treaty only requires an authority and Article 5, paragraph 5 OECD MC does not contain a reference to Article 5, paragraph 4 OECD MC, a permanent establishment is to be regarded as present.

XI. ECONOMIC INDEPENDENCE

The criterion with regard to economic independence is elaborated on in Commentary 5(36), third sentence: "Another important criterion will be whether the entrepreneurial risk has to be borne by the person or the enterprise the person represents". Thus, the intermediary is required to bear the entrepreneurial risk himself. In this respect, it does not concern the risk in relation to transactions concluded by the intermediary for the principal, because, as a rule, these are for the account of the principal. The intermediary is thus required to run an economic risk himself. If the intermediary does not bear any risks himself, e.g. because these have been fully covered by the principal, economic independence does not exist. If, however, the intermediary also performs other activities for his own account (representative function or otherwise), economic independence will be quickly established.[39] The answer to the question whether performing activities for a principal brings about economic dependence, depends on the specific facts and circumstances. If the contract with the principal implies that the intermediary may only act as an exclusive agent on his behalf, this will be an indication of dependence. This exclusion of other agencies is left to the discretion of the parties. However, in this respect the agent must at least have the desire which is to be substantiated by the facts, of further development in an economic sense. We do not believe economic dependence is implied if, in the course of his development, the agent has the misfortune of not acquiring a larger clientele.[40] Very interestingly, from the Explanatory Note of the recently signed Argentina–Netherlands treaty it can be concluded that in the view of the Netherlands, working solely for one enterprise only brings about dependency if the conditions of the commercial or financial relations deviate from what in general is usual for an independent representative.

XII. IN THE COURSE OF THEIR BUSINESS

Commentary 5(38), fifth and sixth sentence, provides guidance on the meaning of the phrase *in the ordinary course of their business*. Persons do not act in the ordinary course of their business if they perform activities which do not belong to the economic sphere of their own enterprise but rather belong to the economic sphere of the enterprise they represent. This criterion raises the question whether the ordinary course of business of the intermediary concerns the business of the actual person himself (a subjective test), or of the category of persons in general (objective test). This issue has generated conflicting case law, but we believe that on the basis of the text of the OECD MC and the Commentary: it is to concern *their* and *his* business. Thus, the frame of reference is constituted by the individual business of the agent, not of the professional group in general.[41] It is our opinion that the reference is to be interpreted in a subjective and not an objective manner.

36. *Skaar*, at 513.
37. *Vogel* 5(169).
38. *Brood/Boomsluiter*, at 199. *Nederlandse Jurisprudentie op vier Internationale Gebieden* (Dutch Case Law in four International Areas), IBFD, (October 1993), at 105.
39. Also *Vogel* 3(171).
40. *Hustons/Williams*, at 135.
41. See also Avery Jones/Ward *supra* note 10 at 173. The Bundesfinanzhof (German Tax Court) supports this view in its judgement of 1983 (BStB1 II 1984, 92).

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In Dutch literature general reference is made to the judgements BNB 1971/110 and BNB 1971/43 as proof of the objective doctrine:[42] ": It is certain that K was a broker and, now that it is common practice here in economic life that *the activities of brokers* comprise a great deal more than mediation activities and other involvement....it may also be assumed that K with regard to the task he had taken on, on behalf of the interested party, was acting in the ordinary course of his business".[43]

We believe that the literature is incorrect: the text of the judgements does not provide sufficient support for the objective doctrine. After all, BNB 1971/110 is to be interpreted with due reservations, since it is not clear whether the Supreme Court supports the objective doctrine of the Court of Appeal. Though the decision of the Court of Appeal was not annulled, it is to be treated with caution in connection with the legal grounds. As the Supreme Court aristocratically puts it: "... whatever the grounds for this decision be...".

The Supreme Court also failed to annul the decision of the Court of Appeal in BNB 1971/43 (United States–Netherlands treaty of 1948). In that case the Court compared the ordinary course of business with "the ordinary course of its business *as such* (Supreme Court). The Court of Appeal stated: "that, considering that acting as an authorised agent of an insurance company [] does not belong to the *ordinary course of business of an insurance broker*, this ordinary course of business is absolutely not present if the broker ... binds himself towards the insurer represented by him to act according to the regulations and instructions issued by these insurers". Although an objective test is applied here, it is not possible to draw general conclusions from this. It is to be pointed out once more that this judgement (year of dispute 1963) was given under the treaty with the United States which was not adapted by means of the modification of 1965. Article II, paragraph 1(i) (old) of this treaty referred with regard to this to the business *as such*. The treaty itself thus explicitly required an objective test, unlike the treaties which were modelled after the OECD MC.

However, the Ship Broker's judgement BNB 1988/258 may be quoted in favour of the objective approach. In this case, the Court of Appeal made the comparison with "a ship broker" in its general sense. The latest twist, however is contained in the Insurer judgement (Supreme Court 28 June 1995).[44] Here, the court opts for the subjective doctrine; the Court of Appeal "comes to the conclusion that C BV, as an independent agent acting on the behalf of the interested party, did act as a person as is incidentally referred to in Article 5, paragraph 5, of the treaty, but that C BV ... with regard to this act[s] in the ordinary course of *their* business in the sense of the sixth paragraph". The Supreme Court followed this judgement.

XIII. SUMMARY

The expression permanent agent in Dutch legislation is interpreted according to the definition in the treaties and the OECD MC. According to Dutch literature and case law, Article 5, paragraph 6 OECD MC is an exception to Article 5, paragraph 5 OECD MC; the provision does not have an independent meaning. Furthermore, "persons" travelling in and out of states on a daily basis can be regarded as permanent agents in the sense of Article 5, paragraph 5 OECD MC. Whether an "authority to conclude contracts" is present, is judged on the basis of the facts. Neither the OECD MC nor the Commentary specify further requirements regarding the scope of the authority: the agent who is merely authorized to add his signature, is granted authority as referred to in Article 5, paragraph 5 OECD MC, but is not regarded as a permanent agent on the basis of Article 5, paragraph 4 OECD MC. The binding element in Dutch law only comes into being between the two parties contracting in their own name, where an authority is binding on a third party. The recent shift in Dutch commissionaire law to direct agency has no taxation consequences. Which law is applicable to a contract involving agents, is determined in the Netherlands by the Hague Convention.[45] For the purpose of defining legal independence, the Dutch court assigns meaning to the freedom of the intermediary in determining the range of his activities. Economic independence may, among others, be achieved by having the intermediary co-perform other activities. In recent case law the question of whether the agent was acting in the ordinary course of *his business* was determined subjectively by reference to the activities of the agent.

42. *Brood/Boomsluiter*, at 201, M. de Best, "Wanneer is er sprake van een vaste vertegenwoordiger" (When is a permanent agent deemed to be present) *Internationaal Belastingbulletin*, (February 1997), at 9.
43. BNB 1971/110.
44. Supreme Court 28 June 1995, rol no. 29 435, BNB 1996/108, including Conclusion by Van Soest and note by C. van Raad.
45. I.e. the *HVV*.

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UNITED KINGDOM

RECENT CHANGES TO THE UK TAX CREDIT REGIME, THE ABOLITION OF ACT, AND CERTAIN RELATED MATTERS

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I. INTRODUCTION

This article examines the main provisions of the Finance (No. 2) Act 1997, (hereinafter F(No. 2)A 1997) affecting the tax credit regime in the United Kingdom. In addition, it outlines certain proposals contained in the Green Budget day[1] consultative document "A Modern System for Corporation Tax". The changes brought about by the F(No. 2)A 1997 can broadly be divided into those that take effect from the Budget day i.e. 2 July 1997, and those that only apply from 6 April 1999. Particular attention is drawn to certain international implications of the changes and related proposals.

II. THE NEW REGIME 1st PHASE: FROM 2/7/97

A. Repayment of tax credit

Otherwise than in situations involving certain current year losses[2] under the old regime normally UK companies could not claim a repayment of the credit attached to dividends received from other UK companies. However, pension funds which are formed as trusts are subject to different rules. Since pension funds are exempt from tax their entitlement to a repayment of the tax credit constituted a considerable advantage. (Insurance companies also had a right to the payment of tax credit in certain circumstances.) With effect from 2 July 1997, Section 19 F(No. 2)A 1997 removes the right of pension funds to reclaim the tax credit attaching to dividends received from other UK companies.[3] Similarly Section 20 F(No. 2)A 1997 ends the right of UK companies to claim a repayment of the tax credit attaching to UK dividends received where that company had certain losses.[4]

The following example illustrates the effect of the changes to the after tax cash flows of "normal" "tax-exempt Pension Funds" and "Loss Companies".

	Normal		Tax-exempt PFs		Loss Companies	
	Pre 2/7/97	Post 1/7/97	Pre 2/7/97	Post 1/7/97	Pre 2/7/97	Post 1/7/97
Div.	80	80	80	80	80	80
TC Refund	–	–	20	–	20	–
After Tax	80*	80	100	80	100	80

* Dividends received from UK Companies are not subject to corporation tax.

It is clear from the above example that tax-exempt pension funds face a dramatic reduction in the value of their dividend receipts. This will inevitably result in a reappraisal of tax efficient structures appropriate to such funds.[5]

B. Anti-avoidance

Certain provisions are incorporated into the new legislation designed to counteract avoidance opportunities that might have otherwise proved attractive under the new regime. In particular Section 28 F(No. 2)A 1997 attacks arrangements designed to pass on the value of the tax credit. Specific legislation targeting share dealers,[6] the use of discretionary trusts[7] and the use of unauthorized unit trusts[8] has also been enacted.

* The author wishes to acknowledge the insightful comments made by Jonathan Schwarz, Roger Moore and Eric Tomsett on earlier drafts of this article.

1. The Green Budget was held on 25 November 1997 in preparation for the March 1998 Budget. The purpose of the Green Budget is to allow for a period of consultation on changes being considered for the actual Budget.
2. Franked Investment Income is not normally taxed. Where a company has franked investment income in excess of its franked payments for an accounting period this surplus may be set off against its trading losses etc. and result in a repayment of the tax credit.
Franked investment income is comprised of UK dividends received plus the attached tax credits. Franked payments are comprised of "qualifying distributions" (i.e. normally dividends) plus advance corporation tax.
Losses for these purposes include amongst others trading losses, charges paid and management expenses.
3. In view of the annual cost to tax-exempt pension funds of losing entitlement to repayment of the tax credit (approximately GBP 5 billion) the normal corporation tax rate for the finance year 1997 was reduced from 33 per cent to 31 per cent. The rate applying to smaller companies i.e. those with "profits" of below GBP 300,000 was also reduced to 21 per cent (from 23 per cent) where the profit was above GBP 300,000 but below GBP 1,500,000 the value of the relief was progressively eroded. The annual cost to the treasury of this reduction in tax rate is estimated to be GBP 2 billion.
4. Strictly this repayment of tax credit was only temporary, since if in a subsequent accounting period the company's franked payments exceed its franked investment income the repayment is effectively recovered by the Inland Revenue. The losses were then reinstated and could be set off against profits. See: Secs. 242(5)-(7)(9) and Sec. 243(4) ICTA 1988.
5. For further consideration of the implications for tax-exempt pension funds see: Malcolm Gammie, "The End of Imputation: Changes in UK Dividend Taxation", 25 *Intertax* No. 10 at 335.
6. See Sec. 24 F(No. 2)A 1997. The broad effect of this legislation is to deny share dealers a tax credit whilst treating dividends as taxable income.
7. Sec. 27 F(No.2) 1997.
8. Sec. 29 F(No. 2) 1997.

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C. Individuals

Individuals are not affected by the first phase of the new regime i.e. they will be subject to tax on dividend income as previously and will as before be able to make a claim for repayment of the tax credit where they have personal allowances/losses available.

III. THE NEW REGIME 2nd PHASE: FROM 6 APRIL 1999 ONWARDS

A. Lower rate of tax credit

From 6 April 1999, the tax credit attaching to dividends has been reduced from one quarter to one ninth.[9] This change is unlikely to have a direct impact on corporations[10] since UK dividends are not subject to corporation tax.[11] There is also no impact on tax-exempt pension funds and companies with trading losses in receipt of dividend income since from 2 July 1997 neither of these entities will be able to claim the refund of tax credits.

B. Individuals

From 6 April 1999 onwards individuals will no longer be able to claim a repayment of income tax where the tax credit attaching to the dividends[12] they receive exceeds their income tax liability for that year.[13]

Individuals subject to the lower or basic rate of tax,[14] will have no further tax to pay since their dividend income will only be subject to tax at the Schedule F ordinary rate i.e. 10 per cent. The resulting liability is therefore satisfied by the tax credit attaching to the dividend.[15] Individuals liable at the higher rate will be subject to tax on their dividend income at the Schedule F upper rate of 32.5 per cent.[16] A comparison of the higher rate computation under the new and old regime is set out below:

	1999/00	1997/98
Div.	90	90
Tax credit	10 (1/9)	22.5 (1/4)
Gross	100	112.5
Tax	32.5 (32.5%)	45 (40%)
Tax credit	(10)	(22.5)
Additional liability	22.5	22.5
Gross div.	100	112.5
Tax	(32.5)	(45)
After tax	67.5	67.5

From the above, it appears that higher rate taxpayers[17] should not be adversely affected by the lowering of the tax credit.[18]

IV. ABOLITION OF ADVANCE CORPORATION TAX (ACT)

The consultative document "A modern system for corporation tax payments" issued on Green Budget day (25 November 1997) announces the proposed abolition of ACT from 6 April 1999. "No ACT will be due on dividends paid or other qualifying distributions made on or after 6 April 1999".
In the words of the consultative document the abolition of ACT will:

- do away with the need for companies to make group income elections so that they can pay dividends to their parent companies without having to account for ACT; and
- enable the tax rules covering payments representative of dividends (manufactured dividends) to be simplified from 1999.

The abolition of ACT will by definition mean that no surplus of ACT will build up on or after 6 April 1999.
Accordingly there will be no need for:

- a successor to the foreign income dividend (FID) scheme when it is abolished in 1999, because the problem in respect of which FIDs were a partial solution will simply disappear; or
- special rules to enable international holding companies to pay dividends out of foreign income without accounting for ACT, since ACT will not apply to any of their dividends from 6 April 1999, just as for other UK companies.

A. Quarterly payments of ACT

In order to compensate the exchequer for lost revenue due to the abolition of ACT, the consultative document proposes that from 6 April 1999 "large"[19] companies will commence to pay their estimated corporation tax liabilities in four equal quarterly instalments.[20] Medium sized companies need only pay half their corporation tax liability in instalments and half as now. Small companies are excluded from the instalment regime and will continue to pay their tax nine months after the end of the accounting date.

9. Sec. 30(3) F(No. 2)A 1997.
10. It may however have an effect on a company's dividend policy.
11. The changes likely to flow from the abolition of ACT are discussed separately below.
12. On 25 November 1997 the Consultative Document "The New Individual Savings Account" was issued. It contains proposals to introduce from April 1999 a new tax free savings account (hereinafter "ISA"). A key point is that "a 10 per cent tax credit will be paid on dividends from UK shares in the ISA for the first five years of the scheme".
13. Transitional relief is provided for charities etc. See Sec 35 F(No. 2)A 1997.
14. The lower and basic rate of tax for 1999/00 (i.e. 6 April 1999 – 5 April 2000 has not yet been set. For 1997/98 they were 20 per cent and 23 per cent respectively.
15. Sec. 31 F(No. 2)A 1997.
16. Sec. 31(5) F(No. 2)A 1997.
17. Higher rate taxpayers holding shares through PEPs will be adversely affected by the ending of repayments of the tax credit since no refunds of the tax credit will be available to PEPs.
18. Special provisions apply to discretionary trusts.
19. The term *large* is misleading since companies with taxable profits of just GBP 1.5 million are considered large. *Small companies* are companies with taxable profits below GBP 300,000 and *medium sized companies* are companies with taxable profits in excess of GBP 300,000 but below GBP 1,500,000. The definitions for *large, medium* and *small* companies follow those used for purposes of calculating entitlement to *small companies relief.*
20. It is also proposed to reduce the rate of corporation tax to 30 per cent from 1 April 1999.

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B. FIDs[21]

Section 36(1) F(No. 2)A 1997 provides that no election that a dividend be classified as a FID be made in respect of any distribution made on or after 6 April 1999. This should have no adverse implications since as mentioned above ACT is also due to be abolished from that date.[22] Similarly from 6 April 1999 there will be no need for the special international headquarters companies (IHC)[23] regime.

C. Planning and other issues

The abolition of ACT is likely to alter the dividend policies of companies. Both the quantum of dividend payments and the timing of those payments may be affected. For instance:

- ACT will no longer constitute a reason for delaying dividend payments to be just prior to the accounting year end;[24]
- companies previously prone to suffering surplus ACT will no longer effectively face a penalty for distributing profits (i.e. such companies may increase their dividend pay out ratio);[25]
- distributing profits to an overseas parent company will no longer trigger a liability to ACT.

There is an obvious incentive for companies wishing to avoid the payment of ACT to delay dividend payments until 6 April 1999. The effectiveness of such a strategy will of course depend on the actual legislation introduced by the 1998 Finance Act.

D. Shadow ACT

The consultative document states that surplus ACT will be "fairly dealt with". This vague phrase may be taken to mean that "companies' existing expectations as regards past surplus ACT will substantially be preserved, no more and no less".

The "meat" of the proposal is that surplus ACT accumulated prior to 6 April 1999 may in certain circumstances reduce a company's corporation tax bill for periods ending on or after that date.[26]

Relief for surplus ACT will be calculated by:

- retaining the existing set-off limit; (20 per cent of taxable profits)
- reducing this amount by "shadow ACT" computed at the same rate as now;
- where any set-off capacity remains after the deduction of shadow ACT, allowing surplus ACT to reduce the companies' corporation tax liability accordingly.

Example

Company Y Ltd which pays a dividend of 50,000 in the period in question has taxable profits of 1,000,000 and surplus ACT carried forward at 6 April 1999 of 250,000:

Computation of set-off	
Maximum set-off 1,000,000 @ 20%	200,000
Less shadow ACT 50,000 @ 20%	(10,000)
Potential set-off	190,000
Corporation tax liability	
Taxable profits	1,000,000
Tax @ 30%	300,000
Surplus ACT set-off	(190,000)
Corporation tax payable	110,000

Surplus ACT	
B/Fwd	250,000
Utilized	(190,000)
C/Fwd	60,000

Opportunities to develop a pro-active strategy to maximize the offset of surplus ACT will be subject to legislation which will be introduced in the 1998 Finance Act. Notwithstanding this it is perhaps likely that the timing of income and expenses may prove significant.

V. INTERNATIONAL

In many tax treaties the United Kingdom provides for a partial repayment of the tax credit. The quantum of repayment varies in certain treaties (e.g. with the Netherlands and Italy) depending on whether the shareholder is a direct corporate[27] (i.e. controls at least 10 per cent of the voting power) or portfolio (less than 10 per cent) investor.

In the case of a direct investor the repayment is equal to: one half the tax credit minus 5 per cent of the aggregate dividend and half tax credit.[28] For portfolio investors the repayment is usually equal to the full tax credit minus 15 per cent of the aggregate dividend and tax credit.

Under the new regime repayment to certain non-resident shareholders is to continue[29] thus until 5 April 1999 non-res-

21. The Foreign Income Dividend scheme is a scheme whereby dividend paying companies with foreign income (subject to certain conditions) may avoid incurring surplus ACT in respect of the "foreign" element of their dividends. See Part VI, Chapter VA ICTA 1988.
22. I.e. therefore the FID regime will no longer be necessary.
23. The principle requirement for a company to qualify as an IHC is that it be at least 80 per cent foreign owned. An IHC need not account for ACT on paying a FID.
24. I.e. this is currently done to ensure the set-off for ACT will be available against the corporation tax liability of the period in which the dividend is paid.
25. It has been argued that this will reduce the incentive for companies with surplus ACT to invest in profitable UK companies.
26. It will not help companies whose corporation tax liability is reduced to nil by double tax relief.
27. Repayment of the tax credit to direct corporate investors at present only applies to 11 treaties (see *Guides to European Taxation, Vol. II, The Taxation of Companies in Europe*, (Amsterdam, IBFD) United Kingdom, at 8.3.1.4. and 8.3.2.2.).
28. A 10 per cent rate applies to direct corporate investors in Canada and Norway.
29. It is an interesting question as to why the UK government did not simply abolish payments of tax credits to non-residents as they have done for residents. Presumably the retention is designed to placate certain treaty partners. (See David Oliver, "Just PlayACTing?" *The Tax Journal*, 20 October 1997, at 14.) However, ironically, as discussed below retention of the regime may prove controversial.

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idents should be unaffected by the changes. From 6 April 1999, onwards[30] however the reduction in the rate of tax credit will drastically reduce/eliminate[31] such non-residents entitlement to repayment of tax credit.

It has been argued by various authors that the deduction from the tax credit mentioned above constitutes a withholding tax and therefore contravenes the EC Parent-Subsidiary Directive as far as it applies to treaties concluded with EU Member States.[32] It is beyond the scope of this article to consider this argument in detail. However it is interesting to note the drafting of Section 30(10) F(No. 2)A 1997 (see below) which seeks to ensure that the reduction in tax credit to one ninth when taken together with the treaty provisions governing the repayment of tax credit does not create a liability to UK tax.

Where
(a) arrangements having effect by virtue of section 788 of the Taxes Act 1988 confer on a person not resident in the United Kingdom the right to a tax credit under section 231 of the Taxes Act 1988 in respect of a dividend of a company resident in the United Kingdom, and
(b) the arrangements contain provision for permitting
  (i) tax to be charged or deducted, or
  (ii) a reduction in the amount of the tax credit that is paid to be made,
by reference to the aggregate of the dividend and the tax credit, and
(c) the amount of that tax or that reduction exceeds the amount of the tax credit,
that provision shall only have the effect of reducing to nil the amount of the payment to which the person is entitled in respect of the tax credit.

From the above it would appear that the drafter believes that the mechanism used to calculate the repayment of tax credit due to the non-resident shareholder could actually in the case of a portfolio investor trigger a charge to tax in the United Kingdom:

Treaty portfolio shareholder

Div.	90
Tax credit	10 (1/9)
	100

Repayment computation

Tax credit	10
Less 15% (90+10)	(15)
Tax payable ?	(5) (Note 1)

Note 1: Section 30(10) F(No. 2)A 1997 reduces the charge to Nil.

It is not at all certain whether in the United Kingdom a tax treaty can impose tax.[33] Notwithstanding this it is clear that the only possible explanation for the legislation is that the Inland Revenue believe that UK treaties can impose tax and that under the reduced tax credit regime they would in fact actually do so unless a specific provision were inserted to prevent this happening.

The problem for the Inland Revenue is that the above conflicts with their long-held argument that the treaty withholding of part of a tax credit was merely an abatement – i.e. that in substance no tax was in fact levied on the dividend.[34] It is now self-evident that for portfolio investors the tax being imposed under certain treaties would exceed the tax credit and actually reduce the dividend, but for the specific relieving legislation. Even with Section 30(10) in place, a reduction to zero in my mind hardly constitutes an "abatement". In form and substance the section operates to limit the tax to the amount of the tax credit. It thus appears clear that certain UK treaties may be construed as imposing a withholding tax, albeit one that government policy has attempted to limit to the tax credit. I.e. merely restricting the withholding charge does not change the nature of the charge. Further it could be argued that the withholding nature of the relevant treaty provisions is further emphasized by the fact that the restriction mechanism operates by reference to the charging provisions of the relevant treaties rather than directly through Section 20 ICTA 1988.[35]

While it is true that from 6 April 1999 direct investors will still be entitled to payment of part of the tax credit, this will be restricted to a mere 0.27778 per cent of the dividend. I.e. in many cases, this entitlement will have no economic value.[36] Consequently the arguments outlined above for portfolio investors in substance apply also to direct investors.

In light of the above, I wonder whether the UK's position is still protected by Article 7(2) of the Parent-Subsidiary Directive which provides:

> This 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 recipients of dividends.

30. After 6 April 1999, non-residents are specifically permitted to continue claiming repayment of tax credits under tax treaties. Sec. 30(9) F(No. 2) 1997.
31. In the case of a portfolio investor the refund is entirely eliminated (see below) while in the case of a direct investor the tax credit refund is very much reduced:

Direct investor

Div.	90
Tax credit	10 (1/9)
	100
Repayment computation	
Tax credit	5.00 (1/2 of 10)
Less 5%(90+5)	(4.75)
Tax repayable	0.25

32. Ronald Dietz, "ACT Dividends and UK Withholding Tax: We Are Not Amused", 51 *Bulletin for International Fiscal Documentation* 5 (1997), at 224. See also John Graham, "EC Parent-Subsidiary Directive and UK Advance Corporation Tax: Abuse by the Tax Authorities?" 32 *European Taxation*, 10 (1992), at 353. Cf. David Hughes, "Non-Discrimination: A Consideration of Article 24(5) OECD Model Convention" 50 *Bulletin for Fiscal Documentation* 9 (1996), at 391 et seq.
33. The question as to whether a UK treaty can impose a higher burden to tax than that which would have existed without a treaty has not yet been settled. The Inland Revenue are believed to take the position that a treaty can create a liability, whilst others disagree. It is highly likely that the courts will be called upon to decide this issue. See Phillip Baker, (1994), *Double Taxation Conventions and International Tax Law,* (2nd Edition) Sweet & Maxwell at 7-10; See also M. Roger Moore, "The Union Texas Case" 28 *European Taxation,* 12 (1988), at 404.
34. See Inland Revenue Consultive Document; "EC Direct Tax Measures".
35. The charging sections for dividends.
36. For example on a payment of a GBP 50,000 dividend, the repayment of 138.89 probably would not even cover the taxpayer's cost of requesting the repayment.

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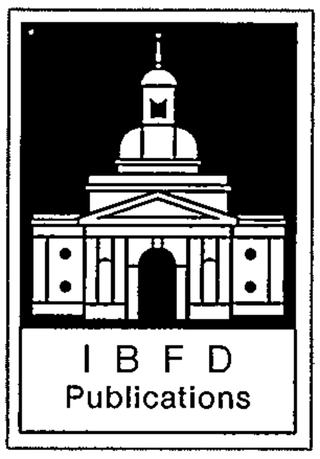
I believe that under the new regime the relevant "agreement-based provisions" may be held not to be designed to eliminate or lessen the economic burden of taxation.[37]

Even if it is accepted that certain UK treaties provide for a tax to be withheld and that Article 7(2) does not apply the question as to whether such withholdings contravene the Parent-Subsidiary Directive is still far from being clear cut. Nevertheless, the reduction in tax credit to one ninth certainly gives an added incentive for taxpayers to argue the point before the European Court of Justice (ECJ).

One further consequence of the new regime regarding unresolved European issues is that the benefits of obtaining a decision by the ECJ in favour of the Most Favoured Nation clause in respect of the tax credit provisions in certain treaties will be greatly diminished.[38]

37. See *supra* note 36.
38. This will not be true if a taxpayer succeeds before the ECJ on the withholding argument discussed in the paragraph directly above.



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UNITED STATES

TAX COURT RULINGS ON SALE OF FRANCHISE, SOURCE OF STOCK LOSS FOR US FOREIGN TAX CREDIT PURPOSES

Decisions of 29 January 1997[1] and 18 June 1997[2] of the US Tax Court

Constance M. McCarthy, Esq.[3]

I. INTRODUCTION

On 29 January 1997 the US Tax Court ruled on the proper tax treatment of the disposition of a franchise by a US company in *International Multifoods Corporation and Affiliated Companies v. Commissioner of Internal Revenue* (hereinafter: *IMC 1*). In its decision authored by Judge Ruwe, the Court held that the sale of International Multifoods Corporation's (hereinafter: the Taxpayer) Mister Donut operations in the Asia-Pacific region constituted a sale of a franchise and trademarks, rather than goodwill. As a result, the sales proceeds are properly treated as US source income. In its June 1997 decision (hereinafter: *IMC 2*), which was again authored by Judge Ruwe and in which the issues severed as part of the Court's ruling in *IMC 1* were resolved, the Tax Court held that the loss suffered by the Taxpayer upon the disposition of stock held in a foreign subsidiary is properly treated as a US source loss for purposes of calculating the US foreign tax credit limitation.

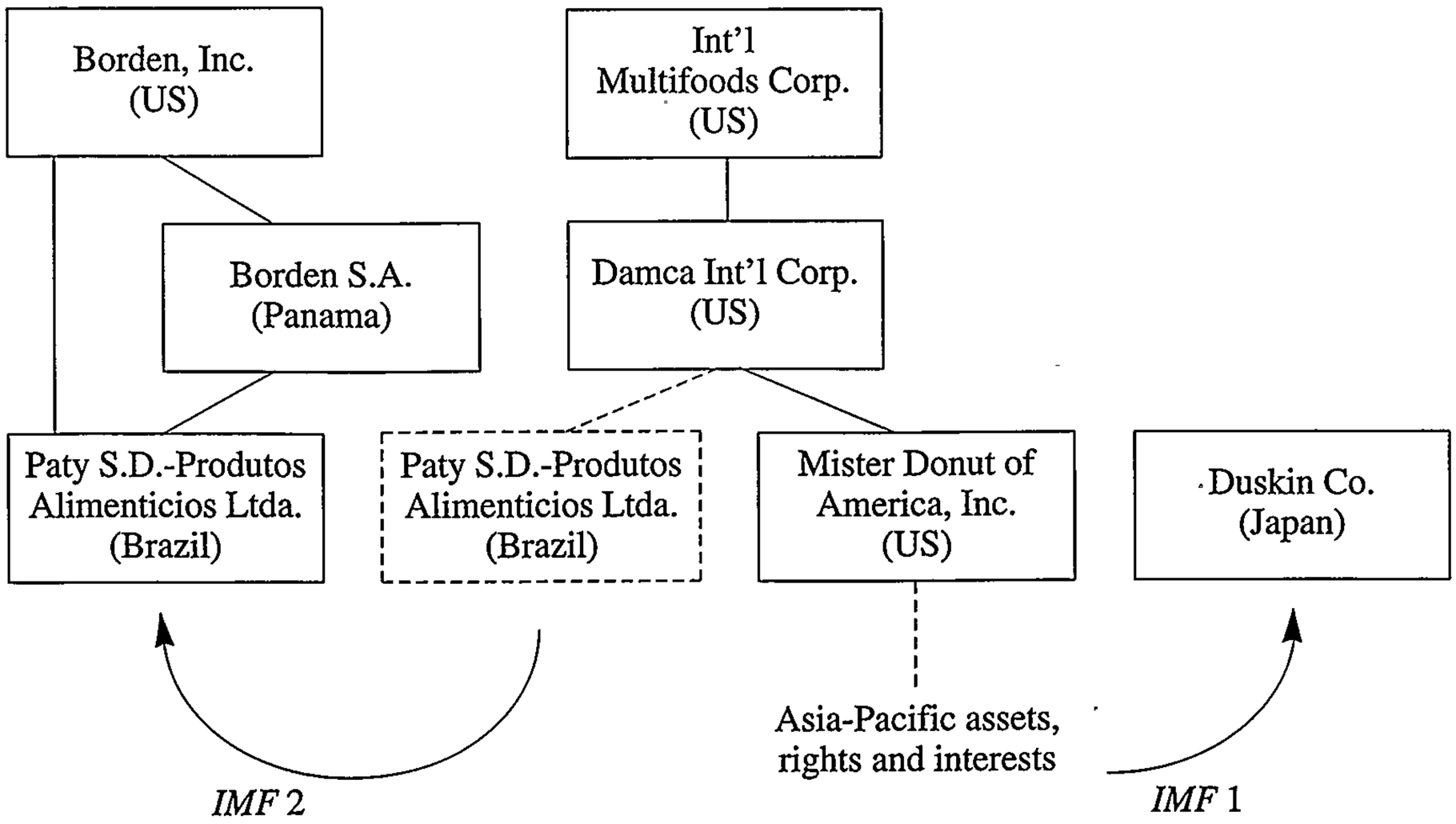
II. THE FACTS

The Taxpayer is a Delaware corporation which maintains its principal place of business in Minneapolis, Minnesota. Along with its affiliated subsidiaries (with which the Taxpayer files consolidated federal income tax returns), the Taxpayer is engaged primarily in the manufacture, processing, and distribution of food products. See illustration 1 for a depiction of the Taxpayer's ownership structure and the transactions at issue in this case.

Mister Donut[4] franchised pastry shops in the United States and abroad. As of January 1989, the Taxpayer had registered

1. 1997 US Tax Ct. LEXIS 3, 108 TC 25 (1997).
2. 1997 US Tax Ct. LEXIS 25, 108 TC 26 (1997).
3. Price Waterhouse LLP, International Tax Services Group, Chicago.
4. Mister Donut's transactions will hereinafter generally be referred to as those of the Taxpayer, since Mister Donut was a wholly owned subsidiary of the Taxpayer.

Int'l Multifoods Corp. v. Cmr



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Mister Donut trademarks in Indonesia, the Philippines, Taiwan, Thailand, Australia, China, Hong Kong, Malaysia, New Zealand, Singapore, and South Korea. The Taxpayer had also entered into franchise agreements in Indonesia, the Philippines, Thailand, and Taiwan (hereinafter collectively: the operating countries).[5] The system by which Mister Donut utilized franchisees to prepare and merchandise its pastries and other food products is referred to in the franchise agreements as the "Mister Donut system."[6] Franchisees were entitled to use the building design, layout, signs, emblems, and colour scheme relating to the Mister Donut system, along with the Taxpayer's copyrights, trade names, trade secrets, know-how, and preparation and merchandising methods, plus any other valuable and confidential information.[7] However, the Taxpayer retained exclusive ownership of its current and future trademarks, as well as any additional materials which might constitute part of the Mister Donut system. No use of the assets was permitted upon termination of a franchise agreement.[8]

In November 1983 the Taxpayer entered into an agreement (hereinafter: the Japan agreement) to sell its Japanese operations to Duskin Company (hereinafter: Duskin).[9] In addition to providing for a transfer of all of the Taxpayer's assets, rights, and interests in Mister Donut in Japan, the Japan agreement contained a covenant not to compete.[10] In January 1989 the Taxpayer entered into an agreement (hereinafter: the Asia-Pacific agreement) to sell its entire interest in designated Asia-Pacific countries to Duskin.[11] Under the Asia-Pacific agreement the Taxpayer sold its existing franchise agreements, trademarks, Mister Donut system, and goodwill for each of the operating countries, and its trademarks and Mister Donut system in the non-operating countries.[12] Like the Japan agreement, the Asia-Pacific agreement contained a covenant not to compete.[13]

Based on an appraisal by the valuation division of an accounting firm, the Asia-Pacific agreement allocated the purchase price between the existing franchises, goodwill, trademarks, and pending trademark applications as follows:[14]

Asset	USD	%
Trademarks	120,000	6
Non-compete agreement	820,000	40
Goodwill	1,110,000	54
Total	2,050,000	100

In reporting US and foreign source income for the year ended 28 January 1989, the Taxpayer allocated the purchase price (subsequent to the allocation of selling expenses among the goodwill and trademarks sold to Duskin)[15] as follows:[16]

Asset	USD
Trademarks	109,907
Non-compete agreement	820,000
Goodwill	1,016,643
Total	1,946,550

With respect to the sale of its interests in Paty S.A.-Produtos Alimenticios, Ltd. (hereinafter: Paty), the facts are as follows. The Taxpayer and its wholly owned subsidiary, Damca International Corporation (hereinafter: Damca), owned Paty.[17] On 30 March 1987, the Taxpayer and Damca entered into an agreement to sell their shares to Borden, Inc. and its Panamanian subsidiary, Borden S.A.[18] The Taxpayer opted to sell Paty because it had proven to be an unprofitable investment; with the exception of one tax year, Paty had never generated net income for any year in which it was owned by the Taxpayer. At the time of the sale, Paty had a net deficit in earnings of USD 5,053,076 and had never paid a dividend to either the Taxpayer or Damca.[19] On its tax return for the year ended 29 February 1988, the Taxpayer reported a loss of USD 3,772,310 on the sale and treated that loss as US source for purposes of computing its foreign tax credit limitation.

Based on the Taxpayer's treatment of the above transactions, the Commissioner determined federal income tax deficiencies of USD 2,962,380 for the tax year ended 28 February 1987 and USD 3,952,402 for the tax year ended 29 February 1988.[20] These deficiencies, which were paid by the Taxpayer, were the subject of a claim of overpayment of tax filed with the Tax Court by the Taxpayer on 1 June 1992.[21] On 29 January 1997, the Tax Court, as discussed below, issued its ruling in *IMC 1* on the issue of the tax treatment of the disposition of the Taxpayer's Asia-Pacific business operations.

As part of its ruling in *IMC 1*, the Court granted the Commissioner's motion to sever the Paty stock loss issue and hold it in abeyance pending receipt of a report from the Commissioner concerning the finalization of the applicable regulations.[22] On 13 March 1997 the Taxpayer filed a Motion for the Court to Decide the Paty Stock Loss Issue, noting that no target date had been set by the Treasury for finalization of the applicable regulations.[23] In granting the Taxpayer's motion, the Court noted that in granting the original motion to sever,

5. 1997 US Tax Ct. LEXIS 3, at 8. The Taxpayer had not entered into franchise agreements in any of the other countries in which it had registered Mister Donut trademarks.
6. Id. at 10. The "Mister Donut system" is described in the franchise agreements as: the name "Mister Donut", a unique and readily recognizable design, colour scheme and layout for the premises wherein such business is conducted (herein called a "Mister Donut Shop") and for its furnishings, signs, emblems, trade names, trademarks, certification marks and service marks..., all of which may be changed, improved and further developed from time to time...
7. Id. at 11-12.
8. Id. at 12.
9. 1997 US Tax Ct. LEXIS 3 Id. at 14. Duskin is a Japanese company which markets a variety of goods and services, primarily through franchise operations.
10. Under the covenant not to compete, the Taxpayer agreed not to conduct any business similar to Mister Donut in Japan for a period of 20 years, and Duskin agreed not to conduct any business similar to Mister Donut anywhere outside of Japan for a period of 10 years.
11. 1997 US Tax Ct. LEXIS 3, at 15.
12. Id.
13. 1997 US Tax Ct. LEXIS 3, at 19.
14. Id. at 24.
15. No selling expenses were allocated to the covenant not to compete.
16. 1997 US Tax Ct. LEXIS 3, at 24.
17. Id. at 9. The Taxpayer owned one share, while Damca owned the remaining 1,597,135,239 shares.
18. 1997 US Tax Ct. LEXIS 25, at 10.
19. Id.
20. 1997 US Tax Ct. LEXIS 25, at 4.
21. Id.
22. 1997 US Tax Ct. LEXIS 3, at 6, *supra* note 1. For a more detailed discussion of these regulations, see the accompanying text at notes 44-61 below.
23. 1997 US Tax Ct. LEXIS 25, at 7.

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the Court had relied on the Commissioner's statement that the proposed regulations were expected to be finalized in early 1997.[24] Although the statute directing that regulations be issued was enacted over 10 years ago, no final regulations have yet been issued and the Court concluded that the Taxpayer was entitled to a decision on the merits. On 18 June 1997 the Tax Court ruled on the stock loss issue in *IMC 2*.

III. THE ISSUES

The two issues facing the Tax Court in *International Multifoods Corp. v. Commissioner* were:

- What portion, if any, of the gain realized by the Taxpayer upon the sale of its Asia-Pacific operations constitutes foreign source income for purposes of computing the US foreign tax credit limitation under Section 904?[25]
- Is the loss suffered by the Taxpayer upon its sale of the stock of Paty S.A. Produtos Alimenticios, Ltda. to be treated as US source for purposes of calculating the US foreign tax credit limitation under Section 904?[26]

IV. THE LAW

A. *IMC 1*: Proper tax treatment of goodwill and covenant not to compete

The rules applicable to the sourcing of income are found under Section 865 and provide that income from the sale of personal property by a US resident is generally treated as US source.[27] In the case of the sale of an intangible, this general rule applies only to the extent that the payments received as consideration for the sale are not contingent on the productivity, use, or disposition of the intangible.[28] An intangible is defined for these purposes as any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other similar property.[29] However, a special rule is provided in the case of goodwill which sources payments received in consideration therefor based on the country in which the goodwill was generated.[30]

B. *IMC 2*: Sourcing of losses on the disposition of stock

The general rules governing the treatment of income as US source are found in Section 861(a), while those applicable to foreign source income are found in Section 862(a). The IRS is authorized by statute to issue regulations governing the allocation of both US and foreign source expenses, losses, and deductions.[31] Under the regulations, deductions are allocated against the class of gross income to which they definitely relate.[32] The regulations also set forth rules governing the allocation of losses arising from the disposition of a capital asset or property described in Section 1231(b),[33] such that such losses are considered definitely related and allocable to the class of gross income to which the property ordinarily gives rise in the hands of the taxpayer.[34]

Under Section 865, income from the sale of non-inventory personal property[35] is sourced based on the residence of the seller.[36] The policy reason behind this provision can be found in the House report accompanying the Tax Reform Act of 1986:

> Source rules for sales of personal property should reflect the location of the economic activity generating the income at issue or the place of utilization of the assets generating that income. In addition, source rules should operate clearly without the necessity for burdensome factual determinations, limit erosion of the US tax base and, in connection with the foreign tax credit limitation, generally not treat as foreign income any income that foreign countries do not or should not tax.
>
> Although the title passage rule operates clearly, it is manipulable. It allows taxpayers to treat sales income as foreign source income simply by passing title to the property sold offshore even though the sales activities may have taken place in the United States. In such cases, the foreign tax credit limitation may be artificially inflated. In addition, foreign countries are unlikely to tax income on a title passage basis. Thus, the title passage rule gives US persons the ability to create foreign source income that is not subject to any foreign tax, and that may ultimately be sheltered from US tax with unrelated excess foreign tax credits. In addition, it gives foreign persons the ability to generate income that should be subject to US tax.
>
> Because the residence of the seller generally is the location of much of the underlying activity that generates income derived from sales of personal property, the committee believes that sales income generally should be sourced there.[37]

The statute provides an exception for the sourcing of gain realized on a domestic corporation's sale of stock in a foreign corporation, such that the gain will be treated as foreign source if: (1) the two corporations would be members of the same affiliated group but for the exclusion of foreign corporations from affiliated groups; (2) the foreign corporation is actively engaged in a trade or business in a particular foreign country; (3) for the three-year period ending with the taxable year of the foreign corporation immediately preceding the year in which the stock disposition occurs, at least 50 per cent of its gross income was derived from the active conduct of a trade or business in that country; and (4) title to the stock

24. Id. at 8.
25. 1997 US Tax Ct. LEXIS 3, at 6.
26. 1997 US Tax Ct. LEXIS 25, at 4.
27. Sec. 865(a)(1). All statutory references are to the Internal Revenue Code of 1986, as amended, unless indicated otherwise. All regulatory references are to the regulations issued under the Internal Revenue Code.
28. Sec. 865(d)(1)(A).
29. Sec. 865(d)(2).
30. Sec. 865(d)(3).
31. Sec. 863(a).
32. Treas. Reg. § 1.861-8(b). A class of gross income is defined as the gross income to which a deduction is definitely related.
33. Sec. 1231(b) concerns the term "property used in the trade or business" and refers to (1) property used in the trade or business, of a character which is subject to depreciation, held for more than one year, and (2) real property used in a trade or business which is held for more than one year and which is not intangible property or inventory-type property.
34. Treas. Reg. § 1.861-8(e)(7).
35. Stock, not being inventory, depreciable property, goods manufactured by the taxpayer, or an intangible, is clearly treated as personal property under the general rule of Sec. 865(a).
36. Sec. 865 was enacted as part of the Tax Reform Act of 1986, Pub. L. 99-514, § 1211(a), 100 Stat. 2085, 2533 and is generally effective for tax years beginning after 31 December 1986.
37. H. Rept. 99-426, at 360 (1985), 1986-3 C.B. (Vol. 2) 1, 360.

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passes to the purchaser in the foreign country in which the trade or business is located.[38]

Section 865(j) authorizes the IRS to issue regulations which are necessary to carry out the purposes of the statute, including regulations applicable to the sourcing of losses resulting from the sale of personal property. The policy behind Section 865(j)(1) can be found in the General Explanation of the Tax Reform Act of 1986, prepared by the Joint Committee on Taxation:

> The Act provides that regulations are to be prescribed by the Secretary carrying out the purposes of the Act's source rule provisions, including the application of the provisions to losses from sales of personal property. ... It is anticipated that regulations will provide that losses from sales of personal property generally will be allocated consistently with the source of income that gains would generate but that variations of this principle may be necessary.[39]

Subsequent to the enactment of Section 865(j) but prior to the issuance of proposed regulations concerning the allocation of losses arising from the disposition of stock,[40] the only other guidance for taxpayers (save the above-discussed legislative history) was the pre-1987 rules contained in Treas. Reg. § 1.861-8(e) and limited case law. Under the pre-1987 regulations, losses were matched against the classes and groupings of income that the related assets generated. Thus, in the case of losses arising from the disposition of stock, such losses would be treated as foreign source since foreign corporations generally generate foreign source income.

The leading case on this subject is *Black & Decker Corp. v. Commissioner* (hereinafter: *B&D*)[41] In *B&D*, the taxpayer sustained a worthless stock loss when the shares it held in its wholly owned foreign subsidiary became worthless. The sole issue before the Tax Court was whether the Section 165(g)(3) loss should be treated as US or foreign source for purposes of calculating the taxpayer's foreign source income (in order to determine the foreign tax credit limitation under Section 904). In agreeing with the Commissioner's arguments and holding that the worthless stock loss is allocable against the taxpayer's foreign source income, the Tax Court compared the factual relationship approach to the automatic dividend theory with respect to the determination of the class of income to which the stock would ordinarily give rise in the hands of the taxpayer. The taxpayer argued that a loss on a stock investment is not ordinarily allocable to the dividend class of income, and characterized the arguments of the Commissioner as advocating an automatic dividend approach under which an investment in stock automatically gives rise to income (or loss) in the dividend category. The Commissioner argued that the fact that the taxpayer's investment generated no dividend income (because the foreign subsidiary had suffered losses and never paid a dividend) does not preclude a finding that the class of gross income to which the loss should be allocated is foreign source dividend income. The Tax Court agreed with the Commissioner and concluded that the regulations require an objective consideration of the facts and circumstances relating to the relationship of the Section 165(g)(3) loss to the class of income to which the stock would ordinarily give rise in the hands of the taxpayer. Since the taxpayer's investment would ordinarily give rise to dividend income, the worthless stock deduction is allocable to dividend income.

In holding that the loss was properly allocated against foreign source income, the Tax Court rejected the taxpayer's argument that the loss should be treated as US source because the investment in the foreign subsidiary was made to protect the taxpayer's US market, a market which generated US source income. The Tax Court treated the worthless stock loss as foreign source because the loss grew out of an activity and use of property in a foreign country. Foreign source dividend income was held to be the class of income which best represented the taxpayer's expected returns from the investment in the foreign subsidiary. This holding was subsequently upheld on appeal to the Fourth Circuit.[42] However, it has been suggested that worthless stock losses incurred after 1986 could nevertheless be treated as US source, since the loss at issue in *B&D* was incurred prior to 1987.[43] In light of the fact that a footnote to the Fourth Circuit's opinion distinguishes between pre-1987 and post-1986 law and transactions governed thereby, some have argued that under post-1986 law, such worthless stock deductions may be treated as US source.[44]

On 5 July 1996 the IRS issued the long-awaited proposed regulations under Section 865(j) concerning the allocation of losses arising from the disposition of stock (hereinafter: the stock loss regulations).[45] Under the general rule,[46] stock losses are allocated in the same manner as stock gains (as determined without regard to Sections 1248[47] and 865(f)[48]). Thus, stock losses are allocated based on the residence of the seller. Loss recognized by a US resident upon the disposition of stock attributable to a foreign branch is treated as foreign source income if a gain would have been taxable by the foreign country and the highest marginal rate of tax imposed in that foreign country is at least 10 per cent.[49] Loss recognized

38. Sec. 865(f), (i)(4).
39. Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, at 922-923 (J. Comm. Print 1987) (hereinafter: General Explanation).
40. For a discussion of the regulations, see text at notes 44-61 below.
41. TC Memo. 1991-557, *aff'd* 986 F.2d 60 (4th Cir. 1993). See also *Ferro-Enamel Corp v. Commissioner*, 43-1 USTC 69369, 134 F.2d 564 (6th Cir.).
42. 986 F.2d 60 (4th Cir. 1993).
43. D.E. Wilson and J.T. Womack, "Proposed Regs May Improve Treatment of Losses on Foreign Stock Dispositions," 96 *TNI* 177-15.
44. Id. See 986 F.2d at 62, n. 1.
45. 61 Fed. Reg. 35698 (8 July 1996). The proposed regulations will become effective for taxable years beginning after the date that is 60 days after the date that the regulations are published as final regulations in the Federal Register. However, the regulations contain a provision which allows the taxpayer to elect retroactive application of the regulations to all of its open tax years which begin after 31 December 1986. See Treas. Reg. § 1.865-2(e).
46. Treas. Reg. § 1.865-2(b). Under Treas. Reg. § 1.865-1, the allocation of a loss arising from the disposition of property not governed by Treas. Reg. 1.865-2 (i.e. personal property other than stock) will continue to be governed by the generally applicable rules of Treas. Reg. 1.865-8, except as specified in other administrative pronouncements.
47. Under Sec. 1248, when a US shareholder disposes of CFC stock, any gain thereon is treated as dividend income to the extent of the earnings and profits generated by the CFC while the taxpayer owned the shares.
48. Sec. 865(f) concerns the sourcing of income from the sale by a domestic corporation of stock in a foreign affiliate.
49. Treas. Reg. § 1.865-2(a)(2).

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by a non-resident alien individual or foreign corporation with respect to stock constituting a US real property interest reduces US source income.[50]

The proposed regulations contain several exceptions to the general rules discussed above. Under the dividend recapture rule,[51] if a taxpayer realizes a loss upon the disposition of stock within 24 months following the inclusion of a dividend or similar amount, a certain amount of that dividend must be recaptured. Once the rule applies, the loss, to the extent of the dividend recapture amount, will be allocated to the same class of gross income as the dividend. However, a de minimis rule provides that there will be no recapture if the sum of all dividend recapture amounts is less than 10 per cent of the realized loss.[52] A dividend recapture amount[53] is defined in the regulations to include:

- an actual dividend,
- a subpart F inclusion attributable to non-passive basket foreign personal holding company income of the controlled foreign corporation (hereinafter: CFC) which is attributable to a dividend received by the CFC,[54]
- a non-passive basket qualified electing fund[55] (hereinafter: QEF) inclusion attributable to a dividend received by a QEF, and
- an inclusion attributable to Sections 956 or 956A.[56]

The preamble to the proposed regulations states that dividends from foreign corporations, which are often sheltered from US tax by application of the US foreign tax credit and do not reduce the shareholder's basis in the stock, may reduce the selling price of the stock, thereby creating or increasing a loss on the sale. In the same vein, the specified subpart F inclusions may increase the shareholder's basis in the stock without substantially affecting the value of the stock; this results in similar opportunities to create a tax mismatch resulting from an economic "wash" by pairing tax-sheltered foreign source income and US source losses.

Under Treas. Reg. § 1.865-2(b)(2), a second exception to the general rule is provided. The consistency rule generally requires that loss recognized upon the disposition of an 80 per cent-owned foreign affiliate reduces foreign source passive basket income if, within the preceding five years, the seller or any member of its consolidated group recognized gain on the disposition of a foreign affiliate which gain was treated as foreign source under Section 865(f). However, where taxpayers could have taken steps to avoid Section 865(f) treatment on gain sales occurring before publication of the proposed regulations, the five-year look-back period will be phased in so that losses will be tainted only by gains recognized after 6 September 1996. Application of this rule results in a punitive taint in cases where Section 865(f) was used within the past five years.

The final exception to the general rule takes the form of a broad anti-abuse rule.[57] This provision is designed to prevent taxpayers from changing the allocation of a built-in loss resulting from the disposition of stock or other personal property by entering into certain reorganization transactions. The anti-abuse rule will apply where any of the following transactions are entered into and "one of the principal purposes" is to change the allocation of a built-in loss:

- a reorganization within the meaning of Section 368(a);
- a liquidation under Section 332;
- a transfer to a foreign corporation under Section 351;
- a transfer to a partnership under Section 721;
- a transfer to a trust;
- a distribution by a partnership;
- a distribution by a trust; or
- a transfer to or from a qualified business unit (hereinafter: QBU)[58] within the meaning of Section 989(a).

Application of this rule will result in the allocation of the loss as if it were recognized on the disposition of stock or other personal property immediately prior to the transaction. In addition, if a loss recognized by a taxpayer as a result of a disposition of stock in a corporation is primarily attributable to a loss with respect to one or more financial instruments held by the corporation, and one of the taxpayer's principal purposes[59] for holding the financial instrument(s) through the corporation is to allocate the loss under Treas. Reg. § 1.865-2, that stock loss will be allocated under Treas. Reg. § 1.865-1 as if it were recognized upon the disposition of the financial instrument(s).

In the case of dispositions of stock by a partnership, a partner's distributive share of any loss resulting therefrom will be allocated and apportioned as if the partner had disposed of the stock.[60] If a sale of stock is attributable to an office or other fixed place of business of the partnership (within the meaning of Section 865(e)(3)), that office or fixed place of business will be considered to be an office of the partner for these purposes.[61] As a result, if the office or fixed place of business is not located in the United States, the loss will be treated as foreign source. An additional provision is included concerning worthless stock which states that worthlessness

50. Treas. Reg. § 1.865-2(a)(3). See Sec. 897 and the regulations thereunder for additional rules governing the treatment of such losses.
51. Treas. Reg. § 1.865-2(b)(1)(i).
52. Treas. Reg. § 1.865-2(b)(1)(ii).
53. Treas. Reg. § 1.865-2(d)(2).
54. This provision is meant to refer to subpart F inclusions resulting from dividends received from lower-tier subsidiaries.
55. Under Secs. 1291-1297, the passive foreign investment company (hereinafter: PFIC) rules apply to the US shareholders of a foreign corporation if at least 75 per cent of the corporation's income is passive or at least 50 per cent of its assets generate passive income. One alternative available to shareholders of a PFIC is to elect to treat the PFIC as a qualified electing fund (hereinafter: QEF). Under this alternative, QEF shareholders are taxed on their share of the PFIC's income as it is realized by the PFIC.
56. Under Sec. 956, a US shareholder of a CFC is subject to current taxation on its pro rata share of any increase in the CFC's investment of earnings in US property. Under Sec. 956A, a US shareholder of a CFC is subject to current taxation of CFC earnings to the extent that the CFC's investment in passive assets exceeds 25 per cent of all its assets.
57. Treas. Reg. § 1.865-2(b)(3).
58. A QBU is defined as a separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records.
59. Whether a taxpayer has "a principal purpose" to allocate loss under Treas. Reg. § 1.865-2 is determined by taking into account all the facts and circumstances, including whether the corporation engages in business activities (other than trading financial instruments) and whether the taxpayer or any related person(s) hold positions that offset loss positions held by the corporation. A person may be deemed to have a principal purpose of affecting loss allocation even though such purpose is outweighed by other purposes (taken together or separately).
60. Treas. Reg. § 1.865-2(c)(1).
61. Id.

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which gives rise to a deduction under Section 165(g)(3) with respect to stock will be treated as a disposition.[62]

V. ARGUMENTS

A. *IMC 1*

With respect to the goodwill, the Taxpayer first argued that the franchisor's interest it conveyed to Duskin consisted exclusively of intangible assets in the form of goodwill (i.e. franchises, trademarks, and the Mister Donut system).[63] According to the Taxpayer, it follows that the income attributable to the sale of this goodwill should be characterized as foreign source under Section 865(d)(3). The Commissioner countered that, although not labelled as such, Duskin actually acquired a territorial franchise from the Taxpayer for the operating and non-operating countries.[64] However, the Taxpayer went on to argue that it did not sell Duskin a franchise, but rather the entire Mister Donut franchising business in the Asia-Pacific region. In order for the sale to be classified as the sale of a franchise, the franchisor must retain an interest in the business, and the Taxpayer argued that it did not retain the requisite interest following the sale to Duskin. Finally, the Commissioner argued that any goodwill associated with the Asia-Pacific franchise business was part of, and inseverable from, the franchisor's rights and trademarks acquired by Duskin.[65] As a result, any gain attributable to the sale of the franchise and trademarks generates US source income, since Section 865 generally sources income based on the residence of the seller.

With respect to the covenant not to compete (hereinafter: the covenant), the Commissioner took the position that the covenant, like the goodwill, was inseverable from the franchisor's interest that the Taxpayer conveyed to Duskin.[66] The franchise rights Duskin acquired provided it with the exclusive right to use the know-how, trade secrets, trademarks, and other components of the Mister Donut system in the operating and non-operating countries. The Commissioner averred that any competition or disclosure of the Mister Donut system by the Taxpayer in these countries would have deprived Duskin of the beneficial enjoyment of the rights which it had acquired.[67] Thus, the Taxpayer's covenant should be viewed as an inseverable element of the franchisor's interest acquired by Duskin. If such an agreement can be segregated, so much as is paid for the covenant not to compete is ordinary income, rather than income from the sale of a capital asset.

Finally, with respect to the allocation of the purchase price to the covenant, the Taxpayer argued that its allocation should be respected; case law indicates that an allocation in a purchase agreement to a covenant not to compete should be respected for Federal tax purposes if it was the intent of the parties to make such an allocation and the covenant possessed independent economic significance.[68] However, the Taxpayer bears the burden of proof with respect to the proper allocation of the purchase price.[69]

B. *IMC 2*

In support of its claim for a refund, the Taxpayer argued that Section 865 mandates symmetrical treatment of gains and losses arising from the sale or other disposition of stock.[70] Since the Taxpayer is a US resident, its loss from the sale of the Paty stock must be treated as US source. In response, the Commissioner argued that Section 865 applies solely to the sourcing of income from the sale of personal property.[71] The Commissioner also maintained that the rules applicable to the allocation of losses are those contained in regulations promulgated under Sections 861(b) and 862(b), since the Tax Reform Act of 1986 did not modify the pre-existing regulations concerning the allocation of losses from the sale of personal property.[72]

The Commissioner took the position that since the Taxpayer's investment in Paty would ordinarily give rise to foreign source income (presumably in the form of dividends), the Taxpayer's loss on the disposition of such stock should be treated as foreign source.[73] (This argument is based on the holding in *Black & Decker*.[74]) The fact that the Taxpayer never received any dividends from Paty is irrelevant to the determination of the class of gross income to which the Paty stock loss should be allocated, since such a determination is based on an objective analysis of the facts and circumstances. With respect to the matter of the issuance of regulations under Section 865, the Commissioner averred that nothing in that section requires the IRS to promulgate "any particular rule" concerning the allocation of losses arising from the disposition of personal property.[75]

VI. THE TAX COURT DECISION OF 29 JANUARY 1997: *IMC 1*

In holding that the goodwill inherent in the Mister Donut business in the Asia-Pacific region was embodied in, and inseverable from, the Taxpayer's franchisor interest and trademarks which were conveyed to Duskin, the Court first rejected the Taxpayer's interpretation of the term "goodwill."[76] The Taxpayer's argument that the franchisor's interest it conveyed to Duskin consisted exclusively of intangibles

62. Treas. Reg. § 1.865-2(c)(2).
63. 1997 US Tax Ct. LEXIS 3, at 26.
64. Id. at 30.
65. Id. at 35-36.
66. Id. at 43.
67. Id.
68. 1997 US Tax Ct. LEXIS 3, at 46, citing *Major v. Commissioner*, 76 TC 239, 246 (1981).
69. Tax Court Rules of Practice and Procedure, Rule 142(a); *Welch v. Helvering*, 290 US 111, 115 (1933); *Peterson Mach. Tool, Inc. v. Commissioner*, 79 TC 72, 81 (1982), *aff'd. without published opinion* 54 AFTR 2d 84-5407, 84-2 USTC par. 9885 (10th Cir. 1984).
70. 1997 US Tax Ct. LEXIS 25, at 14.
71. Id. at 14.
72. Id.
73. 1997 US Tax Ct. LEXIS 25, at 15.
74. See text at *supra* notes 40-43.
75. 1997 US Tax Ct. LEXIS 25, at 18.
76. 1997 US Tax Ct. LEXIS 3, at 27.

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in the form of goodwill, mistakes goodwill for the intangible assets which embody it. The Court went on to discuss goodwill, noting that the essence of goodwill exists in a preexisting business relationship founded upon a continuous course of dealing that can be expected to continue indefinitely.[77] However, an asset does not constitute goodwill merely because it contributes to this expectancy of continued patronage.

In holding that the income attributable to the sale of the franchisor interests and trademarks is properly treated as US source, the Court rejected the Taxpayer's argument equating goodwill with the other assets listed in the definition of the term "intangible" in Section 865(d)(2).[78] The Court reasoned that Congress' enumeration of goodwill in Section 865(d)(2) as a separate intangible asset necessarily indicates that the special sourcing rule contained in Section 865(d)(3) is applicable only where goodwill is separate from the other intangible assets which are specifically mentioned in Section 865(d)(2). The Taxpayer's interpretation (i.e. that the special sourcing rule contained in Section 865(d)(3) also extended to the goodwill element embodied in other intangible assets mentioned in Section 865(d)(2)) was rejected by the Court because it would invalidate the general rule that income from the sale of an intangible asset by a US resident is to be treated as US source income.[79]

The Court next addressed the issue of the characterization of the interest transferred by the Taxpayer to Duskin and held that the sale of the Mister Donut operations by the Taxpayer constituted the sale of a "franchise" for purposes of Section 865(d)(2).[80] Although Section 865 does not define the term "franchise," it is defined in Section 1253(b)(1) for purposes of Section 1253(a) to include "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." Since there is no indication that Congress intended the term "franchise" as used in Section 865 to carry a meaning other than the common understanding of the term, the Court adopted this definition for purposes of Section 865.[81] Under Section 1253(a), the transfer of a franchise will not be treated as the sale or exchange of a capital asset if the transferor retains a significant power, right, or continuing interest with respect to the subject matter of the franchise. Based on this statutory language and the Tax Court's holding in *Jefferson-Pilot Corp. v. Commissioner*,[82] the Court rejected the Taxpayer's interpretation of the term "franchise"[83] and concluded that the sale to Duskin was one of a franchise for purposes of Section 865(d)(2). The language of Section 1253(a) implies that a franchise can in fact be transferred without the retention by the transferor of any significant degree of control.

The Court agreed with the Commissioner that any goodwill associated with the Asia-Pacific franchise business was part of, and inseverable from, the franchisor's rights and trademarks acquired by Duskin.[84] The Court also accepted the Commissioner's argument that any gain attributable to the sale of a franchise or trademark produces US source income, since Section 865 generally sources income based on the residence of the seller. Although there are no cases on point under Section 865, case law interpreting other Code provisions supports the Commissioner's arguments. For example, in *Canterbury v. Commissioner* (hereinafter: *Canterbury*),[85] the Tax Court considered the issue of whether the attributes encompassed by the McDonald's franchise which have traditionally been viewed as non-amortizable goodwill, were embodied in the McDonald's franchise, trademarks, and trade name (which would thereby make their cost amortizable under Section 1253(d)(2)(A)), or whether the franchisee acquired intangible assets (e.g. goodwill) which were not encompassed by, or otherwise attributable to the franchise and which were non-amortizable.[86] The Court concluded that the expectancy of continued patronage which McDonald's enjoys "is created by and flows from the implementation of the McDonald's system and association with the McDonald's name and trademark."[87] The taxpayer acquired no goodwill that was separate and apart from the goodwill inherent in the McDonald's franchise, as the franchise acts as the repository for goodwill.[88] Consequently, the Court held that the goodwill produced by the McDonald's system was embodied in, and inseverable from, the McDonald's franchise acquired by the taxpayer.[89] Thus, the taxpayer acquired no goodwill distinct from the goodwill inherent in the McDonald's franchise.

In concluding in the instant case that the Taxpayer failed to prove that it transferred any goodwill separate and apart from the goodwill inherent in the franchisor's interest and trademarks which the Taxpayer conveyed to Duskin, the Court compared the facts at hand to those in *Canterbury* and other similar cases. Mister Donut's business success resulted from the Mister Donut system and the high standards for quality

77. Id. at 28, citing *Canterbury v. Commissioner*, 99 TC 223, 247; *Computing & Software, Inc. v. Commissioner*, 64 TC 223, 244 (1975); *Newark Morning Ledger Co. v. United States*, 507 US 546, 556 (1993)("The value of every intangible asset is related, to a greater or lesser degree, to the expectation that customers will continue their patronage [i.e. to goodwill]").
78. Id. at 28. Sec. 865(d)(2) defines the term "intangible" to include secret processes or formulae, goodwill, trademarks, and franchises. However, Sec. 865(d)(3) provides a special rule which sources goodwill to the country in which it was generated.
79. Id. at 29. See *Torres v. McDermott, Inc.*, 12 F.3d 521, 526 (5th Cir. 1994); *Israel-British Bank (London), Ltd. v. FDIC*, 536 F.2d 509, 512-513 (2d Cir. 1976); *Edward B. Marks Music Corp. v. Colorado Magnetics, Inc.*, 497 F.2d 285, 288 (10th Cir. 1974)("[i]t is the general rule that a proviso should be strictly construed to the end that an exception does not devour the general policy which a law may embody").
80. Id. at 35.
81. Id. at 31.
82. *Jefferson-Pilot Corp. v. Commissioner*, 98 TC 435 (1992), aff'd 995 F.2d 530 (4th Cir. 1993)(hereinafter: *Jefferson-Pilot*). In *Jefferson-Pilot*, the taxpayer's subsidiary purchased three radio stations and sought a deduction under Sec. 1253(d)(2) for a portion of the purchase price which it claimed was attributable to Federal Communications Commission (hereinafter: FCC) broadcast licences transferred as part of the sale. The Court held that the FCC licences constituted franchises under Sec. 1253, and a ratable portion of the purchase price attributable to the licences was deductible under Sec. 1253(d)(2). As support for its holding, the Court noted that the FCC had retained the right to disapprove of any assignment of the licences, as well as the right to prescribe standards of quality for broadcasting services and for the equipment used to broadcast.
83. 1997 US Tax Ct. LEXIS 3, at 33.
84. Id. at 35-36.
85. 99 TC 223 (1992).
86. Id. at 247.
87. Id. at 248.
88. Id. at 249.
89. Id.

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and service, which the franchisees were required to meet.[90] Although these characteristics produced goodwill in the operating countries, this goodwill was embodied in the franchises and trademarks conveyed to Duskin. Thus, the income attributable to the sale of the franchise or trademarks was treated as US source under Section 865(d)(1).

The Court went on to analyse the proper treatment of the covenant not to compete (which prohibited the Taxpayer from carrying on any business similar to Mister Donut or disclosing any part of the Mister Donut system in certain Asia-Pacific nations) and held that this agreement possessed independent economic significance and was severable from the Taxpayer's franchisor interest and trademarks.[91] In other words, the covenant not to compete did more than just preclude the Taxpayer from depriving Duskin of rights which it had acquired in purchasing the Taxpayer's franchise rights and trademarks. As a result, the amount which is paid for the covenant not to compete is treated as ordinary income and not income from the sale of a capital asset.[92]

Finally, on the issue of the allocation of the purchase price, the Court declined to rely on the allocation contained in the purchase agreement.[93] The Court did not agree with the testimony of the Taxpayer's expert witness and ultimately concluded that USD 300,000 should be allocated to the covenant not to compete.[94] The Commissioner had already conceded that any amount allocated to the covenant would be foreign source income to the Taxpayer.[95]

VII. THE TAX COURT DECISION OF 18 JUNE 1997: *IMC 2*

In its analysis of the proper sourcing of a worthless stock deduction related to a wholly owned foreign subsidiary, the Court first remarked that the Commissioner's reliance on Sections 861 and 862 to justify the application of Treas. Reg. § 1.861-8(e)(7) is misplaced, since those sections are inapplicable to the instant case.[96] The Tax Reform Act of 1986 amended these sections so as to make them inapplicable to the sale of non-inventory personal property.[97] The impact of the amendments becomes more apparent when the current version of Section 861(a) is viewed in the context of Section 861(b), which provides as follows:

> From the items of gross income specified in subsection (a) as being income from sources within the United States, there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto.[98]

After being amended in 1986, Section 861(a) no longer "specifies" gross income which is derived from the sale of non-inventory personal property. A similar provision is contained in Section 862(a) and (b) with respect to foreign source income and related losses. As a result, the Court concluded that the pre-1987 versions of Sections 861 and 862 are no longer applicable to the determination of the source of gain or loss on the sale of non-inventory personal property.[99]

The Court went on to reject the Commissioner's argument which was based on the holding in *Black & Decker*, noting that such reliance was again misplaced.[100] In affirming the Tax Court's decision in that case, the Fourth Circuit stated that the case was governed by the Internal Revenue Code of 1954, which has been superseded by the Internal Revenue Code of 1986.[101] Since the transactions in the instant case took place post-1986 and since the law is different for pre-1987 and post-1986 sales of stock, *Black & Decker* is not applicable to the disposition of the case at hand.

Next, the Court refused to follow the Commissioner's interpretation of Section 865(j). Even though Section 865(j)(1) states that, "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purpose of this section, including regulations ... relating to the treatment of losses," the Commissioner contended that nothing in Section 865 requires the Treasury to promulgate "any particular rule" concerning the allocation of losses on the disposition of personal property.[102] The Court reasoned that by enacting Section 865(j)(1) directing the Secretary to issue regulations necessary to carry out the purpose of this section (i.e. residence-based sourcing), Congress intended to change the rules regarding the allocation of losses realized on the sale of non-inventory personal property.[103] In other words, the enactment of Section 865(j) indicates that the pre-1986 regulations were no longer in accord with the intent of Congress in enacting the Tax Reform Act of 1986.

The purpose behind Section 865(j)(1) can be found in the General Explanation of the Tax Reform Act of 1986 (hereinafter: the General Explanation), which states:

> The Act provides that regulations are to be prescribed by the Secretary carrying out the purposes of the Act's source rule provisions, including the application of the provisions to losses from the sales of personal property ....It is anticipated that regulations will provide that losses from sales of personal property generally will be allocated consistently with the source of income that gains would generate but that variations of this principle may be necessary ...[104]

If Congress has directed that regulations be issued to carry out a statutory purpose, the fact that regulations are not forthcoming cannot be used as a basis for frustrating the legislative objective.[105] The Commissioner, however, argued that

90. 1997 US Tax Ct. LEXIS 3, at 41.
91. Id. at 45.
92. Id. citing *Horton v. Commissioner*, 13 TC 143, 147 (1949).
93. Id. at 45.
94. Id. at 51.
95. Id. at 43.
96. 1997 US Tax Ct. LEXIS 25, at 15-16.
97. Id. See Tax Reform Act of 1986, Sec. 1211(b)(1)(B) and (C), 100 Stat. 2536.
98. Sec. 861(b).
99. 1997 US Tax Ct. LEXIS 25, at 16.
100. Id. at 17
101. *Black & Decker Corporation v. Commissioner of Internal Revenue*, 986 F.2d 60, 62, n. 1.
102. 1997 US Tax Ct. LEXIS 25, at 18.
103. Id.
104. Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 922-923 (J. Comm. Print 1987).
105. 1997 US Tax Ct. LEXIS 25, at 19-20, citing *Estate of Neumann v. Commissioner*, 106 TC 216, 221 (1996); *H. Enters. Intl., Inc. v. Commissioner*, 105 TC 71, 82 (1995); *First Chicago Corp. v. Commissioner*, 88 TC 663, 669 (1987), *aff'd* 842 F.2d (7th Cir. 1988); *Occidental Petroleum Corp. v. Commissioner*, 82 TC 819, 829 (1984).

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the Court's decision in *Occidental Petroleum*[106] was distinguishable because: (1) the statute requiring the issuance of regulations which was at issue in *Occidental Petroleum* explicitly provided that a specific rule was to be adopted by the regulations, whereas Section 865(j) merely provides that regulations are to be issued with respect to a particular subject matter, but does not state or imply what rules are to be adopted with respect thereto and (2) the legislative intent underlying the statute at issue in *Occidental Petroleum* was well documented in the accompanying committee reports, whereas no reference is made to Section 865(j) in the relevant committee reports.[107]

These arguments were rejected by the Court in the instant case because Congress did in fact intend that a "particular rule" be embodied in regulations promulgated under Section 865(j), namely that residence-based sourcing would generally be used to characterize losses suffered on the sale of non-inventory personal property.[108] In addition, the General Explanation does in fact articulate that it was expected that losses generally would be sourced in a manner similar to that applied to gains.[109] In enacting Section 865, Congress determined that the "residence of the seller generally is the location of much of the underlying activity that generates income derived from sales of personal property."[110] Since Section 865(j)(1) directs that regulations be issued to carry out the purpose of Section 865, gains and losses on the sale of non-inventory personal property are generally sourced at the residence of the seller. In addition, the Explanation of Provisions accompanying the regulations states that:

> [Treas. Reg.] [s]ection 1.865-2(a) provides the general rule that stock losses are allocated in the same manner as stock gains... Thus, stock loss generally is allocated to the residence of the seller.[111]

Also, if the proposed regulations are enacted in their current form, the Taxpayer's stock loss would be sourced at the residence of the seller (i.e. treated as US source). Thus, by applying the general rule of residence-based sourcing, the Court held that the loss suffered by the Taxpayer upon its sale of the Paty stock should be treated as US source for purposes of computing the Taxpayer's foreign tax credit limitation under Section 904(a).[112]

VIII. COMMENT

The most significant of the two decisions rendered in *International Multifoods Corporation and Affiliated Companies v. Commissioner* is the June, 1997 ruling on the treatment of losses suffered upon disposition of stock held in a foreign affiliate. The source rules found in Sections 861 through 865 play a vital role in the calculation of the taxpayer's foreign tax credit limitation under Section 904. The purpose of the foreign tax credit limitation is to restrict the availability of the credit to income which would, but for the credit, be subject to both US and foreign tax. The formula for the foreign tax credit limitation is as follows:

$$\text{Pre credit US tax liability} \times \frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income}}$$

Since the greater the foreign source taxable income, the greater the allowable foreign tax credit, it is obvious that taxpayers would often effect their tax planning with an eye towards increasing foreign source income. By treating losses suffered upon the disposition of stock held in a foreign affiliate as US source, the proposed regulations under Section 865(j) represent a long-awaited step towards validating the tax treatment which some taxpayers had been affording such losses prior to the issuance of the regulations. Following the amendment of the source rules in 1986, some taxpayers relied on the legislative history behind the Tax Reform Act of 1986 to claim US source treatment of losses related to the disposition of shares held in a foreign affiliate. However, these efforts were sometimes met with resistance from the IRS in the form of audit adjustments and litigation.[113]

However, following the Tax Court's ruling in *IMC 2*, taxpayers now have substantial authority for purposes of taking a tax return position that stock losses from the disposition of a foreign affiliate should be treated as US source. The Code imposes a penalty of 20 per cent of the underpayment of tax required to be shown on a taxpayer's return.[114] If a taxpayer has "substantial authority" for the tax treatment of an item, the item is treated as if it were shown properly on the return.[115] In other words, the tax attributable to such item is not included in the understatement for the year. Under the regulations, there is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial vis-à-vis the weight of the authorities supporting a contrary treatment. Among the types of authority which will be considered for these purposes are the following:

- the Code;
- proposed, temporary, and final regulations construing the Code;
- revenue rulings and procedures;
- tax treaties and regulations thereunder;
- court cases;
- congressional intent as reflected in committee reports; and

106. *Occidental Petroleum Corp. v. Commissioner*, 82 TC 819, 829 (1984). The Court stated that the failure to issue regulations as required by statute "can hardly render the new [statutory] provisions...inoperative. We must therefore do the best that we can with these new provisions."
107. 1997 US Tax Ct. LEXIS 25, at 22.
108. Id. at 22.
109. Id. at 23, citing *Rivera v. Commissioner*, 89 TC 343, 34, n. 7 (1987). The Court noted that although the General Explanation technically does not rise to the level of legislative history, both the Supreme Court and the Tax Court have looked to the General Explanation in analysing tax statutes and the General Explanation is entitled to "great respect."
110. Id. at 23, citing H. Rept. 99-426, 1986-3 CB (Vol. 2) at 360.
111. 61 Fed. Reg. 35697 (8 July 1996).
112. 1997 US Tax Ct. LEXIS 25, at 24-25. However, the Court states in a footnote to its decision that its holding in this case is narrow in scope and is not to be construed to mean that stock losses must always be sourced at the residence of the seller. The General Explanation notes that exceptions to the general rule may be necessary to prevent abuse, and this fact makes the Court's holding somewhat narrower in scope than it might appear at first blush.
113. M.E. Mares, "AICPA Suggests Changes to Loss Allocation Regs," 96 *TNI* 241-31.
114. Sec. 6662(a).
115. Treas. Reg. § 1.6662-4(d)(1).

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– general explanations of tax legislation prepared by the Joint Committee on Taxation (often referred to as "the Blue Book").

In light of the legislative history, the proposed regulations, and the Tax Court's upholding of the position taken by the proposed regulations, there is substantial authority for taking an undisclosed return position that a loss on the disposition of stock held in a foreign affiliate should be treated US source.

Conference diary

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

JANUARY

Anti-Avoidance, Dukes Hotel, London, the United Kingdom, 22-23 January 1998 (English):

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

Fifth Annual Corporate Tax Managers' Conference, the Berkeley Hotel, London SW1X 7RL, the United Kingdom, 22-23 January 1998 (English):

Jennifer Lockley, Customer Service Manager, IIR Ltd., 6th Floor, 29 Bressenden Place, London SW1E 5DR, Tel.: 44-171-915 5182, Fax: 44-171-393 0313.

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

Transfer Pricing, Berners Hotel, London, the United Kingdom, 28-29 January 1998 (English):

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

Annual Conference on Tax Investigations, the Merchant Centre, London EC4, the United Kingdom, 29 January 1998 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-673 4383, Fax: 44-171-453 2036, E-mail: jennifer.mansour@ibcuk.co.uk

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

Tax Reform in Russia, the Moscow Aerostar Hotel, 37 Leningradsky Prospect, Moscow, 9-10 February 1998 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

Transfer Pricing in Pharmaceuticals, Vienna Hilton, Vienna, Austria, 16-17 February 1998 (English):

Vision in Business Ltd, , 30 City Road, London EC1Y 2AY, Tel.: 44-171-256 5188, Fax: 44-171-256 9393, E-mail: vispharma@aol.com

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

Tax Reform in Mexico, Frankfurt, Germany, 9 January 1998, London, the United Kingdom, 11 March 1998 and Paris, France, 13 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

Tax Treatment of NGOs, A Round-Table, Stork Museum, Amsterdam, the Netherlands, 8-10 March 1998 (English):

The Europhil Trust, Willem de Koning, Zeezigt 80, 1111 TM Diemen, the Netherlands, Fax: 31-20-690 9579, Chief Trustee's Office, Tel.: 333 88 561 646.

APRIL

International Tax Planning Techniques, Amsterdam, the Netherlands, 6-7 April 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

MAY

International Tax Aspects of Financial Derivatives, Amsterdam, the Netherlands, 14-15 May 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

JUNE

International Tax Aspects of Permanent Establishments, Amsterdam, the Netherlands, 18-19 June 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

AUGUST

Summer Course on the Principles of International Taxation, Amsterdam, the Netherlands, 17-28 August 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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IFA NEWS

SOME HIGHLIGHTS FROM THE SECRETARY GENERAL'S 1996/1997 ANNUAL REPORT

J. Frans Spierdijk

INTRODUCTION

During the Geneva General Assembly Sven-Olof Lodin (Sweden) was unanimously appointed as President-Elect of the Association, to succeed our friend Pietro Adonnino at the close of the New Delhi Congress. Pietro will at that time have served IFA for four years, and already at this stage I wish to thank him most sincerely for his friendship and for his devoted and inspiring leadership. IFA continues to grow and flourish, thanks to the invaluable efforts and resources of many, and Sven-Olof can be sure to take over the helm of a healthy Association.

Another unanimous appointment, made by the General Council in Geneva, was Prof. Jacques Malherbe (Belgium) in the function of Vice-Chairman of the Permanent Scientific Committee. Our congratulations to him and our thanks for his willingness to accept this demanding position.

You may be interested to learn that, subject to the approval of the General Council, a small Committee will be set up, consisting of the President, the previous President, the Chairman of the PSC, the General Treasurer, the Chairman of the Nominations Committee and the undersigned. This Committee may make recommendations with regard to the appointment of the President, Secretary General, (Vice) Chairman of the Permanent Scientific Committee and General Treasurer to the Executive Committee. Proposed names for the functions mentioned-above may be presented to this Committee on an ongoing basis. The selection procedure will thus become more open, which, as we understand from feedback from our membership, will be appreciated.

You will have seen that the IFA General Secretariat is accessible nowadays via the World Wide Web. I urge you to use it, since it is an efficient and economical way of communicating. Please regularly check our WEB page http://www.ifa.nl for up-to-date information about the activities of our Association.

It is sad to remind you that in this year IFA lost a prominent member. Mr Demetrios Tsingris, long-time Chairman and Honorary Chairman of our Greek Branch and member of our Association for over 50 years, passed away. In the 1996 Yearbook his friend George Stathopoulos wrote a moving obituary note, paying tribute to this grand and warm personality. Just-before going to print we received the sad news of the demise of our Honorary Member, Prof. Ramón Valdés Costa from Uruguay. I am sure his death is a tremendous shock for many IFA members, and in particular for our members in Latin America.

GENEVA CONGRESS

The fourth Congress in Switzerland, the previous ones being in Zürich in 1951, Basle in 1960 and Lausanne in 1973, proved to be very interesting and enjoyable. The Congress attracted 1394 participants and 452 accompanying persons. The Organizing Committee, under the efficient and stimulating leadership of Me Pierre Gillioz, worked extremely hard to ensure a smooth running of the Congress. The excellent services of Symporg, Geneva, are also gratefully acknowledged. The fact that this was our fiftieth Congress was celebrated by a special show of the finest circus in Switzerland. Many of you will remember the brave elephant ride by our President Adonnino and Pierre Gillioz as one of the highlights of this wonderful and exciting evening at Circus Knie. The excursion day was graced by a sky that can only be that particular colour of blue in a beautiful country like Switzerland, with the Mont Blanc proudly showing its enormous height. The Organizing Committee is to be complimented on such a perfect contract with the weather managers.

With much gratitude I would like to pay tribute to the devoted efforts of all those who were involved in the scientific programme of the Congress. The preparations and presentations require an enormous input, and it is gratifying that so many people are willing to contribute in this way on a voluntary basis.

Dr P. Athanas (Switzerland), assisted by Dr J. Jäger (Switzerland) served as General Reporter, and Mr I.W. Harris (United Kingdom) as Discussion Leader for 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". Thirty-three National Reports appear in the 1996 *Cahiers*. The Panel consisted of Mrs N. Harwerth (USA), Mr H. Langel (Germany), Mrs P. Molina (Spain), Mr M. Pinault (France) and Mrs F.K. Yip (Hong Kong). Mr H. Torrione (Switzerland) was Secretary. "International aspects of thin capitalization" appeared as the Main Subject II in the programme, and was very ably prepared and presented by Prof. D.J. Piltz (Germany) as General Reporter, and Avv. G. Gangemi (Italy) as Discussion Leader. Twenty-eight National Reporters contributed to the *Cahiers*. Panellists were Mr J. Fairley (United Kingdom), Mr T. Mizuno (Japan), Mr J. Sasseville (OECD), Mr S.E. Shay (USA) and Prof. F. Zimmer (Norway). Mrs E. Oechslin (Switzerland) served as Secretary.

Mr J.S. Hausman (Canada) chaired Seminar A which dealt with "Taxation issues in a federal state and economic groupings with concurrent taxing authorities". The Panel consisted of Prof. R.L. Deutsch (Australia), Mr S.L. Gordon (USA), Dr C. Pereira de Rezende (Brazil) and Mr J.M. Tirard (France) with Dr N. Burki (Switzerland) as Secretary. "The Influence of corporate law and accounting principles in determining taxable income" was the title of Seminar B. Prof. P. Thorell (Sweden) was Chairman, and Mrs J. Freedman (United King-

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dom), Prof. N. Herzig (Germany), Prof. M. Nakazato (Japan), Dr A. Schindel (Argentina) and Prof. J.L. Shaw (Uruguay) acted as Panellists, and Mrs J. Zumoffen (Switzerland) as Secretary. Prof. Dr A.J. Rädler was found prepared to sit in the chair of Seminar C "International tax aspects of the economic relations with Eastern Europe", assisted by Dr P.R. Altenburger (Switzerland) as Secretary.

The Panel comprised Mr G. Gundel (Germany), Mr D. Holland (OECD), Mr G. Kopits (Hungary), Mr K.V. Kotov (Russia), Prof. Dr J. Marciniuk (Poland), Mrs I. Rusakova (Russia), Dr A. Storck (Switzerland) and Dr J. Tuma (Czech Republic).

What started on a trial basis during the 1994 Toronto Congress has now become a regular, interesting and much appreciated feature of our annual Congresses. I am of course referring to the joint project with the OECD, where prominent speakers of this organization give an account of their current and forthcoming work on developing the Model Treaty and its Commentary, followed by a discussion between OECD and IFA representatives on practical questions arising under the Model.

The gavel was in the able hands of Prof. Dr K. Vogel (Germany), and the Panel consisted of Mr D. Lüthi (Switzerland), Mr J. Sasseville (Canada), and Mr M. Waters (United Kingdom) for OECD, and Mr J.D.B. Oliver (United Kingdom), Prof. A. Skaar (Norway) and Mr P. Thiria (France) for IFA. Dr I. Salvi assisted as Secretary.

An outstanding success was the Jubilee Symposium on "Visions of the tax systems of the XXI Century". The audience fell under the spell of two distinguished scholars with great experience in creating tax systems, Mr M.A. King (United Kingdom) and Prof. C.E. McLure Jr. (USA). The visions of these excellent Keynote Speakers formed the basis of a more general discussion, led by Prof. S.O. Lodin (Sweden), of what kind of tax landscape may take shape in the next century.

Members of the Panel were Mrs M. Casanegra de Jantscher (Chile), Prof. M. Monti (EU), Prof. W. Ritter (Germany) and Dr P. Shome (India). Mr X. Oberson (Switzerland) was the Secretary. Very appropriately, Chairman Lodin closed the Symposium by singing the famous "que sera, sera" song.

I am pleased that Seminars A, B, D and the Symposium will be published in our "Congress Seminar Series", by Kluwer Law International, and will hopefully be available by the time of the 1997 New Delhi Congress.

PERMANENT SCIENTIFIC COMMITTEE ("PSC")

The January/February meeting was held in Vienna upon the invitation of our Austrian Branch, who proved to be excellent hosts in every respect. Chairman Tillinghast was happy to welcome four new members of the Committee: Avv. B. Gangemi (Italy), Me P. Gillioz (Switzerland), Prof. K. van Raad (Netherlands) and Prof. F. Zimmer (Norway). Thought is being given to expand the Committee with members from Asia, as well as with members deriving from Tax Administrations.

The Geneva Congress procedures were reviewed at length, based on feedback received from IFA members. With regard to the Working Sessions of the two Main Subjects, quite a few members had commented that too much time is spent discussing the text of the draft resolutions and too little time is devoted to explaining the Subjects and discussing substantive issues. In trying to respond to this criticism the PSC has been careful not to give up the very substantial benefit of the new procedures, particularly in terms of improving the thoroughness with which the Subjects are prepared, focusing the discussions on specific issues and encouraging active participation from the floor.

The Permanent Scientific Committee has therefore decided, as an experiment for New Delhi, that the General Reporters and Discussion Leaders prepare a discussion outline which will include specific topics to be considered. The emphasis will be on exposition and analysis and not on any particular resolution or conclusion. Separately, a series of very short and generic resolutions will be prepared, each of which will separately relate to the issues that are identified. At the end of the discussion of each segment a specified amount of time will be reserved for discussion of the relevant portion of the proposed resolution.

Proposed amendments to the resolutions will have to be submitted prior to the beginning of the discussion of the resolution and will be reviewed by two persons, to be designated by the Permanent Scientific Committee. Needless to say that feedback on how these new procedures work in practice is welcome.

We were able to engage Dr M. Lombardi (Italy) as our 1996 research associate. He made an excellent contribution to the work of the PSC, particularly concentrating on (potential) topics for our 1998 London and 1999 Jerusalem Congresses.

Out of four candidates, deriving from Australia, Canada (2) and Israel, Mr Rui Torrao (Canada) was selected for the 1997 research associate position. He started working at the IBFD in May 1997, and I understand from our Chairman of the Research Subcommittee, Prof. Kees van Raad, that he will not have to get bored since he has a full plate of topics which need to be further developed. I wish him success in his efforts.

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

Thanks to the hard work done by the General and National Reporters we have again two fine volumes of *Cahiers* for the New Delhi Congress. Thirty-one National Reports were submitted for Subject I "The taxation of income derived from the supply of technology" and 32 for Subject II "The taxation of investment funds". Five Seminars will be held, as follows:

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A – OECD Model Convention – 1997 and beyond
B – Cross-border valuation for income tax, VAT and customs duties (transfer pricing)
C – Taxation of expatriates
D – Presumptive income taxation
E – Doing business in India

The two Main Subjects for the 1998 London Congress will be I: "Tax treatment of corporate losses" with Prof. A. Michelsen (Denmark) as General Reporter; and II: "Practical issues in the application of double tax conventions" for which Prof. D. Williams (United Kingdom) has agreed to be General Reporter. Prof. D. Gliksberg (Israel) is General Reporter for the first Subject of our Jerusalem Congress in 1999 "Taxation of non-profit organizations" and Prof. M. Ellis (Netherlands) for Subject II "Advance rulings".

In close consultation with the German Branch initial discussions were held on interesting and suitable topics for the 2000 Munich Congress. In my last Report I informed you about a major new initiative by the Permanent Scientific Committee, and in particular its Chairman, David Tillinghast. I am very happy to report that the General Council, during its September 1996 Geneva meeting, unanimously agreed to the launching of the Research Project on the impact of technological and financial innovation on the taxation of income and activities.

IFA has been able to engage outstanding Rapporteurs, who, aided by Consultants, are working very hard on producing draft reports which will be circulated towards the end of 1997 to the National Branches for comments. Rapporteurs on the first segment, which analyses the impact of the communication revolution on traditional source taxation concepts, are Prof. R. Doernberg (USA) and Prof. L. Hinnekens (Belgium). Mr M. Gammie (United Kingdom) and Dr R. Pöllath (Germany) address the second segment relating to innovative financial instruments. During a meeting which will probably be held in London in the spring of 1998 representatives of each National Branch will have the opportunity to discuss the draft with its authors and present their own views. The studies will ultimately be published along with a précis of the views of the National Branches.

EXECUTIVE COMMITTEE

The Executive Committee decided to meet, earlier than usual because of climate conditions, in New Delhi for its Spring meeting. As a rule, if Congresses are held outside Europe this Committee convenes in a European city because of easy connections, the majority of its members deriving from this part of the world. However, the wish of the India Branch to acquaint the members of our Board with this part of the world – for many it was the first time that they were visiting India – was gladly honoured. Promotional Seminars were organized on this occasion in New Delhi, Bombay, Calcutta and Madras, where Executive Committee members addressed large and interested audiences. Proof of the effectiveness of this effort is the growth of our India Branch!

The warm hospitality provided by our Indian friends on this occasion will remain in our memories. I must make mention of the fact that we were very fortunate to be able to partake in the celebration of the Holi Festival at the residence of our friend O.P. Vaish, President of the Congress. Throwing paint at each other is part of the ceremony, and the photographs taken on this occasion are proof of a wonderful day full of laughter and cheerfulness.

We had a very fruitful and constructive meeting at the Oberoi Hotel, which provided excellent facilities. President Adonnino welcomed Prof. K.S. Tikka (Finland) as a new member. As regards the further composition of the Executive Committee, for the period 1997/1998 it will be submitted to the General Council for approval that Mr G. Andrew (South Africa), Mr J. Libin (USA), Mr A. Piera (Spain) and Mr A. Willemsen (Germany) be re-elected for another term of two years. Three members are due for statutory retirement at the close of the New Delhi Congress, i.e. Mr G. Dominjon (France), Prof. L. Hinnekens (Belgium) and Dr C. Pereira de Rezende (Brazil). The Branches in France, Belgium and Uruguay have been requested to propose candidates to replace these three distinguished gentlemen.

The financial position of the Association was reviewed. The General Treasurer was glad to present the results for the year 1996, showing a deficit of NLG 2,524 only, as opposed to previous, less optimistic, forecasts. The principal reason for this was the costs of the 1996 *Cahiers*, which were substantially lower than estimated, thanks to successful negotiations with the publishers and efficiency improvements achieved in the production process. The Executive Committee acknowledged with much gratitude the unrestricted contribution of CHF 50,000 of the Swiss Branch as a result of the financial success of the Geneva 1996 Congress. This favourable result was due to the sponsorship our Swiss friends have been able to collect for the Geneva Congress. In addition, the Branch has donated CHF 50,000 to a scientific project to be defined by the Permanent Scientific Committee. These contributions by Congress Organizing Branches are extremely welcome for the benefit of the entire Association. I join our General Treasurer in expressing the hope that this trend will be continued, although obviously our first aim is and continues to be to keep the Congress fees at a reasonable level.

MEMBERSHIP FEES

The General Treasurer will propose to the General Council to maintain the membership fees for 1998 at the 1997 level, 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 congratulate our General Treasurer and his able assistants on the fact that since 1990 the membership dues have remained at the same level thanks to their efficient running of the Association's financial affairs. Of course this could not be achieved without the assistance of our National

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Branches, and we owe thanks to them for their effective cooperation in collecting the fees.

In Geneva the General Council appointed Mr P. Hobbs (United Kingdom) as Chairman of the Finance Committee. I wish him success in carrying out this function, together with the members of this Committee, Mr G. Ball (USA) and Dr R. Senn (Switzerland).

NATIONAL BRANCHES AND MEMBERSHIP

We did not have the pleasure of welcoming new Branches in our midst at the 1996 Congress. However, we continue to use our best efforts to promote IFA, and, as mentioned earlier, the fact that IFA is organizing its annual Congress in the South Asia Region is already proving its effect in terms of increased membership in that part of the world.

Just before the Geneva Congress I attended the joint French/USA Branch meeting in Dijon. This provided an occasion to take part in high-level, off-the-record discussions in an amicable atmosphere. A most enjoyable experience, not in the least due to the wonderful dinner at the beautiful Clos de Vougeot.

President Adonnino and I took the opportunity of our stay in New Delhi to travel on to Taipei, in order to pay a visit to our Branch there. Vice Minister Yen, the Chairman of this Branch, extended a warm welcome, and it was gratifying to witness at first hand how active this Branch is.

I am happy to report that the Greek Branch shows renewed vitality, despite the sincere loss they recently suffered. Of late they managed to double their membership and we wish them all sorts of success in their enthusiastic endeavours.

With great pleasure I accepted the kind invitation of our UK Branch to attend their annual dinner. It was a very pleasant evening in a convivial atmosphere. Our UK Branch is one of our most active with meetings held almost every month, and it was very nice to see so many familiar faces.

In Hamburg I attended the 13th 'Hamburger Tagung zur Internationalen Besteuerung', at the kind invitation of Prof. L. Fischer. This annual event, which is co-sponsored by our German Branch, provides an excellent opportunity to learn what goes on in the field of international taxation in Germany.

Before long we hope to be able to inform you of the activities of our National Branches via the World Wide Web. So please keep up the good work of informing us of your programmes.

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 excellent contribution in maintaining close contact with the fiscal activities of these organisations.

Our contacts with CIAT are being carefully maintained. In October 1996 I attended their Technical Conference in Italy, and last March I had the pleasure of participating in their 31st General Assembly in Buenos Aires, Argentina.

I continue to participate in the meetings of the Tax Committee of the International Chamber of Commerce in Paris.

MITCHELL B. CARROLL PRIZE 1996

Out of five entries, the Jury decided to award the 1996 Prize to Dr Peter Andrew Harris (Australia) for his dissertation "International aspects of the imputation form of corporate tax systems". The work examines how the imputation form of corporate taxation can operate in cross-border situations, and is a very impressive analysis of a complex subject, combining both technical analysis and the development of broad policy issues. Dr Harris began his IFA "career" in 1992, when he was engaged as our research associate, which, as he stated when addressing the Opening Ceremony of our Geneva Congress, was definitional in his pursuing and the direction of his PhD dissertation.

The Jury decided to grant an honourable mention to the work of Mr Gerald Toifl (Austria) entitled "Die Wegzugsbesteuerung – par. 31 Abs 2Z2 EStG", a dissertation submitted at the Economic University of Vienna.

INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

The relation with the IBFD continues to be a very fruitful one. Our joint research project is proceeding in a way satisfactory to both our organizations, and has proved to be very helpful in increasing the quality, relevance and preparation of the Main Subjects and Seminars that are discussed at our annual Congresses. Prof. Kees van Raad, Chairman of our Research Subcommittee, is also a member of IBFD's Advisory Council. We value Prof. Hamaeker's input in the work of the Permanent Scientific Committee very much.

THE 51st CONGRESS IN NEW DELHI, 19-24 OCTOBER, 1997

We look forward with anticipation to an interesting and enjoyable 51st Congress. A diversified scientific programme has been designed to cater for all tastes, and the Organizing Committee is working very hard to ensure a successful Congress. I join Congress President Vaish in inviting you to experience the Indian culture, the sights and the sounds of this unique and vast country. You will most certainly not regret it!

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RESOLUTIONS – 51ST IFA CONGRESS, NEW DEHLI, 1997

SUBJECT 1: THE TAXATION OF INCOME DERIVED FROM THE SUPPLY OF TECHNOLOGY

FINAL RESOLUTION (ORIGINAL VERSION)

The 51st Congress, having regard to 31 National Reports and the General Report on the Taxation of Income derived from the Supply of Technology, as published in Vol. 82a of the *Cahiers de Droit Fiscal International*, taking note of the discussion during the Congress, has adopted the following resolutions.

I. "Classical" transfers of technology

A. In taxing royalty income from the supply of technology the source and residence states should strive to achieve a result where, as much as possible, the net income of the royalty-recipient bears no double or excessive taxation.

This result may be achieved by reducing withholding rates, as well as by flexible tax credit provisions and providing for the carry back or carry forward of excess tax credits.

B. The source state should grant suppliers of technology the option to elect taxation on a net basis as if they operated through a permanent establishment in the source country.

C. Amounts paid under cost contribution agreements for the joint research and development of technology cannot be regarded as a royalty.

II. Know-how, technical and professional services

A. In order to avoid double taxation of income from technical services, the applicable treaty provisions should be interpreted in the same way by the importing and exporting state. Further efforts by international organizations (OECD) should be made to establish guidelines for distinguishing between know-how, technical services and other services.

B. Income from technical services is not suited for taxation on a gross (withholding) basis by the source state. Consequently, taxation of income from technical services should be based on the OECD permanent establishment/fixed base threshold.

C. In negotiating bilateral tax treaties, if there is any deviation from these principles, using the concept of a special definition of permanent establishment/fixed base (e.g. UN Model) is to be preferred over resort to a gross basis withholding tax. Such a special threshold for technical services should, however, not automatically apply to the taxation of employees (art. 15.2.c) as well in order to avoid unwanted administrative difficulties and unexpected exposures.

III. Special issues for developing countries

A. In designing and applying their tax laws, developing countries should provide for flexibility in determining the tax consequences of contracts so that unrelated, but preferably also related, parties are given the opportunity to rebut certain legal presumptions (such as deductibility ceilings) that developing countries have included in their tax laws and regulations as measures against tax avoidance.

B. When deductibility ceilings apply in one country, these should not result in that country imposing an aggregate taxation greater than the taxation levied in case of a contribution of the same intangible.

C. Each country should carefully analyse the budgetary benefits of a withholding tax on technology payments to non-residents in relation to the cost of importing the technology and the benefits of encouraging local production for regional or global markets.

D. Where developing countries grant special tax incentives or exemptions with regard to their source-taxing rights in order to attract technology such measures should be matched by tax sparing measures in the exporting country either through treaty or unilateral provisions.

IV. Software

A. In determining the classification of income from software transfers, the most important distinction is that between the sale of a software product and the granting of rights with respect to the underlying copyright (a royalty).

B. The transfer of standard software for the internal use of the transferee should be treated as the sale of a product, even though certain sale conditions reflect the customary protection of the copyright owner. The same characterization should apply to site licenses.

C. Income from the grant of an exclusive right to use software in a specific jurisdiction and for the useful life of the product should be treated for tax purposes as a sale of a copyright.

D. A reproduction license (unless it is a site license) may constitute a license (royalty) unless it involves the disposition of an entire right such as an exclusive geographical license for the useful life of the product.

Explanatory notes on the resolution for Subject I by Prof. Dr A.H.M. Daniels, discussion leader for the panel

The Resolution on Subject I addresses four issues:
1. Tax aspects of "classical" transfers of technology;
2. Know-how, technical services and professional services;

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3. Special issues for developing countries;
4. Income tax aspects of software.

1. "Classical" transfers of technology

Paragraph A emphasizes that in order to avoid or reduce double taxation of income derived from the transfer of technology both importing/source states as well as exporting/residence states should take appropriate measures in their tax laws and tax treaties.

Paragraph B provides for the making of an election by the technology exporter (supplier) to be taxed on a net basis by the source country. Such an election can obviously be introduced only provided that a number of conditions (e.g. applying the election on a consistent basis, sufficient proof of income and attributable expenses, etc.) are fulfilled.

The making of an election to be taxed on a net basis as if the supplier operated through a permanent establishment is not intended to create an actual or deemed permanent establishment of the supplier for other purposes, but only to establish the method of calculating the income of the supplier subject to tax in the source state.

During the discussions it was suggested that a separate paragraph be added, stating that a source state should not levy tax on the proceeds from the transfer of the ownership (sale) of intangibles as if they were royalties. The proposed paragraph was not added because this was believed to be self-evident and a well-established principle.

2. Know-how, technical and professional services

Paragraph A addresses the growing number of cases where certain payments for technical services are characterized differently by the source state and the residence state of the service provider. The source state may have an interest in characterizing certain payments as royalties so that a withholding tax may be levied. On the contrary, the residence state may want to characterize such payments as business profits, attributing exclusive taxing rights to the residence state absent a permanent establishment in the source state.

The combination of the two approaches may result in double taxation (i.e. the levy of a withholding tax by the source state while no tax credit will be available in the residence state). Some bilateral tax treaties intend to avoid this conflict in characterization by introducing a special class of income: "income from technical services".

It is believed that in this area there is a great need for guidance and a precise definition to be developed by international institutions. The reference in paragraph A to the OECD is merely intended as an example of such an organization, and it is recognized that organizations other than the OECD (such as the UN) may develop guidelines of the kind referred to in the resolution.

The final part of paragraph C clarifies that if in bilateral tax treaties a lower permanent establishment threshold is negotiated, such lower threshold should not apply in interpreting the term permanent establishment as it is used in Article 15 of the OECD Model Convention. A low permanent establishment threshold would result in the attribution of the right to tax the salaries of employees of the supplier of the technology, even on relatively short projects/stays in the source country. Such a consequence would be a severe obstacle to international business and may result in unjustified tax exemptions in the home state of the employee.

3. Special issues for developing countries

In paragraph A, the opportunity to rebut "legal" presumptions is intended to apply to any presumption used in the application of a developing country's tax law's, not just presumptions in the tax statutes or regulations of such country.

Paragraph D was added as a result of the discussions. It endorses once again the views expressed already by IFA in 1975 in the resolutions adopted at its London Congress.

4. Income tax aspects of software

In paragraph A, no reference is made to the manner in which software is physically transferred, because it is believed that the manner in which software is transferred (whether for example by disk, CD-ROM, Internet, etc.) should not be a decisive factor.

Paragraph B is not intended to address in any manner the taxation of customized software.

The reference to a so-called "site license" means a license that allows the user to make a certain number of copies of the programme solely for internal use by persons in the organization of the user.

SUBJECT 2: THE TAXATION OF INVESTMENT FUNDS FINAL RESOLUTION (ORIGINAL VERSION)

The 51st Congress, having regard to 30 National Reports and the General Report on the Taxation of Investment Funds, as published in Vol. 82b of the *Cahiers de Droit Fiscal International*; taking note of the discussion during the Congress; recognizing the economic importance of investment funds for both investor and investee countries; and with a view to assuring fair and equitable taxation of income (including gains) derived by investment funds, and specifically to avoid double taxation, recommends that:

(1) the contracting parties to a Double Taxation Treaty recognize the importance of investment funds by providing efficient avoidance of double taxation of income derived by such funds; thus

(2) the contracting parties should define investment funds on the basis of their domestic securities legislation and regardless of their legal form and tax treatment, such investment funds should be treated as persons and as resident for treaty purposes;

(3) investment funds defined as residents of a contracting state should benefit from the applicable provisions of the relevant treaty;

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(4) the contracting parties when defining limitations of benefits applicable to investment funds should consider the following issues:
(a) each country has the power to organize the taxation of investors in a fund, irrespective of the distributions of income by the fund and the levy of a tax on the fund, and irrespective of its place of organization;
(b) there may be differences in the tax treatment given to funds offered to the general public and those offered to a limited number of investors;
(c) the countries in which the shares or units of investment funds may be offered and sold may include (i) jurisdictions which have agreed with the contracting parties similar tax relief for their residents and (ii) jurisdictions which are party to regional organizations which prohibit discrimination between residents of their member states;
(d) avoidance of abuse by investors in investment funds may be achieved by several means, including but not limited to taxation of investment funds or withholding on their distributions or requiring funds to provide appropriate information with respect to shareholdings;
(e) limitations could be applied proportionately if and to the extent that the conditions imposed by the treaty are not met.

Explanatory note on the resolution for Subject II by Mr Y. Prussen, discussion leader for the panel

During the last 20 years there has been a spectacular development of investment funds throughout the world. The growth of the fund industry has been accompanied by a cross-border offering of financial products, including shares of investment funds, a decentralization of portfolio management functions, which are carried out close to the markets where investments are made, and changes to fund administration techniques as a result of computerization and the impact of the input of data from various sources located in different jurisdictions. In light of these developments it has become difficult to compare collective investment schemes to traditional commercial or industrial enterprises.

The resolution deals with the relationship between the jurisdiction in which a fund is established ("the host country") and that in which investments are made ("the source country"). It proposes a framework for treaty negotiations in the light of these new developments.

The basic proposal is to have treaty access granted to funds recognized by the authorities of one of the treaty countries, as having been established in its jurisdiction. For this purpose the treaty should define the concept of the investment fund in the light of the domestic securities legislation of the parties to the treaty.

Because of the identity of the economic function of funds, whatever their form may be, and the need to consider taxation or absence of taxation of the revenue derived by or from a fund at the level of the fund's shareholders in order to avoid double or triple taxation of the same income, this definition should be based on economic criteria and it should not be dependent upon the legal form and the tax treatment of the fund.

Thus funds incorporated or established in a treaty country should have the benefit of specific treaty provisions which take into account the special features of investment funds, subject to any limitations on benefits which the treaty may provide.

When considering any limitations of benefits, the negotiating parties should have regard to the following issues:

– It seems unnecessary for a source country to require taxation of a fund or to impose mechanisms designed to generate taxable income in the hands of the fund's shareholders. These issues may be relevant for the country of residence of the investors, but the latter may, should this be appropriate, organize taxation of those shareholders irrespective of any tax paid by a fund, any withholding of tax on distributions by a fund or even irrespective of the distribution of income by a fund. The resolution invites source countries to recognize that taxation of investors is within the competence of the investors' country of residence and that there are models which will allow for a fair tax treatment of investors whatever the specific features of the fund may be.

– Paragraph (b) of the resolution relating to limitations on benefits is to be read in conjunction with paragraph (c). Although funds should be considered as a conduit for investments made on a pooled basis by the fund's shareholders, there is a basic justification for extending the benefit of a treaty to the fund itself, which is the need to adopt a system which on the one hand is practical and which on the other hand may be organized in a manner to limit the benefit to investors qualifying for treaty benefit or equivalent treaty benefit. If a fund is closely held by a limited number of investors, the practical problems, which make it impossible to apply treaties between the source country and the country of residence of investors of a retail fund, do not exist. In the case of a fund whose shares or units are offered to the public or held by a larger number of investors, the concept of "derivative benefits" justifies the entitlement to treaty benefits by the fund in lieu of its shareholders because the fund's shareholders normally reside in jurisdictions where they enjoy equivalent treaty protection.

– A major concern of the tax authorities is to have assurance that the investors who ultimately will benefit from treaty protection are actually taxed, unless there are legitimate reasons to exempt them from tax. The taxation of the fund in lieu of taxation of the investor or the levy of a withholding tax on compulsory distributions may be a means to minimize abuses, but it is difficult to justify the imposition of a tax by the host country which is ultimately borne by the investor if the investor is resident outside the host country and if the income is also derived from abroad. If the tax paid by a fund or withheld upon distribution is to be reimbursed by the host country to shareholders suffering tax on the same income in their country of residence, the host country may face major administrative problems in coping with applications for repayment lodged by thousands or even millions of investors. Thus other ways to avoid any abuse by shareholders should be envisaged, and the development of

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sophisticated shareholder registration systems may lead to possible solutions if information on investors may be made available.

– To the extent that conditions imposed by a treaty cannot be complied with in their entirety, it is advisable to grant to funds treaty protection in proportion to the interests of its shareholders which fulfil such conditions. Market conditions will oblige the industry to provide for mechanisms to ensure that the benefit of the treaty flows through to those investors who fulfil the conditions. If granting treaty benefits to the fund ensures that investors who invest through the interposition of a fund, are not treated worse than as if they made direct investments, granting funds a proportionate treaty access may thus avoid the result that shareholders who do not qualify for treaty protection in case of direct investment are better off by routing their investments through a fund.

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SUMMARY OF PROCEEDINGS, 1997 IFA CONGRESS

Dr J.B. Bracewell-Milnes (United Kingdom) and Dr J. Jäger (Switzerland)

In the first Subject, **The Taxation of Income Derived from the Supply of Technology,** held on 20 October 1997, Mr S.R. Lainoff (USA) and Dr R.C. Vaish (India) acted as General Reporters, Prof. Dr A.H.M. Daniels as Discussion Leader and Mr A. Vohra (India) as Secretary. Panellists were Mr H. Birk (Canada), Mr A. Camelot (France), Prof. C.S. Lee (Republic of Korea) and Mr G. Leonardos (Brazil). The emphasis was on the avoidance of international double taxation. In the taxation of royalty income from "classical" transfers of technology, both the source state and the residence state could contribute to this end; but, in particular, the source state should grant suppliers of technology the option to elect for taxation on a net basis as if they operated through a permanent establishment in the source country. The OECD and other international organizations should establish guidelines for distinguishing between know-how, technical services and professional services. Income from technical services was not suited to taxation on a gross (withholding) basis; an extended concept of permanent establishment/fixed base was to be preferred. Tax incentives in developing countries should be matched by tax sparing in developed countries. Income from the sale of a software product should be distinguished from royalties on the granting of rights to the underlying copyright; and conditions reflecting the customary protection of the copyright owner should not prevent the classification of a transaction as a sale.

The avoidance of international double taxation was also the main theme in the discussion of the second Subject, **The Taxation of Investment Funds,** held on 21 October 1997. General Reporters were Dr P.J.M. Bongaarts (Netherlands) and Mrs L.J. Ed (United Kingdom). Mr Y. Prussen (Luxembourg) acted as Discussion Leader, and Mr D. Bouzoraa (Tunisia) as Secretary, while Mr D. Choski (India), Dr H. Krabbe (Germany), Mr J. Newberg (USA) and Mr A. Pelvang (Denmark) were Panellists. Regardless of their legal form and domestic tax treatment, investment funds should be treated as persons and as residents for treaty purposes; and funds so classified should benefit from the applicable provisions of the relevant treaty. Avoidance of abuse might be achieved by several means, including a withholding tax on distributions or requiring funds to provide appropriate information about shareholdings; limitations could be applied proportionately to the extent that the conditions imposed by the treaty were not met.

Seminar A, "OECD Model Convention – 1997 and beyond" held on 22 October 1997, presented a summary of ongoing and planned projects of the Committee on Fiscal Affairs of the OECD in relation to the Model Convention and its Commentary. In addition, the Seminar Panel discussed the question under what conditions the provision of services could constitute a permanent establishment for purposes of the Convention and the implications of the "revolution" in communication technologies on the permanent establishment concept.

In terms of ongoing OECD projects, Mr J. Sasseville of the OECD Secretariat stated that a number of issues including (i) tax competition among countries; (ii) tax sparing issues, (iii) a draft paper on electronic commerce, which will be presented to a conference to be held on 18-21 November in Turku, Finland; (iv) innovative financial instruments, in particular issues of global trading; (v) additions to the Transfer Pricing Guidelines on which approval had been reached earlier this year in June; (vi) the "Outreach Programme" which is to foster dialogue with non-OECD members and in which also India takes part.

Mr D. Lüthi, who heads Working Party No. 1 of the Committee on Fiscal Affairs, stated that: (i) additional fields of research include the tax treatment of software payments and the treatment of partnerships under the Convention, (ii) future issues to be dealt with include the meaning of the term "effective management" for the purpose of determining corporate residence and the legal status of the Commentary.

According to Mr Sasseville the loose-leaf binder of the Model Convention will be modified to comprise two volumes. Volume 2 will henceforth set forth the positions of 17 non-OECD member countries, on the provisions of the Convention, which should facilitate negotiations with those non-member countries. In addition, some post-1992 OECD reports will be added to the second volume.

In the second part of the Seminar, Prof. A. Skaar of Norway summarized the basic conditions for a permanent establishment under the OECD Model Convention and discussed several cases in which even the existence of a subsidiary could conceivably give rise to a permanent establishment. This notion is of growing concern for MNEs where intra-group services are provided. Dr A. Schäfer of Germany and Mr K.D. Gupta of India commented on this growing tendency.

The possible implications of electronic commerce, in particular via the Internet, were the last subject of Seminar A. Mrs P. Brown of the US Treasury Department and Mr L. de Broe of Belgium discussed whether a server could be qualified as a permanent establishment and whether a sale of a reproducible digital publication constitutes an outright sale or a service relating to an intangible good. In this respect, it was recommended that IFA and the OECD further study these questions, particularly since companies engaged in electronic commerce may increasingly move their operations to "tax haven jurisdictions.

Seminar A was chaired by Prof. K. Vogel of Germany.

Seminar B "Cross Border Valuation for Income Tax, VAT and Customs Duties (Transfer Pricing)", held on 22 October 1997, concentrated on the question whether or not the rules for the determination of transfer prices for purposes of income taxation should also be applied in determining customs duties on the import of goods.

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The Seminar panel stressed that there are pros and cons for the uniform application of a valuation method for both income taxation and customs duties. In order to assess these, Dr A. Manganelli (Italy) set out the basic differences between direct taxes and customs duties, including differences in taxable events (sale or purchase of goods for direct taxes, importation of goods into the country for customs duties), the underlying rationale (to avoid shifting income and the modelling of international streams in trade for customs duties), and the goals pursued by the administration (decrease in the value of purchases for income tax purposes, so as to maximize the taxable base as opposed to an increase in value of the customs duties to produce higher revenues).

Arguments which can be made in favour of a uniform application of valuation methods for both income tax and customs duties purposes were brought forward by Prof. Y. Masui of Japan. These include: (i) the arm's length price should theoretically be an objective value (i.e. a single amount); (ii) perception issues might arise with the tax/customs duties payers if different valuations are used; (iii) the government as levying authority should take a consistent view on all financial burdens, be it taxes or customs duties; (iv) the government or the tax/duty payer could be "whipsawed" by the use of different values.

Mr J.S. Wilkie of Canada then stated the case against applying the same valuation approach, noting that most countries, while acknowledging that there might be similarities in terms of valuation procedures, see no compulsory need for a uniform and identical valuation. Whilst the subject of customs duty is the tradable good itself and the focus of duties is directed at the point and time of importation, the transfer price problems are centred around the personal, organizational and functional characteristics of the parties involved in the trading transaction.

Mr R. Cole of the United States described Section 1059A of the Internal Revenue Code, which provides that the transactional value as determined by customs valuation is a ceiling for the tax cost where the imported goods are acquired from a related party. However, Section 1059A acts as a "one-way street" in that it limits the tax cost when it would otherwise exceed the customs value but does not limit the customs value when it exceeds the tax cost.

The Seminar was chaired by Prof. F. Vanistendael of Belgium and also received contributions from Mr P.V. Ramanan of India.

Seminar C held on 23 October 1997, under the chairmanship of Prof. R. Krever (Australia) with Mrs A.N.D. Borger (Brazil) and Messrs. Prof. L. Burns (Australia), P. Kelly (Belgium), R. Leitner (Austria) and Justice Ranganathan (India) as participants dealt with the topic of "Taxation of Expatriates". Particular attention was given to the question which tax problems arise upon departure to the new country of residence, the taxation while living in a country other than the home country as well as upon departure from the new country. With an increasing globalization and integration of the economies and the emergence of large trading blocks (e.g. the EU) the barriers to mobility of labour are constantly being reduced. Accordingly the number of employees who are being seconded to other countries on a temporary basis is steadily increasing. In addition, the new communication technologies render it possible for employees and independent contractors to perform their services at places other than their employers' or assignors' place of business. It is a widely acknowledged problem that inconsistencies between tax systems in the different countries involved may lead to situations of double but also of non-taxation. Often, existing treaties do not address or account for these problems or provide for little remedy only. Therefore, it was the Seminar's intention to provide the audience with a broad overview of applicable systems of expatriate taxation so as to enable tax advisers to set up a list of pivotal points so as to minimize the danger of multiple taxation. Pivotal points that have been addressed during the session were: when and under what circumstances does the tax liability in the home country cease to apply? This question is substantial for the expatriate since it is usually much easier to acquire residence in another country than to terminate one's residence in the home country. Further, with reference to real life examples, the speakers asked the questions "when is residence in the host country assumed?" and "under what circumstances is the beginning of such a residence either prevented or postponed?" Then again, an important issue is the determination of the taxable basis for an expatriate: whether to be taxed on the worldwide income, on the income derived from work performed in the host state or on another basis. Related to this question is the issue whether, and if so what tax exemptions are available to expats (e.g. for diplomatic envoys or employees of international organizations). It has to be noted though that there are also different fields where inconsistencies in the various tax systems lead to potential double taxation due to a timing difference between the taxable event and a later realization of capital gains or income streams, respectively. In particular, this holds true for income derived from pension plans and employee stock-option plans (ESOPs). The Seminar was rounded off by providing a hands-on set of examples for tax planning mechanisms, which – if applied in a proper manner – could lead to substantial tax reductions for expats.

Seminar D held on 23 October 1997 covered the topic of "Presumptive Income Taxation". As opposed to the "ordinary" tax assessment where the basis subject to income tax consists of all relevant income factors derived throughout the assessment period presumptive taxation takes a less refined approach in that it replaces the ordinary tax base by a single amount (e.g. cost of living actually incurred by the taxpayer, assets held by the taxpayer). The seminar's intention was thus to present the various types of presumptive tax methods currently applied in different jurisdictions and to set out the advantages and problems which arise when applying this particular form of taxation. Presumptive taxation is usually applied by the assessing tax authorities when there is (i) only a limited access to the figures and relevant data needed for a proper assessment, (ii) if it is not possible to match the basis of assessment and the objective of the law, (iii) in the absence of an adequate bookkeeping or (iv) where privacy is protected. Thus, the presumptive taxation provides for an approximation of the taxable income by applying a number

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of auxiliary factors such as the assets held, sales, wages paid, the value of immovable property, or – in past times – even the number of windows of a house. Nowadays, reference is usually made to the assets held by a taxpayer. The speakers provided a broad overview on how these assets are determined in countries like Mexico, Argentina, France and India. In particular in Argentina presumptive taxation based on the gross assets was used as a means to counteract the devastating erosion of the taxable base due to high inflation. However, problems of double taxation could arise in cross-border situations, where a foreign jurisdiction was not willing to accept the presumptive tax for tax credit purposes. In France, the method on which the presumptive taxation is based depends on the qualification of the taxpayer. Different methods are adopted for traders, farmers and providers of professional services. Whilst presumptive taxation has remained attractive in the agricultural sector the number of traders and professional service providers taxed on a presumptive basis has seen a sharp decline during the last 20 years. Particularly noteworthy in connection with the Indian presumptive taxation is the fact that charting parties or owners of ships are subject to a 7.5 per cent tax on the value of the freight leaving an Indian port. Furthermore, the Indian tax system provides for a presumptive taxation of technical services in connection with the extraction of mineral oil and the operation of aircraft. However, difficulties had arisen when this presumptive taxation had been introduced retroactively, thus resulting in an over- or undertaxation. To recapitulate, presumptive taxation, albeit resulting in a reduced administrative burden, will undoubtedly remain an "inaccurate" tax as opposed to a tax which is assessed on more refined subjective factors. However, from an economic and an administrative point of view it continues to be a viable way of taxation in particular for developing countries and transition countries provided that it is not a supplementary tax on top of an ordinary income tax.

The Seminar was chaired by Prof. R. Avi-Yonah (USA) with contributions from Messrs. S.E. Dastur (India), J. Gonzalez-Bendiksen (Mexico), Prof. F. Grapperhaus (Netherlands), H.E. Kaplan (Argentina), M. Taly (France) and Mr P. Byrne (USA) as secretary.

Seminar E "Doing Business in India" held on 23 October 1997, gave an outline of the current conditions, the framework and recent incentives to doing business in India. Now in its 50th year of independence India has seen major changes in the economic framework beginning in 1991. With a population of almost 1 billion, sharply increasing foreign investments and international currency reserves soaring from USD 1 billion in 1991 to as much as USD 30 billion in 1997 India is on the brink of establishing a firm place in the international community of major economic players. The economic liberalization process introduced in 1991 particularly encompassed measures to dismantle the licensing regime for most industries, the abolition of capital controls, measures to take the Indian Rupee to full convertibility, the reduction in restrictions previously imposed on imports of various capital and consumer goods as well as allowing the investment by foreign institutional investors. However, there remain some obstacles to be overcome. Namely the raising of capital both domestic and foreign has to be further encouraged. Although the abolition of the Capitals Issues Control Act must certainly be seen as a step in the right direction it appears that Indian industry in general has not yet benefited to any large extent from this deregulation. Investment in the different fields of Indian industry by investment and venture capital funds should further be encouraged. Then again, a micro- as well as a macro infrastructure (such as roads, ports and telecommunication facilities) needed to run business of every scale and on reasonable terms remains to be provided in some parts of the country. Then again, in terms of the availability of labour force and the control of labour cost there are areas of improvement. As remuneration still continues to be determined by Wage Boards constituted by the Government in most industries the wages remain to be a political rather than an economic issue and thus are beyond the control of management. Furthermore, the Factories Act and the Minimum Wages Act as well as the Industrial Disputes Act constitute impediments still to be coped with. Last but not least Government Policies and Regulations still present some obstacles to a rapid economic and industrial growth. It appears though that – albeit with a long way still to go – the mindset of the Government and Indian industry has taken a change and realized that the need to integrate the Indian economy in the global economy has to be accelerated and that the fight for a level playing field is of higher importance than to seek continued protection and shelter against competition. The meeting was chaired by Mr Parthasarathi Shome with contributions from Messrs N.K. Singh of the Government of India, B. Gupta Ramola of Price Waterhouse, R. Srinivasan of ANZ Grindlays Bank Ltd. and R. Tyagarajan of Thiru Arooran Sugars Ltd.

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Gent, Mys & Breesch, Vlasmarkt 10, 9000 Gent. 1996, p. 258. ISBN: 90 5462 203 2.
Compilation of speeches given during a cycle of 5 seminars in 1995 at the Free University of Brussels on fiscal penal law and fiscal penal procedural law. The different contributions focus on: the use of the results of a tax audit in the framework of a fiscal penal investigation, the use of the results of a penal investigation in tax audits, fiscal administrative penalties in the light of Article 6 of the European Treaty on Human Rights, the cooperation of public offers of taxation to the penal investigation, international cooperation concerning fiscal misdemeanours and confiscations before and after Shengen, the trans-border exchange of information between tax administrations and the use thereof for the penal investigation, the special confiscation (*bijzondere verbeurdverklaring*) of capital benefits applied to fiscal misdemeanours, the different aspects of the legal system for the punishment and avoidance of the laundering of money and tax fraud, general anti-abuse rules in income taxes and the impact thereof on fiscal penal law.
(B. 116.558)

Bulgaria

Doing business in Bulgaria.
Amsterdam, Price Waterhouse. 1997, pp. 176.
Information guide on doing business in Bulgaria. The material includes information (as of 1 July 1996) on the Bulgarian investment climate, foreign investment and trade opportunities, banking and finance, exporting to Bulgaria, audit and accounting, tax system, taxation of corporations and individuals, trusts, VAT and other indirect taxes.
(B. 116.629)

Croatia

Doing business in Croatia.
Amsterdam, Price Waterhouse. 1997, pp. 181.
Information guide for those interested in doing business in Croatia. The material contained in this guide was assembled at 31 March, 1997, and includes information on the Croatian investment climate, business environment, privatization, bankruptcy, foreign trade and foreign exchange, banking system, foreign investment and taxes, auditing and accounting, income tax, profits tax, VAT and other taxes.
(B. 116.585)

Czech Republic

Czech taxation in 1997.
Prague, Trade Links, P.O. Box 131, 110 01 Prague 1, Czech Republic. 1997, pp. 534.
USD 60.
The book contains English translations of Czech laws from 1993 onwards regarding personal income tax, corporate income tax, VAT, excise duties, road tax, real estate transfer tax, and real estate taxation.
(B. 116.537)

Accounting legislation in 1997.
Prague, Trade Links, P.O. Box 131, 110 01 Prague 1, Czech Republic. 1997, pp. 215.
USD 55.
English translation of Czech Republic accounting legislation comprising the Accounting Act (563/1991 Coll., as amended), the Decree of the Federal Ministry of Finance on the Chart of Accounts for Businessmen, V/20 100/1992, as amended, accounting procedures for businessmen, account classes, Decree on Financial Statements for Businessmen, 281/71 701/1995, as amended, and full versions of the Balance Sheet and Profit and Loss Account.
(B. 116.538)

Denmark

Gomard, B.
Aktieselskaber og anpartsselskaber.
3rd Edition.
Copenhagen, Jurist- og Okonomforbundets Forlag. 1996, pp. 472. DKR 582.
ISBN: 87 574 5007 2.
Book on public and private companies established under Danish law. The book covers topics such as the history of the company law, characteristics of companies, groups, formation of companies, share certificates, capital aspects such as equity, convertible bonds, options, increase or decrease of capital, management structures, general meeting, financial statements, distributions and reserves, audit, liquidation and bankruptcy, merger, division and change of entity, liability and penalties, branches of entities established under foreign law, name of a company and registration.
(B. 116.630)

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European Union

Structures of the taxation systems in the European Union.
Brussels, Eurostat. 1996, pp. 87.
ISBN: 92 827 6822 8.
Document providing a picture of statutory contributions and charges in the 15 Member States of the EU over the period 1980 to 1993. The focus of this work is to interpret fiscal trends in order to give a flavour of the evolution of taxation in Europe at different levels of disaggregation.
(B. 116.616)

Picciaredda, F.; Selicato, P.
I tributi e l'ambiente. Profili ricostruttivi.
Milan, Dott. A. Giuffrè Editore. 1996, pp. 200.
ITL 24,000. ISBN: 88 14 06264 1.
The book deals with the relationship between taxes and the environment. It takes into account: the international fiscal politics on the environment (taxes on fuel, vehicles, incentives for non-polluting activities); the EU politics on the environment; and the Italian taxes which relate to the environment (e.g. the tax on the discharge of urban waste material).
(B. 116.386)

Jacobs, O.H.; Spengel, C.
Aspekte der Unternehmensbesteuerung in Europa.
Baden-Baden, Nomos Verlagsgesellschaft. 1996.
ZEW Wirtschaftsanalysen, Band 4, pp. 247.
DEM 69. ISBN: 3 7890 4279 X.
Compilation of papers addressing the current systems of business taxation in Europe and the various reform debates. Particular emphasis on German taxation and the ecotax proposals.
(B. 115.698)

A guide to VAT in the EU. The Single Market changes 1996 update.
The Hague, Kluwer Law International, P.O. Box 85889, 2508 CN The Hague, The Netherlands. 1997. ISBN: 90 411 0658 8.
The book is fully updated to include the latest developments of 1996 and the Directives which have come into force in 1996. It explains how each EC country has implemented the Council Directive 91/680/EC and amending Directives. It gives information on the three new EU members (Austria, Finland and Sweden) and a commentary on the Council Directive 95/7/EC, applicable as from 1 January 1996. Includes analysis of the main features of the transitional VAT system, country chapters, appendices, and an index.
(B. 116.546)

Birkenfeld, W.
Umsatzbesteuerung im Binnenmarkt. Umsatzsteuer für Warenlieferungen und Dienstleistungen in und aus EG-Mitgliedstaaten. 3. Auflage.
Bielefeld, Erich Schmidt Verlag. 1996, pp. 440. DEM 86. ISBN: 3 503 03992 9.
VAT and the Internal Market. Detailed and systematic account of all aspects of VAT relating to cross-border EU transactions with specific reference to the German position.
(B. 115.697)

VAT collection and control procedures applied
in Member States. Second Article 12 report (Regulation (EEC/Euratom) No. 1553/89).
Luxembourg, Office for Official Publications of the EC. 1995, pp. 84. NLG 18.66.
ISBN: 92 826 9375 9.
(B. 116.570)

Centore, P.
IVA comunitaria. Aspetti interpretativi e applicativi.
Milan, Ipsoa Spa. 1997, pp. 821. ITL 100,000.
ISBN: 88 217 0986 8.
Handbook on the European VAT. It deals with both interpretative and practical issues.
(B. 116.445) .

MacLeod, I.; Hendry, I.D.; Hyett, S.
The external relations of the European Communities.
New York, Oxford University Press Inc., 200 Madison Avenue, New York, NY 10016, USA. 1996.
Oxford European Community Series, pp. 432.
ISBN: 0 19 825930 1.
The book describes the rules and practices which govern the conduct of the Communities' external relations and summarizes the current state of the Communities' activities in the external field.
(B. 116.573)

Germany

Heinhold, M.
Unternehmensbesteuerung. Band I: Rechtsform.
Stuttgart, Schäffer-Poeschel Verlag. 1996, pp. 356. DEM 49.80. ISBN: 3 7910 0893 5.
Taxation of enterprises: Volume 1 – Legal form. How different legal forms of companies are taxed under income (shareholders), corporate income (both plus solidarity surcharge), business, inheritance/gift and net wealth tax. Also mixed forms (GmbH&Co KG, GmbH&Still/AG&Still) and companies connected by lease contracts.
(B. 116.563)

Körperschaftsteuergesetz. Kommentar.
Herausgegeben von Arthur Andersen.
Berarbeitet von Edgar Weller.
Bonn, Stollfuss Verlag. 1997.
ISBN: 3 08 254900 4.
Corporate Income Tax Law. Commentary. 2 volume – commentary written by 17 lawyers and tax advisors. Also some related provisions are covered, e.g. Sections 17 and 50d Income Tax Law, Solidarity Surcharge Act and other related sections and titles of the Income Tax Law, Income Tax Ordinance and the General Tax Code. Displays many official forms and gives instructive sample calculations. With extensive index.
(B. 116.586)

KStR-krit. KStG-KStDV-KStR.
Veranlagungszeitraum 1996, Vorauszahlungszeitraum 1997. Herausgegeben und bearbeitet von Ortwin Posdziech.
Bonn, Stollfuss Verlag. 1997, pp. 656.
DEM 171.80. ISBN: 3 08 360396 7.
Corporate income tax Directives critically commented on – for assessments in the year 1996 and prepayments in 1997. Text with explanations and critical comments as to the application of the Directives by the tax authorities. Of particular use to tax councillors and lawyers defending a corporate tax case before a Tax Court. Annexed additional 300 pages including related statutes, decrees and letters of the Ministry of Finance and an index.
(B. 116.539)

Veranlagungs Handausgaben 1996
Sammelband. Einkommensteuer, Körperschaftsteuer, Gewerbesteuer, Umsatzsteuer. Gesetze mit Durchführungsverordnungen, Richtlinien, Hinweisen, Nebenbestimmungen. Ausgabe April 1997.
Bonn, Stollfuss Verlag. 1997, pp. 3010.
DEM 169.80. ISBN: 3 08 367096 6.
Updated extensive documentation of the Individual Income Tax Act, Corporate Income Tax Act, Business Tax Act, Value Added Tax Act and all administrative guidelines thereto.
(B. 116.576)

Haberstock, L.; Breithecker, V.
Einführung in die Betriebswirtschaftliche Steuerlehre. Mit Fallbeispielen, Übungsaufgaben und 9. Auflage.
Hamburg, Steuer- und Wirtschaftsverlag GmbH. 1997, pp. 420. DEM 32.80.
ISBN: 3 89161 109 9.
Introduction to tax economics. This book provides a study guide to the principles of business taxation and tax law and deals specially with tax accounting, the influence of tax in the choice of business form and on business decisions. It includes practice exercises and model answers as well as a bibliography. Updated to 1 January 1997.
(B. 116.561)

Pross, A.
Swap, Zins und Derivat. Finanzinnovationen im nationalen und internationalen Steuerrecht unter besonderer Berücksichtigung des Zinsbegriffs.
From: Achim Pross. 1997, pp. 274.
Swaps, interest and derivatives – financial instruments in national and international tax law, particularly the concept of interest. The book describes German tax aspects regarding financial instruments. Includes a long chapter dealing with swap transactions under the federal tax law of the United States.
(B. 116.571)

Jacobs, O.H.; Spengel, C.
Aspekte der Unternehmensbesteuerung in Europa.
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Compilation of papers addressing the current systems of business taxation in Europe and the various reform debates. Particular emphasis on German taxation and the ecotax proposals.
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Bonn, Stollfuss Verlag. 1997, pp. 1535.
DEM 59.80. ISBN: 3 08 367297 7.
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(B. 116.565)

Ramisch, G.
Das häusliche Arbeitszimmer im Steuerrecht. 4. Auflage.
Stuttgart, Schäffer-Poeschel Verlag. 1996, pp. 180. DEM 36. ISBN: 3 8202 1093 8.
The workroom at home in tax law. Until the Tax Amendment Act 1996 expenses for equipping and furnishing a room at home could be deducted by both self-employed and employees, if the room is primarily used and needed for work. Some provisions giving relief remained after 1996 and are dealt with in this book. The income tax issues like the financing of the room or non-married couples living in a flat are covered as well as VAT issues. With many references, many court decisions, and an index with assets and activities which can be related to a domestic workroom.
(B. 116.575)

Rodenbach, H.J.; Pott, H.M.
Grundbesitz in den neuen Bundesländern. Recht und Steuern. 2. Auflage.
Bonn, Stollfuss Verlag. 1997, pp. 366.
DEM 53.80. ISBN: 3 08 327902 7.
Owning real property in the new German Länder – Law and Taxation. Second edition of the guide to the legal history and the current legal situation of real property in the territory of East Germany. All legal material is reproduced along with by-laws and all interpretative Court decisions. It covers the law of restitution, confiscation, transfer of immovable property and tax. The tax part covers real property tax, real property transfer tax as well as aspects of income taxation.
(B. 116.543)

Birkenfeld, W.
Umsatzbesteuerung im Binnenmarkt. Umsatzsteuer für Warenlieferungen und Dienstleistungen in und aus EG-Mitgliedstaaten. 3. Auflage.
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VAT and the Internal Market. Detailed and systematic account of all aspects of VAT relating to cross-border EU transactions with specific reference to the German position.
(B. 115.697)

Pich, H.
Die neuen Umsatzsteuer-Richtlinien 1996.
Cologne, Peter Deubner Verlag. 1996.
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The new 1996 VAT administrative guidelines. Commentary on the new administrative guidelines with respect to the German VAT Law.
(B. 115.687)

Schulz, B.
Erbschaftsteuer – Schenkungsteuer. 6. Auflage.
Achim, Erich Fleischer Verlag, P.O. Box 1264, 28818 Achim, Germany. 1997.
Grüne Reihe, Band 16, pp. 532. DEM 87.
ISBN: 3 8168 1166 3.
The sixth edition of the publication on the German inheritance tax and gift tax.
(B. 116.562)

Wilke, K.M.
Lehrbuch des internationalen Steuerrechts. 6. Auflage.
Herne, Verlag Neue Wirtschafts-Briefe. 1997, pp. 198. DEM 49. ISBN: 3 482 75516 7.
Revised and updated textbook on international tax law, which contains an introduction to international tax law in general as well as chapters on German aspects of international tax law up to April 1997.
(B. 116.618)

Benkert, M.; Bürkle, A.
Umwandlungsgesetz/Umwandlungssteuergesetz; Law of reorganizations/Reorganization tax law.
Cologne, RWS Verlag Kommunikationsforum GmbH., Aachener Strasse 217, D-50931 Cologne. 1996, pp. 437. DEM 168.
ISBN: 3 8145 8057 5.
This bilingual publication is an introduction to the German Act Reconciling the Law of Reorganizations and the Act amending the Reorganization Tax Law which took effect on 1 January 1995. It provides a better understanding of and access to German reorganization law.
(B. 116.559)

Sauer, O.
Schlagwortregister zur Rechtsprechung und Literatur des gesamten Steuerrechts 1996.
Bonn, Stollfuss Verlag. 1997, pp. 1570.
DEM 225. ISBN: 3 08 372096 3.
List of keywords in taxation. Manual providing in alphabetical order information and sources of tax law publications in 1996.
(B. 116.564)

Vertrags- und Formularbuch Recht und Steuern.
Herausgegeben von Gerhard Brandmüller sen. und Gerhard Brandmüller jun.
Bonn, Stollfuss Verlag. 1997, pp. 2600.
DEM 260. ISBN: 3 08 254000 7.
Contracts- and forms book. Sample contracts, sample application forms, official forms, sample letters, checklists on all main sectors of legal work. With extensive explanations and literature references relating to the displays. Useful practitioner's guide.
(B. 116.662)

Wolf, K.H.
Existenzgründung und Existenzsicherung.
Bonn, Stollfuss Verlag. 1997, pp. 245.
DEM 46.80. ISBN: 3 08 312501 1.
Founding a new business enterprise and securing a running business enterprise. The book describes the conditions to be met when setting up a business, aspects relevant for the choice of a suitable legal form, the foundation formalities, financing, insurance and controlling. The tax-free reserve for the future acquisition of assets (Section 7g Income Tax Law) is explained.
(B. 116.542)

Lammerding, J.
Abgabenordnung – Finanzgerichtsordnung und Nebengesetze. 13. Auflage.
Achim, Erich Fleischer Verlag, P.O. Box 1264, 28818 Achim, Germany. 1997.
Grüne Reihe, Band 2, pp. 724. DEM 79.50.
ISBN: 3 8168 1023 3.
General Tax Code – Tax Court Code and related statutes.
Systematic textbook covering the General Tax Code and the Tax Court Code. Introduction into administrative as well as Court procedure in all tax matters. Relevant Court decisions are worked in and cited, the application decree relating to the General Tax Code is dealt with. Some instructive examples and illustrations are also given.
(B. 116.541)

Hungary

Doing business in Hungary.
Budapest, Arthur Andersen & Co. 1997, pp. 89.
General information about the economic climate in Hungary with an overview of tax, legal and accounting aspects. The topics covered include taxation, employment regulations, company law, accounting and auditing.
(B. 116.633)

Ireland

Barrett, A.; Lawlor, J.; Scott, S.
The fiscal system and the polluter pays principle. A case study of Ireland.
Aldershot, Ashgate Publishing Ltd., Gower House, Croft Road, Aldershot, Hampshire GU11 3HR, United Kingdom.
1997, pp. 223. GBP 37.50.
ISBN: 1 85972 638 0.
The authors systematically examine the Irish fiscal system in an effort to identify the environmental effects of the system through the incentives it creates, and suggest ways of altering the system in an environment-friendly way.
(B. 116.702)

Italy

Oneto, C.
Le società di comodo.
Milan, Dott. A. Giuffrè Editore. 1997, pp. 220.
ITL 30,000. ISBN: 88 14 06393 1.
The tax regime of non-operating companies as changed after the Finance Law for 1997. In particular, the determination of their minimum taxable income.
(B. 116.527)

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Lazzareschi, R.; Murer, R.; Ruffini, L.
La liquidazione coatta amministrativa delle società cooperative.
Milan, Dott. A. Giufrè Editore. 1996, pp. 438.
ITL 52,000. ISBN: 88 14 06091 6.
The "liquidazione coatta amministrativa" is a special bankruptcy procedure applicable to certain entities listed by the law. This book deals with the application of this procedure to cooperatives.
(B. 116.385)

Picciaredda, F.; Selicato, P.
I tributi e l'ambiente. Profili ricostruttivi.
Milan, Dott. A. Giuffrè Editore. 1996, pp. 200.
ITL 24,000. ISBN: 88 14 06264 1.
The book deals with the relationship between taxes and the environment. It takes into account: the international fiscal politics on the environment (taxes on fuel, vehicles, incentives for non-polluting activities); the EU politics on the environment; and the Italian taxes which relate to the environment (e.g. the tax on the discharge of urban waste material).
(B. 116.386)

Bianchi, N.; Cintolesi, E.; Civitareale, S.
Rimborsi spese e fringe benefits in azienda.
Milan, Dott. A. Giuffrè Editore. 1997, pp. 234.
ITL 30,000. ISBN: 88 14 06428 8.
The book deals with the fiscal regime for fringe benefits and reimbursement of expenses to employees. It takes into consideration the changes introduced by the Finance Law for 1997.
(B. 116.528)

Lithuania

Lithuanian newsletter, No. 6, January-March 1997.
Vilnius, KPMG Lietuva, Stulginskio 4, 2600 Vilnius, Lithuania. 1997, pp. 35.
This "Lithuanian Newsletter" is published quarterly by KPMG Lietuva. The purpose of the Newsletter is to summarize developments in Lithuanian taxation and some other relevant topics including financial reporting of interest for expatriates and foreign companies resident in Lithuania. This No. 6 issue covers significant developments in the field of privatization, commercial banks, insurance, companies with participating state capital, labour law, international agreements, and taxation.
(B. 116.634)

Luxembourg

Holding companies in Luxembourg.
Amsterdam, Coopers & Lybrand. 1996, pp. 32.
Information booklet for investors in Luxembourg dealing with the formation, legal framework, regulatory and accounting requirements, and tax treatment of the two main types of Luxembourg holding companies (1929 holding companies and Soparfi's). Account is taken of legislative changes relating to wealth tax and the granting of the affiliation privilege to permanent establishments.
(B. 116.708)

Banking in Luxembourg.
Amsterdam, Coopers & Lybrand. 1996, pp. 48.
Booklet designed to provide a survey of law and regulations relating to banking in Luxembourg, including the structure of the banking industry, issues relating to establishing a banking business, banking legislation and banking taxation. Includes a list of double taxation treaties.
(B. 116.709)

Netherlands

Kavelaars, P.
Vermogenswinstheffing: verlies of (aan-)winst?
Deventer, Kluwer. 1997, pp. 115. NLG 45.
ISBN: 90 200 1974 O.
This book investigates the desirability and feasibility of the introduction of a capital gains tax. It explains the main problems regarding this tax, such as the tax base, a set-off of losses, definition of the term transfer, and the control aspects. Finally an overview is given concerning the relation with other taxes and international aspects, and some foreign systems are explained.
(B. 116.656)

Belastingheffing met toekomst.
Editor C.A. de Kam. Symposium van de Vereniging van Hoofdambtenaren bij het Ministerie van Financiën en de Nederlandse Orde van Belastingadviseurs dd. 29 maart 1995.
Deventer, Kluwer. 1996, pp. 119. NLG 47.50.
ISBN: 90 200 1768 3.
This book contains the contributions to a symposium dealing with the future of the income tax, corporate income tax and indirect taxes. Several proposals to change the system are included, e.g. a dual income tax with various rates for different income categories, a business income tax or a deduction of a primary return. Finally the book contains comments from practitioners to each of the proposals.
(B. 116.602)

Fiscaal memo 1. July 1997.
Deventer, Kluwer. 1997, pp. 296.
ISBN: 90 200 1971 6.
An up-to-date complete overview and explanation of all taxes, social security contribution and the system of students grants. The booklet contains the forfeits, rates, exemptions and amounts of deductions as of 1993, together with a lot of practical information. Includes an overview of important bill proposals, press releases and recent tax information.
(B. 116.623)

Schematisch overzicht van de Nederlandse belastingen. 31th Edition. Samengesteld door J.W. Ilsink en J. Schuurman.
Deventer, Kluwer. 1997, pp. 44.
ISBN: 90 200 1985 6.
Systematic survey of Dutch taxes effective as of 1 January 1997.
(B. 116.671)

Verhoog, W.; Kamerling, R.N.J.
Vijftien over belastingrecht.
Alphen a.d.Rijn, Samsom Bedrijfsinformatie. 1995, pp. 183. NLG 17.50.
ISBN: 90 14 05402 5.
Contributions of 15 experts who explain the influence of the various taxes on business strategy and results and their influence on the function of accountants as advisor and certifying controller.
(B. 116.603)

Dijck, J.E.A.M. van.
Instellingen van algemeen nut. 2nd Edition.
Deventer, Fed. 1997.
Fed Fiscale Brochures, pp. 132. NLG 53.
ISBN: 90 6002 731 0.
Second edition of a monograph describing general welfare organizations from the point of view of personal income tax, company income, and succession law.
(B. 116.611)

Caanen, J.Ch.
De toekomst van de reserve assurantie eigen risico.
Tilburg, Katholieke Universiteit Brabant, P.O. Box 90153, 5000 LE Tilburg, The Netherlands. 1997.
Research Memorandum FEW 729, pp. 35.
Booklet containing a comprehensive overview about jurisprudence and the practical problems of the reserve for entrepreneurship risks which are not insured. The author indicates that in his opinion a more extensive carry-back in combination with the abolition of this reserve could resolve the problems.
(B. 116.608)

Baard, C.B.
De particuliere belegger en de fiscus.
4th Edition.
Deventer, Kluwer. 1997.
Kluwer Belastingwijzers, No. 21, pp. 147.
NLG 36.50 ISBN: 90 200 1954 6.
Fiscal consequences of the different forms of private investment in savings, bonds, shares, options, immovable property, life insurance and investment funds. Financing of investment is also dealt with.
(B. 116.609)

Dijck, J.E.A.M. van.
Bijzondere tarieven in de Wet op de inkomstenbelasting. 2nd Edition.
Deventer, Fed. 1997.
Fed fiscale brochures, pp. 102. NLG 56.
ISBN: 90 6002 724 8.
The book provides a comprehensive explanation of all forms of income which are taxed at a special rate in the income tax, especially those mentioned in Articles 57 and 57a of the Income Tax Act and the

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capitalization of reserves mentioned in Article 58 of the Income Tax Act. These provisions are explained by taking the entrepreneur and the shareholder as a starting point especially with respect to extraordinary income received. Finally, attention is paid to the new regime for substantial shareholders.
(B. 116.524)

Horzen, F. van; Ganzeveld, J.; Blokland, T.
De nieuwe aanmerkelijk-belangregeling.
Deventer, Fed. 1997.
Fed fiscale actualiteiten, No. 30, pp. 119.
NLG 44. ISBN: 90 6002 721 3.
The booklet contains an extensive and practical overview of all aspects of the new regime for substantial shareholders, such as the new criterion, the rate, the acquiring and selling price, losses, usufruct, the time of assessment and the regime for investment companies.
(B. 116.469)

Belonen 1997.
The Hague, Delwel Uitgeverij BV. 1997, pp. 78. NLG 32. ISBN: 90 6155 796 8.
Comprehensive overview of the taxation of remunerations and expense allowances.
(B. 116.523)

Fiscale en financiële jaargids voor de directeur-grootaandeelhouder 1997.
Deventer, Kluwer. 1997, pp. 304. NLG 71.
ISBN: 90 200 1891 1.
1997 Handbook for tax, financial and civil law practice for director-shareholders dealing with the following subjects: how to make reserves for old age, social security aspects, insurances, succession within the BV and management of capital.
(B. 116.615)

Blokland, T.
Het aanmerkelijk belang in kort bestek.
Deventer, Law & Practice Publishers B.V., Keizerstraat 31, 7411 HD Deventer. 1997, pp. 83. ISBN: 90 5454 010 9.
The book contains an overview of the main aspects of the changes within the regime for substantial interest shareholders, such as the new definition of substantial shareholder, the definition of income derived from a substantial shareholding, the calculation of profits and losses resulting from a substantial shareholding, roll-over possibilities, international regulations and the temporary regulations. Finally, the text of the bill as published in the Official Gazette has been included.
(B. 116.635)

Zadelhoff, B.G. van.
Of de BTW het redt met telecom en internet.
Deventer, Kluwer. 1997, pp. 18.
ISBN: 90 200 1870 1.
In this Inaugural lecture the author explains the consequences of the developments in Telecom and Internet on VAT taking into account the establishment of the internal market. To solve the arising problems he recommends to raise the VAT rate for taxable transactions or to introduce a registration levy for computers and modems. The book is of importance for persons interested in the subject.
(B. 116.509)

Syllabus VVV-IBR. Besluit van de directeur-generaal voor Fiscale Zaken namens de Staatssecretaris van Financiën.
The Hague, Ministry of Finance. 1997, pp. 64.
Paper concerning the changes in the decree for the avoidance of double taxation issued by the Ministry of Finance's department of international fiscal affairs. This paper contains a lot of practical information about the application of the exemption method or the credit method and the deduction as costs of foreign withholding tax. Special attention is paid to the situation under tax treaties, the regulation for the Netherlands, the Netherlands Standard Treaty and the commentary to the OECD Model Convention.
(B. 116.549)

De kwijtscheldingsregeling. Een evaluatie.
The Hague, Ministry of Finance. 1997.
Rapportnumer 93, 1997, pp. 32.
Tax amnesty, an evaluation. An overview of how tax amnesty works in practice. Next to an overview of those provisions, the book contains data about the ability of taxpayers to pay and the control rules which are used when dealing with requests for a remission of taxes.
(B. 116.510)

Kamerling, R.N.J.; Haxe, H.L.
Zakboekje voor de belastingcontrole 1997.
Deventer, Gouda Quint. 1997, pp. 197.
NLG 45. ISBN: 90 387 0515 8.
Booklet explaining the fiscal control regulations, especially the rights and obligations of entrepreneurs, consequences of disapproval of the administration, reversed onus of proof, an investigation of books, disclosure of control reports and jurisprudence and literature overviews.
(B. 116.483)

AOW/ANW/AWW.
Compiled by J.H. Mulder.
Deventer, Kluwer. 1996.
Sociale verzekeringswetten No. 4, pp. 256.
ISBN: 90 312 1352 7.
This book contains the text of certain social security laws in the Netherlands.
(B. 116.622)

Schematisch overzicht van de sociale verzekeringswetten. Juli 1997. Samengesteld door L. Opheikens.
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NEW ZEALAND

THE WINE-BOX INQUIRY: NEVER MIND THE FINDINGS BUT WHAT ABOUT THE RECOMMENDATIONS?

Adrian J. Sawyer

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I. INTRODUCTION

On 14 August 1997, almost three years to the day since its official commencement, the *Commission of Inquiry into Certain Matters Relating to Taxation* (known as the *Wine-Box Inquiry*) tabled its report in Parliament.[1] The Report, splendidly set out in two volumes totalling over 800 pages, contains a review of selective evidence from the hearings. Furthermore, in what was a surprising series of findings; it completely vindicates all of the parties that had allegations of tax fraud and conspiracy labelled against them from any wrong-doing. Not only was this an apparent reversal of the tenor of the evidence heard during the Wine-Box Inquiry (evidence which had been heard in public), but it is at least arguable that it reflects a Commissioner (not the Inland Revenue Commissioner, but a retired former Chief Justice) wary of having the matter extended for another three or four years. Any other finding by the Wine-Box Commissioner would involve, as an inevitable consequence, complex court hearings from parties alleging the Wine-Box Commissioner had demonstrated bias in his approach to handling the Inquiry.

What is of most interest, given that the Report reflects what the journalistic news media have labelled "capitulation" by the Wine-Box Commissioner, is the series of far-reaching recommendations for reform of New Zealand's taxation law and practice. After reviewing the Report's findings, this article focuses on the recommendations contained in the Wine-Box Report.

The remainder of this article is as follows. In Section II, the background to the official decision to undertake the Wine-Box Inquiry is presented, including the various court cases involved and threatened. Reference is made to the contents of the Report of the Commission of Inquiry, with an illustration provided of two of the most notorious transactions scrutinized as part of the Inquiry. Section III briefly critiques the findings of the Report and the reaction of the major parties involved. In Section IV, which forms the focal point of the article, the key recommendations of the Report are examined. Reference is made to the reaction to these recommendations to date, with some predictions as to how the New Zealand Parliament is likely to deal with the recommendations. Section V concludes with a reflective examination of what New Zealand has learnt, and what other tax authorities and governments may take from these experiences of the last three or so years.

II. BACKGROUND TO THE COMMISSION OF INQUIRY

A. Launching of the Commission of Inquiry

On 25 August 1994, the New Zealand Prime Minister, Rt Hon. Jim Bolger, issued the following statement:

> "On 16 March 1994, the Honourable Member for Tauranga [Winston Peters, and now both the Treasurer and Deputy Prime Minister] tabled in this House a collection of papers which has become known as the wine-box papers. These referred to tax-related transactions involving the Cook Islands.
>
> By leave of this House, the papers were referred to the Director of the Serious Fraud Office and the Commissioner of Inland Revenue. Both officers reported to their Ministers that most of the papers were already in their possession, and did not disclose evidence of tax evasion or fraud. These Ministers in turn reported to this House. The Commissioner of Inland Revenue noted in his report that the papers did show blatant tax avoidance, that Inland Revenue has been investigating Cook Islands transactions for some years, that 93 investigations had been completed by the

1. A Commission of Inquiry is a person or persons commissioned by the Governor General of New Zealand, by Order in Council, under Sec. 2 of the Commissions of Inquiry Act 1908, to inquire into and report upon any questions arising out of or concerning:
(a) the administration of the Government; or
(b) the working of any existing law; or
(c) the necessity or expediency of any legislation; or
(d) the conduct of any officer in the service of the Crown; or
(e) any disaster or accident (whether due to natural causes or otherwise) in which members of the public were killed or injured or were or might have been exposed to risk of death or injury; or
(f) any other matter of public importance.
The grounds for the Wine-Box Inquiry fall under (f) above. I.e. the allegations of serious risks to the Crown and the public through the impact of the Wine-Box documents on the administrative and supervisory activities of the Inland Revenue Department (IRD) and Serious Fraud Office (SFO) were held to constitute a matter of public importance.

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department and that NZD 55.7m tax had been assessed in relation to tax avoidance schemes. Other investigations are continuing.

There in the normal course of events the matter should have ended. However, the Member for Tauranga has made increasingly serious charges against these two public services and against other individuals who because the charges are made under the absolute privilege of Parliament are denied normal redress in the Courts.

The Member for Tauranga is now also a member of the Finance and Expenditure Select Committee, which has before it proposed amendments to tax legislation which related to tax avoidance. Hearings on these amendments have been publicly described as a [sic] "an enquiry" and have the ability to call into question the integrity of these public servants, the other involved individuals and the organisations that they represent. I understand that the Committee itself has been debating appropriate procedures to ensure that the Committee does not breach the fundamental rights of the individuals to have access to natural justice.

Independent commentators, including the Rt Hon. Sir Geoffrey Palmer [a constitutional law expert and former Prime Minister] have raised these most important issues in public.

On the first day of August [1994] Sir Geoffrey told an Auckland audience he feared the Select Committee inquiry into tax schemes "would do substantial damage to people's rights".

He said he could see the inquiry "turning into a political and media circus" and suggested it would "outweigh fundamental legal safeguards, individual rights and the rule of law."

The Government's view is that the right of individuals to due process and natural justice under the law is one of the cornerstones of our society. Parliament has passed the New Zealand Bill of Rights Act 1990, which enshrines this right into law.

The Government has obtained from the Solicitor-General his views on how these matters can best be carried forward. His opinion, which I will table, concludes:

"In summary, I consider the Select Committee to be a highly inappropriate forum for inquiring into matters arising out of the "wine-box" papers and the investigations into that material conducted by the Commissioner of Inland Revenue and the Director of the Serious Fraud Office. I believe that instead an independent inquiry by a retired senior judge should proceed under the Commissions of Inquiry Act 1908. The terms of inquiry should focus on ensuring that the specialist bodies charged with investigating tax offences and serious fraud have properly performed their respective functions; and on highlighting any lessons that are to be learned from the "wine-box" documents to ensure New Zealand's taxation base is protected".

The Commissioner of Inland Revenue has also requested that the Government hold an independent inquiry, especially into the allegations that he had acted corruptly in reaching his conclusions about the status of the wine-box matters. In his view, the unanswered allegations about his integrity and that of his department raise a serious threat to voluntary compliance, which is an integral part of the way that the New Zealand tax system works, and hence could affect the revenue of the country to the detriment of all New Zealanders.

The Government has accepted this advice. Accordingly, the Government has approached the former Chief Justice Sir Ronald Davison, who has agreed to chair the inquiry. ... "

In response to this statement, the Commissioner of Inland Revenue stated in a media release:[2]

"The Commissioner of Inland Revenue, David Henry, has welcomed the Government's decision to hold a Commission of Inquiry into the way he dealt with the transactions in the so-called 'wine-box' papers.

'I asked the Government to hold an independent inquiry into allegations made under parliamentary privilege, including allegations of impropriety on my part,' Mr Henry said.

'These allegations have been so serious and so repeated that I now feel an inquiry is needed to confirm my integrity, and the integrity of the entire tax administration,' he said.

'It is not so much the personal nature of the allegations which concerns me, but the effect they may have on the tax system.'

'The tax system relies on taxpayers complying with the law voluntarily; for instance, by filing their tax returns. I am concerned by any allegation which might affect that willingness,' he said.

'I look forward to demonstrating the lawful, proper and competent way in which the department dealt with the transactions referred to in the "wine-box" papers,' Mr Henry said.

'I and my officers will be happy to give the inquiry's chair, former Chief Justice Sir Ronald Davison, our fullest cooperation."

The name "Wine-Box" became associated with the Commission of Inquiry since the original documents had been passed to the Hon. Winston Peters in a wine box, from which he tabled the contents in Parliament on 16 March 1994.[3]

The Terms of Reference of the Commission of Inquiry were pivotal in ascertaining the scope of the evidence that could be validly considered by the Inquiry, and possibly were the reason for its "failure" to sustain the Member for Tauranga's allegations. The Terms of Reference were defined as follows:

(1) To inquire into and report whether the Commissioner of Inland Revenue and/or the Director in charge of the Serious Fraud Office acted in a lawful, proper and competent manner in dealing with the transactions referred to in the documents tabled in the House on the 16th March 1994 by the Honourable Member for Tauranga.

(2) To indicate what, if any, changes to the criminal and/or tax law are desirable having regard to the need to protect New Zealand's income tax base from fraud, evasion and avoidance, arising from the kind of transactions outlined in these documents.

(3) To refer any matters relating to specific taxpayers to the appropriate authorities.

It is the second part of the Terms of Reference that receives close attention in this article. Prior to a discussion of the contents of the Commission of Inquiry's Report and an illustration of the most talked about schemes (the "Magnum" and "BNZ Captive Insurance" arrangements), a background to the protracted legal proceedings provides a basis for assessing the outcome of the Inquiry.

2. The Director of the Serious Fraud Office, Charles Sturt, was not so willing to publicly welcome the Inquiry.

3. *Papers Presented, by leave, to the House of Representatives, by the member for Tauranga, the Honourable Winston Peters, on 16 March 1994*, House of Representatives, (1994), Vols 1 to 3.

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B. Legal proceedings surrounding the Commission of Inquiry

Prior to the release of the Report, there had been several court actions to clarify matters, extending as far as to the Privy Council. In late 1992, in *European Pacific Banking Corporation v. Fourth Estate Publications Ltd*,[4] the architect of the Wine-Box schemes had successfully gained an interim injunction to prevent publication of a programme centred around the "Magnum" arrangement.[5] Later in *European Pacific Banking Corporation v. Television New Zealand*,[6] an application for the lifting of the injunction was raised again. The Court of Appeal found an arguable case to allow the matter to proceed by lifting the injunction, and the television programmes and business newspaper features of the Cook Island's schemes were launched. The Commission of Inquiry was set in place shortly afterwards.[7]

In *Fay Richwhite and Co Ltd v. Davison*,[8] the Court of Appeal ruled that for the Commission of Inquiry to be effective in carrying out the Terms of Reference, it was on balance necessary, that the evidence be heard in public, notwithstanding the provisions of Section 13 of the Inland Revenue Department Act 1974 (now Section 81 of the Tax Administration Act 1994[9]). In *Brannigan v. Davison*;[10] *Controller and Auditor General v. Davison*;[11] *KPMG Peat Marwick v. Davison*,[12] the Court of Appeal was asked to consider an application for a judicial review of two of the Wine-Box Commissioner's rulings. The review concerned the decision that the hearings were to be held in public and requests for giving evidence and producing documents. The Court of Appeal dismissed all applications for a judicial review.

One of the parties sought leave to have the appeal heard by the Privy Council. In *Brannigan v. Davison*,[13] the Court of Appeal granted the application for leave to appeal to the Privy Council. Brannigan and the others involved in the application for leave to appeal argued that they were bound by Cook Island's secrecy laws. Furthermore, the applicants contended that Cook Islands' secrecy laws should prevail over New Zealand's laws and the public nature of the Inquiry. In *Brannigan v. Davison*,[14] the Privy Council advised that Brannigan and the other individuals involved in the appeal should give evidence when requested to do so by the Commission of Inquiry.

Just prior to the release of the Wine-Box Report, an application for a further judicial review of the Wine-Box Commissioner's handling of the Inquiry was heard by the High Court. In alleging bias and breaches of natural justice, Smellie J was requested to determine whether the judicial review proceedings be heard in the High Court (sought by the petitioning parties) or Court of Appeal (as requested by the Wine-Box Commissioner). In *Fay Richwhite v. Davison; Attorney-General v. Davison*,[15] Smellie J ruled that the case be heard in the High Court.

4. [1993] 1 NZLR 559; (1993) 6 PRNZ 129 (CA).
5. In three subsequent efforts, Television New Zealand Ltd was unsuccessful in having the injunction lifted: see *European Pacific Banking Corporation v. Television New Zealand*, unreported, HC Auckland, CP768/93, Robertson J, 3 February 1994; *European Pacific Banking Corporation v. Television New Zealand Ltd (No. 2)*, unreported, HC Auckland, CP768/93, Henry J, 30 March 1994; and *European Pacific Banking Corporation v. Television New Zealand Ltd (No. 3)*, unreported, HC Auckland, CP768/93, Robertson J, 12 April 1994.
6. [1994] 3 NZLR 43; (1994) 7 PRNZ 441; (1994) 18 TRNZ 726 (CA).
7. This followed an earlier appointment of Parliament's Finance and Expenditure Select Committee by the National Government to investigate and inquire into the alleged Cook Islands' deals.
8. [1995] 1 NZLR 517; (1995) 17 NZTC 12,011; (1994) 19 TRNZ 393 (CA).
9. Sec. 81 of the Tax Administration Act 1994: Officers to maintain secrecy -
(1) Every officer of the Department -
(a) Shall maintain and aid in maintaining the secrecy of all matters relating to -
(i) The Inland Revenue Acts, including all Acts (whether repealed or not) at any time administered by or in the Department; and
(ii) The Accident Compensation Act 1982 or Accident Rehabilitation and Compensation Insurance Act 1992; and
(iii) The New Zealand Superannuation Act 1974, - which come to the officer's knowledge, and shall not, either while the officer is or after the officer ceases to be an officer of the Department, communicate any such matters to any person except for the purpose of carrying into effect the Acts referred to in subparagraphs (i) and (ii) or any other enactment imposing taxes or duties payable to the Crown, or of carrying into effect the powers, duties, and functions of the Commissioner under the New Zealand Superannuation Act 1974; and
(b) Shall, before the officer begins to perform any official duty as an officer of the Department, make a declaration of fidelity and secrecy in the form prescribed by the Commissioner to maintain secrecy in conformity with this section, which declaration may be made before the Commissioner, [or an officer of the Department,] or any other person authorised by or under the Oaths and Declarations Act 1957 to take statutory declarations. ...
(3) Without limiting the generality of subsection (1), no officer of the Department shall be required to produce in any Court or tribunal any book or document or to divulge or communicate to any Court or tribunal any matter or thing coming under the officer's notice in the performance of the officer's duties as an officer of the Department, except when it is necessary to do so for the purpose of -
(a) Carrying into effect -
(i) The Inland Revenue Acts, including all Acts, whether repealed or not, at any time administered by the Department; or
(ii) The Accident Compensation Act 1982 or the Accident Rehabilitation and Compensation Insurance Act 1992; or
(iii) Any other enactment imposing taxes or duties payable to the Crown; or
(b) Carrying into effect the powers, duties, and functions of the Commissioner under the New Zealand Superannuation Act 1974. ...
(4) Nothing in subsection (1) or subsection (3) shall be deemed to prohibit the Commissioner from -
(a) Communicating such information as is necessary for the purpose of any prosecution under any Act of the Parliament of New Zealand or under the law of any country or territory outside New Zealand, or such information as the Commissioner considers desirable for the purpose of any investigation into any suspected indictable or summary offence, being a prosecution or an investigation in relation to any misappropriation or attempted misappropriation by any person in respect of money payable by the Department to another person or by any person in respect of money entrusted to that person by, for, or on behalf of, another person for payment to the Department: Provided that no communication under this paragraph shall be made in respect of any person to whom any such money was payable, or by, or for, or on behalf of, whom any such money was entrusted, unless that person or that person's legal personal representative, or, where that person is a company, the authorised officer of that company, consents to the communication: ...
(c) Divulging or communicating any matter or thing to the Director of the Serious Fraud Office, or producing in any Court any book or document, that the Commissioner considers desirable for the purposes of any investigation or prosecution in relation to any suspected inland revenue offence, and any such matter or thing shall be deemed to be divulged or communicated, and any such book or document shall be deemed to be produced, for the purpose of carrying into effect the Acts referred to in subparagraphs (i) and (ii) of subsection (1)(a) or any other enactment imposing taxes or duties payable to the Crown: ...
10. [1996] 2 NZLR 278; 338; [1996] NZAR 145; 214 (CA).
11. [1996] 2 NZLR 278; 295; [1996] NZAR 145; 164 (CA).
12. [1996] 2 NZLR 278; 319; [1996] NZAR 145; 193 (CA).
13. (1996) 9 PRNZ 277 (CA).
14. [1997] 1 NZLR 140; (1996) 10 PRNZ 14; (1996) 3 HRNZ 381 (PC).
15. (1997) 18 NZTC 13,256.

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Approximately two months later on 14 August 1997, the Wine-Box Report was tabled in Parliament. The Report's findings completely vindicated the corporates, personnel and government officials ordered to give evidence. All of the allegations made by Winston Peters were declared to be baseless. Furthermore, in stark contrast to the privilege or immunity against legal proceedings afforded to Winston Peters as a Member of Parliament with respect to his allegations, a similar privilege was not available to those parties named in the Wine-Box documents and called to give evidence. After the release of the Report, the various applications for judicial review[16] have been progressively withdrawn; not surprising given the almost unbelievable turnaround of the findings in the context of the preceding evidence.

The matter is far from resolved. On 26 September 1997, the Treasurer and proponent of the Wine-Box Inquiry, the Hon. Winston Peters, announced that he intends to commence an application for judicial review of the Commissioner's findings. The specific matter for review is the inference in the Report that provided taxpayers document their falsities to suit their tax avoidance purposes, there can never be a finding of fraud. Essentially, Winston Peters is seeking a finding that the form over substance argument was incorrectly applied with respect to the "Magnum arrangement". Alternatively, Winston Peters is seeking clarification that a substance over form approach should have been adopted.

The statement made by the Commissioner, Sir Ronald Davison, in the Wine-Box Report concerning the form over substance issue seized upon by Hon. Winston Peters, is that:[17]

> "The fundamental defect in the "form over substance" doctrine is that the IRD is not a party to the transaction. The parties may, therefore, document whatever falsities suit their tax avoidance purposes. Morally, or in principle, there can be no good reason why the fact that they have carried out the transaction according to the (potentially dishonest) forms of it should benefit them."

While not referring to the Wine-Box Report, in a recent statement by Tipping J in the Court of Appeal (as part of a separate judgment but nevertheless overall unanimous decision) in a case concerning whether money stolen from an employer can be treated as income for tax purposes,[18] his Honour states:

> "In my judgment, we should decide the novel problem presented in the present case by affirming our consistent approach in New Zealand to taxation issues. *Except in cases involving sham or avoidance, taxation issues should be decided on the basis of the legal and equitable rights and obligations deriving from the transaction to which the taxpayer is a party, or the circumstances in which the taxpayer is involved.* Taxation issues should not be decided on the basis of the so called economic substance or reality of the transaction, or of the circumstances in which the taxpayer is involved.

As Lord Browne-Wilkinson has recently observed in *CIR v. McGuchian*, (House of Lords, judgment 12 June 1997):

> "Liability to tax depends on statutory construction not moral disapproval."

I would venture to expand his Lordship's statement by saying that in New Zealand liability to tax depends not on moral disapproval but on statutory construction applied to legal rights and obligations. In the same case, Lord Steyn cited *IRC v. Duke of Westminster* [1936] AC 1, 19, per Lord Tomlin, as authority for the proposition that whatever the substance of the arrangements may have been, their fiscal effect has to be in accordance with the legal rights and obligations they have created. In *McGuchian*, their Lordships indicated that this "formalistic" approach was no longer appropriate when examining cases in which tax avoidance was at issue. No longer was tax law to be regarded as some island of literal interpretation. While fully accepting that to be so in cases of alleged avoidance (as was *McGuchian*) I consider Lord Tomlin's statement still holds good when the taxation consequences of transactions and circumstances, not said to involve avoidance or sham, are in issue. If tax is to be levied according to whatever is perceived to be the economic substance or reality of the situation, rather than according to the rights and obligations involved, we would be embarking into uncertain waters, and waters as unsound as they would be uncertain. For my part, I am unwilling to see taxpayers placed in such a situation."

This insightful observation hints at the possible future direction of interpretation of tax avoidance by the Court of Appeal in New Zealand. Cases involving shams and avoidance issues should not be decided on the normal basis of form over substance, where the legal and equitable rights and obligations deriving from the transaction to which the taxpayer is a party (or the circumstances in which the taxpayer is involved) take precedence.[19] In the light of the observations by Tipping J in *"A Taxpayer v. C of IR"*, there may be an arguable case that the Wine-Box Commissioner should have applied the substance over form approach to the Wine-Box evidenced transactions, including the Magnum arrangement. The approach taken by Tipping J would clearly support Sir Ronald's finding that an argument theoretically could be pursued that the transactions were tax avoidance (which could be pursued by the Commissioner of Inland Revenue). However, in practicable terms it is unlikely, given Sir Ronald's statement that all income received had been disclosed and returned by European Pacific Funds Management Ltd, one of the European Pacific Group of companies.[20]

C. Commission of Inquiry Report: Farcical, factual or fortuitous?

The Wine-Box Report is surprisingly brief given the 13,000 pages of typed transcripts of verbatim records of the hearing. Its 800 or so pages represent a selective reproduction of the context of the Inquiry, a non-representative selection of the evidence, a series of surprising findings given the tenor of the

16. This included applications led by Fay Richwhite & Co Ltd, including European Pacific and Brierley Investments Ltd, and applications by the Inland Revenue Department and Serious Fraud Office.
17. Wine-Box Report, 3:1.55. The first number refers to the part of the Report, the second to the section, the third to the page number.
18. *"A Taxpayer v. C of IR"*, unreported, Court of Appeal, CA196/96, 28 August 1997, Richardson P, Keith, Tipping and Elias JJ, emphasis added.
19. The issue of form over substance was discussed by Robertson, B, "Form and Substance", (1997) 41 *Current Taxation* at 67-68. The decision in *A Taxpayer v. C of IR* is discussed by Robertson, B, "Ill-Gotten Gains and Income Tax", (1997) 41 *Current Taxation* at 73-76.
20. Wine-Box Report 2:1.66 with respect to the Magnum arrangement. It should be noted that EP Funds Management was wound up prior to the Inquiry and in any instance the dividend income was exempt from tax under former Sec. 63 of the Income Tax Act 1976.

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publicly heard evidence, and some radical recommendations for "improving" the state of New Zealand's tax system.[21]

The Report commences with an overview of the information relating to Commissions of Inquiry and the establishment of the Wine-Box Commission of Inquiry. The Terms of Reference, scope of the Inquiry and the process followed during the proceedings are then presented. The remainder of the first part of the Report examines:

- the history of the Wine-Box documents, including their nature and classification;
- the role of the architect of the schemes involved (the European Pacific Group of companies);
- the role of tax havens generally; and
- the political background (including the efforts made by the Inland Revenue Department (IRD) and Serious Fraud Office (SFO) in earlier "examinations" of the Wine-Box documents).

The core aspects of the Report's findings are contained in Volume 2. The Commission of Inquiry's approach to classifying the documents is explained, and then related to the concepts of tax planning, avoidance and evasion. The allegations of the Hon. Winston Peters are set out in detail and exposed for what the Commission determined they were; unfounded and damaging to the IRD, SFO and business practice in New Zealand.

After providing a glowing report of the manner in which the IRD and SFO dealt with the Wine-Box documents, Sir Ronald's conclusions are contained in Part Seven of Volume 2, in the face of critical and seriously damaging evidence to the contrary. Evidence given at the hearings had been riddled by frequent lapses of memory and evasive answers. The European Pacific Group's legal representative was known for being legally present and not present from time to time; a situation that provided a lighter moment to an otherwise tense and protracted period of hearings.

After the events leading up to the release of the findings, expectations were for a severe criticism of the IRD's and SFO's actions (or more correctly, relative inaction), and the behaviour of the corporates and personnel involved. Furthermore, the preparation for a judicial review of Sir Ronald's alleged bias by several of the corporates involved in the Wine-Box affair, and complementary proceedings initiated by the IRD and SFO alleging unfairness, suggested a damning report of the behaviour of these organizations was inevitable. Such an expectation implied protracted legal arguments would be expounded in judicial forums for the foreseeable future.

The Report concludes that there is no foundation to Winston Peters' claims of:

(1) fraud in the transactions;
(2) corruption by the heads of the IRD and SFO;
(3) conspiracy to pervert the course of justice by the IRD and SFO;
(4) conspiracy not to prosecute the corporates and individuals involved by the IRD and SFO;
(5) conspiracy to defraud by the corporates and individuals named as parties and called as witnesses, with respect to the four key transactions included in the Wine-Box documents.[22]

The majority of commentators would concur with these findings, although some confuse morality and ethical issues with illegality and the concept of fraud. The transactions evidenced by the Wine-Box documents were described as representing both several corporates' intent on reducing their exposure to the "burdensome" tax environment of the mid to late 1980s, and (part of) the tax industry of the time, whereby loopholes were isolated and exploited as far as *legally* possible. In this environment, the worst possible outcome was a finding by the Commissioner of Inland Revenue that the transactions were tax avoidance. The "penalty" would be the ineffectiveness of the transactions to render the advantage sought, i.e. a legislatively enforced requirement that those involved pay the tax.

The Report then considers the role of the IRD and SFO in accordance with the first part of the Terms of Reference, which is restated below:

> "(1) To inquire into and report whether the Commissioner of Inland Revenue and/or the Director in charge of the Serious Fraud Office acted in a lawful, proper and competent manner in dealing with the transactions referred to in the documents tabled in the House on the 16th March 1994 by the Honourable Member for Tauranga;"

Both the IRD and SFO are cleared in the Report of any unlawful behaviour, impropriety or incompetence. It is this last finding that has a hollow ring to it. The evidence presented to the Commission of Inquiry included revelations that the Wine-Box documents were not examined in detail when they were claimed to have been so examined by both the IRD and SFO. Furthermore, admissions of a lack of understanding of fraud and associated issues by some officials in the IRD and the SFO director, Charles Sturt, when under cross-examination, were heard. Importantly, the admission from the SFO that it misled Parliament, when viewed collectively with the other revelations, has led to the conclusion of incompetence by many commentators, analysts and the like, but not so to the Wine-Box Commissioner, Sir Ronald Davison.

In an amazing statement, Sir Ronald states in his Report (with respect to the IRD):[23]

> "There can be no substance to an allegation that it [the IRD] was incompetent in that it failed to detect fraud or tax evasion when there was in fact no evidence at all to indicate that such occurred in relation to any of the wine-box transactions."

and later with respect to the SFO:[24]

21. In October 1995, a publication, prepared in a narrative journalistic manner, was released providing an extensive background to the Wine-Box Inquiry. It suggested the Inquiry would involve an uncovering of a conspiracy; see Wishart, I, *The Paradise Conspiracy* (Auckland, Howling at The Moon Publications, 1995).
22. The four key transactions were Magnum; Japanese Investment Funds (JIF); Mandatory Convertible Notes/Redeemable Preference Shares (MCN/RPS); and BNZ Captive Insurance schemes. The first and fourth series of transactions are graphically illustrated later in this article.
23. Wine-Box Report, 2:7.8.
24. Id. at 2:7.9.

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> "The SFO cannot be held to have been incompetent for not detecting fraud in transactions where no fraud existed."

With respect, Sir Ronald Davison appears to have missed the point. The evidence did not suggest there was any fraud, so the fact that the IRD and SFO did not detect any is not surprising. However, the process by which the IRD and SFO went about examining the documents and the quality of the staff assigned to the task would, it is submitted, have made it extremely unlikely that either would have found fraud if it had existed, or at least been able to argue a reasonable case to sustain its existence in court proceedings (if these should arise). For example, the IRD personnel responsible for international tax issues had not scrutinized the documents when they stated they had done so.

The IRD's contribution to the Inquiry has been highlighted by its assistance to the Commission of Inquiry throughout by giving formal evidence when requested, making informal presentations to the Counsel Assisting the Commission of Inquiry, and providing over 19,000 pages of information.

Concerning its investigation of the "Wine-Box" deals, the IRD stated that since obtaining the "Wine-Box" papers from the Serious Fraud Office in February 1993, a year before the Hon. Winston Peters tabled them in Parliament, Inland Revenue continued to investigate the 60 deals involved. Initially this work was done by a project team who analysed the papers concurrently with the investigation of large corporates. Assessments to early 1996 totalled NZD 500 million in additional income and NZD 140 million in additional tax. However, the IRD has not been appreciative of the media's role during the hearings, complaining of the media's inability to understand the complex international transactions, asserting that cross-examination is not covered adequately and damaging headlines often remain unaltered.

The head of the Tax Intelligence Unit in the Inland Revenue Department at the time, admitted during the hearings that he did not understand the Magnum arrangement until he saw the documentary explaining the deal on Television New Zealand. Other internal difficulties with senior staff within the IRD did not assist the IRD's efforts in reviewing the Wine-Box documents.

Turning to the SFO, the director, Charles Sturt, admitted during the hearings that he could not explain the Magnum arrangement, even though he had personally investigated the Wine-Box (which he admitted took only a matter of a few hours). Ironically, when asked to define fraud at the hearings, Sturt could not do so. Shortly afterwards, he stepped down from the position, citing ill health. If this situation does not suggest incompetence by the IRD, and the SFO particularly, then it begs the question; "What must exist for incompetence to be established?"

Journalistic comment has been severely critical of the Wine-Box Inquiry Report's findings; the scathing nature no better illustrated by features in the *National Business Review* and *The Independent* on 15 August 1997 and 22 August 1997. These features focused on the whitewash of Winston Peters' allegations and the capitulation by the Wine-Box Commissioner, despite the overwhelming evidence suggesting otherwise. The following quotation from one of the business magazines, that was central to exposing the Wine-Box dealings, aptly describes the situation:[25]

> Chalkie has an analogy for the sort of logic Sir Ron is applying here. The SFO and the IRD visit their optician for an eye test. Because they are blind they cannot see the chart in front of them. Enter Sir Ron. He takes away the chart. In doing so he restores their sight as neither the SFO nor the IRD can be considered blind for failing to see something that isn't there.

It is the scope of the first part of the Terms of Reference that, notwithstanding the misplaced allegations of Winston Peters concerning the concept of fraud, ensured that related matters, such as the deals with various bloodstock investigations, were outside the scope of the Commission of Inquiry.[26] Additionally, the findings of the Wine-Box Inquiry lack substantial arguments and comprehensive analysis of the evidence presented at the hearings; a surprising result given the commendations for the meticulous and unfazed attitude taken by Sir Ronald throughout the hearings until the threatened review of his alleged bias.[27]

D. The Magnum arrangement

Behind the Magnum scheme was a European Pacific ("EP") financial structure enabling the Cook Islands-based company to collect more than NZD 400,000 in fees and apparently avoid some NZD 2.05 million in tax. The essence of this tax saving scheme rested on arrangements EP made with the Cook Islands government, as set out in the steps below:

(1) EP Funds Management loaned NZD 32.229 million to another subsidiary, Harcourt Acceptances, which immediately paid NZD 2.518 million in interest. Of this interest, NZD 1.637 million was paid to EP Funds Management and the other NZD 881,582 was paid to the Cook Islands Inland Revenue Department.[28]

(2) At the same time, another European Pacific subsidiary, Dundee Investments, sold a promissory note to the Cook Islands Property Corporation (i.e.: the Cook Islands Cabinet) for NZD 10,881,582.

(3) The Cook Islands Property Corporation then on-sold the promissory note to a fourth European Pacific subsidiary, European Pacific Merchant Finance, for NZD 10,050,000 (representing a loss of NZD 831,582), which had been collected earlier by the Cook Islands Government. The Cook Islands Government received NZD 50,000 net as a fee for its part in the deal.

25. "Sir Ron performs modern miracle: IRD, SFO: They once was blind but now can see", (1997) *The Independent*, 22 August, 40 and 27. *The Independent* magazine was also subjected to the interim injunction restraining publication of the Cook Island's deals contained in the wine box.
26. A publication drawing upon the wider allegations outside the Wine-Box Inquiry, including those mooted by Winston Peters, was published almost concurrently with the Wine-Box Report; see Wishart, I, *Lawyers, Guns and Money* (Auckland, Howling at The Moon Publications, 1997).
27. See *Fay Richwhite v. Davison, Auditor-General v. Davison* (1997) 18 NZTC 13,256.
28. The Cook Islands uses New Zealand currency which eliminates the potential for currency exchange rate risk.

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(4) Harcourt advanced the NZD 32 million loan to EP Merchant Finance, less the interest and a NZD 200,000 fee. The net balance of NZD 30 million was loaned to its parent company, European Pacific Banking Corporation. The EP Banking corporation indemnified the loan to EP Merchant Finance from Harcourt and deposited the NZD 30 million in the Bank of New Zealand's Hong Kong branch at 14.85 per cent interest.

(5) The transaction ended when the BNZ bought Magnum's preference shares at their face value of NZD 34.4 million. EP Banking Corporation, in turn, bought the shares for the same amount using the NZD 30 million deposit at the bank.

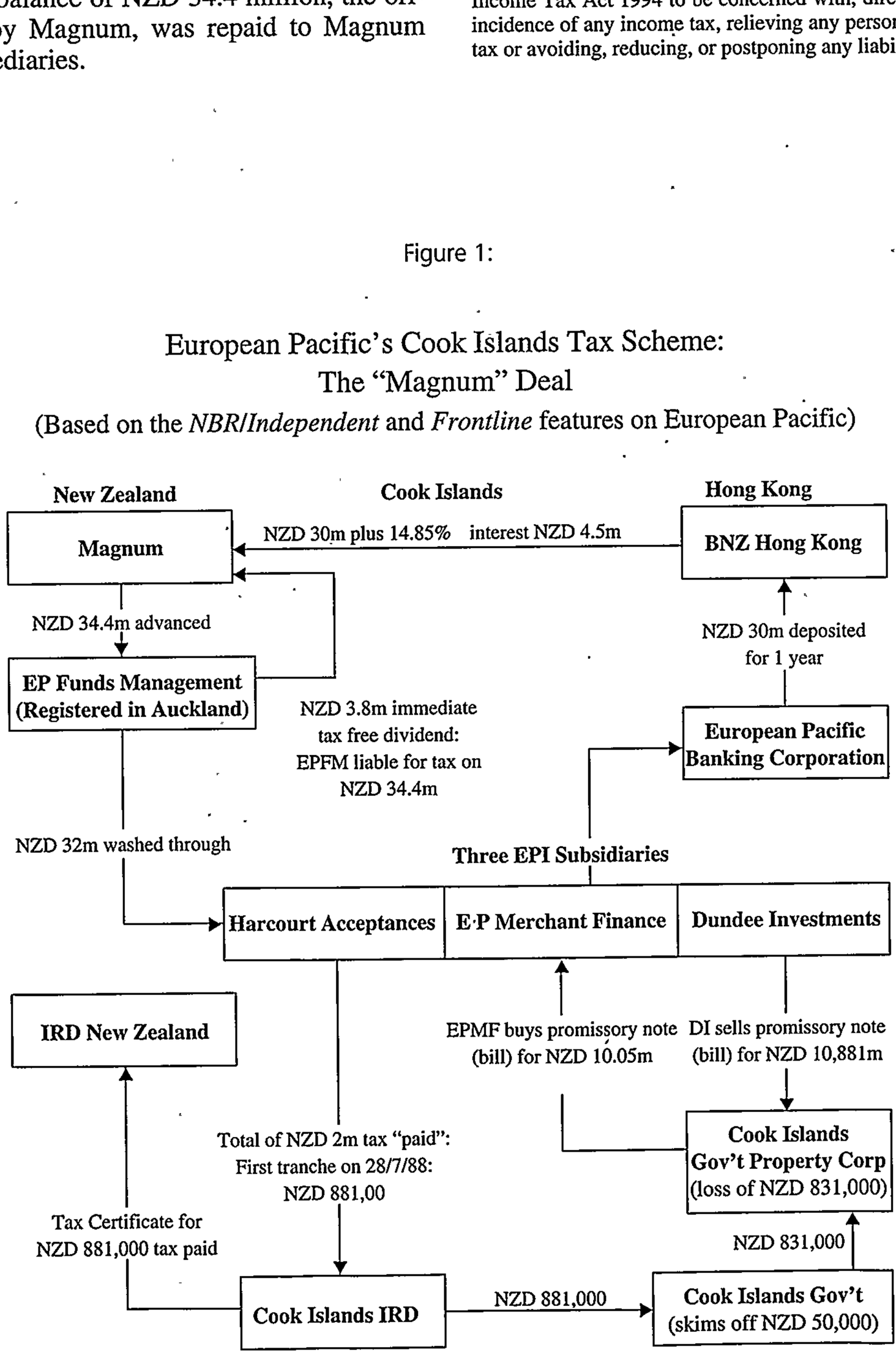
(6) By now the deposit account at the BNZ in Hong Kong had increased to NZD 34.455 million and EP took a further NZD 55,000 fee. The balance of NZD 34.4 million, the original sum advanced by Magnum, was repaid to Magnum through the EP intermediaries.

The tax advantage to the European Pacific Group was that Harcourt Acceptances had received two Cook Islands tax certificates showing total tax paid in the Cook Islands of NZD 2.05 million; NZD 881,582 initially and NZD 1,168,609 some 12 months later. EP could in turn use the certificates to offset against its overall New Zealand tax liability. The arrangement consisted of the entire set of transactions enabling the tax certificates to be obtained. Consequently, the issue is whether this was tax planning, tax avoidance or tax evasion, with the most likely being that of avoidance.[29]

29. If it is avoidance, then a formal ruling is beyond the Terms of Reference of the Wine-Box Inquiry. Tax avoidance is itself defined by Sec. OB 1 of the Income Tax Act 1994 to be concerned with, directly or indirectly, altering the incidence of any income tax, relieving any person from liability to pay income tax or avoiding, reducing, or postponing any liability to income tax.

Figure 1:

European Pacific's Cook Islands Tax Scheme:
The "Magnum" Deal
(Based on the *NBR/Independent* and *Frontline* features on European Pacific)



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Ohms (1996) concludes that the Magnum arrangement was, on the face of things; undertaken for the purpose of generating a tax certificate, which is necessarily avoidance.[30] The Magnum arrangement is set out in Figure 1.

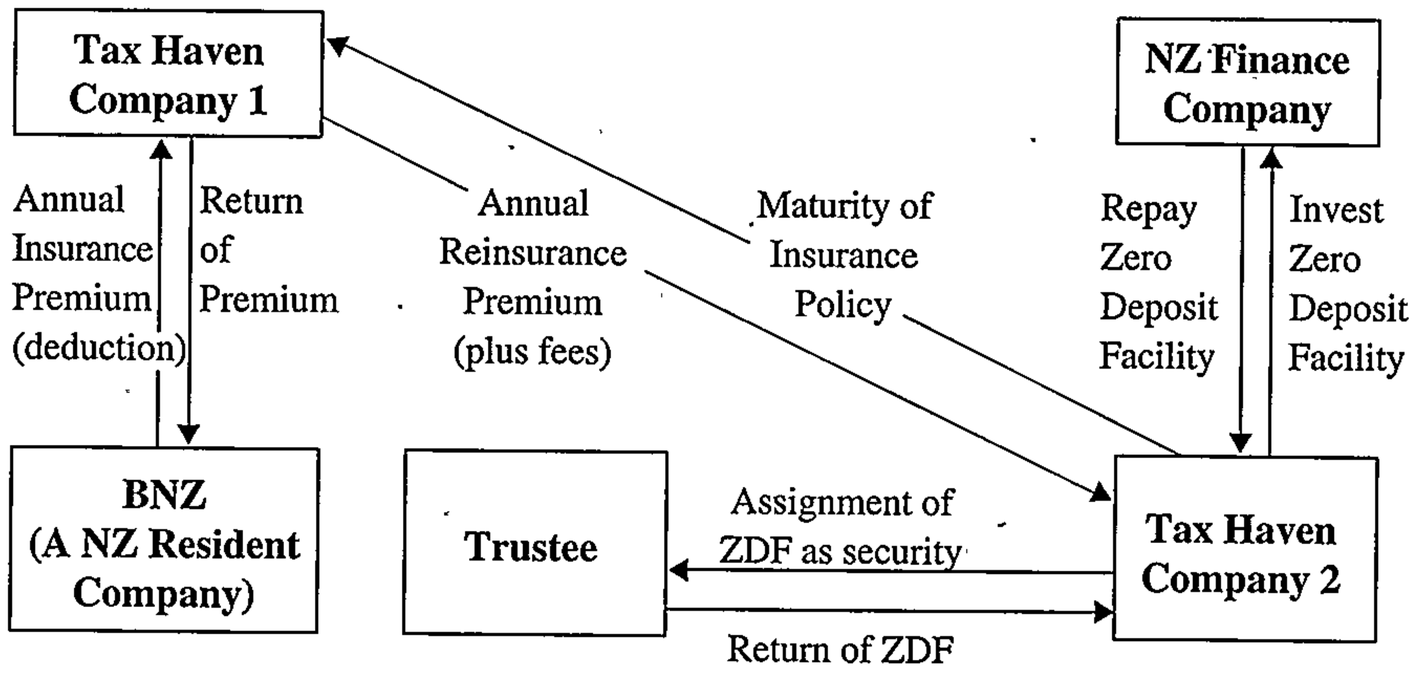
E. The BNZ Captive Insurance Scheme

Also included in the Wine-Box documents is a scheme involving the Bank of New Zealand (BNZ) and a so-called "captive insurance company". The basis of the transaction was that the BNZ, a NZ resident company, established a captive insurance company in a tax haven and entered into an insurance contract to cover designated assets. The premiums paid were deductible in New Zealand for tax purposes and received as tax free income in the tax haven. At the end of the insurance contract, all premiums were to be returned to the BNZ tax free, less the promoter's costs. The effect of such a scheme was to reduce tax (by claiming the expense) and to get the funds back in due course.

Captive Insurance Schemes are described in the Wine-Box Report.[31] According to Ohms (1996), the BNZ enters into an insurance policy with Tax Haven Co 1. The policy provides for payment of NZD 50 million upon the occurrence of specified events. Tax Haven Co 1 reinsures its liability with Tax Haven Co 2. New Zealand Co pays annual insurance premiums totalling NZD 50 million (plus fees) to Tax Haven Co 1 which in turn pays Tax Haven Co 2. Tax Haven Co 2 initially enters into a zero coupon bond facility with New Zealand Finance Co and deposits the premiums with it. The face value of the zero coupon bond is NZD 50 million, and the zero coupon bond is assigned to a trustee for New Zealand Co. At the end of the insurance contract, the zero coupon bond is redeemed and the premiums returned to New Zealand Co. This is illustrated by referring to Figure 2.

Figure 2:

The BNZ Captive Insurance Scheme – Simplified[32].



Could this transaction, when viewed in its entirety, amount to tax evasion? The *actus reus* and *mens rea* must be proven to establish fraud; the *actus reus* is easily established, since the scheme, when viewed in its entirety, reduces the BNZ's income by NZD 50 million. The NZD 50 million is eventually returned free of tax. The problem is establishing the *mens rea* or intent. As Ohms (1996)[33] asserts:

> "Was this scheme carried out to avoid paying tax in circumstances where it was known, or should have been known, that the transaction was untenable? [*R v. Petherick* (1994) 16 NZTC 11,134]. This is simply a question of fact. Suppose the scheme had already been overturned by the courts. This would be evasion …
>
> What about a less extreme case? The [BNZ] seeks a legal opinion that clearly says the transaction is untenable. A second opinion confirms the first. A third opinion also confirms this. To proceed in the circumstances would also be evasion."

If it is not evasion, what of avoidance? The Wine-Box Inquiry Report clears such a transaction of amounting to fraud (and impliedly evasion). Furthermore, the IRD has indicated the Commissioner could treat an arrangement of that nature as tax avoidance.[34]

30. Ohms, C. "Tax Dodging: What's legal? What's not?" (1996) *The Independent*, 30 August, at 14. This was the third in a series of four articles on tax planning, avoidance, and evasion. The other articles by Ohms in this series are: "When does legal tax avoidance become criminal tax evasion?" (1996) The Independent, 16 August, at 32; "Tax Dodging: What's legal? What's not?" (1996) *The Independent*, 23 August, at 25; and "Tax Dodging: What's legal? What's not?" (1996) *The Independent*, 6 September, at 19. For more in-depth analyses of avoidance in New Zealand, see Ohms, C. "Section 99: The General Anti-Avoidance Rule – Analysis and Reform" (1994) 1 *New Zealand Journal of Taxation Law and Policy*, at 87; and Sawyer, A. J., "Blurring the Distinction between Avoidance and Evasion – The Abusive Tax Position", (1996) *British Tax Review*, No. 5, at 483.

31. Wine-Box Report 2:1.92-93.

32. Based upon Ohms, C., "Tax Dodging: What's legal? What's not?" (1996) *The Independent*, 23 August, at 25.

33. Ohms, C., "Tax Dodging: What's legal? What's not?" (1996) *The Independent*, 23 August, at 25.

34. Wine-Box Report, 2:5.28, where there was no further action taken by the IRD as all income was either returned or was not New Zealand income.

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To answer the opening question to this section of the article: "Is the Report farcical, factual or fortuitous?" It is arguable that the scant use of the evidence presented at the Inquiry and associated lack of legal argument suggests the Inquiry's Report is farcical. However, it could also be argued that it is factual and representative of the evidence, as far as reasonably practical, given the lapses of memory and illusory nature of the documentary evidence throughout the hearings. Cynically speaking, it may be fortuitous for the corporates and individuals, the IRD, the SFO (and perhaps for the Wine-Box Commissioner), that the outcome of the Report has avoided the implications of protracted judicial review applications (notwithstanding the pending application for judicial review of Sir Ronald Davison's findings by Winston Peters).

What about the direct costs to the New Zealand public of the Commission of Inquiry? The (nearly finalized) costs to date have been estimated as approximately NZD 11 million, the largest component being the fees paid to the lawyers and accountants and to the Commissioner, Sir Ronald Davison. European Pacific has estimated its own costs at being NZD 80 million, while other corporates have made estimates in the millions of dollars.[35] In the light of this information and the nature of the findings, was the Inquiry and the ensuing Report really worth the time and expense? Putting the revelations of the 1980s business culture in New Zealand and the Cook Islands, and the inference of incompetence by the IRD and SFO, to one side, the recommendations for changes to the legislative environment offer some valuable return for the effort and expense. A critique of the recommendations is now presented.

III. THE RECOMMENDATIONS FOR CHANGE

A. A summary of the submissions for change

The Commission of Inquiry's second and third parts to its Terms of Reference are reproduced below:

(2) To indicate what, if any, changes to the criminal and/or tax law are desirable having regard to the need to protect New Zealand's income tax base from fraud, evasion and avoidance; arising from the kind of transactions outlined in these documents.

(3) To refer any matters relating to specific taxpayers to the appropriate authorities.

The third part to the Terms of Reference became redundant in the light of the paucity of findings and negative response pertaining to the first part of the Terms of Reference. That is, there was no prima facie case, in the view of the Wine-Box Commissioner, for the allegations of fraud and conspiracy, or for further review of the actions of the IRD and SFO.

1. Transactions raising concerns identified during the Inquiry and historical efforts to address shortcomings in the tax system

The Wine-Box Inquiry identified a variety of transactions or activities during the course of its hearing:

(1) capital gains and their relation to taxable income;
(2) interest deductibility;
(3) redeemable preference share financing;
(4) sourcing of income;
(5) residence of offshore companies;
(6) allocation of costs to offshore companies;
(7) circular self-cancelling arrangements;
(8) compliance with the international tax regime;
(9) unwinding of offshore structures;
(10) non-resident withholding tax branch exemption; and
(11) advancing or postponing payments of interest.

The Report then identifies major changes to the tax system from the mid 1980s onwards which have effectively eliminated any repetition of the activities subjected to scrutiny in the wine box of documents.

Specifically, from 1 July 1986, an accruals regime was implemented to require, *inter alia*, that interest expense and income must be returned evenly over the period of a loan. An international tax regime was introduced from 1 April 1988 creating a trust regime, Controlled Foreign Company (CFC) regime, Foreign Investment Fund (FIF) regime (although this was not fully effective until 1992), and a Foreign Dividend Withholding Payment (FDWP) regime, subjecting companies to a 33 per cent withholding tax on foreign dividends received.

The CFC and FIF regimes were substantially amended in 1993 to reflect the changing business environment and to strengthen the tax base. Furthermore, a Non-Dividend Repatriation regime was introduced to complement the CFC regime, and the introduction of a Underlying Foreign Tax Credit (UFTC) regime ensured the availability of a credit for genuine underlying company tax paid overseas to offset a FDWP liability.

Removal of the inter-corporate dividend exemption for companies outside a wholly owned group was implemented from 1 April 1992; a move which the then Minister of Finance attributed to a study on effective tax rates undertaken by the writer.[36]

Other changes to the Income Tax Act 1976 (now the Income Tax Act 1994) include:

(1) introducing a resident and non-resident withholding tax regime for interest and dividends;
(2) taxing income of many previously tax exempt bodies;
(3) strengthening the provisional tax rules;
(4) substantially curbing the use of tax losses and restricting the use of imputation credits;
(5) introducing an Approved Issuer Levy (AIL) as a substitute for NRWT;

35. Included in the Report are details of assessments totalling over NZD 83 million for Wine-Box transactions, although NZD 44 million is able to be offset by available losses. There are no details provided concerning the amount of tax actually paid; see Wine-Box Report 2:5.26-33.

36. Richardson, Hon. R, "Parliamentary Debates on the Second Reading of the Income Tax Amendment Bill (No. 6) 1992", *Hansard*, at 7117-18. This referred to the study by Sawyer, A. J, *Company Effective Tax Rates in New Zealand: A Preliminary Analysis*, (1991) Department of Accountancy, University of Canterbury Working Paper Series, 4/91.

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(6) repealing the excess retention tax while tightening and widening the dividend definition;
(7) introducing a new qualifying company regime to treat certain companies like partnerships for tax purposes;
(8) introducing a consolidation regime for wholly owned groups;
(9) implementing changes to reflect the environment created for companies under the new Companies Act 1993;
(10) creating an entertainment tax regime;
(11) commencing a regime for issuing binding tax rulings (related to the growing informal self-assessment process);
(12) implementing a new disputes resolution procedure;
(13) imposing a more severe and comprehensive penalties regime;
(14) tightening the anti-avoidance tools available to the Commissioner; and
(15) reorganizing the Income Tax Act 1976 and commencing the progressive rewrite of the Income Tax Act 1994.

The Wine-Box Report discusses the submissions by the Institute of Chartered Accountants of New Zealand and the New Zealand Law Society on the legislative changes, and includes substantial extracts from their respective submissions with an analysis thereof. Sir Ronald Davison declined to make any recommendations, acknowledging that the submissions raise issues of policy that need to be aired through the Generic Tax Policy Process,[37] and that the Inquiry did not have the benefit of an economic analysis in any case. The Commissioner of Inland Revenue's concerns are then addressed by the Report.

2. Specific issues examined by the Wine-Box Inquiry

Specifically, the Commissioner of Inland Revenue sought consideration of the following issues:
- the general anti-avoidance provision of Section 99/GB 1 of the Income Tax Act;
- form over substance rules;
- the time bar for the amendment of assessments;
- liquidation of companies to avoid the impact of assessments;
- legal professional privilege;
- interest deductibility;
- matters identified as hindering IRD negotiations; and
- tax credits.

(a) *The general anti-avoidance provision of Section 99/GB 1 of the Income Tax Act*

The Report provides an extremely useful summary of the IRD's current policy statement on Section 99/GB 1 of the Income Tax Act, recommendations for reform from the Valabh Consultative Committee,[38] a suggested redraft from Chris Ohms,[39] and the judiciary's application of avoidance sections in New Zealand, Australia, Canada and the United States. From this discussion, the Report identifies four options:[40]

1. Retain the present Section GB 1;

2. Retain the present Section GB 1 but make sufficient amendments which are designed to make the circumstances of the application of the section clearer and more certain from the taxpayer's point of view [especially important under a system of self-assessment];

3. Repeal Section GB 1 and rely on the United Kingdom [and United States] practice; or

4. Repeal Section GB 1 and replace it with legislation modelled upon some other jurisdiction."

Sir Ronald's preference is for option 1, but if there is to be any amendment, then option 2. That is, if there is to be any change, Sir Ronald's preference is for some form of amendment to the current Section GB 1 of the Income Tax Act 1994.[41] Apart from option 1, the three other identified options require proposals that must be reviewed via the Generic Tax Policy Process. However, Section 99 (now Section GB 1) was considered by the Wine-Box Commissioner to be sufficient to deal with the transactions evidenced by those contained in the wine box. It is of interest to note that if the penalty for taking an abusive tax position had been in existence at the time of the transactions evidenced in the Wine-Box, it would almost certainly have been invoked by the Commissioner of Inland Revenue. This would have added a 100 per cent penalty for the tax shortfall arising on the transactions, since the transactions in the wine box evidenced concealment, circularity of funding and a lack of commercial reality.[42]

(b) *Form over substance rules*

It is acknowledged that it is a well-established Anglo-Saxon judicial doctrine that the courts will apply a (legal) form over (economic) substance approach to considering tax matters in every instance, apart from sham transactions. However, there is a growing international recognition that this doctrine is being relaxed to allow consideration of the economic substance of a transaction or of income as well as the legal form, where the activities involved may amount to avoidance. This is particularly relevant in Australia. The reason for this change is the ability of taxpayers to document whatever falsities suit their tax avoidance purposes, knowing that provided the form of their transactions satisfies the provisions of the legislation (and there is no sham), then the substance is beyond the purview of the courts.

Caution has been expressed by various parties that formalizing the substance over form approach for avoidance issues may have adverse consequences. Surprisingly, included in this group is the Commissioner of Inland Revenue. The rec-

37. For a discussion of the GTPP, see Sawyer, A. J., "Broadening the Scope of Consultation and Strategic Focus in Tax Policy Formulation: Some Recent Developments", (1996) 2 *New Zealand Journal of Taxation Law and Policy*, March, at 17-39.
38. Valabh Committee, *Final Report of the Consultative Committee on the Taxation of Income from Capital*, (1992, Wellington, Government Printer), Chapter 3: Tax Avoidance.
39. Chris Ohms is a specialist in tax avoidance research at the University of Auckland's Department of Commercial Law.
40. Wine-Box Report, 3:1.52-53.
41. Wine-Box Report, 3:1.54.
42. See Sec. 141E of the Tax Administration Act 1994. For further discussion of the abusive tax position shortfall penalty, see Sawyer, A. J., "Blurring the Distinction between Avoidance and Evasion – The Abusive Tax Position", (1996) *British Tax Review*, No. 5, at 483.

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ommendation of the Commission of Inquiry on the form and substance debate is:[43]

> In the opinion of the Commission, the law in New Zealand should be examined and a decision made as to whether the "form over substance" of a transaction should be taken into account in considering whether or not transactions amount to tax avoidance.

Recent indications from the Prime Minister, the Rt Hon. Jim Bolger, have been that rather than have the Treasurer, the Hon. Winston Peters, pursue a judicial review of the Inquiry findings, if a change to the current form over substance rule is required, this will be done through the parliamentary process. While the future development of the Wine-Box Report is inherently political, a move towards the accountants' use of substance over form in reporting and assessing financial information may yet appear in the tax arena. Such a colossal change will up-root decades of established judicial dicta.

(c) *The time bar for the amendment of assessments*

The time bar for reopening assessments (other than where fraud or failure to return income of a particular source is contended), is four years from the end of the year of the original assessment (with provision for a suspension of this period for a further six months).[44] This relatively short period for reassessments and consequential objections to the reassessment has frequently led taxpayers to pursue a judicial review of the Commissioner's actions when they are time barred from pursuing the objection process. A proposed amendment to alter this current practice has been awaiting the release of the Wine-Box Report. The amendment proposes that the four-year period cease to apply where judicial review proceedings have been issued (primarily as a delaying tactic), and when Section 17[45] notices ordering the production of information to the Commissioner have been issued.

The Wine-Box Commission is in favour of the proposed amendment, which would insert a new Section 108B to the Tax Administration Act 1994.[46]

(d) *Liquidation of companies to avoid the impact of assessments*

The problem of companies being set up for tax avoidance purposes and, once such purposes have been served, being liquidated to avoid the payment of any tax, has received attention in the Report. The Report makes reference to the efforts in Australia to deal with the "Bottom of the Harbour" tax schemes; an instance of this practice. The Wine-Box Commissioner expresses support for strengthening the powers of the Commissioner of Inland Revenue to have an ability to trace proceeds of tax avoidance transactions, especially when they are contended to be "blatant tax avoidance" or what may now be described as taking an abusive tax position.[47]

(e) *Legal professional privilege*

Perhaps the most frustrating aspect of an investigation conducted by the IRD of a taxpayer's affairs is the imposition of legal professional privilege, or more correctly, the privilege for the client and not his or her lawyer, to refuse to produce confidential information or to answer questions. Section 20 of the Tax Administration Act 1994 legislates for solicitor-client privilege in tax matters. This is in addition to litigation privilege at common law.

The head of the IRD's international tax unit, John Nash, identifies numerous problems with legal professional privilege, to which the Wine-Box Commissioner cannot suggest any solutions. Sir Ronald Davison considered abolition versus retention of privilege in a severely restrictive and amended form. Sir Ronald's preference is for abolishing privilege for tax matters.[48] While recognizing this action will draw vehement opposition and will require extensive consultation, repeal of legal professional privilege for tax matters has been rumoured to be receiving some support within Government.

The Wine-Box Commission's recommendation does not specify the extent of abolition; is his preference effectively that only Section 20 of the Tax Administration Act 1994 be repealed or does this extend to common law litigation privilege? Where will the boundaries of abolition lie? What will be the impact on taxpayers, their legal advisers, and the judicial process? Such questions wrench at the heart of legal (and tax) practice and litigation.

The President of the New Zealand Law Society, Ian Haynes, has voiced concern at the proposal for abolition. He emphasizes the need for consultation, identifies the difficulties in setting the boundaries, and observes that if abolition of privilege becomes firm Government policy, then it should be restricted to providing the IRD with enhanced powers to the minimum necessary. Upsetting established legal practice should not be considered lightly. Haynes concludes:[49]

> One possibility would be to permit privilege to be overruled on the application of the IRD Commissioner at the discretion of, and to the extent permitted by, the court. Factors could be laid down which the court would take into account in exercising its discretion.

Given that the New Zealand Law Commission has recently proposed the extension of legal professional privilege to accountants providing tax advice,[50] the future of legal professional privilege in New Zealand is far from certain. The ramifications of the process for formally considering abolition should be closely observed by legal experts in other countries where legal professional privilege exists for tax matters.

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43. Wine-Box Report, 3:1.58.
44. See Sec. 108(2) of the Tax Administration Act 1994.
45. Sec. 17 of the Tax Administration Act 1994.
46. Wine-Box Report, 3:1.59. Clause 30 of the Taxpayer Compliance, Penalties and Disputes Resolution Bill 1995, prior to an amendment which introduced the current Sec. 108B of the Tax Administration Act 1994, contained this proposed extension of the time bar.
47. Wine-Box Report, 3:1.59-60.
48. Wine-Box Report, 3:1.63.
49. Haynes, I, "Winebox recommendations: Haynes warns against erosion of legal privilege" (1997) *Law Talk*, Vol. 484, at 7. Haynes' comments are acknowledged to be a personal view rather than that of the NZLS which is due to consider the issue of privilege in conjunction with the Law Commission.
50. There has been considerable debate over whether privilege should be extended beyond legal practitioners to accountants involved in providing "tax advice". Considerations for extension were raised in Law Commission, *Evidence Law: Privilege*, Wellington, Law Commission, May 1994. The Tax Education Office's comments from its submission are set out in Tax Education Office *Newsletter* 90 (30 June 1994), at 17-18.

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(f) *Interest deductibility*

There have been suggestions for substantial amendment or repeal of the interest deductibility provisions of Section DD 1(1)(b) of the Income Tax Act 1994 in relation to interest on borrowings to finance the capitalization of a subsidiary. Indeed, John Nash, head of the IRD's international tax unit has stated that it would assist the IRD if they were repealed. The Wine-Box Commission's Report, in the writer's view, correctly steers clear of making any recommendation since the policy issues are enormous; repeal is far too simplistic as an option.[51] Interest deductibility is under consideration by officials with the possibility of a discussion document to be issued in the medium term future.

(g) *Matters identified as hindering IRD negotiations*

The areas of hindrance to the IRD's administration of the Inland Revenue Acts raised by John Nash are reproduced by Sir Ronald in his Report without comment. Sir Ronald's view is that they form part of the consideration of wider policy issues. Specifically, the areas identified by Nash are typical of the "cat and mouse game" between revenue authorities and the more aggressive tax advisers and their clients:[52]

"1. No access to records of former tax haven subsidiaries which have been sold or liquidated;
2. Claimed lack of control of records held by wholly owned tax haven subsidiaries;
3. Strict interpretation of Section 428 [Section 22 of the Tax Administration Act 1994] as to the non-retention of correspondence, board reports and internal memoranda;
4. The destruction of working papers and notes once a structured financing/investment transaction had been completed;
5. No records are kept as to the disposal of files;
6. The provision of significant new evidence only after amended assessments have been raised [since 1 October 1996, notices of proposed adjustments have been issued];
7. Explanations on questions of law have not always been forthcoming;
8. So-called leading questions have not been answered;
9. Creative interpretations to information requests, resulting in selective provision of documents;
10. Legal professional privilege has been claimed to prevent access to files held by lawyers and delay access to records on taxpayers' premises; and
11. Challenges made as to whether information requested is "necessary and relevant" or beyond our [the IRD's] jurisdiction (for example, information relating to non-resident entities prior to the introduction of the international tax regime)."

The policy issues and sheer size of the potential ramifications of each issue raised by the IRD require comprehensive and individual attention in the context of the role of the IRD in administering the Inland Revenue Acts, and for taxpayers' rights and obligations. Action on these matters is unlikely to be undertaken in haste, except perhaps for the legal professional privilege issue. The issues raised by Nash are relevant to a future review of the Tax Administration Act 1994, conducted as part of the concluding stages of the Generic Tax Policy Process.[53]

(h) *Tax credits*

Draft legislation has been before Parliament, in the form of the Taxation Reform (Companies and Other Matters) Bill 1996, awaiting the outcome of the Wine-Box Inquiry. The Bill proposes to amend Section GB 1 of the Income Tax Act 1994, to allow reconstruction of tax credits such as imputation credits and foreign tax credits, in cases of avoidance. It also proposes to deny foreign tax credit claims where there is a corresponding benefit to an associate of the taxpayer, requiring disclosure of this associated benefit. Furthermore, the Bill also contains a more efficient and timely process for adding countries to the schedule 6[54] list of countries whose taxes receive limited recognition for certain New Zealand tax purposes.

It is the view of the Wine-Box Commissioner that the proposed changes should be implemented in substantially their present form, as contained in the Taxation Reform (Companies and Other Matters) Bill 1996.[55]

The Wine-Box Report recommendations conclude with an observation that recent amendments to the Tax Administration Act 1994[56] reflect a new environment. These amendments include:

- restating the compliance obligations expected of taxpayers;[57]
- imposing more stringent and coherent penalties[58] and interest[59] for taxpayers failing to meet their obligations; and
- a less judicially focused process for resolving disputes prior to the issue of a reassessment by the Commissioner.[60]

This new era or environment is heralded as one far removed from the commercial morality associated with the activities evidenced by the Wine-Box Inquiry. The jury is out.

B. Possible implications if the recommended changes are adopted by Parliament

While it is not possible to predict which of the recommendations the Government will wish to pursue by introducing legislation to Parliament, what can be said is that any recommendation that becomes Government policy must be subjected to scrutiny and consultation through the Generic Tax Policy Process. The first step will be the ministerial committee, yet to be formed, to review the Wine-Box Inquiry Report and formulate a strategy for the Government to make its response. The selection process for this committee is cur-

51. Wine-Box Report, 3:1.65.
52. Id.
53. See Sawyer, *supra* note 36.
54. Formerly Sch. 17A of the Income Tax Act 1976.
55. Wine-Box Report, 3:1.66.
56. Tax Administration Amendment Act (No. 2) 1996.
57. See Part IIA of the Tax Administration Act 1994.
58. See Part IX of the Tax Administration Act 1994.
59. See Part VII of the Tax Administration Act 1994.
60. See Part VIIIA of the Tax Administration Act 1994.

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rently in progress, with Winston Peters insisting that he form a critical part in the selection process and sit on the committee.

Referring to the general issues associated with the transactions evidenced by the Wine-Box Inquiry, the following areas are expected to attract close attention and criticism by the business community and tax advisers if significant change is proposed:

- expanding the taxation of capital gains to include more such items in taxable income;
- restrictions (or removal of) interest deductibility,[61] and further restrictions on advancing or postponing payments of interest beyond those contained currently in the accruals regime; and
- alterations to capture further sources of income within the tax base.

Other issues surrounding the Wine-Box documents that have already received significant attention through policy initiatives and amending legislation include:

- restrictions on redeemable preference share financing;
- restrictions on hiding behind the residence of offshore companies;
- new transfer pricing and thin capitalization rules that will have an impact upon the allocation of costs to (related) offshore companies;
- the introduction of the abusive tax position which should provide a disincentive for taxpayers to enter circular self-cancelling arrangements given the size of the penalty and associated use of money interest provisions;
- strengthening of the international tax regime(s), with increased penalties for non-compliance with the various regimes; and
- the ability to unwind selected offshore structures if the proposed amendments in the Taxation Reform (Companies and Other Matters) Bill 1996 are revived to deal with tax credits.

Turning to the issues raised by the Commissioner of Inland Revenue, widespread concern from corporates and tax advisers is anticipated if the following issues are moved onto the Government's tax policy agenda:

- significant changes to expand the general anti-avoidance provision of Section GB 1 of the Income Tax Act;
- adoption of a resolution to reverse the traditional form over substance rules to take an economic substance over form approach as applied in financial accounting;
- abolition of (or even a substantial restriction on) legal professional privilege for tax matters; and
- restrictions on interest deductibility (as discussed above).

The practice of liquidating companies to avoid the impact of assessments is less likely to attract a negative response if proposals similar to those in Australia are considered. Furthermore, proposals for restricting the use of tax credits have already received some attention with pending draft legislation. A proposal to further extend the current time bar for the amendment of assessments beyond the current suspension of six months may be expected to attract scrutiny. The reason for scrutiny is that any extension should be considered in impartial terms such that it applies to taxpayers pursuing judicial review applications, and to the Commissioner of Inland Revenue using Section 17 notices,[62] while also allowing taxpayers an extension if they have pursued a challenge to a previous assessment issued by the Commissioner.

The plethora of matters identified as hindering IRD negotiations by the international tax unit head, John Nash, require exploration of their potential scope, implications, and rationale within the context of taxpayers' overall tax obligations, as contained in Part IIA of the Tax Administration Act 1994. It should not be lost that in an environment of self-assessment, taxpayers require certainty and an ability to readily ascertain their liability to tax. To facilitate this process, the Commissioner's obligations should be specified and clarified in precise terms; a proposal which the writer was unsuccessful in achieving on a previous occasion because officials viewed it to be overly restrictive on the Commissioner.[63]

The current policy agenda of the Coalition Government includes several items that incorporate issues arising from the Wine-Box Inquiry,[64] in conjunction with the Committee of

61. This issue is already under review with a discussion document expected in the near future. The Wine-Box Report does not make any recommendations on the issue.
62. See *supra* note 44.
63. For a discussion of the proposal, see Sawyer, A. J., Taxpayer Compliance, Penalties and Disputes Resolution Bill Encapsulates Earlier Proposals – An Update, 50 *Bulletin for International Fiscal Documentation*, 2 (1996), at 72-78.
64. The three-year revenue strategy (phase 3 in the GTPP) provides that the overall objectives of the Coalition Government's tax policy are that New Zealand will have a tax system that:
(1) provides the revenue the Government needs to meet its expenses (including providing for surpluses), to reduce debts and to allow for future cuts in tax rates;
(2) reduces economic growth as little as possible, consistent with the need to raise revenues;
(3) is fair, with all taxpayers making an equitable contribution, based on their ability to pay;
(4) minimizes opportunities for avoidance and is vigorously enforced, with effective penalties for non-compliance; and
(5) has low compliance and administrative costs.

The three-year work programme (phase 4 in the GTPP) is designed to give effect to the overall strategy, which the Government has confirmed is founded upon a broad-based, low-rate tax system emphasizing tax base protection. Items which the Coalition Government has stated will be in the tax base maintenance and remedial legislation programme include:
(1) reviewing the use of passive investment funds by superannuation funds to ensure that revenue gains are taxed when realized by the superannuation fund;
(2) dealing with the problem of avoiding GST through issuing travel vouchers overseas which are then redeemable in New Zealand;
(3) reviewing the taxation of restrictive covenants and lease inducement payments; and
(4) developing legislation as necessary to remedy unintended shortcomings and consequences in existing legislation, such as reviews of depreciation and the law on the taxation of group investment funds (a review of the depreciation regime has been included in recent proposed remedial legislation).

Consultative discussion documents, issued as part of the GTPP inviting public consultation through submissions, are intended to cover the following issues:
(1) the taxation of trading stock/inventory (a discussion document was released in April 1997);
(2) the taxation of conduit investment (a discussion document was released in May 1997);
(3) the tax credit option for taxpayers on the lower marginal rate of tax of 21.5 per cent rather than the top rate of 33 per cent, as outlined in the April 1997 report of the Working Party on the Taxation of Life Insurance and Superannuation Fund Savings (known as the TOLIS group);
(4) the next stages of the Income Tax Act 1994 rewrite, the first incorporating Parts C, D and E (which was released in September 1997);

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Experts charged with the responsibility of reviewing the appropriateness of the current criminal sanctions in the tax system for tax evasion.

From the agenda announced by the Coalition Government earlier this year, it is unlikely that many of the issues raised in the Report will be tackled in the current three-year cycle. Should such issues be included, then a significant number of the items announced as part of the programme must be postponed or relegated to some future date for consideration. However, with the abundance of critical non-tax issues the Coalition Government is currently facing, coupled with the considerable lead time required to prepare discussion documents and re-jig the legislative programme, concerted efforts for pursuing the reforms suggested in the Wine-Box Report are not likely to be of high priority. This is buttressed by the anticipated public resistance to many of the proposals (from tax advisers and corporates at least) and the political nature of the Wine-Box Report, unless IRD officials can convince key ministers otherwise.

IV. CONCLUSIONS

What may be gleaned from the Wine-Box Inquiry for New Zealand taxpayers and the public in general? and more importantly, what lessons do the affair and associated events offer for tax authorities and governments in other countries?

The formal part of the Wine-Box Inquiry represents three years of concerted effort from a Commissioner exhibiting the tenacity and commitment to see the Inquiry to its conclusion. The Inquiry followed concerted efforts by the news media and the Member for Tauranga, the Hon. Winston Peters, to press for a formal inquiry during a period of two years prior to the announcement of the setting up of a Commission of Inquiry on 25 August 1994.

The evidence given, and revelations made, during the hearings concerning the aggressive tax planning activities of the mid and late 1980s, have provided the public with an almost unbelievable documentary of business practices of the time. Furthermore, the Inquiry exposed the inadequacies of two of the major enforcement bodies, the IRD and the SFO, when faced with the activities undertaken by sophisticated corporates and their advisers. The Inquiry revealed the efforts taken to exploit deficiencies in the legislative environment of the tax system at the time. This was an environment working frantically to cope with a recently deregulated financial system and unprecedented freedoms for business activity. "Household names" were made to appear less than experts, with professional businessmen admitting to almost constant memory lapses and a lack of attention to retaining documentary evidence. To cap-off the revelations, the recalcitrant attitude of Cook Islands' officials, reliant upon New Zealand Government aid, made a thorough and comprehensive analysis of the issues raised by the Wine-Box Inquiry impossible.

The Final Report is disappointing given the commendable efforts of the Commissioner during the Inquiry. While the complete vindication of the parties from any fraud or conspiracy was almost inevitable, the selective discussion of the thousands of pages of evidence and the commendation of the actions of the IRD and SFO cause concern. Collectively, they raise the question of whether the threats of years of complex legal argument and judicial reviews of the Commissioner's handling of the Inquiry had an influence on the Wine-Box Commissioner's final decision. The financial cost of the Inquiry is not insignificant; to date, NZD 11m has been appropriated from the public purse. The corporates and individuals involved have incurred costs in excess of NZD 100m.

However, the full value of the Inquiry and its associated Report have yet to be ascertained. The dominant factor underlying the revelations, ensuing criticism and potentially the pressure on the Government for further reform, is the public nature of the hearings. The unprecedented publicity represents the anthesis of the secrecy that prevails in tax matters; secrecy which is provided by Section 81 of the Tax Administration Act 1994. The impact of the publicity of the hearings was enhanced through the use of the latest computerized technology and daily high-profile journalistic reporting of the proceedings.

New Zealand experienced perhaps the most dramatic economic transformation during the mid and late 1980s in international terms. A newly found freedom was taken to in excess by some corporates and individuals seeking to reduce their exposure and liability to an internationally uncompeti-

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(5) codification of the current informal self-assessment system operating in New Zealand, including the removal of discretions granted to the Commissioner in the legislation and the associated compliance implications of this codification;
(6) a comprehensive review of the taxation of financial arrangements and a consideration of an earlier review of the taxation of foreign exchange gains and losses (the accruals regime has been in place for over ten years) [this is likely to encompass a few of the issues raised in the Wine-Box Report];
(7) a post-implementation review of GST, which has been in place for over ten years;
(8) policy on the timing of deductions and other related issues, including a review of the tax treatment of research and development expenditure [this could include interest deductibility and timing issues as raised in the Wine-Box Report]; and
(9) the taxation of Maori authorities and related issues, particularly in the light of the recent growth in businesses run by Maori authorities and tribal groups.

This three-year programme will also incorporate the continuing dialogue between government officials and business representatives on New Zealand's international tax rules, and the Australian Government on trans-Tasman issues. The dialogue will focus on the anomaly that results in the double taxation of the New Zealand income of New Zealand shareholders of Australian companies through the non-recognition of imputation/franking credits between the jurisdictions (a thorny and contentious issue existing for many years between government officials and politicians in both New Zealand and Australia). It is also intended that a reciprocal agreement with Australia for the collection of child support payments from liable parents be developed.

Other matters and items included in the three-year tax policy work programme incorporate:
(1) the development of transfer pricing guidelines as part of double tax agreement negotiations (the Australia – New Zealand DTA was the most recent to be renegotiated in 1995) [this is likely to encompass a few of the issues raised in the Wine-Box Report];
(2) a post-implementation review of the new compliance and penalties regime, implemented with effect generally from 1 April 1997 [this is likely to encompass a few of the issues raised in the Wine-Box Report]; and
(3) continued research on improving the efficiency and fairness of the tax system, including further tax cuts beyond 1998/99 (this is related to the proposed compulsory retirement savings scheme voted on at a referendum held in September 1997 which rejected outright the proposed scheme by 92.4 per cent to 7.6 per cent).

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tive domestic and international corporate tax regime. This background should not be lost in the review of the findings.

It is an understatement to conclude that the activities evidenced by the Wine-Box Inquiry hearings, and as discussed in the Report, could not be repeated. Today's legislative environment would treat such activities, at a minimum, as taking an abusive tax position. More likely, however, they would be held to constitute a failure to satisfy tax obligations leading to penalties for activities amounting to tax evasion. Furthermore, there has been a gradual change in the corporate culture of New Zealand. Ethical standards are gradually rising and both corporates and individuals are focusing more upon creating real profits as opposed to "intangible and illusory" paper profits. The New Zealand financial markets now reward corporates whose activities involve generating sustainable and growing cash flows, which are accompanied by good dividends with imputation credits for tax paid in New Zealand.

The excesses of the financial markets in the 1980s worldwide were evidenced by the market failures in 1987 and 1988. However, the new confidence exhibited by buoyant international financial markets and business generally, compared to the relatively poorly performing New Zealand markets, is in part attributable to the relative severity of the activities conducted by many New Zealand corporates and individuals during the period investigated by the Wine-Box Inquiry.

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IRELAND

RECENT DEVELOPMENTS IN IRELAND

Charles Haccius

Two events have taken place recently, both of which merit the attention of those concerned with tax at an international level:

I. TAXES CONSOLIDATION ACT 1997

On Tuesday, 2 December 1997, the Taxes Consolidation Act 1997 received the presidential assent and became law. The Act makes no innovations and, as its title implies, merely consolidates the existing Irish income tax, capital gains tax and corporation tax legislation into a single enactment.

II. IRISH BUDGET PROPOSALS

The other event is the Irish Budget, presented to the Irish National Parliament by the Minister for Finance, Mr Charles McCreevy, on Wednesday, 3 December 1997. This is the first of five annual budgets intended to be presented to the National Parliament by the new administration, all five of which will give priority to tax reform in an EU context.

The salient features of the Budget are as follows.

A. Corporation tax

The standard rate of Irish corporation tax is to be reduced by 4 per cent from 36 per cent to 32 per cent. The lower rate of 28 per cent on the first IEP 50,000 of a company's taxable profits is to be reduced by 3 per cent from 28 per cent to 25 per cent.

The rate of Irish corporation tax payable by companies carrying on the business of life assurance is to be reduced by 2 per cent likewise, from 26 per cent to 24 per cent.

B. Income tax

The standard rate of Irish income tax is to be reduced by 2 per cent from 26 per cent to 24 per cent. The higher rate, applicable to taxable income in excess of IEP 10,000, is to be reduced by 2 per cent likewise, from 48 per cent to 46 per cent.

The rate of Irish withholding tax ("direct income retention tax") deductible at source from interest arising from a "special savings account" is to be increased by 5 per cent from 15 per cent to 20 per cent. An appropriate refund will be made if a provision of a tax treaty between Ireland and the recipient's country of residence corresponding to Article 11(2) of the OECD Model Convention specifies a lower rate, or exempts the interest from Irish income tax altogether.

C. Capital gains tax

A major reduction, from 40 per cent to 20 per cent, is to be made in the rate of Irish capital gains tax. Chargeable gains derived from the disposal of land in Ireland having development potential, however, will still be taxed at a rate of 40 per cent.

D. Personal allowances

Minor adjustments are to be made to an individual's personal allowances for the purposes of Irish income tax, the most significant of which will be an increase of IEP 3,500 in the allowance available to a recently widowed parent with dependent children. The allowance will now amount to IEP 5,000 in the year of assessment following the individual's bereavement, reducing by IEP 1,000 in each succeeding year of assessment over a four-year period.

The exemption of an individual disponer for the purposes of Irish capital gains tax, however, is to be reduced from IEP 1,000 to IEP 500 of the aggregate amount of the chargeable gains accruing in a given year of assessment, following the 50 per cent reduction in the rate of Irish capital gains tax.

E. Tax shelters

1. Restrictions

The availability of certain domestic tax shelters is to be restricted. These shelters depend on the ability of a taxpayer to claim an immediate capital allowance in respect of an investment made by him in a designated project, and to offset this allowance against income other than that arising from the project itself. The proposed restrictions are as follows.

(a) *Construction projects*

Capital allowances available in respect of investments in certain designated construction projects are to be subject to an annual cap of IEP 25,000 to the extent that the claimant seeks to offset the allowances against income derived by him otherwise than as rental income arising from the project itself.

(b) *Hotel projects*

Capital allowances in respect of investments in hotel projects will cease to be offsettable against income received by the

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claimant otherwise than as rental income arising from the project itself. The restriction will not apply to those engaged in the active management of the hotel in question.

The restriction will not apply to hotel projects in certain country areas in which the administration wishes to promote tourism.

(c) *Business expansion schemes*

The maximum permissible investment in a business expansion scheme is to be reduced from IEP 1,000,000 to IEP 250,000 per project.

2. The availability of certain existing tax shelters is to be prolonged

(a) *Multi-storey car parks*

Capital allowances are to remain claimable in respect of investments in multi-storey car parks, if made prior to 30 June 1999, conditionally upon 15 per cent of the total cost of the project being incurred before 30 June 1998.

(b) *Seaside resorts*

Capital allowances are to remain claimable likewise in respect of investments in certain designated seaside resorts made prior to 30 June 1999, once again conditionally upon 15 per cent of the cost of the project being incurred before 30 June 1998.

3. New tax shelter

A new tax shelter is to be introduced:

Nursing homes

Capital allowances are to be made available in respect of investments in nursing homes. These are to be available at an annual rate of 15 per cent over the first six years, with a final allowance of 10 per cent in the seventh year. The allowances are to be subject to an annual cap of IEP 25,000 to the extent that the claimant seeks to offset the allowances against income derived by the claimant otherwise than as rental income arising from the project itself. There will be a claw-back if the building ceases to be used as a nursing home within ten years after the making of the investment.

F. Charities

Relief is also to be introduced in respect of corporate donations to certain designated charities. The donation must be not less than IEP 250 and not more than IEP 10,000 to any one such charity. Relief will be subject to an overall maximum of IEP 50,000 per company in any one year, or 10 per cent of the donor company's taxable income, whichever is less.

Relief is also to be introduced in respect of individual and corporate donations to schools in disadvantaged areas.

III. INTERNATIONAL ASPECTS

By far the most interesting part of the Irish Budget proposals, from an international standpoint, is the administration's long term plans in regard to (A) manufacturing relief, and (B) the taxation of dividends. The two subjects are interlinked, and will be discussed in that order.

A. Manufacturing relief

Manufacturing relief was first introduced by the Finance Act 1980, and allows relief in respect of profits accruing from the "sale" of "goods" "manufactured" in Ireland. The effect of the relief, in practical terms, is to reduce the rate of Irish corporation tax payable in respect of such profits from the usual rate of 36 per cent (shortly to be 32 per cent) to 10 per cent.

By degrees, the relief has been extended to a number of activities (design and planning services relating to engineering projects executed outside Ireland, computer services, shipping activities, film making etc.) which would not otherwise qualify for the relief. The relief has also been extended to trading operations carried on in the Dublin International Financial Services Centre ("the IFSC"), and in the Shannon Custom-free Airport ("Shannon").

In most cases, manufacturing relief is due to expire on 31 December 2010. In the case of trading operations carried on in the IFSC and in Shannon, however, the scheduled expiry date is 31 December 2005.

In 2006, when manufacturing relief in respect of profits accruing from trading operations carried on in the IFSC and in Shannon is due to expire, the standard rate of Irish corporation tax payable in respect of a company's trading profits will be reduced to 12.5 per cent (only 2.5 per cent higher than the rate currently payable in respect of profits qualifying for manufacturing relief).

Income derived by a company otherwise than from trading activities (for example, rental income, interest or dividends received by a company from its shareholding in an overseas subsidiary) will be taxed at a rate of 25 per cent.

During this interim period 2006 to 2011, therefore, the profits of a company subject to Irish corporation tax will be subject to three different rates of corporation tax, viz:

(1) Trading profits still qualifying for manufacturing relief will continue to be subject to Irish corporation tax at a reduced rate of 10 per cent.
(2) Trading profits not so qualifying will be subject to Irish corporation tax at a rate of 12.5 per cent.
(3) Income arising otherwise than from the company's trading activities will be subject to Irish corporation tax at a rate of 25 per cent.

In 2011, when manufacturing relief is finally phased out, the profits of a company subject to Irish corporation tax will be subject to Irish corporation tax at either one of two rates:

(1) Trading profits, whether arising from the sale of goods manufactured in Ireland or otherwise, will be subject to Irish corporation tax at a rate of 12.5 per cent;

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(2) Income arising otherwise than from the company's trading activities will be subject to Irish corporation tax at a rate of 25 per cent.

The above mentioned rates will apply to companies resident outside Ireland carrying on a trade in Ireland through an Irish "branch or agency" as well as to companies resident in Ireland.

B. Dividends

1. Abolition of the imputation system

The second proposal is to abolish what is referred to in the observations in the OECD Commentary concerning Article 10 of the OECD Model Convention as the 'imputation system' of taxing dividends. Unlike manufacturing relief, which is to be phased out over a period of approximately 12 years, the 'imputation system' is to be phased out over a two year period (to be precise, in the years of assessment 1998/99 and 1999/00).

The tax credit (currently $^{21}/_{79}$) is to be reduced to $^{11}/_{89}$ in the year of assessment 1998/99 and abolished altogether in the year of assessment 1999/00. The 'tax-bite' on a hypothetical dividend of IEP 10,000 taxed in the hands of the recipient at the higher rate of 48 per cent (in the year of assessment 1997/98) or of 46 per cent (in the years of assessment 1998/99 and 1999/00) will accordingly be as follows:

	1997/98	1998/99	1999/00
Dividend	10,000	10,000	10,000
Add tax credit	2,658	1,864	–
	12,658	11,864	10,000
Income tax	6,074	5,457	4,600
Less tax credit	(2,658)	(1,864)	–
	3,416	3,593	4,600

The phasing out of the 'imputation system' of taxing dividends derived from Irish resident companies and its replacement by what is referred to in the observations in the OECD Commentary concerning Article 10 as the 'classical system', however, will not affect non-residents. Dividends paid by Irish resident companies to non-residents will continue to be exempt, both from Irish income tax and from Irish corporation tax.

In many cases dividends paid by an Irish resident company to a parent company resident in one or other of Ireland's treaty partners will also be exempt from tax in the parent company's country of residence by reason of provisions to that effect in the tax treaty between that country and Ireland. In other cases such dividends will be exempt from tax in the parent's country of residence by reason of unilateral exempting provisions in that country's domestic tax legislation.

A logical consequence of the phasing out of the 'imputation system' of taxing dividends will be the corresponding abolition of advance corporation tax, the purpose of which is to finance the tax credit allowable to the recipient of a dividend under the 'imputation system'.

The upshot, under the long term proposals in the Irish Budget, is that in 2011, when manufacturing relief is finally phased out, non-resident companies carrying on trading activities in Ireland, either through an Irish "branch or agency" or through an Irish resident subsidiary, will be in much the same position as at present. If anything, the position of such a non-resident company will be more favourable since it will no longer be necessary to demonstrate that the company's profits arise from the sale of goods manufactured in Ireland, or from activities assimilated by the Irish domestic tax legislation to such activities.

2. Stock dividends

Distributions payable, at the option of the recipient, by way of an issue of additional shares in the capital of a company, credited as fully paid up, are to be treated henceforth as dividends. This will be so, irrespective of whether the company is resident in Ireland or outside Ireland.

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SOUTH AFRICA

NEW UNITED STATES–SOUTH AFRICA TREATY: CLARIFICATION ON STC

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I. INTRODUCTION

South Africa and the United States signed a new Double Tax Convention on 17 February 1997. The Convention was ratified on 31 October 1997. This article points out how the ratified Convention corrects an error previously identified by the author.

II. THE PROBLEM

In a previous article (*Bulletin*, 6 (1997) at 284) this author pointed out a flaw in the newly signed Double Tax Convention between South Africa and the United States. This flaw would have denied credits for South African secondary tax on companies (STC) being granted to US residents and citizens.

This denial resulted in spite of the fact that Article 2 of the Convention defined *South African Tax* as including both South African normal tax and STC. The critical problem arose in Article 23(1)(b), which governs the elimination of double taxation for US companies holding at least 10 per cent of the voting stock in a South African company. This provision referred simply to *South African Income Tax* in the original signed version. This term effectively excludes STC (since STC is a corporate tax on distributed dividends, less dividend income, and is not a tax on income per se). In consequence, no credit could be claimed for STC, despite the clear intention (by virtue of its inclusion in Article 2) that such a credit should be available.

The author suggested that the words *South African Income Tax* should be replaced in Article 23(1)(b) with the words *South African Tax*.

III. THE SOLUTION

Despite an original reaction from a US Treasury official which seemed to indicate disagreement with this view, it appears that the author's analysis has now been accepted as correct and that the IRS were aware of the problem. This is manifest in that the final version of the Convention, ratified on 31 October 1997, has replaced the term *South African Income Tax* in Article 23(1)(b) with the term *South African Tax*.

The problem identified by the author has thus fallen away.

In summary, STC may now be claimed as a credit under Article 23(1)(b), which states 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 a resident or a citizen of the United States as a credit against the United States tax on income:
>
> (b) in the case of a United States 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 United States company receives dividends, the South African tax paid by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.

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BELGIUM

TAX TREATMENT OF MIGRATION OF COMPANIES TO BELGIUM

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I. INTRODUCTION

In recent years, there has been a growing interest in the migration of companies to Belgium. This can be explained by the fact that in certain respects Belgium offers a very attractive corporate income tax regime, access to which has been facilitated by favourable statements made by the Minister of Finance on the fiscal treatment of pre-migration equity.

The statements issued by the Minister of Finance are very welcome, in view of the absence of specific rules laid down in Belgian statute on this matter. Companies that want to migrate to Belgium now have a certain level of comfort as to their tax situation (in Belgium) upon and after migration. However, as will be explained below, there are still a number of tax issues that remain unclear.

II. COMPANY LAW PRINCIPLES

As mentioned above, the Belgian Income Tax Code (ITC) does not provide for specific rules on the migration of companies to Belgium.[1] Since it is a generally accepted principle of Belgian law that the rules set forth in common law also apply in tax law (except in cases where the tax legislation explicitly deviates from the common law), the rules laid down in Belgian company law and international private law serve as a basis for the analysis of the income tax treatment of companies that migrate to Belgium.

Contrary to Anglo-Saxon legal systems, which are based on the so-called "incorporation theory", Belgian company law[2] is based on the concept of the "principal seat".

According to Article 197 of the Coordinated Law on Commercial Companies, all companies which have their principal seat in Belgium are subject to Belgian company law, even if they are incorporated outside Belgium.[3]

The principal seat is the place where the activities and transactions of a company are managed, regardless of where these activities and transactions actually take place. The following factors are amongst others, relevant in determining the location of the principal seat. The place(s) where:

- the Board of Directors sits;
- the shareholders' General Meeting is held;
- the management is located;
- the bookkeeping is done;
- the archives are kept.

The principal seat needs to be distinguished from the statutory seat (i.e. seat which is mentioned in the by-laws of the company) and also from the seat of exploitation (i.e. place where the operating activities take place).

Since the "*Lamot* case",[4] it is generally accepted in Belgian law that a foreign company is able to relocate its principle seat to Belgium, without dissolution in the country of origin and reincorporation in Belgium (i.e. the legal personality of the foreign company can continue to exist upon migration to Belgium), where the principal seat is legally relocated to Belgium according to the laws of the country of origin, and the corporate laws of that country recognize the continuity of the legal personality of the company.[5]

III. CORPORATE INCOME TAXES

A. Fiscal advantages of migration to Belgium

In view of the favourable Belgian tax regulations on capital gains realized on shares and the participation exemption, Belgium can be seen as an attractive location for companies to move to, in the following situations.

1. Transfer to Belgium of foreign subsidiaries of Belgian holding companies

Migration to Belgium can enable a company to qualify for the participation exemption. Belgian companies holding shares in other companies can benefit from the participation exemption, i.e. 95 per cent of the dividends received is tax

1. Art. 210(1)(3) ITC provides that the change of the legal form of a company is in principle to be considered as a liquidation and the establishment of a new company. This article is also applicable to the conversion of the legal form of a company that is established outside Belgium. It can, however, by definition, not be applicable upon transfer of a company's principal seat to Belgium, since Art. 210(1)(3) ITC is only applicable to domestic companies, possibly established outside Belgium, that convert their legal form (for a definition of "domestic companies", reference is made to Section III, 2).
2. I.e. like the company law of most of the other civil law countries.
3. Belgium will recognize the application of the incorporation principle in some cases based on the principles of international private law. More particularly, if the foreign company law is based on the incorporation principle, a company, established in Belgium but with its principal seat in the other country, will be considered to be still governed by Belgian law. This is an application of the *renvoi* principle.
4. Cass., 12 November 1965, *R.W.*, 1965-66, at 911.
5. In Germany, for example, it is considered that the emigration of a German corporation always entails the dissolution of this corporation.

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deductible, provided that a general quantitative condition is met, and to the extent that these dividends do not fall within the scope of the exceptions explicitly mentioned in the statute. These exceptions refer to dividends received from companies located in a country where the general tax regime is significantly more advantageous than in Belgium, non-intra group finance companies, offshore companies and foreign companies with finance branches. The same exceptions are applicable concerning the exemption of capital gains on shares.[6]

Since dividends originating from a company located in a tax haven do not qualify for the participation exemption or for the exemption of capital gains on shares, one could consider transferring the principal seat of a Belgian company's subsidiary to Belgium. As a result of this operation, dividends subsequently distributed would normally qualify for the participation exemption in Belgium and the capital gains realized upon sale of these shares would be tax exempt in Belgium.

2. Transfer to Belgium of foreign holding companies

Under Belgian tax law, capital gains realized on shares are exempt from corporate income tax, to the extent that the conditions required to qualify for the participation exemption are met.[6]

Companies that are located in a country that does not grant a tax exemption on capital gains on shares, could therefore consider moving to Belgium, and to realize capital gains on shares after migration.[7]

One should of course examine, on a case-by-case basis, the tax consequences of migration in the country of origin. As is the case in Belgium, other countries might have introduced "exit tax" legislation. General anti-tax abuse legislation in the country of origin should also be considered.[8]

B. General principles

Article 179 ITC provides that domestic corporations (*binnenlandse vennootschappen/sociétés résidentes*) are subject to Belgian corporate income taxes.

Article 2(2)(2) ITC defines a domestic corporation as a company that has its statutory seat, main establishment or place of management in Belgium, and that is not excluded from corporate income tax.

Although the statute itself uses the term "or", it is accepted that the terms used in Article 2 should be interpreted to be mutually connected.[9] It is, in other words, not sufficient for a company to have its statutory seat in Belgium in order to be(come) subject to the Belgian corporate income tax system.

The application of Articles 2 and 179 ITC implies that a migrated company is subject to the same corporate income tax regime as a company that was established in Belgium (assuming that the conditions as laid down in Article 2 are fulfilled).

The analysis hereafter is limited to the situation where there is continuity of the legal personality of the migrated company. If this is not the case,[10] the transaction will be treated in Belgium as if a new (Belgian) company has been established.

C. Tax treatment of paid-up capital

The question arises as to what can be considered to be the paid-up capital of a company after migration to Belgium. This question is of importance because, under Belgian tax law, a company's paid-up capital can be distributed tax-free to the shareholders (i.e. without corporate income tax and/or withholding tax becoming due).

While some authors defend the position that the paid-up capital of a migrated company is the paid-up capital as shown in the company's financial statements at the moment of migration,[11] the Minister of Finance is of the opinion that the composition of the paid-up capital of a migrated company should be evaluated in accordance with the rules laid down in Belgian tax legislation.[12] The position of the Minister of Finance seems to be more appropriate, if only because any other position would imply that a simple restructuring of a company's balance sheet before migration might suffice to escape from any taxation in Belgium.

Thus, if the capital of a company included incorporated reserves at the moment of migration, this part of the capital could not be distributed tax-free. The distribution of the part of the capital representing incorporated (taxed or tax-free) reserves would be subject to the Belgian withholding tax regime for dividend distributions (except for distributions made upon liquidation). The corporate income tax treatment of the distribution of such reserves as were incorporated in the capital before migration is the same as the treatment of the reserves that were not incorporated in the capital.

D. Tax treatment of taxed reserves

It is generally accepted in Belgian doctrine that reserves that have been taxed prior to migration are not subject to Belgian

6. For a more in-depth analysis of the current Belgian participation exemption system, reference is made to 37 *European Taxation*, 3 (1997), at 95; reference is also made to Marc Dassesse, "The Belgian RDT System Confronts Community Law – The Time For A Rethink Has Come" 51 *Bulletin for Fiscal Documentation*, 8/9 (1997) concerning the compatibility of the Belgian participation exemption system with Community Law.
7. The profits realized could later be repatriated to the shareholders without any additional tax burden, if the company is liquidated. This is because, under Belgian tax law, there is no withholding tax due on reserves that are paid out upon liquidation.
8. For examples, see E. Van der Bruggen, "Het fiscaal regime van naar België verplaatste vennootschappen", *T.R.V.*, (1994), at 500-503.
9. L. Hinnekens, "Territorialiteit", *Vennootschap en Belasting*, Kluwer, 1993, at 570; J.P. Lagae, "De migratie van vennootschappen en de Belgische inkomstenbelastingen", *Liber Amicorum E. Krings*, Brussel, E. Story-Scientia, (1991), at 1031 et seq.
10. This would be the case if the emigration entails, according to the law of the country of origin, the dissolution of the company, or if the changes to the by-laws can not occur without infringement of the basic characteristics a "Belgian" company should have.
11. J.F. Lycops, "Het Kapitaal", *Vennootschap en belastingen*, Antwerpen, Kluwer, 1988, U, 1-7270.
12. *Vr. en Antw. Kamer*, 14 February 1994, nr. 94, at 9218 – Vr. nr. 855 Dupré, 28 December 1993.

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corporate income tax in the event of a distribution or liquidation of the company (after migration). This position has been explicitly confirmed on several occasions by the Minister of Finance.[13]

The most recent question that was submitted to the Minister was related to the Belgian tax regime applicable to reserves built up by a company which had its principal seat in a tax haven prior to the transfer of the seat to Belgium.

In response to earlier parliamentary questions, the Minister of Finance confirmed that reserves which had been subject to sufficient tax in a foreign country should be treated as taxed reserves in the Belgian opening balance sheet. It was, however, unclear whether this position extended to situations in which the reserves had not previously been subject to a tax similar to the Belgian corporate income tax. The Minister replied that even if the foreign company had its seat in a tax haven prior to the transfer of its seat to Belgium, the previously taxed reserves should be considered as taxed reserves after the fiscal migration for Belgian corporate income tax purposes. The Minister stated that it was of no importance that the income tax levied in the foreign country was substantially lower than the Belgian corporate tax rate. As a result, upon distribution of these reserves in Belgium, in principle only a withholding tax is due.

E. Tax treatment of tax-free reserves

While there is a consensus concerning the treatment of previously taxed reserves, the situation is less clear with regard to the status of the tax-free reserves existing at the moment of transfer of the principal seat.

For example, what would happen upon migration with asset revaluation reserves that are included in the transferred company's balance sheet (and that have not been subject to taxation in the country of origin)?

To analyse this problem, it is important to determine the legal concept based on which reserves could be exempt from taxation in Belgium after transfer of a company's principal seat to Belgium.

From the different statements issued by the Minister of Finance, it seems that the Minister recognizes the tax exemption of transferred reserves where:

- the reserves have been effectively taxed abroad (albeit perhaps at a low tax rate); or
- the reserves have been exempt from taxation by virtue of a specific exemption provision in foreign law that is similar to an exemption system existing in Belgian law.

One of the replies of the Minister related to the situation where a company's seat was transferred to Belgium after the company had realized (tax-free) capital gains on shares. The Minister indicated that these capital gains could be considered as taxed reserves.[14]

Together with other authors,[15] one can say that the tax exemption in Belgium is rather to be granted (for companies that have transferred their seat from a tax treaty country) based on the provisions of the relevant treaty. Belgium does not have the authority to subject to taxation profits that have been realized by a company at a time when that company was resident in a treaty country (assuming that there is no permanent establishment in Belgium).

While the application of the above treaty concept should have the same results as the concept that seems to be used by the Minister of Finance as far as taxed reserves (including capital gains realized on shares) are concerned, the consequences might be different for tax-free reserves such as for example asset revaluation reserves on shares.

In a treaty situation one can argue that the revaluation reserves can not be subject to corporate income tax in Belgium after migration. The income tax treaties provide that profits of an enterprise are only taxable in the country of residence of the enterprise (assuming no permanent establishment in the other State). Article 3(2) of the treaties provides that any term not defined in the Convention shall have the meaning it has under the laws of that State concerning the taxes to which the Convention applies. Under internal Belgian tax legislation, unrealized capital gains on shareholdings qualify as profits (albeit tax-exempt provided that certain conditions are fulfilled). Asset revaluation reserves on shares could consequently not be taxed in Belgium, since the power to tax these reserves would be allocated to the other Contracting State. The tax treatment of these reserves in the other State is of no importance. In a non-treaty situation, the same result could be achieved by application of the territoriality principle laid down in Article 2 ITC (supra).[16] It is unclear whether the Minister of Finance would come to the same conclusion on this point.[17]

The same problems might arise with regard to (temporarily) tax-free reserves where Belgium does not recognize a similar (temporary) exemption system.

Depending on the nature of the reserves, it should however be possible to apply the same principles as mentioned above (i.e. no taxation in Belgium to the extent the power of taxation on these reserves would be allocated to another country in accordance with the income tax conventions concluded by Belgium).

13. *Vr. en Antw. Kamer*, 18 April 1994, nr. 102, at 10462 – Vr. nr. 947 Dupré, 8 March 1994; *Vr. en Antw. Kamer*, 13 June 1994, nr. 109, at 11345 – Vr. nr. 996 De Clippele, 29 March 1994; *Vr. en Antw. Kamer*, 26 February 1996, nr. 23, at 2531 – Vr. nr. 189 Jozef, 11 December 1995.
14. One could wonder whether the Minister would have taken the same position if Belgium did not have a system of tax exemption for capital gains realized on shares.
15. W. Piot, "Fiscale implicaties van zetelverplaatsing naar en vanuit België", *AFT*, (1997) at 16.
16. See also E. van der Bruggen, *supra* note 8, at 496.
17. This discussion might be academic, if the Belgian tax administration accepts that the asset revaluation reserve on shares can (continue to) be booked after migration on a separate account on the company's balance sheet. In such case, the unrealized capital gain remains tax-free as long as it is booked on such separate account. Upon subsequent realization of a capital gain, the exemption would become final.

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F. Loss compensation

An interesting question is whether companies that have transferred their seat to Belgium can use the tax loss carry forward built up before migration against profits realized after migration.

A distinction should be made between losses realized outside Belgium before transfer, and losses realized by a (Belgian) permanent establishment of the transferred company.

Based on the territoriality principle, one must conclude that losses realized outside of Belgium before transfer of the principal seat can not be used against profits realized after the transfer.[18] The same territoriality principle allows that losses, realized by a Belgian permanent establishment of the transferred company, can be used after transfer of the principal seat to Belgium. This has been confirmed by the Minister of Finance.[19]

G. Anti-abuse legislation

One could wonder whether the Belgian tax administration could invoke anti-tax abuse legislation in order to challenge the tax-inspired migration of companies to Belgium. The tax administration could have an interest in doing so in the situation where the principal seat of a foreign subsidiary of a Belgian holding company is transferred to Belgium in order to avoid the exceptions under which the participation exemption can not be claimed (see point III.A.1 supra).

Article 344(1) ITC provides for an anti-abuse rule allowing the tax authorities to change the legal qualification of an act (or of several acts realizing a single transaction), if they suspect that the legal qualification given by the parties to the relevant act(s) has been chosen in an aim to avoid taxes. The taxpayer may rebut this requalification by proving that the given qualification corresponds to legitimate economic or financial needs.

Considering that Article 344(1) ITC only allows the authorities to change the legal qualification of certain acts and does not allow for rejecting the existence of these acts,[20] it will be difficult to apply the article to the case at hand. If the tax authorities treat the migration as not having taken place,[21] this would not merely be a change of the legal qualification, but would be a denial of the migration itself.[22]

IV. CAPITAL TAXES

According to Article 118 of the Belgian Registration Tax Code, the transfer of a company's principal seat to Belgium is considered as the establishment of a Belgian company followed by a contribution, and a capital duty of 0.5 per cent is due at the moment of migration. An exemption is however available for migrating companies originating from an EU member state, provided that the company has been subject to a capital tax in the country of origin.[23]

18. E. van der Bruggen, *supra* note 8, at 498; contra : J.P. Lagae, *supra* note 9, at 1046.
19. *Vr. en Antw. Senaat*, nr. 2, 19 April 1988, nr. 28, at 59 – Vr. nr. 28 De Clippele, 17 March 1988. It should be noted that the Minister of Finance requires that the losses have not yet been used in the country of origin. This position is, in absence of any legal justification, incorrect (see also E. van der Bruggen, *supra* note 8, at 498; contra : I. Behaeghe, "Vennootschapsbelasting – belastingstelsel meerwaarden – overdraagbare bedrijfsverliezen – verplaatsing van een buitenlandse vennootschap naar België – Parlementaire vraag", *Fiscale Koerier*, 1988, at 273).
20. S. Van Crombrugge, "De invoering van het leerstuk van de fraus legis of wetsontduiking in het Belgisch fiscaal recht", *T.R.V.*, 1993, at 281.
21. I.e. that if any dividends were distributed, the dividends would be treated as distributed by a foreign company not meeting the conditions to benefit from the participation exemption.
22. See also W. Piot, *supra* note 15, at 17.
23. Art. 121, 1, 2° Registration Tax Code.

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INTERNATIONAL

SOME TAX ASPECTS OF GUARANTEES, LETTERS OF COMFORT AND KEEP-WELL AGREEMENTS BETWEEN GROUP COMPANIES

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I. INTRODUCTION

Related companies often support one another when borrowing money from third parties. The support can take many forms, from joint and several liability, surety or guarantee by one company for the other's debts to much less stringent forms like letters of awareness, letters of comfort or keep-well agreements. Such letters or agreements are also called letters of patronage in continental Europe. In this paper we will use the term 'letters of comfort' to refer to these arrangements.

Typically, it is the parent company that provides the support for companies belonging to the group it controls. The support may also be provided by a specialized financing company. Where the equity situation of such specialized company is insufficient to sustain its support of the other group companies' borrowings, it may need endorsement by the ultimate parent company. Another situation is where the assets of a group which may serve as security for group companies' debts belong to one or more subsidiaries, while the group's borrowing requirements are handled by the group's parent or specialized group company. In such a case it may also be the subsidiary(ies) that provides security. In this paper we will concentrate on the situation of a parent company providing security for its subsidiaries' borrowings.

After analysing the private law consequences of the several arrangements, we will focus on three tax questions. The first is whether a remuneration is required for the support provided. The second question is what would be a remuneration at arm's length. The third question is whether a provision may be made for liabilities following from such arrangements and whether an eventual payment may be charged against the taxable profits of the provider. We will examine the views of four selected countries; France, Germany, the Netherlands and the United Kingdom on these questions and, where available, the OECD view. After comparing these views we will draw conclusions and make certain recommendations.

II. LEGAL ASPECTS

In this part we will analyse the differences in legally binding force of various forms of guarantee and letters of comfort. We will use the term guarantee to indicate arrangements where the legally binding character is indisputable, e.g. joint and several liability, surety and guarantees as opposed to letters of comfort and keep-well agreements.

A. Distinction between guarantees and letters of comfort

Surety and guarantee are obligations legally binding on the party pledging to pay a debt in case of the default of the original debtor. A person who is jointly liable, may even be asked to pay the other person's debt without that person first being held responsible for it. The essential distinction between guarantees and letters of comfort is that under a guarantee a person makes himself liable to a third party for the default of the principal debtor of an obligation. Under letters of awareness, letters of comfort or keep-well agreements the issuer will at most only be liable for damages upon default of the original debtor. Whether the issuer may be held liable at all, depends heavily on the exact wording of the document.

If letters of comfort are not binding on the issuer, then why would the issuer bother to issue such letter, or why would any creditor take note of it? For the issuer, one reason could be the protection of its balance sheet. Liability for a subsidiary's debts usually must be mentioned in the annual accounts and may reduce the parent company's ability to obtain credit on its own behalf. The parent company may also have given a negative pledge; a promise not to pledge all or some of its assets as security for specific debts. In other cases the borrowing company can provide sufficient collateral for its loan, but a letter of comfort from the parent company enables it to obtain a lower interest rate.

For a creditor a letter of comfort at least means that the parent company is aware of the subsidiary's borrowing. Where the fixed assets of the borrowing company have already been pledged as collateral for other debts, a letter of comfort may be the only available security for the bank short of a legally binding guarantee, surety or declaration of joint liability.

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B. Letters of comfort

To our knowledge letters of comfort have not been regulated in any domestic legislation. It is a phenomenon that has developed in commercial practice and therefore has assumed many forms and varieties. A very non-committal form is the so-called letter of awareness. Such letter merely states that the parent company is aware of the credit being extended to the subsidiary, or that the parent approves the credit. As a statement of fact this type of declaration can hardly be imagined to oblige the parent company to anything towards the creditor. Perhaps a creditor could argue on the basis of such declaration, that a parent should not drain a subsidiary of its liquid assets and resources to such an extent as to virtually prevent it from meeting its obligations under the credit agreement. In the absence of such "tortuous" conduct the declaration will be of little value to the creditor.

Another type often found is the declaration that the parent company will maintain its level of participation in the subsidiary during the term of the loan. At first glance this type of declaration seems to entail a firm obligation on the part of the parent company. The question however is what are the consequences of the parent not keeping its undertaking. If the participation is ended notwithstanding the declaration, it is uncertain what remedies would be available to the creditor. Does the divestment cause him damage? Only where it could be proven that the divestment directly caused the creditor damage, would it seem that he would be able to make any claims against the parent company.

The next type is a declaration of intent. The parent company may declare that it will exercise its influence on the subsidiary in order that it operates its business in a prudent manner, or in order that it meets its obligations under the loan agreement. Where the subsidiary is 100 per cent owned by the parent, its influence on the subsidiary's conduct of business should normally guarantee the stated aims. However, a prudent conduct of business is no guarantee that the business will prosper. Even where a company conducts its business in a prudent manner losses may still arise due to external factors. Where the undertaking is to cause the subsidiary to meet its loan obligations, this seems to be a specific and unequivocal undertaking. It does not specify however the degree of effort that is required from the parent.[1]

A variation on the type discussed in the preceding paragraph is the declaration of the parent company that it is its intention to provide the subsidiary with funds which it may request in order to fulfil its obligations under the loan agreement. The declaration may also be that it is the parent's policy not to distinguish between its own obligations and those of its subsidiaries. One may argue that such a declaration of intent or policy is nothing more than a statement of fact. On the other hand it could be argued that the statement is deliberately made towards a creditor. If it is not intended that the creditor rely on the declaration, then it would not make sense to make the statement in the first place.[2]

The final category to be discussed is the undertaking to maintain net worth or liquidity. Within this category variations also occur. Typically the declaration is that the parent undertakes to maintain the net worth of the subsidiary at a specific level or to maintain sufficient liquidity in the subsidiary to enable it to meet its obligations (under the credit arrangement). The undertaking can be limited to the normal conduct of the subsidiary's business, or in time, or it may be less binding by only undertaking an effort to maintain net worth or liquidity.

Declarations of more than one type described here are often combined in one document.

C. Keep-well agreements

In contrast to letters of comfort which are, in principle, unilateral declarations issued to the creditor for whose benefit they are issued, keep-well agreements are contracts between the parent company and the company actually borrowing. Under such contract the parent company usually assumes the obligation to maintain its holding, to maintain a certain net worth and/or to enable the debtor company to meet its obligations towards third parties. As a contract it is binding on the parties to it; it is not, however, a contract with the creditor. Even if the contract remains private between the parties, still, in the case of bankruptcy for instance, the liquidators of the debtor company may hold the parent liable to the contract. Apart therefrom, if the contract has been brought to the attention of the creditor, the question arises whether the creditor may derive any rights from it. If the parent company has agreed that, under certain conditions, certain creditors may enforce the contract on behalf of the debtor company, the contract may be characterized as a contract for the benefit of a third party. The question then is whether the third party is entitled to independently enforce the rights purportedly conferred on it by the contract, or may enforce them only after expressly accepting the benefit of the contract. The answer would seem to depend on the private law governing the contract.

D. Consequences of guarantees, sureties and joint liability

For an evaluation of the tax consequences of guarantees and letters of comfort it is necessary to analyse what are the obligations undertaken under the several types of security arrangement. Under a joint liability the creditor may address any debtor he sees fit to perform the contract for which they are jointly liable. The debtor who pays may have recourse against his fellow debtors, dependent on the relationship underlying the joint liability.

A guarantee gives the creditor the right to hold the guarantor liable for a failure on the part of the principal debtor to perform his contractual obligations. The guarantor is only liable in the case of a proven default of the principal debtor. The

1. Cf. the case *Soc. Générale de Fonderie v. SA Champex* hereafter under section II. E.
2. The UK decision in *Kleinwort Ltd v. Malaysia Mining* [1989] 1 WLR 379 shows both lines of argument, the High Court determining in favour of a binding promise and the Court of Appeal to a moral responsibility only.

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same goes for surety. The guarantor or the surety can only be called upon to pay after the default of the principal debtor has been established. Normally the surety will be subrogated to the rights of the creditor upon payment of the principal debtor's debt, but such subrogation may be excluded contractually. Whether a guarantor is subrogated depends on the contract between the guarantor and the person for whom the guarantee has been given.

The common feature of the forms of security discussed in this paragraph is that the person giving security for another person, agrees to be held liable in court under certain conditions. There is a risk that the person must pay and thereby incur a loss.

E. Consequences of letters of comfort

A declaration of awareness seems not to oblige the person giving the declaration to anything directly. As stated earlier, such declaration may perhaps be construed as prohibiting the parent company from draining the subsidiary excessively of its cash resources on grounds of "equity". A direct obligation towards the creditors of the subsidiary company cannot be construed out of such declaration however.

Where the issuer of a letter of comfort undertakes to maintain the level of its participation in the debtor company, a clear obligation is assumed. Unclear, however, are the consequences of a breach of this undertaking. Normally, the sale of the shares in the debtor company does not mean that it will not pay its debts. The sale may even be a turn for the better and thus enhance the creditor's chances of being repaid. In *Chemco Leasing Spa v. Rediffusion Plc*[3] the debtor's parent not only had given the undertaking as discussed here, but also had undertaken "to give Chemco prior notification, should we dispose of our interest during the lifetime of the leases. If we dispose of our interest we undertake to take over the remaining liabilities to Chemco of CMC Italy should the new shareholders be unacceptable to Chemco." Rediffusion sold its shares in CMC on 16 December 1981. The sale was notified to Chemco shortly before the effectuation of the sale. CMC was declared bankrupt on 23 July 1982 and on 3 September 1982 Chemco notified Rediffusion that it could not accept the new shareholders of CMC and sued for damages. The Court held that Chemco in principle could demand that Rediffusion take over the remaining liabilities under the leasing agreements between Chemco and CMC. The rejection of the new shareholders, however, had been unduly delayed in the Court's view and therefore Chemco had lost its rights under the letter of comfort. It was the additional undertaking to take over the liability of the debtor company under certain conditions, which would have made Rediffusion liable. In the absence of the additional undertaking Chemco would probably have had to prove, that Rediffusion was aware of the imminent bankruptcy in order to sue it for damages. The sole undertaking to maintain a given level of participation, will not easily make the parent company liable for its subsidiary's debt. We are not aware of case law from other countries.

There is a considerable body of case law regarding declarations of intent or policy. The continental courts seem to be more inclined to give binding force to such declarations than their English counterparts. However, the existence of such a difference in approach is difficult to ascertain, because in a number of cases decided by continental courts the declaration of intent was reinforced by additional undertakings such as to pay the subsidiary's debts as debts of the parent company, or to indemnify the creditor in case of the default of the subsidiary company. The undertaking to pay the subsidiary's debts as if they were debts of the parent company, is of course little less than a declaration of surety and it is obvious that the parent is held liable in such a case. An undertaking to indemnify the creditor in case of default is also unequivocal.

Where the commitment of the parent company is limited to its best efforts, the difference in approach is clearer. The *Tribunal de Commerce* in Paris decided that the undertaking to take all necessary steps to enable the subsidiary to meet its obligations towards the bank made the parent company liable to supply the subsidiary with sufficient funds, but not directly liable to the bank for payment of the subsidiary's debt.[4] Similarly the Court of Appeal in Paris decided that a commitment to take all necessary steps to ensure that the subsidiary could fulfil its obligations towards the bank, could not be seen or relied upon as a surety or guarantee. The parent company was, however, obliged to do all it could to prevent the default of its subsidiary. In that particular case the parent company had provided additional loans and made additional capital contributions, until its own position (i.e. its own solvency) was threatened. The Court decided that the creditor could not demand more from the parent company under the letter of comfort.[5] The two French decisions may be compared to the British decision in *Kleinwort Benson v. Malaysia Mining Corporation Berhad*,[6] where a letter stating that "It is our policy to ensure that the business of MMC Metals is at all times in a position to meet its liabilities to you under the above arrangements" was held to entail no more than a moral obligation towards the bank. Gibson L.J. considered that

> "the concept of a comfort letter, to which the parties had resort when the defendants refused to assume joint and several liability or to give a guarantee, was known by both sides at least to extend to or to include a document under which the defendants would give comfort to the plaintiffs by assuming, not a legal liability to ensure repayment of the liabilities of their subsidiary, but a moral responsibility only."

This decision is in marked contrast to the French *Fonderie* case, especially in respect of the question whether the parent company had made any effort to prevent the default of its subsidiary.

The Dutch approach is shown in two decisions of the Hoge Raad (the Dutch Supreme Court). In HR 15 September 1985, NJ 1987,98 it was decided that a parent company should compensate the creditors of a company it had just taken over. The creditors had been encouraged by the parent company to

3. Court of Appeal (QB), 11 December 1986, (1987) 1 FTLR 201.
4. Tribunal de Commerce Paris, 16 June 1986, RJC 1987, at 53.
5. Cour d'Appel Paris, 10 March 1989, D 1989 J. at 436 (*Soc. Générale de Fonderie v. SA Champex*).
6. Cf. *supra* note 1.

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resume business with its new subsidiary. The Supreme Court decided that in such circumstances the parent's letter of comfort amounted to a formal guarantee from the parent company. In a second case in 1994[7] the Supreme Court ruled that a parent company had breached its duty of care towards its subsidiary's creditors. In that case, managers of the parent company had made statements during the negotiations of a contract between the subsidiary and a third party, that the subsidiary's creditors would be taken care of and that the parent company wanted to maintain its good reputation. Timmerman[8] concludes from this case that under Dutch law a parent company which has involved itself intensively in its subsidiary's affairs must have due regard to the interests of the subsidiary's creditors.

We have not found cases specifically dealing with keep-well agreements.

III. TAX ISSUES

In this part we will discuss the tax treatment of letters of comfort in France, Germany, the Netherlands and the United Kingdom. Next we deal with the views of the OECD, where available and finally we will draw some conclusions and make a few recommendations.

A. Short survey of tax issues

There are three main issues relating to guarantees, and letters of comfort.

1. Should a remuneration be paid for the issue of a guarantee/ letter of comfort?

The question whether or not a remuneration should be charged has several aspects. On the one hand one might argue that the activity of providing a guarantee or letter of comfort is a service that can be obtained from third parties and therefore should be remunerated. On the other hand the advantage resulting from this type of activity (a higher credit rating and thus lower financing costs) might be considered simply as the result of being part of a group – comparable for example to the advantages resulting from central purchases – and therefore require no remuneration.[9] Where the parent company is the providing company a remuneration might be denied because the guarantee or the letter of comfort is provided solely in its own interest. Would the same be true where a subsidiary is the providing company? Furthermore the question arises whether there is any difference if a guarantee has been provided, or a letter of comfort?

2. What would be an arm's length remuneration?

Once it is established that there is an intra-group service to be remunerated at arm's length, the question is how to determine the amount of the remuneration. Straightforward comparables (e.g. bank guarantees) may not be available, or where available might need to be adjusted as the reason for providing the guarantee or letter of comfort may be mixed (i.e. it may both be in the interest of the provider and the debtor).

3. May a provision for possible claims be created?

Where a guarantee or letter of comfort has been provided, claims may arise. Generally the resulting payment will be tax deductible where the reason for providing the service is not solely the self interest of the provider. If the letter of comfort or the guarantee is provided in managing and protecting the parent company's investments, no fee may be charged to the debtor. The question is whether under these circumstances the provider may still form a provision, or deduct eventual payments from taxable profits. The answer will depend on the tax treatment of participations and benefits therefrom under the domestic law of the parent company's country of residence. In the Netherlands for example, all benefits from qualifying participations are exempt. Any expense for the protection of the parent's investment must be added to the book value of the participation. If the participation is sold afterwards and the total sum invested in it cannot be recovered, the resulting loss is exempted, or in other words not taken into account. However, if the participation is liquidated, the Dutch parent company may deduct the difference between the total sum invested and the proceeds from the liquidation as a liquidation loss.[10]

B. Selected countries

1. France

(a) *Qualification*

Neither statutory nor administrative tax law deals with the qualification question of the provision of intra-group guarantees or letters of comfort. Case law however shows that normally a charge should be taken into account[11] except where a parent company provides a free guarantee in its own interest. Case law has held that a parent company is acting in its own interest where it has:

- a financial interest: the parent company wants to keep a foreign subsidiary which is close to bankruptcy, or which has financial problems;[12] or
- a commercial interest: the parent gives its guarantee free of charge in order to keep and/or develop its trading opportunities with the subsidiary.[13]

Determining when a parent company is acting in its own self-interest may be difficult. The French Tax Administration in its instruction concerning cancellations of debt[14] took the view that a parent company acts in its own financial interest

7. Hoge Raad 18 November 1994, RvdW 1994,251.
8. L. Timmerman, "The law on corporate groups in the Netherlands", *I Grupppi di Società*, 1996, at 351.
9. OECD Guidelines para. 7. 13.
10. This is the principle; the Corporate Income Tax Act 1969 contains a number of anti-abuse provisions which prevent artificial increases of liquidation losses.
11. According to CE 24 February 1978, nr. 2372 the provision of a guarantee without charge to a third party is considered as an "abnormal act of management" because there is no income for the supply of this service.
12. CE 13 January 1967, nr. 68139.
13. CE 3 March 1989, nr. 77581.
14. 22 August 1983, 4 A6-7-83.

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where it provides guarantees to a subsidiary having a negative net equity. The *Conseil d'Etat*, however, held that a parent company does not act in its own interest if it provides a guarantee to improve the value of the shares of the subsidiary or to increase the expected dividends. In the case of 9 March 1979, nr. 10454 the Council also held that the parent company did not act in its own interest. The parent company's argument in this case, that the subsidiary was owned by the group and that the parent company should therefore contribute to its development was rejected.

There is no indication in statutory law, case law or administrative law as to whether the above also applies where a letter of comfort has been provided.

(b) *Arm's length remuneration*

In France the question as to whether an arm's length remuneration should be charged for providing intra-group guarantees depends on the facts and circumstances of each case (e.g. the associated risk). Much case law exists on this issue. To mention just a few examples: in CAA 20 October 1994, nr. 93PA00715 the court ruled an acceptable commission rate would be 0.5 per cent of the sum guaranteed. In CE 17 February 1992, nr. 81690 and 82782 the French tax administration argued for a rate of 1 per cent of the sum guaranteed. However, the *Conseil d'Etat* set the rate at 0.25 per cent as the beneficiary was in a strong financial position and therefore the risk was not very great.

No statutory, administrative or case law dealing with letters of comfort, has been found.

(c) *Provisions*

Pursuant to Article 39-1-5 CGI provisions are deductible under the following general conditions:

- the provision must refer to charges which are tax deductible;
- the charge must be precisely estimated;
- the charge must be probable at the time the books are closed;
- the agreement(s) from which the liability may arise, must be in writing and signed;
- the event with regard to which the provision was created must arise out of events that have already taken place or which are still occurring at the time the books are closed;
- the provisions must be visible in the (commercial) accounts.

Thus the guarantor can form a tax deductible provision for risks of the guarantee if it is probable that the debtor will be unable to pay, the guarantee will be used and the guarantor will not be able to recover the debt. If the guarantee is regarded as an "abnormal act of management", the implication is that the parent company acted in its own interest by providing the guarantee and no provision will presumably be allowed.

The above also applies to letters of comfort. This implies for instance that a provision may not be formed if the issue had not been authorized by the board of directors, or if the provision cannot precisely be estimated.

2. Germany

(a) *Qualification*

German case law[15] shows that only under certain circumstances should a remuneration be taken into account if a person provides a guarantee to a related person. This is the case if the reason for agreeing to act as a guarantor lies outside the shareholding relationship e.g. where the guarantee benefits the debtor (e.g. by saving him financing costs or by allowing him access to a certain capital market). However, even though the debtor might benefit, a charge may not be appropriate where the interests of the guarantor's own business prevail and the guarantor would have given the guarantee without charge to an unrelated party in the interests of its own business.[16]

The above also applies to letters of comfort having a guarantee character.[17]

(b) *Arm's length remuneration*

The decision in BFH 19 May 1982, held that insofar as the conditions set out above are met a guarantee commission should be charged to the extent that this would have been agreed between third parties. It is not clear what amounts of fees are customary.

(c) *Provisions*

In Germany tax accounting rules to a considerable extent follow commercial accounting rules (the "Maßgeblichkeit" principle). The exception is where tax law explicitly provides otherwise. The commercial law code (Article 40 (III), HGB) prescribes that bad debts should be valued at their probable value. Uncollectible items should be entered at nil. A bad debt exists where the contract will probably show a loss in a subsequent year.

3. United Kingdom

(a) *Qualification*

In general, in the United Kingdom the intra-group provision of guarantees and letters of comfort is considered as a service to be remunerated at arm's length where the service does in fact add to the obligations of the provider. No special transfer pricing rules, guidelines, or case law are available. However, case law on the deductibility of expenses indicates that a fee should not be taken into account if the parent is providing the service solely in its own interest.[18]

15. *BFH* 19 March 1975, *BStBl* II 1975, at 614; *BFH* 19 May 1982, *BStBl* II 1982, at 631.
16. Verwaltungsgrundsätze, para. 4.4; Th. Borstell, *Finanzierungsleistungen im Konzern, Handbuch der Verrechnungspreise*, 1997, C.H. Beck, at 910-911.
17. Verwaltungsgrundsätze, para. 4.4.3.
18. The *Robinson v. Scott-Bader* case concerned the deductibility of salary and expenses of an employee seconded to manage the affairs of an ailing overseas subsidiary. The Court held that the parent should deduct the salary of the employee since the assistance was provided in the parent's own interest.

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(b) *Arm's length remuneration*

No statutory, administrative or case law is available. In practice, if a bank guarantee is provided fees of between 0.375 per cent and 1.5 per cent of the sum guaranteed are taken into account.

(c) *Provisions*

In the United Kingdom bad debts arising from a company's trade are deductible in the period in which their recovery is considered impossible. Any subsequent recoveries are taxed in the period of receipt. Provisions for doubtful debts are allowed to the extent that specific debts are expected to be irrecoverable.

4. The Netherlands

(a) *Qualification*

In the Netherlands no statutory or administrative law in respect of intra-group guarantees and letters of comfort exists. However, the Netherlands has adopted the OECD Guidelines and therefore, what is said in the Guidelines also applies to the Netherlands.[19]

There is a considerable amount of case law dealing with guarantees from sole shareholders/directors for their company's debt. These decisions emphasize the shareholders interest in providing guarantees and therefore refuse a deduction of fees for such guarantees. Fees that have been paid are treated as dividend distributions in most cases.

Only two cases are available on the qualification issue in intra-group situations. The first case before the Court of Appeal at 's Hertogenbosch[20] involved a guarantee. Upon the sale of its German subsidiary the Dutch parent company had to pay off debts of the subsidiary, for which it had provided a guarantee. The Court held that the guarantee had been provided by the parent in its capacity of shareholder. Therefore the payment was considered to be connected to the participation and was excluded from the taxable profit under the participation exemption. The second case decided by the Amsterdam Court of Appeal on 16 April 1993[21] considered a net worth statement. The two shareholders of a Dutch company had guaranteed to a bank that they would maintain the net worth of their joint subsidiary at at least NLG 1,500,000. Subsequently they made a loan to the company which the tax inspector argued was really an informal capital contribution. The Court held that loans extended by the two shareholders to the subsidiary, even if subordinated, would not contribute to the subsidiary's equity and hence could not increase its net worth. Consequently it held that the shareholders' payments under the keep-well agreement could not be anything other than informal contributions of capital.

The case law described here would seem to imply that under Dutch law a guarantee or letter of comfort provided by a parent company to a subsidiary is always provided by the parent in its capacity of shareholder. In our opinion this is not the case however. In the first place the Dutch Supreme Court has held repeatedly and consistently, that, in principle, a shareholder/parent company is free to choose between the granting of a loan and a contribution of capital to the company seeking funds. If a loan is made under arm's length conditions, it must be treated as a loan. If a parent company may lend money under arm's length conditions to its subsidiary, it must also be allowed to give it a guarantee or letter of comfort as a less far-reaching engagement. If however, the solvency of the subsidiary and its creditworthiness in general is such that the parent/lender cannot reasonably expect to receive repayment, the "loan" is recharacterized as an (informal) capital contribution. If in similar circumstances a guarantee or letter of comfort is legally enforceable and is likely to be invoked, it must be treated as a conditional contribution of capital to the subsidiary and no charge could be imposed.

(b) *Arm's length remuneration*

No statutory, administrative or case law is available. In practice fees for bank guarantees may amount to up to 1 per cent of the sum guaranteed.

(c) *Provisions*

Dutch tax law allows the formation of provisions under the following conditions:

- there must be a legal relationship, from which an obligation may result which is enforceable in court.[22] (It is not strictly necessary that the obligation already formally exists.);[23]
- there must be a reasonable chance that the obligation will be enforced.[24]

No specific case law exists in respect of the formation of a provision for guarantees or letters of comfort in intra-group relationships.

5. The OECD view

(a) *Qualification*

The treatment of intra-group services is dealt with in Chapter VII of the Transfer Pricing Guidelines of the OECD. These Guidelines do not specifically deal with guarantees or letters of comfort. In a few instances guarantees are mentioned, but not discussed in any systematic manner.

According to paragraph 7.6 of the 1996 Guidelines whether or not an intra-group service (to be remunerated at arm's length) has been rendered depends on whether the activity "provides a respective group member with economic or commercial value to enhance its commercial position. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing

19. Tweede Kamer (the Lower House of the Dutch parliament) 1996-1997, 25087, nr. 2. Answer of the Director for International Fiscal Affairs of the Ministry of Finance before the Finance Committee in a debate on tax treaty policy.
20. Hof 's Hertogenbosch 8 January 1988, *BNB* 1989/52.
21. Hof Amsterdam 16 April 1993, nr. 91/1869, *Vakstudie-Nieuws* 1993, at 2563.
22. Hoge Raad 22 December 1993, nr. 29230, *BNB* 1994/121.
23. However, if the person wishing to make the provision is in a position to prevent the obligation from coming into existence, no provision is allowed.
24. Hoge Raad 7 December 1983, nr. 22226, *BNB* 1984/37.

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to pay for the activity if performed for it by an independent enterprise". In-house performance, which is mentioned as an alternative yardstick by the Guidelines, is of course not an option in the case of guarantees or letters of comfort (paragraph 7.6 1996 Guidelines).

On the other hand, according to paragraph 7.13 of the Guidelines, "an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed". As an example of such incidental benefit the Guidelines mention a credit-rating of an associated enterprise by reason of its affiliation alone, being higher than if it were unaffiliated. In such a case no service is provided and no remuneration would be appropriate.

In general, the provision of a guarantee, a deliberate act of an associated enterprise, is, in the view of the OECD, a service requiring a remuneration (paragraph 7.13). The Guidelines do not, however, specifically refer to letters of comfort, nor do they distinguish between enforceable and non-enforceable instruments. Consequently it remains unclear what criterion should be applied for determining the performance of a service. The willingness criterion is the only one mentioned and it is mentioned without any reservation.

A fee would not be appropriate where the intra-group activity should be considered as shareholder activity, being an activity performed by the parent company *solely* because of its ownership-interest in the debtor company, i.e. in its capacity of shareholder. It may be very difficult if not practically impossible, to demonstrate that a guarantee or letter of comfort was concluded or issued solely in the interest of the parent or the subsidiary.

(b) *Amount of arm's length remuneration*

Paragraphs 7.19-7.37 of the Guidelines deal with the charge for intra-group services. The arm's length remuneration should be set at the price that would have been made and accepted between independent enterprises in comparable situations (paragraph 7.19). Where a direct-charge method is difficult to apply, MNE groups may apply indirect-charge methods (paragraph 7.22). An indirect-charge method is not allowed according to the Guidelines, if the specific service forms the main business activity of the enterprise and the services are also provided to third parties (paragraph 7.23). The compensation for services rendered to an associated enterprise may also be included in the price for other transfers (paragraph 7.26). Relevant considerations in determining the arm's length price include:

- the value of the service to the recipient;
- how much a comparable independent enterprise would be prepared to pay for that service in comparable circumstances;
- the costs to the service provider.

How these general considerations would work out for guarantees and letters of comfort is not further elaborated.[25] Bank charges for a guarantee would seem to be good comparables where the parent company has made legally enforceable obligations. Where bank charges would not be considered as comparables, the difference in interest charged in the presence or absence of a letter of comfort could perhaps be the basis for determining an arm's length remuneration. Independent parties may be expected to somehow share the benefit from the guarantee, although usually the subsidiary will be in a weaker position than the parent company.

(c) *Provisions*

The OECD, to our knowledge, did not deal with the question under *what* circumstances a provision should be allowed.

IV. COMPARISON

A. Qualification

1. Guarantees

The countries surveyed, as well as the OECD, in principle do allow an arm's length fee where intra-group guarantees are provided. No charge is however allowed if the guarantee is provided by a parent company in its own interest. Countries differ, however, in their determination of when exactly a parent company acts in its own interest where it provides a guarantee to another group member. The OECD, not dealing with guarantees specifically, takes the considerations of the beneficiary in accepting the service as the basic criterion. Where the parent company provides the guarantee *solely* in its own interest, it would effectively be forced upon the subsidiary, who would not be willing to pay for it if it were an independent enterprise.

The German *Verwaltungsgrundsätze*, however, seems to give priority to the considerations of the providing (parent) company. If the parent company would have been willing to provide the guarantee without charge to an unrelated party in the interest of its own business, a fee would not be appropriate. Dutch case law seems to follow a comparable approach, although it does not take the charge of a fee as its starting point but the assumption of the liability. Would a person other than a shareholder assume the liability under the same or similar circumstances? Thus where the guarantee is both in the interest of the providing parent company and of the receiving subsidiary the OECD view seems to be that a fee should be taken into account, whereas in Germany no fee will be taken into account. Obviously, this difference can easily lead to double taxation. It remains to be seen whether the Dutch unqualified acceptance of the Guidelines will be reflected in Dutch case law.

Furthermore the criterion of the parent company acting in its own interest raises difficult questions. Is the interest of the parent company not the prosperity of the subsidiary? On the other hand, is it conceivable that a guarantee is not in the

25. In paras. 7.38-7.39 the Guidelines give some examples of the applicability of transfer pricing methods. For debt-factoring activities CUP could be appropriate. Cost plus could be appropriate for contract manufacturing and contract research. Administration of licenses is also dealt with. However, no particular method is indicated.

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interest of the subsidiary company? French case law shows that in France the parent company must have a specific direct financial or economic interest. Does such a specific interest mean, however, that the guarantee is exclusively in the parent's interest? Even if the interest of the parent company is an appropriate criterion for deciding in what circumstances a charge must be made and allowed, its application differs from country to country, leaving a multitude of possibilities for double taxation. The OECD does not provide much guidance on this question.

2. Letters of comfort

The tax implications of letters of comfort are even more vague. Of the countries reviewed Germany is the only one where a criterion for solving the qualification problem is explicitly laid down, albeit in an administrative regulation. Fees, according to the *Verwaltungsgrundsätze*, are taken into account if the letter of comfort has a guarantee character. The circumstances under which this is the case are not further set out. In Dutch case law payments resulting from a net worth statement were qualified as capital contributions,[26] even though one might argue that the agreement at stake had a guarantee character. Our survey did not yield any further information about the possible qualification issues of letters of comfort, nor about relevant French and UK statutory, administrative or case law.

B. Arm's length remuneration

Neither the OECD nor the countries surveyed have provided for specific rules for the determination of what is an arm's length remuneration of intra-group guarantees or letters of comfort. However, in France case law suggests that the financial situation of the beneficiary is considered as decisive.

C. Provisions

All countries surveyed allow a provision for intra-group guarantees and comparable obligations although conditions for granting relief vary from country to country. French legislation seems to be the most detailed and precise in requiring that agreements giving rise to the obligations for which the provision is made, are signed and in insisting on accurate estimates of the risk. Dutch law seems to be more lenient in that a legal relationship not being a perfect contract or agreement can be sufficient justification for allowing a provision. The criterion is whether an obligation may be enforced against the enterprise, without any action or agreement on its part. The difference in approach may be explained from the state of private law in respect of the conclusion of contracts and of pre-contractual relations.

In all countries the amount of the provision depends on the probability of the obligation being enforced. This does not necessarily mean that estimates of it cannot vary from country to country.

V. CONCLUSIONS AND RECOMMENDATIONS

As our survey shows the treatment of guarantees and letters of comfort in legislation, in case law and by the OECD is rather haphazard and incomplete. In the absence of consensus or clear guidance the risk of double taxation and of distorted competition looms large.

A. Qualification

Following the OECD Guidelines the first question is whether there is an intra-group service. The criterion to answer this question provided in the Guidelines is the subsidiary's willingness to pay for the guarantee or the letter of comfort. It may be questioned whether the willingness to pay for the service really is the proper criterion in this case. Unlike with other intra-group services, such as advisory or management services, or joint development and research, in the case of guarantees and letters of comfort usually a third party will be involved. It will often be the prospective creditor who will ask for some form of security for repayment of the loan. In the absence of such security he may charge a higher interest rate or not be willing to give a loan at all. Therefore the subsidiary may not have a choice, whether or not to obtain the guarantee or letter of comfort. Another question is whether it is conceivable that an unrelated party could provide a letter of comfort along the lines described in this paper.[27]

If the letter would not entail any liability in law, the parent could provide the same letter to an unrelated party, although, of course, the comfort provided in that case must be much less. If there is no relationship between the provider of the letter of comfort and the debtor, the well-being, the standing etc. of the company providing the letter is much less affected by a default of the debtor than where the two are related. So what we are saying is that there is, nearly by definition, no comparable unrelated situation for a letter of comfort. Consequently the willingness-to-pay criterion cannot be applied.

In the case of letters of comfort we submit that the willingness to provide the service (i.e. to issue a letter of comfort) free of charge to a third party is a more appropriate criterion. We assume that then the crucial question would be whether the parent company can be held liable in court under the letter of comfort. If it could be held liable, the parent will not be willing to issue a letter of comfort free of charge. No independent person would assume such liability without proper compensation. Still the decision to provide the guarantee or letter of comfort could be made in the capacity of shareholder; e.g. if the creditworthiness of the subsidiary would prevent it from obtaining the loan in the first place.[28]

Where the parent cannot be held liable in court, the issue of a letter of comfort could be considered to follow from the nor-

26. Cf. *supra* note 21.
27. The essence of a letter of comfort is that the issuer assures the recipient of his influence on the borrowing company on the basis of his participation in that company. The existence of a relationship between the two companies is the very basis of the comfort the letter provides to the creditor.
28. I.e. the decision to provide the guarantee would seem to be based on the shareholder's interest.

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mal conduct of business within a group without necessitating a separate and distinct remuneration, or as a benefit mentioned in paragraph 7.13 of the 1996 OECD Guidelines.[29]

To take the enforceability of letters of comfort as the decisive criterion could be said to only shift the problem from the field of tax law to the field of private law. To a certain extent this is true. Nevertheless, in our opinion the freedom to conclude contracts according to the parties' wishes is fundamental. The object of tax law is to apply the tax legislation to the actual behaviour of the taxpayers. In that context substance should prevail over form, and the substance of the taxpayer's conduct should be the basis for the application of the tax law.

The reality is that the private law of different countries does not seem to judge the question of the liability in law uniformly. The picture provided by case law is not very clear, as in many cases where the provider of the letter of comfort was held liable, the letter of comfort was drafted as unequivocally binding the provider. Where the binding is not unequivocal there seems to be a tendency in (Anglo-Saxon) common law to deny a legal obligation on the part of the parent company. Civil law courts seem more ready to construe an obligation "in equity", or in good faith or in reasonableness. Such differences between countries, of course do not make it any easier to determine whether or not a fee is required.

Given these differences between the private law of countries, private international law provides rules to decide which law would govern the interpretation of a letter of comfort. The multitude of possible arrangements, however, makes finding a solution to the problem a hard task. The applicable law could be determined on the basis of the place of negotiation of the "contract" or arrangement, the country where it was concluded, the residence country of the provider of the guarantee or letter of comfort, or rather the country of the creditor as the guarantee or letter of comfort is accessory to the loan contract. Under the Rome Convention on Contractual Obligations the law governing "the most characteristic activity" would be decisive. Countries may, however, differ on the question of what is indeed the most characteristic activity.

Even if there would be agreement in respect of guarantees and letters of comfort on the liability issue a remuneration may still not be appropriate where the parent is held liable if the parent company acted solely in its own interest. The Guidelines and most countries surveyed agree on this point. But again countries differ in their determination of when the parent is acting in its own interest. In general the interest of the parent company is that the subsidiary prospers, thus the parent will receive dividends and see the value of its participation increase.

In Germany the parent is held not to act in its own interest if the guarantee or letter of comfort benefits the debtor company. This does not seem to be a very distinctive criterion. The debtor company will always benefit, although the extent of the benefit may not always be clear.

The German *Verwaltungsgrundsätze* also provides that no fee is allowed when the guarantee or letter of comfort would have been provided to a third party free of charge. This statement could be taken as just an application of the arm's length principle to the question of guarantees. That does not change the fact that the guarantee or letter of comfort is a service, which may be of very great value to the third party concerned. In such cases the question is mostly not whether the beneficiary is prepared to pay, but rather if he is able to *pay* for the service.

The French courts have developed a more distinctive criterion. The parent company should have a specific financial or commercial interest, other than merely receiving dividends, for it to be considered to act in its own interest. We have not found, however, more specific decisions. We suggest that a parent company be only considered to act in its own interest, where the loan can be demonstrated to be made for a specific, well defined interest of the parent company which is independent of the (ordinary) business of the subsidiary.

Until now we have only discussed, whether a fee would have to be charged for a guarantee or letter of comfort. Another problem is the moment at which the question of the remuneration should be answered. Is it exclusively the moment at which the guarantee or letter of comfort is issued, or could subsequent developments influence, justify, or even require, a review of the question at a later moment. Suppose e.g. that at the time the guarantee or letter of comfort is provided, the subsidiary is a healthy company and pays an arm's length fee. Later circumstances have changed and bankruptcy looms over the subsidiary. Could it be argued that at that moment the self-interest of the parent company again comes into play? Would it be relevant whether the parent in the absence of a guarantee or letter of comfort would pay the subsidiary's creditors? Such an approach which is contingent on later developments is heavily reminiscent of the US "commensurate with income" criterion for royalties and is open to the same criticism as those regulations. Especially in case of guarantees and letters of comfort such an approach has the scent of hind sight and would not seem to be in accordance with the arm's length principle. We submit that it is the moment of the issue of the guarantee or letter of comfort at which it must be decided whether the parent company is acting in its own interest or not and whether the charge of a fee is appropriate.

To sum up, the provision of a guarantee is generally considered as a service, if rendered intra-group. The position regarding the issue of letters of comfort is less clear, although in most countries an instrument which could result in obligations enforceable in court, will be assimilated to a legally binding guarantee. The criterion suggested in the OECD Guidelines for recognizing an intra-group service, the willingness of the recipient to pay for it, should perhaps be replaced by the criterion whether the guarantor or issuer of a letter of comfort would be prepared to provide the guarantee or letter of comfort to unrelated parties under the same conditions.

In principle countries also seem to agree that the undertaking of legally binding obligations should be remunerated, unless

29. Indeed the paragraph states that an intra-group service would usually exist where a guarantee is given by a group member. As a guarantee implies legal responsibility, our approach seems to fit in with the Guidelines.

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the undertaking is based on the self interest of the person undertaking the obligation. The case where a guarantee would be provided to an unrelated party free of charge, presumably is a species of the self interest exception. The application of the self interest exception varies considerably from country to country.

B. Arm's length remuneration

The question of what is an arm's length remuneration for an intra-group guarantee or letter of comfort is not dealt with explicitly in the OECD Guidelines. They only incidentally mention the question in the Chapter on intra-group services. The general principles outlined in that Chapter are not very well tailored to deal with this question. It seems that the specific aspects of the provision of security for group companies' debts warrant a separate treatment in the Guidelines. The amount of savings in interest expenses for the debtor company could perhaps be the point of departure. However, it is submitted that some corrections would be necessary as in an arm's length relation the beneficiary would not be prepared to surrender the full amount saved. Moreover in the determination of the arm's length rate it should somehow be taken into account, that indirectly the parent also benefits from the arrangement in the form of the increase in value of the shares of the subsidiary or an increase of the expected dividend due to the lower interest expenses of the subsidiary company. The subject could be entered on the Committee on Fiscal Affairs' agenda for the revision of the Guidelines.

Apart from the question of what constitutes an arm's length remuneration for a parent company providing security for its subsidiaries' debts, one must consider whether the same aspects play a role when the provider of the security is not the parent company but a specialized group company. If the same aspects are relevant for the question of determining the arm's length remuneration, what are the consequences for the answer to the question? Should it be decisive whether the providing subsidiary would have been prepared to provide the guarantee free of charge to a third party, or should the willingness of the receiving company to pay for the service be decisive? The latter would be in line with the general approach of the Guidelines, but it will be clear that we would prefer the former criterion.

Where under arm's length conditions a fee would have been appropriate, but no fee has actually been charged, the question of secondary adjustments also arises. Secondary adjustments in cases involving group finance companies are more complicated than in a direct parent-subsidiary relation, because they require a triangular operation and three tax authorities are involved. If no cash movements are made after the initial profit correction, a hidden distribution of the financing company to the group parent is construed, while the profit of the debtor company should be reduced by the amount of the non-paid fee, followed by an (informal) contribution of capital by the parent to the debtor company. The withholding tax complications connected with these constructive capital movements are obvious, not to mention the question of whether the fee which had to be paid by the debtor would be subject to a possible interest withholding tax. We will not elaborate on these issues further.

C. Provisions

The question of the admissibility of a provision for risks under letters of comfort is not so much a question of double taxation as of the delineation of the taxable basis under domestic law. Nor is it really a transfer pricing issue. Therefore the role of the OECD in this respect is rather limited. Nevertheless, if the Committee on Fiscal Affairs would take up the subject of guarantees and letters of comfort in the framework of the Guidelines it would be useful to devote some time also to the question of provisions for risks connected therewith. Alternatively, the EU could play a role, were the issue of harmonization of direct taxes not so thoroughly deadlocked.

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Conference diary

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

FEBRUARY

Tax Reform in Russia, the Moscow Aerostar Hotel, 37 Leningradsky Prospect, Moscow, 9-10 February 1998 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

Transfer Pricing in Pharmaceuticals, Vienna Hilton, Vienna, Austria, 16-17 February 1998 (English):

Vision in Business Ltd, , 30 City Road, London EC1Y 2AY, Tel.: 44-171-256 5188, Fax: 44-171-256 9393, E-mail: vispharma@aol.com

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

Tax Treatment of NGOs, A Round-Table, Stork Museum, Amsterdam, the Netherlands, 8-10 March 1998 (English):

The Europhil Trust, Willem de Koning, Zeezigt 80, 1111 TM Diemen, the Netherlands, Fax: 31-20-690 9579, Chief Trustee's Office, Tel.: 333 88 561 646.

Tax Reform in Mexico, Frankfurt, Germany, 9 March 1998, London, the United Kingdom, 11 March 1998 and Paris, France, 13 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

Tax and the Internet, London Hilton, London, the United Kingdom, 16 March 1998 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-673 4383, Fax: 44-171-453 2036.

Trusts '98, The Westbury Hotel, London, the United Kingdom, 25-26 March 1998 (English):

EuroForum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

Tackling Customs and VAT in CEE and Russia, Sheraton Hotel, Warsaw, Poland, 25-27 March 1998 (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

Transfer Pricing and Controlled Foreign Companies, Hyde Park Hotel, London, the United Kingdom, 30 March 1998 (English):

IBC UK Conferences Limited, Gilmoora House, 57/61 Mortimer Street, London W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-453 2036, E-mail: jennifer.mansour@ibcuk.co.uk

APRIL

International Tax Planning Techniques, Amsterdam, the Netherlands, 6-7 April 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

The 1998 China Tax & Accounting Summit, The Hong Kong Hotel, Hong Kong, 27-29 April 1998 (English):

Insight, 1/F Chinachem Hollywood Centre, 1-13 Hollywood Road, Hong Kong, Tel.: 852-2520 1481, Fax: 852-2866 7340.

MAY

International Tax Aspects of Financial Derivatives, Amsterdam, the Netherlands, 14-15 May 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

JUNE

International Tax Aspects of Permanent Establishments, Amsterdam, the Netherlands, 18-19 June 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

AUGUST

Summer Course on the Principles of International Taxation, Amsterdam, the Netherlands, 17-28 August 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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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 54-56 of the January 1998 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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Doing business in Kenya.
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South Africa

Price Waterhouse
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Guide to assist taxpayers filing their income tax returns. The material is based on the law as of January 1997 and covers: individual income tax, business and professions income and deductions, estates and trusts, corporate income tax, estate duty, partnerships, etc.
(B. 13.559)

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Johannesburg, Coopers & Lybrand and Sanlam. 1997, pp. 127. ISBN: 1 874956 29 4.
Information guide on the South African tax system covering individual and corporate income taxes, indirect taxes, international tax aspects, estate duty, etc.
(B. 13.562)

Dawson, F.J.
Estate planning guide.
Durban, Butterworths. 1996, pp. 103. ZAR 82.19. ISBN: 0 409 07778 X.
In this book the author discusses the chief points of business and personal law which affect the acquisition, preservation and disposition of a person's assets.
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ASIA & THE PACIFIC

Australia

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From the CCH Tax Editors.
North Ryde, CCH Australia Limited. 1997, pp. 1881. ISBN: 1 86264 874 3.
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(B. 58.359)

Hong Kong

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6th Edition.
Singapore, CCH Asia Pte Ltd. 1997, pp. 670.
ISSN: 0218 8767.
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Aussensteuerrecht
Doppelbesteuerungsabkommen und EU-Recht im Spannungsverhältnis. Festschrift für Helmut Debatin zum 70. Geburtstag.
Herausgegeben von Gabrielle Burmeister und Dieter Endres.
Munich, Verlag C.H. Beck. 1997, pp. 481.
DEM 198. ISBN: 3 406 42555 0.

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Foreign tax law, tax treaties and EU-law in relation to each other. Publication in honour of the 70th birthday of Helmut Debatin. Articles on the international tax law of Germany, written by Baranowski, Becker, Bogenschütz, Burmester, Endres, Spengel, Herzig, F. E. E. Hey, Hundt, Jackstein, Otto H. Jacobs, Cornelia and Gerhard Kraft, Krause-Junk, Regina Müller, Krüger, Michael Lang, Menck, Meyer-Marsilius, Rädler, Runge, Sass, Schlüter, Streichen and Storck.
(B. 116.665)

Hannes, B.
Qualifikationskonflikte im Internationalen Steuerrecht.
Hamburg, Steuer- und Wirtschaftsverlag. 1992.
Schriften zum Steuer-, Rechnungs- und Prüfungswesen, Band 9, pp. 338.
ISBN: 3 89161 709 7.
Problems which arise when treaty signatories classify income differently. An inventory of issues under which classification differences can arise. The issues are categorized, and several solutions to avoid or abolish these differences are proposed.
(B. 116.796)

Debatin, H.; Wassermeyer, F.
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ISBN: 3 406 41921 6.
This first binder covers text of and detailed commentaries on the OECD Double Taxation Convention on Income and Capital of 1992. This volume is the first in a series of five, which gradually replaces the former publication "Korn/Debatin, Doppelbesteuerung" and contains the text, official commentary as well as extensive analysis of the OECD Model Treaties on Income and Capital and on Inheritance. Volumes 2 to 5 will contain general commentary on, as well as the texts of all comprehensive and limited double taxation treaties concluded by Germany. For certain treaties there is also an explanation of the relevant tax law of the other contracting state. Price of the basicwork: DEM 398. Future supplements will keep this loose-leaf publication up-to-date.
(B. 116.831)

Von der DM zum Euro. Wegweiser zur EURO-Umstellung.
Nürnberg, DATEV Informationszentren. 1997, pp. 22.
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(B. 116.670)

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Verfassungsrechtliche Vorgaben für die Steuergesetzgebung im Vergleich Deutschland-Schweiz.
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A comparison of constitutional issues regarding tax legislation in Germany and Switzerland. Principles regarding the jurisdiction (both states are federal states), the form, the procedure and the content, as set out in the constitution of each of the two states, are explained and comprehensively analysed. A short special chapter describes the subject matter in the United States.
(B. 116.625)

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Finanzgerichtsordnung. 60 praktische Fälle. 5. Auflage.
Achim, Erich Fleischer Verlag, P.O. Box 1264, 28818 Achim, Germany. 1997.
Steuer Seminar, Band 9, pp. 186. DEM 39.50.
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(B. 116.566)

Festschrift für Wolfgang Ritter zum 70. Geburtstag. Steuerrecht, Steuer- und Rechtspolitik, Wirtschaftsrecht und Unternehmensverfassung, Umweltrecht.
Herausgegeben von Max Dietrich Kley, Eckart Sünner und Arnold Willemsen.
Cologne, Verlag Dr. Otto Schmidt. 1997, pp. 1023. DEM 298. ISBN: 3 504 06019 0.
Tax law, tax and legal policy, industrial law and business structure, environmental law. Publication commemorating the 70th birthday of Wolfgang Ritter. Collection of articles in the specified fields of law. Included in the tax part are: Harlow on the international tax scene (English), Baumgartner/Storck on headquarters structures, Becker on penalties in the United States and Germany, Dann on advance rulings in Germany and Europe, Eilers on APAs, Krebühl on the credit method in the United States, Laule on limitation on benefits under German domestic law (Section 50d(1) ITL), Mössner on residence and domicile in the United Kingdom, Lethaus on treaty rights of a partnership and Vogel on "good neighbourliness" in administrative and international law.
(B. 116.683)

Isle of Man

Graeme, J.G.; Rogers, A.C.; Shires, M.; Jones, K.A.
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Croydon, Tolley Publishing Company Ltd. 1997, pp. 264. GBP 36.95.
ISBN: 1 86012 542 5.
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ITL 48.000. ISBN: 88 14 06053 3.
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(B. 116.740)

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Deventer, Kluwer. 1997.
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NLG 36.50. ISBN: 90 200 1916 3.
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Memo financiële planning.
Deventer, Kluwer. 1997, pp. 325. NLG 31.50.
ISBN: 90 200 1909 0.
This book contains a comprehensive overview of income planning, net wealth planning and estate planning and explains all important figures, exemptions and deductions. Next to fiscal law, also important civil law regulations such as inheritance law, pension law and social security are explained.
(B. 116.690)

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ISBN: 90 6002 739 6.
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Wegwijzers Financiële Planning, No. 3, pp. 160. NLG 49.50. ISBN: 90 200 1970 8.
Tax planning for director-shareholders. This book deals especially with the private financial situation of a director-shareholder. The book provides answers on questions such as the

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legal form to be chosen, the consequences of the new regime for substantial interest shareholders concerning director-shareholders, BV-structures, possibilities to transfer a business, inheritance of business property, investment possibilities, adequate pensions, employment and social security questions.
(B. 116.699)

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(B. 116.658)

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(B. 116.705)

Betten, R.
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Lelystad, Koninklijke Vermande B.V. 1996, pp. 206. NLG 49. ISBN: 90 5458 348 7.
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(B. 116.655)

Weerepas, M.J.G.A.M.
Belasting- en premieheffing "grensarbeid Nederland–België".
Deventer, Gouda Quint. 1997.
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NLG 65. ISBN: 90 387 0574 3.
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Wit, W. de.
Nationale milieubelastingen en het EG-Verdrag.
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Takens, J.W.; Wagenaar, H.A.; Wiarda, F.J.; Wit, J.P. de.
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(B. 116.693)

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(B. 116.803)

Meyjes, P.; Soest, J. van; Berge, J.W. van den;
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The book contains a comprehensive overview concerning fiscal procedure, such as the procedure for the Court of Appeal and the Supreme Court, the terms which have to be met and the requirements a written appeal has to fulfil. Furthermore, various case law and references to other publications have been included.
(B. 116.700)

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(B. 116.686)

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(B. 116.711)

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Verfassungsrechtliche Vorgaben für die Steuergesetzgebung im Vergleich Deutschland–Schweiz.
Munich, Verlag C.H. Beck. 1997.
Münchener Universitätsschriften, Band 121, pp. 446. DEM 204. ISBN: 3 406 41715 9.
A comparison of constitutional demands regarding tax legislation in Germany and Switzerland. Principles regarding the jurisdiction (both states are federal states), the form, the procedure and the content, as set out in the constitution of each of the two states, are laid out and analysed comprehensively. A short special chapter portrays the subject matter in the United States of America.
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(B. 116.688)

United Kingdom

Inspection of schemes operated by financial intermediaries.
London, Inland Revenue. 1997, pp. 15.
Booklet describing how the Inland Revenue conducts investigations into the records of financial intermediaries (e.g. banks) who are responsible for deduction of tax and relief at source, including subsequent remedial action and taxpayer's rights.
(B. 116.724)

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Leighton Buzzard, Rushmere Wynne Ltd., 4-5 Harmill, Grovebury Road, Leighton Buzzard, Bedfordshire LU7 8FF, United Kingdom.
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A comprehensive detailed guide to VAT including the legislation, Customs and Excise notices and leaflets and all relevant information up to and including the 1997 Finance Act. This latest edition is fully cross referenced to the publication "De Voil Indirect Tax Service".
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INTERNATIONAL

Taxation issues in a federal state and economic groupings with concurrent taxing authorities. Proceedings of a Seminar held in Geneva in 1996 during the 50th Congress of the IFA International Fiscal Association.
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(B. 116.818)

Doggart, C.
Steuerparadiese und wie man sie nutzt.
Düsseldorf, Verlag Wirtschaft und Finanzen, Postfach 10 11 02, 40002 Düsseldorf, Germany. 1997, pp. 344. DEM 168.
Revised and updated 1997 edition of publication on the use of tax havens by companies in particular, and also by individuals. The book analyses the corporate use made by such diverse industries as offshore investments and banking, captive insurance, shipping and offshore manufacturing. Countries dealt with are: Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, Hong Kong, the Channel Islands, Liechtenstein, Luxembourg, Isle of Man, Mauritius, the Netherlands Antilles, Switzerland and Cyprus. Includes a survey of measures by various industrialized countries to combat the use of tax havens.
(B. 116.680)

Coopers & Lybrand.
International transfer pricing 1997-98.
Bicester, CCH Editions Limited. 1997, pp. 450. GBP 65. ISBN: 0 86325 465 9.
The book gives practical guidance on how to determine defensible transfer prices across the full range of goods and services and how to prepare for the negotiations in which they must be sustained. Illustrated with a wealth of examples. Covers overviews of the transfer pricing regimes in 35 countries.
(B. 116.763)

National treaty law and practice.
Editors Monroe Leigh and Merritt R. Blakeslee.
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Festschrift für Wolfgang Ritter zum 70. Geburtstag. Steuerrecht, Steuer- und Rechtspolitik, Wirtschaftsrecht und Unternehmensverfassung, Umweltrecht..
Herausgegeben von Max Dietrich Kley, Eckart Sünner und Arnold Willemsen.
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Tax law, tax and legal policy, industrial law and business structure, environmental law. Publication commemorating the 70th birthday of Wolfgang Ritter. Collection of articles in the specified fields of law. Included in the tax part are: Harlow on the international tax scene (English), Baumgartner/Storck on headquarters structures, Becker on penalties in the United States and Germany, Dann on advance rulings in Germany and Europe, Eilers on APAs, Krebühl on the credit method in the United States, Laule on limitation on benefits under German domestic law (Section 50d(1) ITL), Mössner on residence and domicile in the United Kingdom, Lethaus on treaty rights of a partnership and Vogel on "good neighborliness" in administrative and international law.
(B. 116.683)

The influence of corporate law and accounting principles in determining taxable income. Proceedings of a Seminar held in Geneva in 1996 during the 50th Congress of the IFA International Fiscal Association.
The Hague, Kluwer Law International. 1997.
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The contributions in this booklet include: "Tax versus commercial accounting in Germany" by N. Herzig; "Tax accounting in Japan" by M. Nakazato; "The role of realisation: accounting, company law and taxation" by J. Freedman; and "Taxation in hyperinflationary economies" by A. Schindel and J.L. Shaw.
(B. 116.820)

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MIDDLE EAST

Bahrain

Doing business in Bahrain.
Amsterdam, Price Waterhouse. 1997, pp. 108.
Guide providing potential investors with a quick reference guide to investing in Bahrain. The material was assembled in August 1996 and covers information on foreign investment and trade opportunities, tax system, banking and finance, auditing and accounting.
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United Arab Emirates

Doing business in the United Arab Emirates.
Amsterdam, Price Waterhouse. 1997, pp. 119.
This guide provides potential investors with a quick reference guide to investing in the United Arab Emirates. The material was assembled in August 1996 and covers information on foreign investment and trade opportunities, banking and finance, exporting to the United Arab Emirates, business entities, labour relations and social security, tax system, auditing and accounting.
(B. 58.361)

NORTH AMERICA

Canada

Corporate tax strategy 1997-1998.
Markham, Butterworths Canada Ltd., 75 Clegg Road, Markham, Ont. L6G 1A1, Canada. 1997, pp. 239. ISBN: 0 433 40390 X.
Practical information to reduce and monitor the corporate tax liability throughout the year. The book deals with corporate income taxes, both federal and provincial, taking into account the current legislation as of 15 June 1997.
(B. 116.817)

Doing business in Canada.
Amsterdam, Price Waterhouse. 1997, pp. 306.
Information guide on the business environment, foreign investment, banking and finance, labour relations and social security, auditing and accounting, tax system, tax administration, and the taxation of corporations and individuals, in Canada, as of October 1996.
(B. 116.701)

The Practitioner's Income Tax Act.
12th Edition. Editor David M. Sherman.
Scarborough, Carswell Thomson Professional Publishing. 1997, pp. 2321.
ISBN: 0 459 57578 3.
The book includes the text of the Act re-enacted as R.S.C. 1985 (5th Supp.) on 1 March, 1994, and further consolidated by numerous amending bills, plus all draft amendments to 1 July, 1997, the Canada–US and Canada–UK tax treaties, and Income Tax Interpretation Act, press releases, etc.
(B. 116.660)

Report of proceedings of the forty-eighth tax conference convened by the Canadian Tax Foundation, Montreal, November 25-27, 1996.
Toronto, Canadian Tax Foundation. 1997, pp. 1350. ISBN: 0 88808 118 9.
This 2-volume publication covers the proceedings of the annual CTF conference. The topics discussed include international tax planning, corporate reorganizations, the taxation of business and property income, and a small business case study.
(B. 116.776)

USA

The taxation of multinational corporations.
Editor Joel Slemrod.
The Hague, Kluwer Academic Publishers. 1996, pp. 157. NLG 185.
ISBN: 0 7923 9719 3.
The book presents empirical and conceptual research on the taxation of multinational corporations. Topics include: rules for the allocation of interest expense between domestic (US) and foreign-source income; compliance with the foreign tax provisions of the US Tax Code, an international comparison of the average effective rates of corporate taxation of multinationals, the effect of taxation on foreign direct investment, and international tax policy reviewed in parallel with the theory of international trade.
(B. 116.764)

Hellerstein, J.R.; Hellerstein, W.; Youngman, J.M.
State and local taxation. Cases and materials. 6th Edition.
St. Paul, West Publishing Co. 1997, pp. 1031.
ISBN: 0 314 21126 8.
Revised and updated edition of casebook to take account of the key developments in the law of state and local taxation. The chapter on property taxation has been completely rewritten. The chapters on jurisdiction, division of the tax base, sales taxation, procedures of Supreme Court decisions, has been reorganized, reshaped and/or modernized. This sixth edition of the casebook is now accompanied by a "Teacher's Manual", which provides answers to all of the questions raised in the casebook as well as summaries of all of the principal cases.
(B. 116.807)

Kuntz, J.D.; Peroni, R.J.
U.S. international taxation. 3 Volumes.
Boston, Warren, Gorham & Lamont. 1997.
ISBN: 0 7913 3030 3.
A comprehensive treatise on the international tax rules of the United States. These three volumes contain a complete, detailed and expert explanation of the full range of laws, regulations, and court decisions that make up the international tax system of the United States. The major topics covered include general principles of US international taxation, the taxation of US persons with foreign activities, the taxation of foreign persons with US activities, and taxation relating to US possessions. Future supplements will keep this loose-leaf publication up-to-date.
(B. 116.669)

Gröhs, B.; Jirousek, H.; Lang, M.; Loukota, H.
Kurzkommentar zum neuen Doppelbesteuerungsabkommen Österreich–USA.
Vienna, Linde Verlag Wien GmbH. 1997.
Schriftenreihe zum Internationalen Steuerrecht, Band 5, pp. 246. ATS 470.
ISBN: 3 85122 648 8.
Short commentary on the new tax treaty between Austria and the United States. The authors give, from an Austrian point of view, short comments on the provisions in the tax treaty which are useful for tax planning in relation to the United States.
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Australia

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– Legislation
release 99 and 100
– Rulings and guidelines
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Austria

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Belgium

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Foreign investment in Canada
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Denmark

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Copenhagen, A.S. Skattekartoteket Informationskontor.

European Union

Handboek voor de Europese Gemeenschappen
– Verdragsteksten en aanverwante stukken
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Deventer, Kluwer.

France

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Paris, Editions du Juris Classeur.

Germany

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Heidelberg, C.F. Müller Juristischer Verlag.

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INTERNATIONAL

AN INTERNATIONAL COMPARISON OF FLOW-THROUGH REGIMES HOW DOES NEW ZEALAND'S NEW REGIME RATE?

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I. INTRODUCTION

In a recent paper I considered how the imputation systems of Australia, Malaysia, New Zealand, Singapore and Sri Lanka may be neutralized in accordance with the composite tax principle.[2] That paper foreshadowed the introduction by New Zealand of a flow-through regime for foreign-source income derived by resident companies distributed to non-resident shareholders (the "flow-through situation"). Details of that regime are now available.[3] This paper assesses the NZ regime by comparing it with the flow-through regimes of Australia, Malaysia, Singapore and the United Kingdom. This comparison reveals that the flow-through regimes of these five countries operate in substantially different manners. Which regime is most favourable (from a non-resident investor perspective) depends on many factors including location and type of foreign-source income derived, foreign tax paid with respect thereto, timing of receipt and distribution by the interposed company and method of foreign tax relief adopted by the investor's residence country.

Each of Australia, Malaysia, New Zealand, Singapore and the United Kingdom presently adopt the imputation form of corporate income tax systems. These countries demonstrate a propensity to amend their imputation systems on a regular and substantial basis. This paper takes into account amendments or announcements made to the end of 1997. Worthy of particular mention are amendments made by the UK Government. Initially that government announced and implemented both the removal of refundability of dividend tax credits (effective immediately with respect to pension funds) and the abolition of the flow-through regime (effective from April 1999).[4] By way of consultative document issued in November 1997, that government also effectively announced the abolition of advance corporation tax ("ACT") (effective from April 1999) and, therefore, the imputation system.[5] The UK imputation system is to be replaced with a notional dividend tax credit system.[6] It appears this new system will be structured in such a way as to produce results similar to those available under the United Kingdom's present flow-through regime. This paper considers these various amendments and announcements to the extent they impact on the flow-through regimes.

Their flow-through regimes aside, each of Australia, Malaysia, New Zealand, Singapore and the United Kingdom levies tax in the flow-through situation. This tax is imposed either at the point of derivation of foreign profits by resident companies or the point of their distribution.[7] This appears contrary to the philosophy of the imputation system which suggests companies only be subject to tax for collection and timing purposes and are not appropriate final tax subjects. Therefore, because in the flow-through situation the country of corporate residence is neither the source country nor the country of the ultimate shareholder's residence, imputation countries should not levy a permanent tax.[8] This principle is underlined by recent efforts of imputation countries to produce flow-through without (or with reduced) taxation.[9]

While flow-through without taxation to non-resident shareholders is widely accepted by imputation countries, the main issue is how to achieve or ensure this result. This acceptance involves ignoring resident companies (as a tax subject) after distribution of foreign-source income to non-resident shareholders. However, in an environment where shareholdings in resident companies are transferable between residents and

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2. P.A. Harris, "Neutralizing the Imputation Systems",3 *Asia-Pacific Tax Bulletin*, 6 (1997), at 164.
3. New Zealand's flow-through regime was introduced as Taxation (Remedial Provisions) Bill (No. 2) 1997. The Bill was preceded by a consultation process, see W. Peters and B. Birch, *The Taxation of Conduit Investment: A Government discussion document* (Wellington: Inland Revenue Department), and accompanied by a commentary, see B. Birch, *Taxation (Remedial Provisions) Bill (No. 2) 1997: Commentary on the Bill* (Wellington: Inland Revenue Department). The paper proceeds on the assumption the regime is enacted as introduced.
4. Finance (No. 2) Act 1997 (UK) Secs. 19, 30 and 36.
5. Inland Revenue (1997), *A modern system for corporation tax payments* (London: Inland Revenue).
6. Regarding the distinction between the imputation system and the notional dividend tax credit system, see P.A. Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems* (Amsterdam: International Bureau of Fiscal Documentation, 1996) at 71.
7. See generally, P.A. Harris, *supra* note 6 at 381-397.
8. For example, see B. Birch, *supra* note 3 at 3.
9. In the present context, the Singaporean flow-through regime was introduced in 1992, the Australian and UK in 1994, the Malaysian in 1995 and the NZ from the 1998/99 income year.

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non-residents, imputation countries cannot be sure where foreign income is derived by resident companies whether it will be distributed to resident or non-resident shareholders. There is an unavoidable interface between taxation by imputation countries in the flow-through situation and the manner in which they treat residents which derive foreign income through resident companies (in particular, whether corporate level foreign tax relief is passed to resident shareholders). It is this interface which accounts for much of the complexity of flow-through regimes.

The NZ flow-through regime is compared with those of Australia, Malaysia, Singapore and the United Kingdom (existing and proposed) under three primary headings. Section 2 considers the options available for imputation countries when designing a flow-through regime. The third section considers the types of restrictions which may be incorporated in a flow-through regime. The fourth section provides a worked example demonstrating and comparing the operation of the flow-through regimes of Australia, Malaysia, New Zealand, Singapore and the United Kingdom. The final section offers some concluding remarks.

II. OPTIONS IN DESIGNING A FLOW-THROUGH REGIME

There are two primary options for an imputation country designing a flow-through regime. A flow-through regime may be incorporated within the imputation system or it may be separate from the imputation system. I have discussed elsewhere the practicality and theoretical correctness of incorporating flow through without taxation within an imputation system.[10] However, it is unrealistic to suggest that imputation countries will generally adopt that approach in the near future. In particular, such incorporation involves granting regular dividend tax credits under the imputation system with respect to the distribution of foreign-source income in excess of domestic corporation tax levied with respect to such income, i.e. involves the integration of foreign income (but not necessarily foreign taxes) within the imputation system.

Under each of the Australian, Malaysian, NZ, Singaporean and UK imputation systems, shareholders may be granted dividend tax credits with distributions which exceed their tax liability with respect to such distributions, i.e. realize excess dividend tax credits. Under these imputation systems shareholders may either have excess dividend tax credits refunded (Malaysia, Singapore and, no longer including pension funds, the United Kingdom), may have them carried forward (after conversion to a loss, New Zealand) or, at least, are entitled to set the excess against other income tax liability of the year of distribution (Australia). It is unacceptable to imputation countries to grant, on distribution, dividend tax credits in excess of domestic corporation tax levied with respect to foreign-source income of resident companies because, where such grant results in shareholders realizing excess dividend tax credits, an imputation country may refund tax it has not collected or, at least, permit shareholders to shelter other income from tax with the excess. Accordingly, the refusal to incorporate a flow-through regime within an imputation system is invariably linked to notions of protecting the tax base.

The link between the use of excess dividend tax credits and the incorporation of a flow-through regime within a corporate tax system is demonstrated by the recent reforms in the United Kingdom. Prior to the reforms, the United Kingdom granted refundable dividend tax credits under its imputation system. Therefore, it is not surprising that the flow-through regime introduced in 1994 was not incorporated in the imputation system. However, from April 1999, dividend tax credits will no longer be refundable (subject to minor exceptions). Dividend tax credits will only be available for use against any shareholder tax levied with respect to dividends to which they are attached, i.e. excess dividend tax credits may not be used at all.[11] With the tax base protected in this way, it is not surprising that with the abolition of the imputation system (ACT) the UK Government is willing to grant shareholders full dividend tax credits under the proposed notional dividend tax credit system even with respect to distributions of foreign-source income. Therefore, from April 1999 the United Kingdom will effectively incorporate a form of flow-through regime within its corporate tax system.[12]

In an imputation context, however, a pragmatic approach accepts that flow-through regimes will be created outside or parallel with an imputation system. On the one hand, this is a pity because of the complexity and inconsistency resulting from the interface between the imputation system and the flow-through regime.[13] On the other hand, such an approach promotes flexibility. Where the regime is separate, government may regulate the activities which and persons who may benefit from the regime as well as the extent of relief, none of which need coincide with a generally wider scope of relief provided under an imputation system. This flexibility proves irresistible to most governments. Limiting the activities or persons who may benefit from a flow-through regime and the extent of relief is necessarily inequitable and inefficient, i.e. all persons and activities are not treated in a similar manner under what is (usually) in name a general income tax.

Assuming a flow-through regime is to be structured outside the imputation system, the structural options for the regime are similar to those available for imputation systems in general.[14] Flow-through regimes seek to ensure that foreign-source income of resident companies flowing to non-resident shareholders is not subject to tax (or subject to reduced tax) in the country of corporate residence. This exemption (or reduction) may (or may not) be available at the point of derivation of such income by resident companies but, in any case, must materialize at the point of distribution of such income by resident companies to non-resident shareholders. As resident companies may have other income which is not to benefit from such relief, flow-through regimes must provide a method by which income for which relief is to be pro-

10. See P.A. Harris, *supra* note 2 and *supra* note 6 particularly chapters seven and eight.
11. See Income and Corporation Taxes Act 1988 ("ICTA") (UK) Secs. 1A(5) and 231(3) and (3AA).
12. See Inland Revenue, *supra* note 5 at 5.
13. For example, see W. Peters and B. Birch, *supra* note 3 at vii.
14. In this regard, see P.A. Harris, *supra* note 6 at chapter three.

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vided on distribution to non-resident shareholders may be identified, i.e. there is a recording requirement. Secondly, there must be a mechanism to ensure that such relief is provided where the foreign income is considered distributed to non-resident shareholders. Thirdly, assuming resident companies have profits for which relief is available and other profits for which relief is not available, there must be an ordering rule which determines when each type of profit is considered distributed. This heading considers each of these structural features in turn.

A. Recording extent of relief

The options for recording the extent of relief under a flow-through regime are multifarious. In part, this reflects that foreign source profits of resident companies with respect to which flow-through relief may be granted may be distributed to resident shareholders as well as non-resident shareholders. In essence, recording may relate to the foreign profits element, the foreign tax treatment of those profits or the domestic corporation tax treatment of those profits. The most accurate recording method (which also provides the maximum number of options for the treatment of foreign profits on distribution) also records the relationship between these elements, e.g. record foreign profits together with their foreign and domestic tax treatment. Simpler recording methods may be adopted depending on, e.g. the method of foreign tax relief adopted at the corporate level, that to be adopted at the shareholder level and degree of accuracy sought.

With effect from the 1998 year of assessment, the exemption for foreign-source income of Malaysian companies received in Malaysia (introduced from 1995) is withdrawn.[15] This means the former method of providing foreign tax relief is revived. Malaysia only imposes income tax on foreign income received in Malaysia, i.e. a remittance basis. Further, Malaysia unilaterally grants a direct foreign tax credit. However, the credit is limited to the lower of one half of foreign tax suffered or Malaysian tax chargeable with respect to foreign income.[16] Malaysia grants more comprehensive relief under its double tax treaties including, in some instances, an indirect foreign tax credit.

The exemption system introduced by Malaysia in 1995 was, effectively, accompanied by a flow-through regime.[17] While the exemption system is withdrawn with effect from 1998, the flow-through regime has not been, as yet, withdrawn. This paper proceeds on the basis that the flow-through regime will be retained although it is noted that the removal of the exemption system has seriously restricted the ability to flow foreign-source income through Malaysian companies without charge to Malaysian income tax. Under the flow-through regime, income arising from sources outside Malaysia received in Malaysia by resident companies is credited to an account ("exempt account"). The exempt account is debited with dividends paid by resident companies out of foreign income.[18] The exempt account records foreign profits available for flow-through relief without reference to the foreign tax treatment of such profits prior to receipt in Malaysia or, indeed, reference to their Malaysian tax treatment. This method of recording may be contrasted with Malaysia's general imputation account which records Malaysian company tax assessed on resident companies (the Section 108 account) without reference to corporate profits.

The Australian and Singaporean flow-through regimes provide examples of recording profits in relation to foreign tax treatment. In the case of Australia, the foreign dividend account ("FDA") effectively records dividends received by resident companies from foreign subsidiaries which do not suffer Australian company tax. Where the subject dividends are exempt, the entire amount is credited to the account (much like under the Malaysian system). Where the subject dividends only entitle the recipient to foreign tax credits, the dividends are apportioned between a part considered subject to Australian company tax (at the headline rate) and a part considered subject to foreign tax. The latter part is credited to the FDA. The FDA is debited with distributions considered made therefrom.[19] The former portion of such dividends is credited to resident companies' franking account (the general imputation account) which is an example of recording foreign profits in relation to domestic corporation tax treatment.

In the case of Singapore all foreign source profits of Singaporean companies granted foreign tax relief may be credited to the profits account. Singapore generally provides foreign tax relief in the form of foreign tax credits.[20] Foreign profits of resident companies are apportioned between an amount considered to suffer Singapore company tax (at the headline rate) and an amount considered exempt from Singapore company tax. The latter part is credited to an exempt account, the Section 13E account.[21] However, unlike the Australian flow-through regime, such credit only occurs where foreign profits are received in Singapore. The Section 13E account is debited with distributions considered made therefrom.[22] By contrast, the former portion is not recorded. Rather, Singapore company tax levied with respect to foreign profits is recorded without reference to those profits in the general imputation account recording Singapore company tax levied on particular companies (the Section 44 account).

The United Kingdom offers foreign tax relief in the form of both a direct and indirect foreign tax credit.[23] Under the United Kingdom's current flow-through regime, the foreign income dividend ("FID") scheme, UK companies are effectively required to record certain items of foreign source profit for which foreign tax relief is granted together with their domestic corporation tax treatment.[24] Under this scheme, each item of foreign income is recorded separately, i.e. pool-

15. Income Tax Act 1967 ("ITA") (Malaysia) Sec. 3C was withdrawn by Finance (No. 2) Act 1997 (Malaysia) Sec. 4.
16. ITA (Malaysia) Sec. 133 and Sch. 7 paras. 13-14.
17. The flow-through regime was introduced by Income Tax (Exemption) (No. 31) Order 1995 ("Exemption Order 31") (Malaysia).
18. Exemption Order 31 (Malaysia) para. 3 applying ITA (Malaysia) Sch. 7A paras. 5(1) and (2).
19. FDAs are regulated by the Income Tax Assessment Act 1936 ("ITAA") (Australia) Part III Division 11A Subdivision B.
20. ITA (Singapore) Secs. 48-50A.
21. Id. Sec. 13E(2).
22. Id. Sec. 13E(3).
23. ICTA (UK) Sec. 790.
24. The FID scheme is regulated by ICTA (UK) Part VI Chapter V.A.

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ing of profits is not possible. This is necessary because, in order to secure the benefits of the scheme, companies must elect for dividends to be treated as FIDs and match them with specific profits for which foreign tax relief has been granted.[25] However, these records are of a limited nature, they need only include foreign profits of the previous year as FIDs may not be matched with profits of any earlier year. By contrast, the United Kingdom's ACT imputation system, in effect, requires companies record corporation tax paid within the previous six years without reference to corporate profits.

New Zealand also primarily offers foreign tax relief in the form of a direct and indirect foreign tax credit.[26] The NZ flow-through regime records NZ tax levied or not levied (as a result of the flow-through relief) with respect to corporate profits giving rise to flow-through relief without reference to those profits. This record takes the form of two running accounts, the dividend withholding payment ("DWP") account and the conduit tax relief ("CTR") account. The DWP account was introduced with the imputation system but its scope has been extended with the introduction of the flow-through regime. For reasons which are not presently relevant,[27] NZ tax levied on resident companies with respect to foreign dividends is designated DWP.[28] DWPs may be credited to an account designated the DWP account.[29] Concurrent with the introduction of New Zealand's flow-through regime, DWP is also levied with respect to income attributed to NZ companies under New Zealand's accruals regimes.[30] Accordingly, the DWP account presently records NZ tax levied with respect to income for which flow-through relief is available (primarily foreign profits which are or which are likely to be distributed in the form of foreign dividends). This is consistent with New Zealand's general imputation credit account which records regular NZ company tax paid by resident companies. Both accounts record corporate tax without reference to corporate profits.

The NZ flow-through regime is somewhat complicated because its introduction was accompanied by an exception to the foreign tax credit system, i.e. it incorporates a limited exemption from NZ tax for certain foreign corporate profits particularly those taxable on an accruals basis. NZ DWP levied on an accruals basis with respect to such profits (after foreign tax credit relief and certain other amounts) is reduced according to the portion of non-resident shareholders in subject NZ companies.[31] A similar relief is available in the less common scenario where NZ companies are liable to pay DWP with respect to the receipt of foreign dividends.[32] NZ companies seeking either form of reduction in DWP must elect to maintain a CTR account. This account is credited with the amount of the reduction in NZ DWP. The account is debited where CTR credits are attached to dividends distributed to shareholders of NZ companies.[33] Unlike the other flow-through regimes, the NZ regime does not record foreign profits of resident companies.

B. Mechanism providing relief

Each of the Australian, Singaporean and, to a limited extent, Malaysian flow-through regimes record foreign source profits of resident companies which have not suffered domestic corporation tax. Further, each of these regimes provides flow-through relief by simply exempting the distribution of such profits. In the cases of Malaysia and Singapore, the exemption is general.[34] In the case of Australia the exemption is only available with respect to non-resident dividend withholding tax, i.e. only non-resident shareholders of Australian companies may benefit.[35]

In a similar fashion, the United Kingdom's present flow-through regime records foreign source profits but, as mentioned, does so together with any foreign tax relief granted. The mechanics by which the FID scheme provides relief are rather complex.[36] Broadly, ACT is levied on companies with respect to the distribution of dividends. This tax funds an equivalent dividend tax credit in the hands of shareholders. The tax may also be set against the general (mainstream) corporation tax liability. As foreign tax relief reduces the mainstream corporation tax liability, the distribution of foreign source profits may give rise to ACT in circumstances where there is no mainstream corporation tax liability to set the ACT against (surplus ACT). Where FIDs are matched with distributable foreign profits, ACT levied with respect to such dividends is refunded to companies to the extent it constitutes surplus ACT.[37] Resident shareholders are, in effect, only entitled to an exemption from basic and lower (but not higher) rate tax with respect to the receipt of FIDs.[38] Non-resident shareholders are not directly taxable with respect to distributions from UK companies (including FIDs).[39] Therefore, the approach under the UK flow-through regime is not dissimilar from that under the Australian, Malaysian and Singaporean regimes.

By contrast, the NZ flow-through regime does not exempt resident companies' distributions of foreign-source income to non-resident shareholders from non-resident withholding tax.[40] The rationale for this imposition is that such withholding tax is creditable to non-resident shareholders if their

25. ICTA (UK) Sec. 246J.
26. ITA 1994 (NZ) Part L Subpart C and Part L Subpart F.
27. See P.A. Harris, *supra* note 6 at 703-704.
28. DWP is imposed according to ITA (NZ) Part N Subpart H.
29. The DWP account is regulated by ITA (NZ) Part M Subpart G.
30. New Zealand has two accruals regimes, the controlled foreign company and the foreign investment fund regimes; see ITA (NZ) Part C Subpart G.
31. ITA (NZ) Sec. KH1 sets out the formula for calculating the relief from DWP levied on an accruals basis. Sec. KH2 contains rules for determining what percentage of a company's shareholders are non-resident.
32. ITA (NZ) Sec. NH7.
33. The rules relating to the maintenance of CTR accounts are contained in ITA (NZ) Part M Subpart I.
34. Exemption Order 31 (Malaysia) para. 2 and ITA (Singapore) Sec. 13E(4), respectively.
35. ITAA (Australia) Sec. 128B(3)(gaa).
36. See generally P.A. Harris (1997), "The FID Scheme: A Damage Assessment", *British Tax Review*, No. 2, at 82.
37. ICTA (UK) Sec. 246N.
38. ICTA (UK) Secs. 246C and 246D.
39. Finance Act 1995 Sec. 128 and ICTA (UK) Secs. 208 and 233.
40. NZ non-resident withholding tax is levied on distributions of NZ companies at the formal rate of 30 per cent (reduced to 15 per cent under New Zealand's double tax treaties). However, to the extent distributions of NZ companies have imputation, DWP or CTR credits attached at the corporate tax rate (on the grossed up amount), non-resident withholding tax is reduced to 15 per cent; ITA (NZ) Sec. NG2.

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country of residence adopts a direct foreign tax credit system. In this case, the withholding tax represents a net benefit to the NZ Treasury without affecting the return of such non-resident shareholders.[41] Of course, this will not be the case where the country of shareholders' residence does not provide foreign tax relief, does so using the exemption method or the foreign tax credit limit is exhausted with other taxes.

The mechanism used by New Zealand to provide flow-through relief is a tax credit system. The type of credit attached to dividends distributed by NZ companies from flow-through income to non-resident shareholders depends on whether distributing companies elect to maintain a CTR account. Where a CTR account is not maintained, DWP credits may be attached to dividends distributed by NZ companies to their shareholders (including non-resident shareholders).[42] Where non-resident shareholders receive dividends with DWP credits attached, the credits may be used to offset non-resident withholding tax and any excess is refunded to non-resident shareholders.[43] Non-resident withholding tax is imposed on the grossed up amount.

Where NZ companies maintain a CTR account, dividends distributed by NZ companies to non-resident shareholders (but not those distributed to resident shareholders) may have credits attached from that account.[44] Further, subject to a transitional rule, from April 1998 only resident shareholders (not non-resident shareholders) may have credits from NZ companies' DWP account attached to their dividends.[45] CTR credits are treated as DWP credits for the purposes of the credit allocation and benchmark dividend rules.[46] Therefore, NZ companies are effectively required to distribute DWP credits and CTR credits proportionately to their resident and non-resident shareholders, respectively.

CTR credits attached to dividends distributed to non-resident shareholders may not be used to offset non-resident withholding tax. Rather, distributing companies must pay a supplementary dividend to non-resident shareholders (not available to resident shareholders) equal to the amount of the credits.[47] The principle underlying this approach is that New Zealand forgoes tax at the corporate level (which would otherwise be levied after foreign tax credit relief) on income from foreign share interests of NZ companies but only with respect to their non-resident shareholders. That is, the amount of such income attributable to resident shareholders is taxed at the corporate level (with foreign tax credit relief) but that attributable to non-resident shareholders is not taxed (exemption relief after foreign tax credit relief). Where such income is distributed, NZ company tax paid is credited to the resident shareholders who must include such credit in their taxable income, taking their dividends to a pre-NZ tax figure. In order to produce equality of treatment between resident and non-resident shareholders, the NZ company tax (less foreign tax credit relief) attributable to the non-resident shareholders which was not paid (but retained by the company) must be distributed by the company to the non-resident shareholders. This is achieved through the payment to non-resident shareholders of a supplementary dividend.

C. Ordering rules

A flow-through regime which is separate from an imputation system requires ordering rules which determine when profits to be granted flow-through relief are considered distributed. Primarily, the Australian, Malaysian, NZ, Singaporean and UK flow-through regimes adopt discretionary ordering rules. For example, the Malaysian and Singaporean provisions simply refer to dividends being distributed from the relevant sources of income.[48] There are no express or implicit restrictions on when resident companies may distribute dividends from such sources. Where companies decide to exercise this discretion, the imputation system ordering rules do not apply.[49]

Similarly, UK companies have a choice whether to elect that a dividend be treated as a FID.[50] The distribution of FIDs had not proved popular among UK companies. This was largely due to the refundability of regular dividend tax credits and large proportions of tax exempt shareholders. However, as dividend tax credits attached to regular dividends are no longer refundable to pension funds, their relative attractiveness when compared with FIDs has been removed. So FIDs are proving more popular as a result of the recent UK reforms and are likely to remain so until their abolition in 1999.[51] The effect of refunding ACT under the FID scheme is to except the UK imputation system's inherent ordering rule.

The Australian flow-through regime is also discretionary in form, Australian companies "may" attach FDA credits to dividends distributed.[52] However, the ordering rules of the imputation system are not displaced where Australian companies exercise their discretion to distribute dividends from the FDA.[53] So the Australian imputation system contains an implicit ordering rule which suggests dividends will only be distributed from the FDA after all profits subject to Australian company tax (at the headline rate) are distributed.[54]

The NZ ordering rule is somewhat composite. NZ companies may have three different types of accounts from which credits may be attached to dividends, i.e. the imputation credit, DWP and CTR accounts. The attachment of credits from the

41. See W. Peters and B. Birch, *supra* note 3 at 12.
42. ITA (NZ) Sec. MG6.
43. ITA (NZ) Sec. LD9.
44. ITA (NZ) Sec. MI7.
45. ITA (NZ) Sec. MG6.
46. ITA (NZ) Sec. MI8. The credit allocation and benchmark dividend rules are contained in Secs. MG8 and MG10.
47. ITA (NZ) Sec. LG1.
48. Exemption Order 31 (Malaysia) para. 2 and ITA (Singapore) Secs. 13E(1) and (3).
49. Exemption Order 31 (Malaysia) applying ITA (Malaysia) Sch. 7A para. 5(7) and ITA (Singapore) Sec. 13E(5).
50. ICTA (UK) Sec. 246A.
51. S. Edge (1997), "The Last Piece of the Jigsaw", *The Tax Journal*, Monday, 4 August, at 2.
52. ITAA (Australia) Sec. 128TC(1).
53. The imputation system's ordering rule considers fully taxed profits as distributed first; ITAA (Australia) Sec. 160AQE.
54. Non-resident shareholders receive no additional benefit should a company declare a dividend to be distributed from the FDA which is also considered distributed from the franking account.

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imputation credit account is discretionary.[55] The same is true of DWP credits.[56] The position is slightly different where NZ companies elect to maintain a CTR account. As mentioned above, CTR credits attached to dividends of NZ companies are treated as DWP credits for the purposes of the credit allocation and benchmark dividend rules. On one view, this is a mandatory ordering rule with respect to the attachment of CTR credits, i.e. where DWP credits are attached to dividends distributed to resident shareholders, CTR credits must be attached to dividends distributed to non-resident shareholders.[57] It is also a form of prorate ordering rule as the different types of credits must be attached to the dividends in equal proportions.

Irregularities in this prorate ordering rule occur where the ratio of resident to non-resident shareholders of NZ companies changes between the point the NZ tax system recognizes flow-through foreign income of such companies and the point of distribution by such companies. Where the proportion of resident shareholders increases, such companies' DWP account may be in debit at the end of the tax year but not their CTR account. In this case, credit in the CTR account must be transferred to the DWP account to clear the debit.[58] As credit in the CTR account represents tax *not* levied by New Zealand, such companies are required to pay the amount transferred to the Inland Revenue.[59] However, as such companies proportion of non-resident shareholders has decreased, their liability to distribute supplementary dividends to non-resident shareholders under the flow-through regime has also decreased.

Where the proportion of non-resident shareholders increases, NZ companies' CTR account may be in debit at the end of the tax year but not their DWP account. In this case, credit in the DWP account must be transferred to the CTR account to clear the debit.[60] As the credit transferred represents tax New Zealand *did* levy which it would not have if the higher proportion of non-resident shareholders existed at the time the flow-through foreign-source income was recognized by New Zealand, such companies are entitled to a refund from the Inland Revenue of the amount transferred.[61] However, as such companies' proportion of non-resident shareholders has increased, they have a greater liability to distribute supplementary dividends to their non-resident shareholders. This underlines that DWP credits represent tax paid and so the government funds the credit to resident shareholders whereas CTR credits represent tax not paid and so NZ companies fund the credit to non-resident shareholders in the form of a supplementary dividend.

III. RESTRICTIONS ON FLOW-THROUGH

Conceptually, flow-through income will have a source (location), may be characterized as a particular type of income, may be recognized by the tax system at a particular time, may be subject to foreign tax, will be derived by a particular type of resident company and will be distributed to particular types of shareholder.[62] These characteristics provide a useful framework within which to discuss the restrictions incorporated in flow-through regimes.

A. Location of source

None of the flow-through regimes under consideration provide an express exclusion from flow-through depending on the location of foreign-source income derived by resident companies. This form is also reflected in the substantial operation of the UK regime. Under that regime, flow-through treatment may be granted irrespective of the location of the source of foreign income derived. The same is, in principle, true of the Malaysian and Singaporean flow-through regimes. However, both these regimes are in some respects limited with respect to foreign income derived by resident companies from non-treaty countries. This is because in the non-treaty situation both Malaysia's and Singapore's unilateral foreign tax relief is not comprehensive. As mentioned, Malaysia limits its unilateral foreign tax credit to the lower of one half foreign tax suffered by residents or Malaysian tax chargeable with respect to foreign income. Singapore also does not offer full unilateral foreign tax relief. For example, foreign tax relief is not generally available with respect to non-dividend passive income derived from non-treaty countries. As both the Malaysian and Singaporean flow-through regimes are linked to the provision of foreign tax relief, they are limited in this regard.

While the Australian flow-through regime has no express location restriction, indirectly it may be considered to incorporate a limited form of such a restriction. Only certain non-portfolio dividends are credited to resident companies' FDA. However, such dividends distributed from income previously attributed under Australia's accruals regimes (controlled foreign companies and foreign investment funds) are not available for credit.[63] In particular, the controlled foreign companies regime is targeted at attributing to Australian resident shareholders non-active income of controlled foreign companies. Nevertheless, attribution is less likely to occur where foreign companies are resident in specified broad-exemption listed countries.[64] Therefore, non-active income of companies resident in broad-exemption listed countries distributed to related Australian companies is more likely to be credited to such Australian companies' FDA and flow through Australia to non-residents without Australian tax than non-active income of companies resident in other countries.

55. ITA (NZ) Sec. ME6.
56. ITA (NZ) Sec. MG6.
57. As to the need for a mandatory ordering rule in this context, see W. Peters and B. Birch, *supra* note 3 at 27.
58. ITA (NZ) Sec. MI6(1).
59. ITA (NZ) Sec. MI11.
60. ITA (NZ) Sec. MI6(2).
61. ITA (NZ) Sec. MI10.
62. Dividends will also be distributed to shareholders in particular portions. This raises the issue of dividend streaming which is beyond the scope of this paper.
63. ITAA (Australia) Sec. 128TC(2)(b).
64. Australian resident 10 per cent shareholders in controlled foreign companies resident in broad-exemption listed countries are primarily only attributed income subject to certain tax concessions (eligible designated concession income) and foreign source income which has not been taxed in a broad-exemption listed country or Australia; see ITAA (Australia) Sec. 385. As to broad-exemption listed countries; see Income Tax Regulations (Australia) Sch. 10.

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The NZ approach requires some explanation. Prior to the introduction of the flow-through regime, the NZ imputation system behaved (in some respects) in the same manner as the Australian imputation system with respect to flow-through income (for which the FDA mechanism is not available). Such income would either be subject to Australian or NZ tax (e.g. residual tax under the foreign tax credit system) or not (as a result of foreign tax relief). The portion of flow-through income considered taxed by Australia or New Zealand (at the headline rate) would flow through those countries subject to tax at the corporate tax rate (36 per cent and 33 per cent, respectively) because distributions would effectively not be taxed.[65] The portion not subject to Australian or NZ tax would flow through subject only to dividend withholding tax (30 per cent, generally reduced to 15 per cent under treaty). With respect to both countries, foreign tax relief was likely to be highest with respect to income derived by resident companies from listed (high tax) countries.[66] Neither the Australian nor NZ flow-through regimes are designed to rectify this disparity.

The case of NZ resident companies in receipt of foreign dividends requires further elaboration. Foreign source dividends are exempt from company tax in the hands of recipient NZ companies.[67] However, such dividends are subject to DWP which is effectively a substitute for company tax. DWP is reduced by both direct and underlying foreign tax credits.[68] Further, NZ companies may use DWPs to attach DWP credits to their own distributions. As mentioned, unlike imputation credits, non-resident shareholders are entitled to set DWP credits against their liability for non-resident withholding tax and be refunded the excess. This is an exception to the position mentioned in the last paragraph where flow-through income which is subject to NZ tax when derived is only effectively subject to non-resident withholding tax after distribution.

NZ companies are taxed somewhat differently with respect to their shareholdings in companies resident in unlisted countries. In this case, NZ companies are likely to be taxed on an accruals basis (controlled foreign companies and foreign investment fund measures). However, tax paid with respect to attributed income of foreign companies (before the introduction of the flow-through regime) was not credited to the DWP account but, rather, the imputation credit account. Such income was not subject to further taxation (i.e. DWP) where distributed to NZ companies which were previously subject to attribution.[69] In the result, to the extent that NZ companies were granted foreign tax relief with respect to dividends received from companies in listed countries, they could redistribute those dividends only subject to non-resident withholding tax. To the extent such dividends where subject to DWP, they could be redistributed with the same result because of the refundability of excess DWP credits for non-resident shareholders. However, because NZ companies were likely to be subject to attribution with respect to shareholdings in companies resident in unlisted countries and because the nature of the tax regimes of those countries meant that foreign tax relief was likely to be minimal, a substantial portion of income flowing from such companies through NZ companies to non-resident shareholders would suffer NZ tax at the corporate rate.

The NZ flow-through regime is specifically targeted at removing this disparity. It seeks to tax foreign dividends flowing through resident companies to non-resident shareholders at the consistent rate of non-resident withholding tax irrespective of whether distributing companies are resident in listed or unlisted countries.[70] In order to achieve this result, tax levied with respect to income attributed to resident companies under New Zealand's accruals regimes (controlled foreign companies and foreign investment funds) is now credited to such companies' DWP account and not their imputation credit account.[71] Further, as mentioned above, the NZ flow-through regime provides resident companies with a reduction of such DWP on attribution or distribution according to their proportion of non-resident shareholders. It is NZ DWP forgone (after foreign tax credit relief) because of resident companies' non-resident shareholders which is credited to the CTR account.

So while the NZ flow-through regime is targeted at dividends received from companies resident in unlisted countries, its effect is really to equalize the treatment with dividends received from companies resident in listed countries. It is important to emphasize again that the NZ regime may not produce flow through without charge to tax, its object is to subject all foreign dividends received by resident companies redistributed to non-resident shareholders to NZ non-resident withholding tax. There appears to be a continuing inconsistency in the NZ system. Non-resident withholding tax continues to be levied with respect to dividends of resident companies at a dual rate. Only fully franked dividends are subject to withholding tax at the rate of 15 per cent, the unfranked portion being taxed at 30 per cent (15 per cent in the case of a treaty). Accordingly, the portion of foreign dividends of NZ companies exempt from NZ tax as a result of foreign tax credit relief suffers non-resident withholding tax at the rate of 30 per cent on redistribution to shareholders resident in a non-treaty country. The other portion suffers non-resident withholding tax at the rate of 15 per cent.

65. In the case of Australia, franked dividends are not subject to dividend withholding tax; ITAA (Australia) Sec. 128B(3)(ga). In the case of New Zealand, this result is produced under the foreign investor tax credit regime; ITA (NZ) Part L Subpart E.
66. Both Australia's and New Zealand's listed countries are likely to impose greater levels of tax than unlisted countries producing relatively greater relief under their foreign tax credit systems; see ITAA (Australia) Part III Div. 18 and ITA (NZ) Part L Subpart C. Further in the case of Australia, resident companies' listed country branch profits are generally exempt as are non-portfolio dividends received from foreign companies distributed out of listed country profits; see ITAA (Australia) Secs. 23AH and 23AJ, respectively.
67. ITA (NZ) Sec. CB10(1).
68. ITA (NZ) Sec. NH2 and Part L Subpart F. Where the distributing foreign company is a 10 per cent subsidiary resident in a listed country recipient NZ parents are, as a general rule, presumed to have paid creditable foreign tax equivalent to DWP; Sec. LF5. Grey list countries are listed in Sch. 3 Part A.
69. This is achieved through the use of a branch equivalent tax account; see ITA (NZ) Part M Subpart F.
70. W. Peters and B. Birch, *supra* note 3 at 7.
71. ITA (NZ) Secs. ME5(6) and (7).

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B. Type of income

Flow-through regimes may also be restricted according to type of income derived by resident companies. In this scenario the Malaysian, Singaporean and UK regimes may be contrasted with the Australian and NZ regimes. The former regimes are broadly drafted and apparently have the potential to apply to all types of foreign-source income. In the case of the United Kingdom, this width is reflected in the application of the regime. However, in the case of Malaysia and Singapore there appears to be an implicit restriction. These regimes apply with respect to foreign "income" of resident companies (irrespective of type).[72] According to common law tradition, "income" does not include capital gains. Indeed, it is on this basis that Malaysia, New Zealand and Singapore still refrain from taxing most capital gains. It appears that foreign capital gains of resident companies may not be credited to resident companies' exempt account (Malaysia) or Section 13E account (Singapore) irrespective of whether such gains suffer taxation in the country of source. Therefore, such gains may be subject to equalization tax at the corporate tax rate where distributed to resident or non-resident shareholders.[73] Contrast the UK approach (the UK tax system specifically taxes capital gains) where the flow-through regime refers to "income, or any chargeable gain, in respect of which double tax relief is afforded".[74]

To complete the foreign capital gains picture, in the case of New Zealand any foreign capital gain of resident companies will not be taxed where derived and so will not give rise to credit in resident companies' imputation credit account. As no imputation credits will be attached where such gains are distributed by resident companies to non-resident shareholders, such shareholders will be subject to 30 per cent non-resident withholding tax (15 per cent in a treaty situation). In the case of Australia, foreign capital gains of resident companies are taxable but any international double taxation is relieved through the provision of foreign tax credits.[75] Any portion of such capital gains considered as not suffering Australian company tax as a result of foreign tax relief is not creditable to resident companies' FDA. That portion will suffer dividend withholding tax where distributed to non-resident shareholders (30 per cent or, as a general rule, 15 per cent in a treaty situation). Further, any portion considered as suffering Australian company tax at the headline rate (i.e. 36 per cent) is not subject to dividend withholding tax on distribution to non-resident shareholders.

The NZ flow-through regime is restricted as to the types of income to which it applies. The NZ regime only applies to two types of foreign-source income of resident companies, foreign dividends and income attributed under New Zealand's accruals regimes. If the accruals regimes are viewed as taxing foreign dividends prior to distribution, the NZ regime only applies to one type of income, i.e. foreign dividends.

New Zealand's controlled foreign company regime may apply where five or fewer NZ residents control more than 50 per cent of non-resident companies.[76] However, attribution does not occur with respect to companies resident in grey list countries.[77] All types of income of controlled foreign companies may be attributed and taxed to residents holding a direct or indirect interest of 10 per cent in such a company. DWP liability of resident companies with respect to attributed income of controlled foreign companies may be reduced by provision for an underlying foreign tax credit.[78] Resident companies' DWP liability is credited to a branch equivalent tax account (before reduction under the CTR mechanism).[79] The DWP liability is then reduced according to the proportion of non-resident shareholders in the attributed resident company. The amount of relief is credited to the CTR account and the remaining liability is, once paid, credited to the DWP account.

The foreign investment fund measures may also attribute income to NZ resident companies with interests in foreign companies, irrespective of whether foreign companies are controlled by NZ residents. These measures do not apply where the controlled foreign company measures apply.[80] Further, they do not apply, as a general rule, with respect to foreign companies resident in grey list countries.[81] Attributed income is calculated in one of four manners; the accounting profits, branch equivalent, comparative value and deemed rate of return methods.[82] Where the branch equivalent method is adopted, the DWP liability of resident companies with respect to the attributed income of related foreign investment funds may be reduced by provision for an underlying foreign tax credit.[83] The branch equivalent tax, CTR and DWP accounts are credited as under the controlled foreign company regime. However, CTR from DWP under the foreign investment fund measures for resident companies with respect to their proportion of non-resident shareholders is only provided to resident companies using the accounting profits or branch equivalent methods of calculating attributable income.

Where foreign companies distribute dividends to NZ resident companies which have been attributed income under either the controlled foreign company or foreign investment fund regimes, the latter may use credit in their branch equivalent tax account to offset a DWP liability.[84]

The position is somewhat different where NZ resident companies are not subject to attribution with respect to their interests in foreign companies, e.g. with respect to interests in listed country companies. In this case, DWP liability arising

72. Exemption Order 31 (Malaysia) para. 2 and ITA (Singapore) Sec. 13E(1).
73. Equalization tax is imposed by ITA (Malaysia) Sec. 108 and ITA (Singapore) Sec. 44.
74. ICTA (UK) Sec. 246I. "Double tax relief" may be granted under double tax treaty or unilaterally with respect to taxes levied on foreign source income as well as capital gains of UK residents; Secs. 788 and 789.
75. For the purposes of foreign tax credit relief, capital gains are considered foreign income and capital gains taxes are considered creditable foreign taxes; see ITAA (Australia) Secs. 160AE(2) and 6AB(2), respectively.
76. ITA (NZ) Sec. CG4.
77. ITA (NZ) Sec. CG13.
78. ITA (NZ) Sec. LC4.
79. ITA (NZ) Sec. MF4.
80. ITA (NZ) Sec. CG15(2)(a).
81. ITA (NZ) Sec. CG15(2)(b).
82. ITA (NZ) Sec. CG16.
83. ITA (NZ) Sec. CG21 applying Sec. LC4.
84. ITA (NZ) Sec. MF5.

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on the receipt of foreign dividends will not be offset by branch equivalent tax account credits. However, DWP liability will be offset by both direct and underlying foreign tax credits. While this relief will in many cases exhaust that liability, any remaining liability is further relieved under the flow-through regime according to the proportion of non-resident shareholders in recipient resident companies. Any remaining dividend withholding tax liability and the amount of flow-through relief will be credited to the DWP and CTR accounts, respectively.

The Australian flow-through regime is even more restrictive. It only applies to the receipt of non-portfolio dividends by Australian companies. The regime is not available unless resident companies have a 10 per cent interest in distributing foreign companies. Further, profits attributed and taxed to resident companies under Australia's controlled foreign company and foreign investment fund regimes may not be credited to the FDA as there is no dividend at the point of attribution. Further even where dividends are distributed from attributed income, they are specifically excluded from credit to the FDA. This means that the Australian flow-through regime is not available with respect to attributed income, even after receipt. On the other hand, as active income of foreign subsidiaries (even those resident in unlisted countries) is not subject to attribution under the controlled foreign company regime, such income may benefit from the flow-through regime.[85] Further, it appears that passive foreign income distributed by foreign subsidiaries (even those resident in unlisted countries) to an Australian parent in the year of potential attribution is not subject to attribution and so may benefit from the flow-through regime.[86]

The restriction incorporated in the Australian and NZ flow-through regimes to share interests in foreign companies creates an incentive for resident companies to derive foreign-source income through foreign subsidiaries. Those regimes are not available with respect to foreign branch income of resident companies. Through the use of a foreign subsidiary virtually any type of income may be converted into non-portfolio foreign dividends. Therefore, the apparently narrow form of the Australian and NZ regimes may not be reflected in practice. However, the Australian restriction to income from broad-exemption listed countries or active income is a substantial restriction.

C. Time of recognition

Flow-through regimes recognize foreign-source income available for flow-through treatment at a specific time. As a general rule, this recognition is the time of recording the flow-through income or tax treatment of that income, e.g. crediting of the relevant account. The flow-through regimes under consideration demonstrate three different approaches to this timing issue.

Under New Zealand's flow-through regime recognition is at the point of attribution under the accruals regimes. Profits of non-resident companies (primarily those resident in unlisted countries) may be attributed to resident companies giving rise to credit in their DWP and CTR accounts. Credit in these accounts may be used to attach credits to dividends distributed to shareholders of resident companies. This may occur despite the fact that the attributed profits of non-resident companies giving rise to credit in those accounts have not been distributed to or received by the resident companies.

The Australian, NZ and UK flow-through regimes demonstrate recognition at the point of realization, e.g. the distribution of dividends. Dividends may only be credited to Australian companies' FDA where they are "paid to" such companies.[87] The same is effectively true of the NZ regime where NZ companies receive dividends from listed country companies, i.e. companies with respect to which NZ companies are not, as a general rule, subject to attribution. The UK FID scheme is broader in potentially applying to all forms of foreign-source income of resident companies. In effect, that scheme requires income be realized by UK companies before the benefits of the scheme are available. UK companies may be taxed on an accruals basis with respect to the profits of foreign subsidiaries under the United Kingdom's controlled foreign companies regime.[88] The better view is that the FID scheme is not available until such time as UK parents are distributed attributed profits by controlled foreign companies.[89]

The Malaysian and Singaporean approach is most restrictive with respect to timing. Foreign-source income may only be credited to resident companies' exempt account (Malaysia) or Section 13E account (Singapore) where "received in" Malaysia or Singapore.[90] So, for example, foreign income derived by a foreign branch of a resident company which has not been remitted to Malaysia or Singapore is not available for flow-through treatment. If such income is distributed before it is credited to the flow-through account, the result may be the imposition of equalization tax.

D. Foreign tax treatment

Flow-through regimes may also be restricted according to the foreign tax treatment of foreign-source income. Perhaps the most favourable treatment in this regard is provided by Australia where non-portfolio dividends distributed out of unattributed income by non-resident 10 per cent subsidiaries to Australian parents are exempt. Such dividends may be credited to Australian parents' FDA irrespective of the level of foreign tax suffered. However, the exemption is only likely to be available where the dividends (or underlying profits) have suffered tax comparable to that which Australia would impose in the absence of the exemption.[91]

85. However, the foreign investment fund regime may still apply with respect to non-portfolio interests of Australian parents in foreign companies.
86. ITAA (Australia) Secs. 387 (controlled foreign companies) and 530 (foreign investment funds).
87. ITAA (Australia) Sec. 128TA(1).
88. ICTA (UK) Part XVII Chapter IV.
89. See P.A. Harris (1995), "UK and Australian HQ Regimes: Concessions or Removing Discrimination?", *Tax Notes International*, Vol. 10, No. 10, March 6, at 843 and 854-855.
90. Exemption Order 31 (Malaysia) para. 2 and ITA (Singapore) Sec. 13E(1), respectively.
91. See generally ITAA (Australia) Secs. 23AJ and 380.

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The Singaporean flow-through regime and the Australian regime with respect to non-exempt non-portfolio dividends received by resident companies from 10 per cent foreign subsidiaries operate similarly in this regard. In both cases, foreign tax relief takes the form of foreign tax credits. Such flow-through income is divided into two portions, that considered exempt from Australian or Singaporean tax and that considered to suffer Australian or Singaporean tax at the (headline) corporate tax rate. The exempt portion is credited to resident companies' FDA (Australia) or Section 13E account (Singapore) and will not suffer tax on distribution to non-resident shareholders. However, the other portion does suffer tax at the corporate rate which is not refunded where distributed to non-resident shareholders although such distribution is not subject to further tax, e.g. dividend withholding tax.

Although the present UK flow-through regime is different in form, its substantial operation may be similar. As the United Kingdom also provides foreign tax relief in the form of dividend tax credits, foreign-source income of UK companies may be divided into a portion considered to suffer UK tax (at the corporate rate) and a portion considered exempt from UK tax. Assuming the exempt portion results in surplus ACT on distribution, where the foreign-source income is matched with FIDs it will pass through to non-resident shareholders without UK taxation (as a result of the refund of ACT attributable to the matched foreign income).[92] Any portion of foreign income of UK companies subject to UK corporation tax on derivation will be subject to ACT on distribution (which will not be refundable under the FID scheme). However, the ACT will be able to be set against the corporation tax liability with the result that this portion of foreign-source income will flow through the United Kingdom subject to UK tax at the corporate rate.

Similarly, under the NZ regime income from foreign share interests of NZ companies may be divided into a portion liable to NZ DWP (at the corporate rate prior to CTR) and a portion considered exempt from NZ DWP (as a result of foreign tax credit relief). However, the NZ flow-through regime operates in reverse to those of Australia, Singapore and the United Kingdom. As a result of CTR, the portion liable to DWP may flow through New Zealand subject only to non-resident withholding tax at 15 per cent whereas the portion considered exempt from DWP (as a result of foreign tax credit relief) may flow through subject to non-resident withholding tax at the rate of 30 per cent. In a treaty scenario the non-resident withholding tax is reduced to 15 per cent so that all flow-through income is subject to NZ tax at that rate.

Even in this situation New Zealand may temporarily levy greater than its non-resident withholding tax rate before flow-through income is distributed. This is likely to be the case where NZ companies do not elect to maintain a CTR account. In this case DWP at up to the NZ corporate tax rate (less foreign tax credit relief) will be payable on both attributable income and foreign dividends without relief for the portion of such income or dividends attributable to non-resident shareholders. On redistribution by NZ companies, non-resident shareholders will be granted DWP credits to set against non-resident withholding tax and any excess credits will be refunded. Even where NZ companies do maintain a CTR account, New Zealand may temporarily levy greater than tax at its non-resident withholding tax rate before flow-through income is distributed. This may occur if the proportion of resident shareholders decreases before distribution by NZ companies of attributable income or dividends subject to DWP (less foreign tax credit relief). On distribution part of the DWP made (which, as a result of CTR, would all be attributable to the previous resident shareholders) may be effectively credited to non-resident shareholders with excess credits refunded.

The Malaysian treatment is somewhat confused as a result of the removal of the exemption for foreign-source income of Malaysian companies from 1998. Such companies are now (once again) granted foreign tax relief in the form of foreign tax credits. However, at present Malaysian companies are able to credit the entire amount of "income from sources outside Malaysia and received in Malaysia..." to an exempt account.[93] Apparently, this includes both any portion considered subject to Malaysian tax (at the corporate rate) and any portion considered exempt from Malaysian tax. All such foreign income may be distributed exempt from Malaysian tax. It appears that any Malaysian company tax paid with respect to foreign income may still be credited to the general imputation tax account (Section 108 account). Such credit may be used to shelter other exempt income (which may not be credited to an exempt account, e.g. capital gains or foreign income not received in Malaysia) from equalization tax on distribution. It remains to be seen whether the flow-through account mechanism will be amended to account for this apparent anomaly.

E. Type of resident company

Sometimes flow-through regimes are limited to specific types of resident companies. The present discussion is limited to flow-through regimes of general application. However, the Malaysian regime expressly does not apply to companies "carrying on the business of banking, insurance, shipping and air transport..."[94] In order for Australian companies to benefit from the FDA regime they must hold a 10 per cent interest in distributing non-resident companies. Where NZ companies are subject to attribution under the foreign investment fund measures, CTR is only available where either the accounting profits or branch equivalent methods of calculating attributable income is adopted.

F. Type of shareholder

The present discussion has focused on non-resident shareholders of resident companies as the beneficiaries of flow-through regimes. The flow-through regimes under consideration demonstrate that a flow-through regime may be

92. Surplus ACT available for refund is calculated under ICTA (UK) Sec. 246N.
93. Exemption Order 31 (Malaysia) para. 2.
94. Exemption Order 31 para. 2.

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incorporated in a wider regime passing foreign tax relief granted to resident companies to their shareholders on distribution. This is the position under the Malaysian, Singaporean and UK regimes. Under the Malaysian and Singaporean regimes, not only are dividends distributed from resident companies' exempt account (Malaysia) or Section 13E account (Singapore) exempt in the hands of non-resident shareholders, they are exempt in the hands of resident shareholders as well.[95] Similarly, resident individual shareholders receiving FIDs from UK companies are, effectively, exempt from lower (and basic) rate tax with respect thereto.[96] Distributions between resident UK companies are generally exempt from UK corporation tax.[97]

Contrast the position under the Australian and NZ regimes where corporate level foreign tax relief may not, as a general rule, be passed to resident shareholders. In the case of Australia, distributions from the FDA only provide an exemption from dividend withholding tax. As only non-residents are subject to that tax, only they may benefit from the FDA regime. The NZ regime does not pass corporate level foreign tax relief to either resident or non-resident shareholders of resident companies. It imposes NZ tax on income from foreign share interests (net of foreign tax) derived through NZ companies at marginal rates (non-resident withholding tax in the case of non-residents).

However, one benefit available under the NZ regime is deferral. The higher the percentage of non-resident shareholders which NZ companies have, the lower the percentage of income from foreign share interests which will be taxed by New Zealand prior to distribution by NZ companies to their shareholders (irrespective of the level of foreign tax imposed). Wholly non-resident owned NZ companies are not subject to accruals or realizations taxation by New Zealand with respect to income derived through non-resident companies (at least until such NZ companies distribute that income to their non-resident owners). The same is true of the Malaysian and Singaporean regimes with the proviso that the income is not received in Malaysia or Singapore. As the percentage of resident shareholders in NZ companies rises, the deferral advantage is removed.

It appears the NZ regime may be distortionary. Two NZ companies will be taxed differently with respect to their attributed or retained profits from similar offshore activities depending on their percentage of foreign ownership. The greater deferral advantage secured by the company with a greater proportion of non-resident shareholders is not limited to the non-resident shareholders. That deferral advantage may increase the profits of the company generally and any resident shareholders may then benefit in the deferral secured as a result of the company having non-resident shareholders. The result is a rather awkward incentive for residents to hold minority interests in non-resident owned NZ companies which derive lowly taxed foreign income. In this way, some NZ residents may be considered to benefit from the flow-through regime.

A specific type of shareholder worthy of further consideration is resident corporate shareholders in other resident companies. Where Malaysian companies receive dividends distributed by other Malaysian companies out of their exempt profits account, recipient companies may credit those dividends to their own exempt account.[98] This means recipient companies may redistribute exempt dividends as exempt dividends. Similarly, UK companies are only liable for ACT with respect to their own FIDs to the extent to which the FIDs they distribute exceed FIDs received from other UK companies.[99] Accordingly, UK companies may distribute FIDs received as FIDs. In the case of Singapore, treatment similar to that under the Malaysian regime is only available where recipient companies own not less than 50 per cent of distributing companies.[100]

The Australian and NZ regimes are most restrictive. In the case of Australia, recipient resident companies may only credit FDA dividends received from other resident companies to their own FDA where distributing companies are wholly owned by recipient companies.[101] Similarly in the case of New Zealand, CTR credits may, in effect, only be passed between wholly owned group companies, thereby preserving the deferral advantage under New Zealand's flow-through regime.[102] However, DWP credits may be passed between NZ companies, irrespective of the intensity of their relationship, and ultimately to resident individual or non-resident shareholders. So while the deferral advantage is lost (not granted) with respect to dividends (potentially) distributed between non-wholly owned group companies, the right to reduce New Zealand's tax take from the corporate tax rate to the non-resident withholding tax rate is not lost.

95. Exemption Order 31 (Malaysia) para. 2 and ITA (Singapore) Sec. 13E(4), respectively.
96. ICTA (UK) Sec. 246D.
97. ICTA (UK) Sec. 208.
98. Exemption Order 31 (Malaysia) para. 3 applying ITA (Malaysia) Sch. 7A para. 5(6).
99. ICTA (UK) Sec. 246F.
100. ITA (Singapore) Secs. 13B(4C) and (6).
101. ITAA (Australia) Sec. 128TA(1)(c).
102. ITA (NZ) Secs. CB10, OE7 and OE8.

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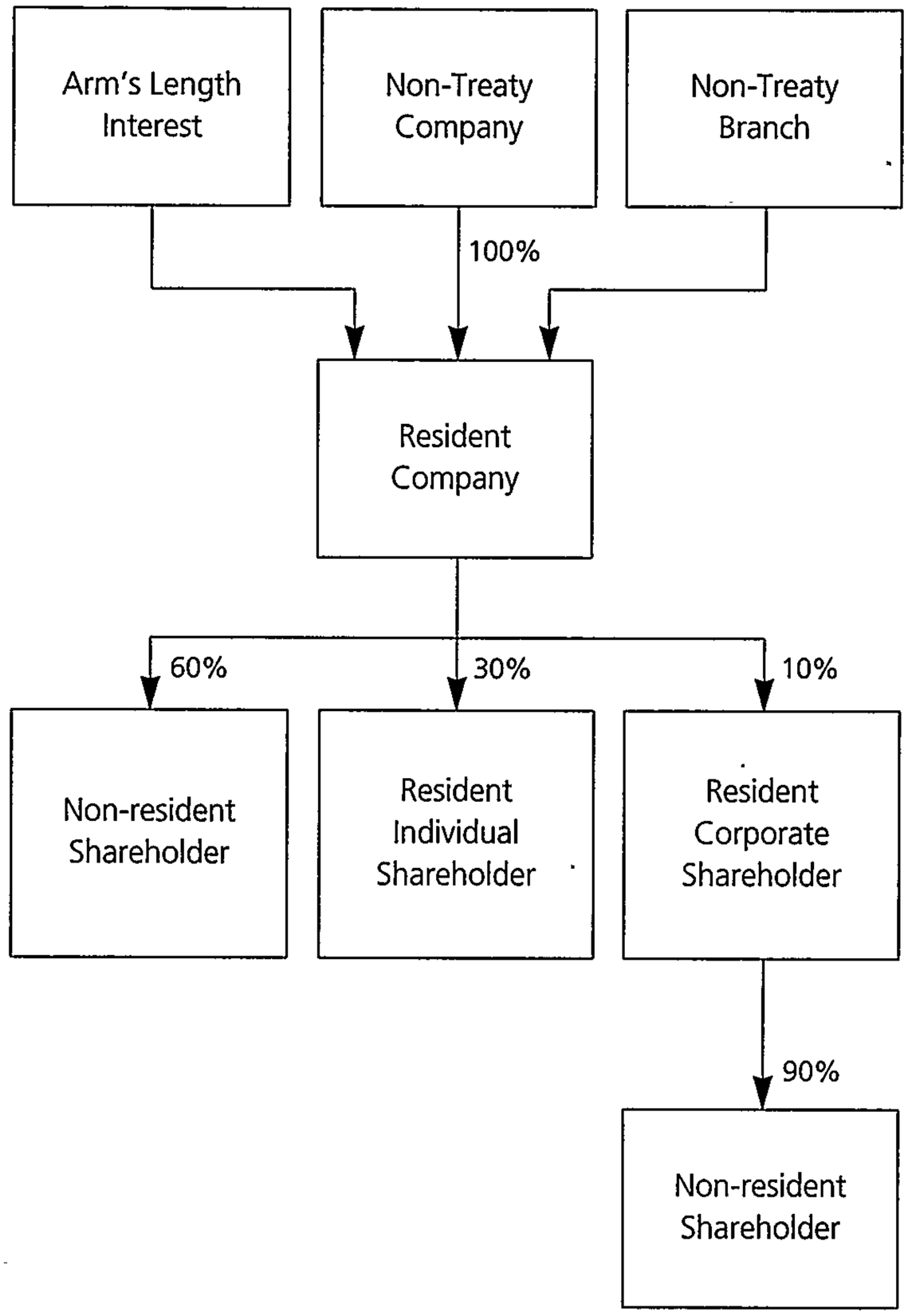
IV. EXAMPLE



Resident Company derives income from Non-Treaty Country. This income is potentially of three types:

(i) arm's length interest;
(ii) dividends from a wholly owned company resident in Non-Treaty Country carrying on the business of manufacturing and investment in that country, and
(iii) branch profits from retailing branches in Non-Treaty Country.

Assume that Non-Treaty Country imposes a uniform tax of 20 per cent on all domestic source income of non-residents as well as on domestic profits of resident companies. Non-Treaty Country exempts dividends of resident companies. Resident Company is held as to 60 per cent by a non-resident shareholder, 30 per cent by a resident individual shareholder and 10 per cent by a resident corporate shareholder which is 90 per cent owned by a non-resident.

During the tax year Resident Company derives 100 Non-Treaty Country interest and its Non-Treaty Country retailing branches also produce a profit of 100. Further, Non-Treaty Company derives 50 profits from its manufacturing business and 50 dividend income. Non-Treaty Country subjects each of these amounts to 20 per cent tax leaving Resident Company with 80 from each of these sources (net of Non-Treaty Country tax) at its disposal. The interest of 80 is received by Resident Company. Further, assume that initially the 80 branch profits are reinvested in Non-Treaty Country operations without repatriation and the profits of Non-Treaty Company are not distributed (the situation where the profits are repatriated and distributed, respectively, will also be considered). Finally, Resident Company declares a dividend. The following discussion considers how each of these events would be treated where Resident Company is resident in Australia, Malaysia, New Zealand, Singapore and the United Kingdom (both current and proposed systems). For the sake of simplicity, the discussion does not consider issues as to timing the payment of tax.

A. Interest

Australia would tax Resident Company with respect to its interest income but provide foreign tax relief in the form of a direct foreign tax credit. The credit would equal 20, making gross income of 100 (80 + 20) giving rise to company tax liability of 36 (100 x 36%). This liability would be reduced by the credit making a net liability to Australian company tax of 16 (36 – 20) and profits net of tax of 64 (100 – 20 – 16). Resident Company would credit its franking account with approximately 28 (16 x $^{64}/_{36}$).

Assuming Malaysia has no double tax treaty with Non-Treaty Country, Malaysia would tax Resident Company with respect to its interest income but provide a limited direct foreign tax credit. This credit is limited to the lower of the Malaysian company tax liability or half the foreign tax liability with respect to the income. Only 80 interest income is "received in" Malaysia so the company tax liability is approximately 22 (80 x 28%). Therefore, the foreign tax credit is limited to 10 (half of 20) and residual Malaysian company tax is approximately 12 (22 – 10), leaving profits net of tax of 68 (80 – 12). Interestingly however, as a result of the anomaly referred to above, it appears 80 would be credited to Resident Company's exempt account as well as 12 to its Section 108 account. Of course, the interest income would not be taxable if it was not received in Malaysia.

New Zealand would also tax the interest income of Resident Company with foreign tax relief in the form of a direct foreign tax credit. Gross income would be 100 (80 + 20) giving rise to company tax liability of 33 (100 x 33%), residual tax liability after foreign tax relief of 13 (33 – 20) and profits net of tax of 67 (100 – 20 – 13). Resident Company would credit its imputation credit account with NZ tax paid, i.e. 13.

Assuming Singapore has no double tax treaty with Non-Treaty Country and that country is not a member of the British Commonwealth, Singapore would not provide Resident Company with foreign tax relief with respect to the interest income received in Singapore. The 80 interest income (received in Singapore) would be subject to Singaporean company tax of approximately 21 (80 x 26%) leaving profits net of tax of 59 (100 – 20 – 21). Resident Company would credit its Section 44 account with Singaporean tax paid, i.e. 21. As in the case of Malaysia, the interest income would not be taxable if it was not received in Singapore.

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The United Kingdom would also tax the interest income of Resident Company with foreign tax relief in the form of a direct foreign tax credit. Gross income would be 100 (80 + 20) giving rise to company tax liability of 31 (100 x 31%) (assuming the small company tax rate is not available), residual tax liability after foreign tax relief of 11 (31 – 20) and profits net of tax of 69 (100 – 20 – 11). The tax liability of 11 may be offset by ACT levied with respect to distributions made by Resident Company. This treatment will not be altered under the proposed UK system save that the comment regarding ACT will not be relevant as none will be levied.

B. Branch profits

Assuming Non-Treaty Country is not a broad- or limited-exemption listed country for Australian tax purposes, Australia would tax Resident Company with respect to its branch profits but provide foreign tax relief in the form of a direct foreign tax credit. The calculations are the same as for the interest income leaving Resident Company with an Australian company tax liability of 16, after tax profits of 64 and a franking account credit of 28. If Non-Treaty Country was a listed country, the branch profits would be exempt from Australian tax, Resident Company would have net profits of 80 and no credit to its franking account.

The branch profits of Resident Company would not be subject to tax in Malaysia. Further, as the profits have not been received in Malaysia, nothing would be credited to Resident Company's exempt account. If the 80 profits were received in Malaysia, the calculations would be the same as for the interest income leaving Resident Company with Malaysian company tax liability of 12, after tax profits of 68, credit to exempt account of 80 and credit to Section 108 account of 12.

New Zealand would tax the branch profits with foreign tax relief in the form of a direct foreign tax credit. The calculations are the same as for the interest income leaving Resident Company with NZ company tax liability of 13, after tax profits of 67 and an imputation credit account credit of 13.

As in the case of Malaysia, the branch profits of Resident Company would not be subject to tax in Singapore. Further, as the profits have not been received in Singapore, nothing would be credited to Resident Company's Section 13E account. If the profits were received in Singapore they would be taxable but Resident Company would be granted a direct foreign tax credit. Gross income would be 100 (80 + 20) giving rise to company tax liability of 26 (100 x 26%), residual tax liability after foreign tax relief of 6 (26 – 20) and profits net of tax of 74 (100 – 20 – 6). Resident Company would credit its Section 44 account with Singaporean tax paid, i.e. 6. Further, it would credit its Section 13E account with the amount of net branch profits considered not to have suffered Singaporean company tax (at the headline rate), i.e. 57 (74 x $^{20}/_{26}$).

The United Kingdom would tax the branch profits with foreign tax relief in the form of a direct foreign tax credit. The calculations and comments are the same as for the interest income leaving Resident Company with UK corporation tax liability of 11 and after tax profits of 69.

C. Non-treaty company profits

Non-Treaty Company is a controlled foreign company for the purposes of Australian tax law and Resident Company is an attributable taxpayer. Resident Company would be taxable on a current basis with respect to the dividend income of Non-Treaty Company irrespective of whether that income is distributed by Non-Treaty Company. However, Resident Company would only be attributed the dividend income and not the manufacturing profits. Further, Resident Company would be entitled to an underlying foreign tax credit for Non-Treaty Country company tax paid with respect to the attributed dividend income. The credit would equal 10, making gross attributed income of 50 (40 + 10) giving rise to Australian company tax liability of 18 (50 x 36%). This liability would be reduced by the credit making a net liability to Australian company tax of 8 (18 – 10) which, assuming Resident Company does not receive any of the profits of Non-Treaty Company, would have to be met with other funds. Resident Company would credit its franking account with approximately 14 (8 x $^{64}/_{36}$). Resident Company would also credit an attribution account with 40 to ensure it is not subject to Australian tax a second time when the attributed profits are distributed.

No amount would be credited to Resident Company's FDA until Non-Treaty Company's profits are distributed. At this time, of a dividend of 80, 40 will be exempt as a distribution of previously attributed profits. This amount is not creditable to Resident Company's FDA. Resident Company will be entitled to underlying foreign tax credits with respect to the other portion of the dividend, i.e. the 40 manufacturing profits net of Non-Treaty Country tax. The calculation is the same as at the point of attribution, i.e. an Australian company tax liability of 8 and a franking account credit of approximately 14. Further, the remainder of the dividend net of Australian tax, i.e. 18 (40 – 8 – 14), will be credited to Resident Company's FDA.

Malaysia would not tax Resident Company with respect to the profits of Non-Treaty Company. Further, Resident Company's exempt account would not be credited until those profits are distributed and received in Malaysia. At this stage the entire amount would be taxable, Malaysia does not unilaterally grant underlying foreign tax relief. The 80 profits received in Malaysia would be subject to company tax of approximately 22 (80 x 28%) leaving after tax profits of 58 (80 – 22). However, the exempt account will still be credited with 80 and the Section 108 account with the company tax of 22.

Non-Treaty Company is a controlled foreign company for the purposes of NZ tax law and Resident Company is an attributable taxpayer. Resident Company would be taxable on a current basis with respect to all the profits of Non-Treaty Company, i.e. irrespective of the type of income derived by Non-Treaty Company. Resident Company would be entitled to an underlying foreign tax credit for Non-Treaty Country

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company tax paid with respect to the attributed profits. The credit would equal 20, making gross attributed income of 100 (80 + 20) giving rise to NZ company tax liability of 33 (100 x 33%). This liability would be reduced by the credit making a net liability to NZ company tax of 13 (33 – 20). This liability would be further reduced according to the percentage of non-resident shareholders in Resident Company, i.e. approximately 8 (13 x 60%), assuming Resident Company maintains a CTR account. Resident Company would credit its DWP account with NZ tax paid, i.e. approximately 5 (13 – 8). It would credit its CTR account with NZ tax not levied (after foreign tax credit relief), i.e. approximately 8. Resident Company would also credit a branch equivalent tax account with 13 to ensure it is not subject to NZ tax a second time where the attributed profits are distributed. This position would not be altered where the profits are distributed as the 13 credit in Resident Company's branch equivalent tax account would be sufficient to offset NZ DWP liability with respect to receipt of the dividend (that liability being calculated in the same manner as at the point of attribution).

Singapore would not tax Resident Company with respect to the profits of Non-Treaty Company. Further, Resident Company would not be taxed until those profits are distributed and received in Singapore at which time they would be granted underlying foreign tax relief and give rise to credit in Resident Company's Section 13E account. At this time the calculations would be the same as for the branch profits (assuming the branch profits were received in Singapore), i.e. tax liability of 6 (credited to the Section 44 account) and a credit to the Section 13E account of 57.

Non-Treaty Company is a controlled foreign company for the purposes of UK tax law. Whether Resident Company will be attributed income of Non-Treaty Company under the United Kingdom's controlled foreign companies regime depends on whether Non-Treaty Company is mainly engaged in active business or whether the *de minimis* exception applies (chargeable profits less than GBP 20,000). Assuming Resident Company is subject to attribution, it would be subject to a sum equal to corporation tax on a current basis with respect to all the profits of Non-Treaty Company, i.e. irrespective of type of income derived by Non-Treaty Company. Resident Company would be entitled to underlying foreign tax credit relief for Non-Treaty Country company tax paid with respect to the attributed profits. The credit would equal 20, making gross attributed income of 100 (80 + 20) giving rise to a UK liability of a sum equal to corporation tax of 31 (100 x 31%). This liability would be reduced by the credit making a net liability of 11 (33 – 20). The tax liability of 11 may be offset by ACT levied with respect to distributions made by Resident Company. The position would not be altered where the attributed profits are distributed to Resident Company. If Resident Company is not attributed income of Non-Treaty Company, a similar UK corporation tax liability would arise at the point of distribution, i.e. 11 which may be reduced by ACT levied. This treatment will not be altered under the proposed UK system save that the comment regarding ACT will not be relevant as none will be levied.

D. Distribution of dividend

The effects of Resident Company distributing a dividend depend on the above discussion and tax treatment. That discussion may be divided into two scenarios, i.e. where the branch and subsidiary profits are received by Resident Company in its country of residence and where they are not. The following discussion will first assume a dividend of 180 is distributed by Resident Company according to shareholding, i.e. it will be received as to 108 by Non-resident Shareholder, 54 by Resident Individual Shareholder and 18 by Resident Corporate Shareholder. This part of the discussion will first consider where the branch and subsidiary profits are received by Resident Company in its country of residence and second consider where they are not. This comparison highlights the substantial and complex consequences of the timing differences between the various countries' systems. Finally, the discussion will consider the scenario where Resident Company pursues a full distribution policy. This consideration assumes the branch and subsidiary profits are received by Resident Company in its country of residence.

1. 180 Dividend; branch and subsidiary profits not received

In this case the treatment by the countries under consideration may be compared as to total tax levied and total credit to various accounts.

Tax Levied on Derivation

	Australia	Malaysia	NZ	Singapore	UK
Interest	16	12	13	21	11
Branch	16	–	13	–	11
Subsidiary	8	–	5	–	11
Total	40	12	31	21	33

In this scenario in the case of Australia, Resident Company will have credit in its franking account of approximately 71 (40 x 64/36) but no credit in its FDA. This means the dividend of 180 will be franked as to approximately 39 per cent. Non-resident Shareholder will not be subject to dividend withholding tax with respect to the franked portion of the dividend, i.e. 42 (108 x 39%). That tax will be imposed with respect to the unfranked portion of 66 (108 – 42) at the rate of 30 per cent (treaty rate of 15 per cent) leaving a tax liability of approximately 20 (10 in the case of a treaty) and a net return of 88 (98 in the case of a treaty).

Resident Individual Shareholder will be entitled to a non-refundable dividend tax credit of approximately 12 (54 x 39% x 36/64) which must be included in taxable income (grossed up) making gross income of 66 (54 + 12). This amount will be subject to tax at marginal rates but tax liability will be reduced by the dividend tax credit. Assuming the Resident Individual Shareholder is subject to tax at the highest marginal rate with respect to this income, the tax liability is 31 (66 x 47%). The dividend tax credit reduces this liability to 19 (31 – 12), producing a net return of approximately 35 (54 – 19). Assuming Resident Corporate Shareholder is a private company, it will effectively be entitled to an exemption with respect to the franked portion of its dividend, i.e. 7

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(18 x 39%), but the unfranked portion will be subject to company tax of approximately 4 (11 x 36%) leaving a net return of approximately 14 (18 – 4). Resident Corporate Shareholder may credit the net return of 14 to its own franking account.

In this scenario in the case of Malaysia, Resident Company will have credit in its exempt account of 80 (with respect to the interest income) and 12 credit in its Section 108 account. Assuming the 80 is distributed proportionately to shareholders, Non-resident Shareholder will receive an exempt dividend of 48 (80 x 60%), Resident Individual Shareholder of 24 (80 x 30%) and Resident Corporate Shareholder of 8 (80 x 10%). Further, Resident Corporate Shareholder will be entitled to credit that 8 to its own exempt profits account. Distribution of the remaining 100 may expose Resident Company to an equalization tax liability. That potential liability is equal to dividend tax credits attached to this part of the dividend, i.e. approximately 39 (100 x $^{100}/_{72}$ x 28%), less credit in Resident Company's Section 108 account of 12, i.e. a liability of approximately 27 (39 – 12). Non-resident Shareholder will still be effectively exempt with respect to the remaining portion of the dividend of 60 (108 – 48).

Both Resident Individual Shareholder and Resident Corporate Shareholder will be entitled to refundable dividend tax credits of approximately 12 [(54 – 24) x $^{28}/_{72}$] and 4 [(18 – 8) x $^{28}/_{72}$], respectively. These dividend tax credits will also be included in taxable income (grossed up) making gross income of approximately 42 (30 + 12) in the case of Resident Individual Shareholder and 14 (10 + 4) in the case of Resident Corporate Shareholder. These amounts will be subject to tax at marginal rates but the tax liability will be reduced by the dividend tax credits. Assuming Resident Individual Shareholder is subject to tax at the highest marginal rate (30 per cent) with respect to this income, Resident Individual Shareholder has a tax liability of approximately 13 (42 x 30%) reduced by the dividend tax credit to 1 (13 – 12). There is no further tax liability for Resident Corporate Shareholder as dividend tax credits will meet company tax assessed. Further, Resident Corporate Shareholder will be entitled to credit the tax offset by its dividend tax credit (i.e. 4) to its own Section 108 account. This leaves a net return to Resident Individual Shareholder and Resident Corporate Shareholder of 53 (24 + 30 – 1) and 18 (8 + 10), respectively.

In this scenario in the case of New Zealand, Resident Company will have approximately 26 credit in its imputation credit account, 5 credit in its DWP account and 8 credit in its CTR account. Non-resident Shareholder receives a dividend of 108 but is also entitled to two supplementary dividends from Resident Company, one under the CTR regime and another under the foreign investor tax credit regime. The dividend will have all the CTR credit attached to it entitling Non-resident Shareholder to a supplementary dividend of 8. The process to determine the supplementary dividend under the foreign investor tax credit regime is complex but broadly entitles Non-resident Shareholder to a supplementary dividend of 36 per cent ($^{67}/_{187}$) of dividend tax credits which would be attached to the dividend if Non-resident Shareholder was a resident. Further, Resident Company will be able to reduce its NZ tax liability by the amount of this supplementary dividend. Assuming a supplementary dividend of 5 reduces existing company tax liability of 26, the imputation credit account will have a balance of approximately 21. In this case, Non-resident Shareholder would have attached approximately 13 (21 x 60%) in dividend tax credits giving rise to a supplementary dividend of approximately 5 (13 x 36%).

This leaves Non-resident Shareholder with a total dividend of 121 (108 + 8 + 5). NZ non-resident withholding tax will be imposed at the rate of 15 per cent to the fully franked part of the dividend, i.e. approximately 43 [(13 + 8) x $^{67}/_{33}$] and 30 per cent to the unfranked part of the dividend (assuming Non-resident Shareholder is not resident in a treaty country), i.e. 78 (121 – 43). The former liability would be approximately 6 (43 x 15%) and the latter 23 (78 x 30%), making a net return of 92 (121 – 6 – 23). If Non-resident Shareholder is resident in a treaty country, non-resident withholding tax will be imposed at a flat rate of 15 per cent making a liability of 18 (121 x 15%) and a net return of approximately 103 (121 – 18). Further, the NZ supplementary dividend regimes are built on the premise that, unlike the other regimes under consideration, the non-resident withholding tax of 29 (18 in the case of a treaty) will be available for credit should Non-resident Shareholder's country of residence adopt a direct foreign tax credit regime.

Resident Individual Shareholder and Resident Corporate Shareholder will share the remaining imputation account credits and all of the DWP credits. Resident Individual Shareholder will have a dividend of 60, non-refundable dividend tax credits of approximately 6 (21 x 30%) and refundable DWP credits of 4 (5 x 75%) making taxable income of 64 (54 + 6 + 4). Resident Corporate Shareholder will have a dividend of 18, non-refundable dividend tax credits of approximately 2 (21 x 10%) and refundable DWP credits of 1 (5 x 25%) making taxable income of 21 (18 + 2 + 1). These amounts will be subject to tax at marginal rates but tax liability will be reduced by the dividend tax credits and DWP credits. Assuming Resident Individual Shareholder is subject to tax at the highest marginal rate (33 per cent) with respect to this income, Resident Individual Shareholder and Resident Corporate Shareholder have tax liabilities of 21 (64 x 33%) and 7 (21 x 33%), respectively, the tax credits reducing this liability to 11 (21 – 10) and 4 (7 – 3), respectively. This leaves a net return to Resident Individual Shareholder and Resident Corporate Shareholder of 43 (54 – 11) and 14 (18 – 4), respectively. Further, Resident Corporate Shareholder will be entitled to credit the credits to its own accounts, i.e. 2 to its imputation credit account and 1 to its DWP account.

In this scenario in the case of Singapore, Resident Company will have 21 credit in its Section 44 account but no credit in its Section 13E account. Distribution of a dividend of 180 may expose Resident Company to an equalization tax liability. That potential liability is equal to dividend tax credits attached to the dividend, i.e. approximately 63 (180 x $^{26}/_{74}$), less credit in the Section 44 account, i.e. a liability of approximately 42 (63 – 21). Resident Company may set equalization tax paid against any future company tax liability. Non-

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resident Shareholder will be effectively exempt with respect to the dividend of 108.

Both Resident Individual Shareholder and Resident Corporate Shareholder will be entitled to refundable dividend tax credits of approximately 19 (54 x 26/74) and 6 (18 x 26/74), respectively. These dividend tax credits will also be included in taxable income (grossed up) making gross income of approximately 73 (54 + 19) in the case of Resident Individual Shareholder and 24 (18 + 6) in the case of Resident Corporate Shareholder. These amounts will be subject to tax at marginal rates but the tax liability will be reduced by the dividend tax credits. Assuming Resident Individual Shareholder is subject to tax at the highest marginal rate (28% less a 10% rebate, say 25%) with respect to this income, there is a tax liability of approximately 18 (73 x 25%) which is fully offset by the dividend tax credit. Indeed, Resident Individual Shareholder will be entitled to a small refund of excess dividend tax credits which is ignored for present purposes. Resident Corporate Shareholder's tax liability will also be fully offset by the dividend tax credit. Further, Resident Corporate Shareholder will be entitled to credit the tax offset by its dividend tax credit (i.e. 6) to its own Section 44 account. This leaves a net return to Resident Individual Shareholder and Resident Corporate Shareholder of 54 and 18, respectively.

In this scenario in the case of the United Kingdom, Resident Company will be liable for ACT with respect to the distribution of 180 in an amount of 45 (180 x 20/80). This amount may be set against and exhaust Resident Company's liability to corporation tax resulting in total surplus ACT of 12 (33 – 45) (assuming Resident Company is subject to attribution of Non-Treaty Company's profits). Resident Company has 138 distributable foreign profits (69 interest income and 69 branch profits) which may be matched with FIDs. However, in order to maximize refundable dividend tax credits to shareholders, it is likely that Resident Company would only declare a FID of such an amount which when matched with distributable foreign profits gives rise to surplus ACT from the distribution equal to total surplus ACT for the period. Therefore, it is assumed that Resident Company declares a FID of 48. Resident Company may be refunded surplus ACT attributable to the distribution of this amount. In broad terms, the refund is equal to the lesser of two amounts, ACT attributable to the distribution of the FID, i.e. 12 (48 x 20/80), or total surplus ACT for the period, i.e. 12. Therefore, Resident Company may have 12 refunded leaving a net ACT liability of 33 and no corporation tax liability. Non-resident Shareholder will be effectively exempt with respect to both the FID of 29 (48 x 60%) and the regular dividend of 79 (132 x 60%), assuming Non-resident Shareholder is not entitled to a refund of dividend tax credits under a double tax treaty.

Resident Individual Shareholder will receive a FID of approximately 14 (48 x 30%) and a regular dividend of 40 (132 x 30%). Gross up will bring the FID to approximately 18 (14 x 100/80) and the regular dividend to 50 (40 x 100/80) making taxable income of approximately 68 (18 + 50). Resident Individual Shareholder may only be subject to tax at the difference between the lower rate and the higher rate with respect to the FID. Assuming Resident Individual Shareholder is subject to tax at the highest marginal rate (40 per cent) with respect to this income, there is a tax liability of approximately 4 [18 x [40% – 20%)]. With respect to the regular dividend, Resident Individual Shareholder receives a refundable dividend tax credit of approximately 10 (40 x 20/80). This credit will offset the tax liability of 20 (50 x 40%) making a net tax liability with respect to the regular dividend of 10. The net return to Resident Individual Shareholder is approximately 40 (54 – 4 – 10). Resident Corporate Shareholder will neither be taxable with respect to the receipt of the FID of approximately 5 (48 x 10%) nor the regular dividend of approximately 13 (132 x 10%). Resident Corporate Shareholder may redistribute these amounts as FIDs and regular dividends, respectively, without liability for ACT.

The scenario will be different under the proposed UK regime. In this case no ACT will be levied on the distribution of 180 and the corporation tax liability of 33 will stand. There will be no FID, the entire 180 constituting a regular dividend. The distribution of 108 to Non-resident Shareholder will still be effectively exempt. However, under the proposal dividend tax credits are to be reduced to 10 per cent of gross distributions. So Resident Individual Shareholder will have taxable income of approximately 60 (54 x 100/90) and a non-refundable dividend tax credit of 6 (60 x 10%). However, Resident Individual Shareholder will only be liable to higher rate tax with respect to the dividend, reduced to 32.5 per cent with respect to dividend income, making a tax liability of approximately 20 (60 x 32.5%) and a net tax liability of 14 (20 – 6) after deduction of dividend tax credits. Note that the reduction in the higher rate effectively preserves the tax treatment under the present system. Resident Corporate Shareholder will not be taxable with respect to the receipt of the dividend of 18. Further, dividend tax credits will be available on redistribution of this amount. Accordingly, the corporate level and shareholder level treatment under the proposed system produce the same returns as under the present system.

The various taxes levied as a result of the distribution and the returns to the shareholders may be summarized as follows:

Taxes Levied On Distribution

Type of Tax	Australia	Malaysia	NZ	Singapore	UK
Corporate	–	27	(5)	42	–
Non-resident	20	–	29	–	–
Resident Individual	19	1	11	–	14
Resident Corporate	4	–	4	–	–
Total	43	28	39	42	14

Return To Shareholders

	Australia	Malaysia	NZ	Singapore	UK
Non-resident	88	108	92	108	108
Resident Individual	35	53	43	54	40
Resident Corporate	14	18	14	18	18
Total	137	179	149	180	166

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It is also possible to calculate remaining profits as follows:

Remaining Profits

	Australia	Malaysia	NZ	Singapore	UK
Net Profits	240	240	240	240	240
Less Derivation Taxes	40	12	31	21	33
Distribution Taxes	43	28	39	42	14
Return to Shareholders	137	179	149	180	166
Remaining Profits	20	21	21	(3)	27

Under only the Australian and UK approaches does the sum of Distribution Taxes and Return to Shareholders equal the amount of the distribution, i.e. 180. In the remaining cases, the difference is due to a corporate level tax liability. This is most obvious in the cases of Malaysia and Singapore where the difference is equal to Resident Company's liability for equalization tax. It is a little more subtle in the case of New Zealand where the difference is equal to Resident Company's liability to distribute a supplementary dividend to Non-resident Shareholder under the CTR regime. Note that the supplementary dividend under the foreign investor tax credit regime did not produce this result. This demonstrates that the NZ government funds supplementary dividends under the foreign investor tax credit regime (through a company tax credit) whereas NZ companies must fund such dividends under the CTR regime.

2. 180 Dividend; branch and subsidiary profits received

Again, in this case the treatment by the countries under consideration may be compared as to total tax levied and total credit to various accounts.

Tax Levied on Derivation

	Australia	Malaysia	NZ	Singapore	UK
Interest	16	12	13	21	11
Branch	16	12	13	6	11
Subsidiary	16	22	5	6	11
Total	48	46	31	33	33

In this scenario in the case of Australia, Resident Company will have credit in its franking account of approximately 85 (48 x $^{64}/_{36}$) and credit in its FDA of 18. This means the dividend of 180 will be franked as to approximately 47 per cent and also have a FDA percentage of 10 per cent. Non-resident Shareholder will not be subject to dividend withholding tax with respect to the franked percentage of the dividend or the FDA percentage, i.e. approximately 62 [108 x (47% + 10%)]. That tax will be imposed with respect to the unfranked portion of 46 (108 – 62) at the rate of 30 per cent (treaty rate of 15 per cent) leaving a tax liability of approximately 14 (7 in the case of a treaty) and a net return of 94 (101 in the case of a treaty).

Resident Individual Shareholder will be entitled to a non-refundable dividend tax credit of approximately 14 (54 x 47% x $^{36}/_{64}$) which must be included in taxable income (grossed up) making gross income of 68 (54 + 14). This amount will be subject to tax of approximately 32 (68 x 47%) leaving net tax after the dividend tax credit of 18 (32 – 14) and a net return of approximately 36 (54 – 18). Resident Corporate Shareholder will effectively be entitled to an exemption with respect to the franked portion of its dividend, i.e. 9 (18 x 47%), but the unfranked portion will be subject to company tax of approximately 3 (9 x 36%) leaving a net return after tax of 15 (18 – 3). Resident Corporate Shareholder may credit the net return of 15 to its franking account. Neither Resident Individual Shareholder nor Resident Corporate Shareholder is entitled to use FDA credits attached to the dividend. Further, Resident Corporate Shareholder may not credit the FDA percentage of the dividend to its own FDA.

In this scenario in the case of Malaysia, Resident Company will have 46 credit in its Section 108 account and 240 credit in its exempt account. Resident Company will distribute a dividend of 118 subject to the Section 108 account mechanism in order to maximize the refundability of dividend tax credits in the hands of shareholders. The dividend tax credits attached to this dividend will exhaust the Section 108 account credit, i.e. 118 x $^{28}/_{72}$ leaves approximately 46 debit to that account. The remaining 62 (180 – 118) of the dividend will be distributed from the exempt account. Non-resident Shareholder will be effectively exempt with respect to the dividend of 108 (both on the portion subject to Section 108 and that distributed from the exempt account).

Resident Individual Shareholder and Resident Corporate Shareholder will receive a dividend subject to the Section 108 account mechanism of approximately 35 (118 x 30%) and 12 (118 x 10%), respectively. This dividend will carry refundable dividend tax credits of 14 (35 x $^{28}/_{72}$) and 5 (12 x $^{28}/_{72}$), respectively. These dividend tax credits will also be included in taxable income (grossed up) making gross income of approximately 49 (35 + 14) in the case of Resident Individual Shareholder and 17 (12 + 5) in the case of Resident Corporate Shareholder. Resident Individual Shareholder will have a tax liability of 15 (49 x 30%) reduced by the dividend tax credit to 1 (15 – 14). The dividend tax credits will exhaust the tax liability of Resident Corporate Shareholder. Further, Resident Corporate Shareholder will be entitled to credit the tax offset by its dividend tax credit (i.e. 5) to its own Section 108 account. The exempt account portion of the dividend will be exempt in both the hands of Resident Individual Shareholder, i.e. approximately 19 (62 x 30%), and Resident Corporate Shareholder, i.e. approximately 6 (62 x 10%). Resident Corporate Shareholder will be entitled to credit this portion to its own exempt account. This makes a gross return to Resident Individual Shareholder and Resident Corporate Shareholder of 53 (35 + 19 – 1) and 18 (12 + 6), respectively.

In this scenario in the case of New Zealand, the position of Resident Company and its shareholders is the same as described above before the branch and subsidiary profits are received.

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In this scenario in the case of Singapore, Resident Company will have 33 credit in its Section 44 account and 114 credit in its Section 13E account. Resident Company will distribute a dividend of 93 subject to the Section 44 account mechanism in order to maximize the refundability of dividend tax credits in the hands of shareholders. The dividend tax credits attached to this dividend will exhaust the Section 44 account credit, i.e. 93 x 26/74 leaving approximately 33 debit to that account. The remaining 87 (180 – 93) of the dividend will be distributed from the Section 13E account. Non-resident Shareholder will be effectively exempt with respect to the dividend of 108 (both on the portion subject to Section 44 and that distributed from the Section 13E account).

Resident Individual Shareholder and Resident Corporate Shareholder will receive a dividend subject to the Section 44 account mechanism of approximately 28 (93 x 30%) and 9 (93 x 10%), respectively. This dividend will carry refundable dividend tax credits of 10 (28 x 26/74) and 3 (9 x 26/74), respectively. These dividend tax credits will also be included in taxable income (grossed up) making gross income of approximately 38 (28 + 10) in the case of Resident Individual Shareholder and 12 (9 + 3) in the case of Resident Corporate Shareholder. The dividend tax credits will exhaust the tax liability of Resident Individual Shareholder and Resident Corporate Shareholder. Further, Resident Corporate Shareholder will be entitled to credit the tax offset by its dividend tax credit (i.e. 3) to its own Section 44 account. The exempt account portion of the dividend will be exempt in both the hands of Resident Individual Shareholder, i.e. approximately 26 (87 x 30%), and Resident Corporate Shareholder, i.e. approximately 9 (87 x 10%). Resident Corporate Shareholder will not be entitled to credit this portion to its own Section 13E account and so redistribution of this amount may give rise to equalization tax. This makes a gross return to Resident Individual Shareholder and Resident Corporate Shareholder of 54 (28 + 26) and 18 (9 + 9), respectively.

In this scenario in the case of the United Kingdom, Resident Company will have 207 in distributable foreign profits (69 interest income, 69 branch profits and 69 dividends) which may be matched with FIDs. However, Resident Company is unlikely to declare a FID of any greater amount, i.e. 48, than in the scenario described above before the branch and subsidiary profits are received. Therefore, the calculations are the same for this scenario as in the previous scenario. Further, the calculations under the proposed UK regime are also similar.

The various taxes levied as a result of the distribution and returns to the shareholders may be summarized as follows:

Taxes Levied On Distribution

Type of Tax	Australia	Malaysia	NZ	Singapore	UK
Corporate	–	–	(5)	–	–
Non-resident	14	–	29	–	–
Resident Individual	18	1	11	–	14
Resident Corporate	3	–	4	–	–
Total	35	1	39	–	14

Return To Shareholders

	Australia	Malaysia	NZ	Singapore	UK
Non-resident	94	108	92	108	108
Resident Individual	36	53	43	54	40
Resident Corporate	15	18	14	18	18
Total	145	179	149	180	166

It is also possible to calculate remaining profits as follows:

Remaining Profits

	Australia	Malaysia	NZ	Singapore	UK
Net Profits	240	240	240	240	240
Less					
Derivation Taxes	48	46	31	33	33
Distribution Taxes	35	1	39	–	14
Return to Shareholders	145	179	149	180	166
Remaining Profits	12	14	21	27	27

Note that the Malaysian and Singaporean flow-through regimes have full effect, relieving Resident Company of any equalization tax liability. Now only in the case of New Zealand does the sum of Distribution Taxes and Return to Shareholders exceed the amount of the distribution. Put another way, except in the case of New Zealand, the sum of Derivation Taxes and Remaining Profits equals the difference between profits net of Non-Treaty Country tax, i.e. 240, and the amount of the distribution. Although New Zealand levies the lowest amount of tax on derivation, it does not have the highest amount of retained profits after distribution. This illustrates that the NZ flow-through regime requires NZ companies fund CTR credits with retained profits. Note also that despite the lowest levy of tax on derivation, the NZ regime produces the greatest levy of tax on Non-resident Shareholder. This illustrates that New Zealand continues to levy a substantial tax on flow-through income, i.e. non-resident withholding tax.

3. Full distribution; branch and subsidiary profits received

Finally, the full distribution scenario is considered because it demonstrates the extent to which the various flow-through regimes under consideration achieve flow through on the given facts. It is only where the branch and subsidiary profits are received by Resident Company in its country of residence and distributed that any tax liability to be imposed by such country is finally crystallized. As this part of the discussion is only concerned with the extent to which flow through is achieved, only distribution to Non-resident Shareholder is considered. In this case, Resident Company receives 240 Non-Treaty Country source income net of Non-Treaty Country tax. The various taxes levied by the countries under con-

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sideration as a result of derivation and receipt of this income are summarized in the table under the previous paragraph heading. Further, Resident Company will have credit in its various accounts as described under that heading. The benchmark for flow through is where the residence country of Resident Company does not impose any tax on Non-resident Shareholder's share of Resident Company's profits after distribution. This benchmark is a return of 144 (240 x 60%) net of taxes imposed by the residence country of Resident Company.

In this scenario in the case of Australia, Resident Company will have 192 (240 – 48) available for distribution after Australian company tax. From this, Non-resident Shareholder will be entitled to a dividend of approximately 115 (192 x 60%). As mentioned under the previous paragraph heading, Resident Company will have credit in its franking account of approximately 85 and credit in its FDA of 18. This means the dividend of 192 will be franked as to approximately 44 per cent and also have a FDA percentage of 9 per cent. Non-resident Shareholder will not be subject to dividend withholding tax with respect to the franked percentage of the dividend or the FDA percentage, i.e. approximately 61 [115 x (44% + 9%)]. That tax will be imposed with respect to the unfranked portion of approximately 54 (115 – 61) at the rate of 30 per cent (treaty rate of 15%) leaving a tax liability of approximately 16 (8 in the case of a treaty). This leaves Non-resident Shareholder with a return net of Australian tax of approximately 99 (107 in the case of a treaty).

In this scenario in the case of Malaysia, Resident Company will have 194 (240 – 46) available for distribution after Malaysian company tax. From this, Non-resident Shareholder will be entitled to a dividend of approximately 116 (194 x 60%). Resident Company will still distribute a dividend of 118 (composite to all shareholders) subject to the Section 108 account mechanism in order to maximize the refundability of dividend tax credits in the hands of shareholders without liability for equalization tax. The remaining 76 (194 – 118) of the dividend will be distributed from the exempt account. Non-resident Shareholder will be effectively exempt with respect to the dividend of 116 which will equal Non-resident Shareholder's return net of Malaysian tax. Note, however, the substantial credit remaining in Resident Company's exempt account (164) apparently available to shelter the distribution of other exempt profits from Malaysian tax.

This scenario in the case of New Zealand is complex if account is to be taken of tax credits available to Resident Company on distribution under the foreign investor tax credit regime and its liability for supplementary dividends. As a starting point, Resident Company apparently has 209 (240 – 31) available for distribution after NZ company tax. However, assuming Resident Company will exhaust credits in its various accounts as a result of the distribution, liability to distribute a supplementary dividend under the CTR regime should be deducted from this amount, i.e. 8, leaving adjusted distributable profits of 201. From this, Non-resident Shareholder will be entitled to a dividend of approximately 121 (201 x 60%). Non-resident Shareholder is also entitled to two supplementary dividends from Resident Company, one under the CTR regime and another under the foreign investor tax credit regime which are calculated as discussed under the previous paragraph heading. The first will be funded from the distributable profits of Resident Company (as accounted for above) and the second by the NZ Revenue (Resident Company will receive a tax credit equivalent to the supplementary dividend which will reduce its company tax liability). Therefore, Non-resident Shareholder will be entitled to a total dividend of approximately 134 (121 + 8 + 5). NZ non-resident withholding tax will be imposed at the rate of 15 per cent to the fully franked part of the dividend, i.e. approximately 43 [(13 + 8) x $^{67}/_{33}$] and 30 per cent to the unfranked part of the dividend (assuming Non-resident Shareholder is not resident in a treaty country), i.e. 91 (134 – 43). The former liability would be approximately 6 (43 x 15%) and the latter 27 (91 x 30%), making a net return of 101 (134 – 6 – 27). If Non-resident Shareholder is resident in a treaty country, non-resident withholding tax would be imposed at a flat rate of 15 per cent making a liability of 20 (134 x 15%) and a net return of 114 (134 – 20).

In this scenario in the case of Singapore, Resident Company will have 207 (240 – 33) available for distribution after Singaporean company tax. From this, Non-resident Shareholder will be entitled to a dividend of approximately 124 (207 x 60%). Resident Company will still distribute a dividend of 93 (composite to all shareholders) subject to the Section 44 account mechanism in order to maximize the refundability of dividend tax credits in the hands of shareholders without liability for equalization tax. The remaining 114 (207 – 93) of the dividend will be distributed from the exempt account. Note that in this way under a full distribution policy both Section 44 and Section 13E accounts are exhausted. Non-resident Shareholder will be effectively exempt with respect to the dividend of 124 which will equal Non-resident Shareholder's return net of Singaporean tax.

In this scenario in the case of the United Kingdom, Resident Company will have 207 (240 – 33) available for distribution after UK company tax. Resident Company will be liable for ACT with respect to the distribution of 207 in an amount of 52 (207 x $^{20}/_{80}$). This amount may be set against and exhaust Resident Company's liability to corporation tax resulting in total surplus ACT of 19 (33 – 52). Resident Company will again try to maximize refundable dividend tax credits to shareholders. It is likely that Resident Company declares a FID of 76 ensuring a refund of the surplus ACT, i.e. 19 (76 x $^{20}/_{80}$). This again leaves a net ACT liability of 33 and no corporation tax liability. The remainder of the dividend, 131 (207 – 76), will be distributed as a regular dividend with regular dividend tax credits attached. In the result, Non-resident Shareholder will be entitled to a total dividend of approximately 124 (207 x 60%). Non-resident Shareholder will be effectively exempt with respect to both the FID and regular dividend portions, assuming Non-resident Shareholder is not entitled to a refund of dividend tax credits under a double tax treaty. This leaves Non-resident Shareholder with a return net of UK tax of 124. Calculations under the proposed UK regime would be similar.

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The results of this part of the discussion may be summarized as follows:

Country	Return to Non-resident Shareholder
Benchmark (Flow Through)	144
Australia	99 (107 treaty)
Malaysia	116
New Zealand	101 (114 treaty)
Singapore	124
United Kingdom	124

It is apparent that none of the flow-through regimes produce flow through on the given facts. Singapore and the United Kingdom produce the most favourable result primarily because of the broad nature of their regimes. Malaysia's regime is also broad, its reduced return is primarily attributable to limited unilateral foreign tax relief. The Australian and NZ flow-through regimes are least favourable reflecting their restricted nature. However, not too much weight should be given to this selected result which may be substantially improved in given cases with a little tax planning, e.g. in the cases of Australia and New Zealand by Resident Company deriving all the income through a non-resident subsidiary. Further, flow through is more likely to be achieved where the source country tax rate exceeds the corporate tax rate of the residence country of Resident Company. The example has served to highlight the substantial differences and complexity involved in applying the various regimes.

V. CONCLUSION

This paper has assessed NZ's flow-through regime by comparing it with those of Australia, Malaysia, Singapore and the United Kingdom. The striking feature of all these regimes is their complexity. Indeed, in many respects NZ's regime may be considered the most complex. Further, as the above example particularly illustrates, these regimes are often erratic, inconsistent and selective. At least in part, this is because the regimes are patched onto and not incorporated in the framework of the respective corporate tax systems. Another reason is that the regimes appear to be introduced in pursuit of specific policy grounds rather than the overall equity and efficiency of the income tax system. Hence, the Malaysian and Singaporean regimes are framed in such a way as to encourage resident companies to repatriate foreign profits. Benefits of the Australian regime are only available to non-residents but not, generally, non-residents who derive passive income from unlisted countries through Australian companies. The present UK regime was specifically targeted at surplus ACT.

The policy underpinning the NZ regime is somewhat subtle. The regime does reduce NZ tax on flow-through income but, unlike the other regimes, it does not remove it. Rather, the NZ regime's complexity lies in seeking to ensure that NZ tax levied on flow-through income is creditable under other countries' direct foreign tax credit regimes. Further, the NZ regime seeks to except the accruals regimes to the extent that NZ companies are owned by non-residents. The mechanism adopted appears inequitable and inefficient because NZ companies engaged in the same offshore activities are not treated in the same manner by New Zealand. Rather, NZ companies engaged in such activities may view their NZ shareholders as a handicap.

In my view, imputation countries are presently adopting the wrong approach to flow through. As the proposed UK corporate tax system demonstrates, it is possible to sensibly incorporate a flow-through regime within a corporate tax system with a substantial reduction in complexity. This is not to hold the proposed UK corporate tax system up as some kind of model. It will incorporate substantial inequities including the non-refundability of dividend tax credits and, due to the partial nature of its dividend relief, a distortion between debt and equity financing. Indeed, it is reasonable to suggest that the main reason why it is acceptable to the UK Government to incorporate flow through within its proposed corporate tax system is the existence of these inequities. Nevertheless, the proposal does demonstrate the substantial savings in complexity which may be generated by incorporating a flow-through regime within an imputation system instead of patching it on.

Surely it is better to structure a tax system in the most equitable and efficient manner and then (if governments cannot resist) introduce policy objectives. In practical terms, it appears appropriate for imputation systems (and income tax systems in general) to be structured in accordance with the composite tax principle and then impose restrictions according to, e.g. whether income is sourced in a listed country or of a particular type or received in the subject country. At least in this case the income tax system will have a solid foundation, structure, some balance and transparency. Further, it is then a simple matter to incorporate a flow-through regime into an imputation system. Until such fundamental restructuring occurs it appears our tax systems will continue to grow in sometimes blinding complexity without any indication of what the system seeks to achieve as a whole and where the system may be heading.

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CANADA

RESIDENCE OF TRUSTS FOR CANADIAN TAX PURPOSES

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I. INTRODUCTION

The concept of residency is fundamental to our tax system. An individual, trust, or a corporation resident in Canada is taxable on global income. A non-resident of Canada is only taxable in Canada to the extent that the non-resident carries on business in Canada, is employed in Canada or disposes of taxable Canadian property. A non-resident is also subject to Canadian withholding tax on interest, rents, royalties, dividends and management fees paid or credited to it.

I will attempt to summarize the law on residency and the administrative practice of Revenue Canada and to draw conclusions. I will briefly review the statutory references to residency and the jurisprudence.

Although the topic is not new, the increase in international trade both to and from Canada has resulted in an increase in the use of international structures designed to be tax effective and to allow businesses to remain competitive in the international marketplace. While historically the use of international trusts was the domain only of a select few wealthy individuals and international companies, it is now available to small and medium sized businesses, owner-managers and persons of more modest means.

II. RESIDENCY OF TRUSTS

A. Overview of trusts

Before delving into an analysis of the Canadian law on the residency of a trust, a review of certain basic characteristics of a trust would be helpful. A trust is not a legal entity. It is a relationship between various parties.

The settlor makes a gift to trustees who are required to hold the trust property for the benefit of the beneficiaries. The settlor must have the "animus donandi" (intention to make a gift). A trust may have more than one settlor as it may receive gifts from more than one person. The *Income Tax Act* deems the person who has transferred the most property to be the settlor for tax purposes.[1] If the trust fails because there are no longer any beneficiaries, the trust property reverts back to the settlor. In a testamentary trust, the testator is the settlor. The settlor may be resident in Canada or outside of Canada. Depending on the nature of the indenture, the settlor may or may not have any ongoing involvement with the trust. For example, the settlor may retain the right to replace the trustees, to appoint a protector, to appoint beneficiaries and to vary the trust. The settlor may also provide the trustees with one or more letters of wishes. This is more common in international trusts.

A letter of wishes is precatory in nature and not binding on the trustees. However, professional trustees will follow the wishes of the settlor. The letter of wishes may indicate the desired investment policy of the trust or the way in which the settlor wishes the distributions to be made to the beneficiaries.

If the settlor retained all of the powers, made all the decisions and continued to treat the property as if no trust were created, Revenue Canada may argue that no trust was created and that the trustee was merely the agent of the settlor.[2]

A trust is created when it is constituted. Property must be legally transferred to the trustees who must carry out the terms of the trust for the benefit of the beneficiaries. Given the fact that the trust obligations are enforceable against the trustees, the residence of the trustees is relevant in determining the residency of the trust. The trustees are the legal owners of the trust property. As domestic law may otherwise restrict the powers of the trustees, it is common for the trust deed or trust indenture to clarify and to expand the powers of the trustees. The trustees are required to act in a fiduciary manner and to maintain an even hand between all beneficiaries. In other words, the trustees must act fairly and impartially in carrying out the terms of the trust.

There may be one or more trustees. The trustees may reside in different jurisdictions. The trustees may be individuals or corporations. In some cases, the trustee may be a foreign branch office of a corporation. The trustees may meet to make their decisions or otherwise agree. Decisions of the trustees must be unanimous unless the trust deed provides for majority rule. The trustees are limited in their ability to delegate their powers. The powers of the trustees may include the discretion to distribute or accumulate income or capital of the trust, to make distributions, equally or unequally to beneficiaries, to invest the trust property in any investment, to buy or sell any trust investment, to hire investment advisors, to borrow from or lend funds to the settlor or the beneficiaries, to attend to all banking, to manage any business interests of the trust and to determine when to terminate the trust. The

1. Sec. 108 Income Tax Act (ITA).
2. See for example, *Claudia Rahman v. Chase Bank (CI) Trust Company Limited*, Jersey Royal Court (Samedi Division) 6 June 1991 cited by Wallace M. Howick in *Diversification and Offshore Trusts 1994 Conference Report* 23:95.

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trustees have an obligation to provide an account to the beneficiaries. They may have the right to appoint replacement trustees and to appoint other beneficiaries.

In the common law, the beneficiaries have a chose in action. They do not have direct ownership of the trust property. The only right of a beneficiary is to demand that the trustees carry out the terms of the trust. A beneficiary may sue a trustee, who acts capriciously, for breach of trust. The Income Tax Act defines a beneficiary as a person who has a present or future (absolute or contingent) interest in the trust.[3]

In international trusts, it is not uncommon to have a protector. The protector may be an individual or a corporation. The trust indenture would set out the rights of the protector. The protector would not be entrusted with ownership of the property nor typically with day-to-day decision making. The protector may have the right to remove and replace trustees and possibly to be consulted on certain major decisions (e.g. borrowing, distributions, purchase and sale of assets). If the protector has too many powers, tax authorities may regard the protector as having the same status as a trustee for purposes of determining the residency of the trust.

The trust may contemplate an investment advisor who could be named in the trust indenture or be appointed by the settlor, trustees or protector. The investment advisor may be protected from liability. The trust indenture may also relieve the trustees from personal liability in connection with the investment decisions of the investment advisors.

The trust indenture may specify the jurisdiction of choice of the trust. It may provide that the trust is to be governed by the laws of a specific jurisdiction and that all legal matters pertaining to the trust are to be resolved in that jurisdiction. The trust indenture may also enable the trustees to change the jurisdiction of the trust.

Based on the foregoing, there are several possible approaches to determining the residency of a trust. The possible relevant factors are:

- the residency of the settlor (but only if the settlor exercises continued control over the administration of the trust);
- the residency of the trustees (the approach favoured by Revenue Canada and possibly by the courts). However, problems may arise where the trustees reside in several jurisdictions or where the branch office of a corporate trustee resident in another jurisdiction acts as a trustee. Whether the trust document provides for a decision by a majority or a unanimous decision may be relevant if one of the trustees is resident in Canada. In the case of multiple trustees, a determination is required as to whether the trust deed requires any trustee to be in the majority or whether one trustee factually manages the trust;
- the place where the trust is administered may be important. This would be the place where meetings of the trustees are held and where the banking is done. The jurisdiction clause in the trust may also support the residency of the trust;
- the residency of the protector would be relevant only where the protector is clearly involved in managing the trust. The power to appoint trustees should not be sufficient for this purpose. The power to control all investments and distributions would be; and
- the location of the trust property may be relevant especially if it is difficult to determine residency based on the other criteria.

A straightforward example would be a trust settled by a resident of Canada by transferring property in Canada to Canadian resident trustees for the benefit of Canadian resident beneficiaries. The trust indenture confirms that the trust is governed by the laws of Ontario. Clearly, the trust would be resident in Canada. However, there are several permutations and combinations which may complicate the determination of residency. For example:

- the settlor may retain extensive powers in the trust indenture or a letter of wishes;
- the trustees may reside in different jurisdictions and the trust indenture may require a unanimous decision or a majority possibly with one trustee being in the majority; and
- the trust indenture may provide for the appointment of a protector who has extensive powers.

B. Carter Commission

The Carter Commission recommended that the residency of a trust be determined primarily by reference to the residence of the trustee. A Canadian corporate trustee would make the trust resident in Canada. The Carter Commission also recommended that a trust be resident in Canada if it carried on all or substantially all of its business in Canada or where substantially all of its property is located in Canada.[4] The Income Tax Act does not specifically deal with the determination of residency of a trust although, as indicated below, there are specific references in the Act to non-resident trusts.

C. Jurisprudence

Before reviewing the jurisprudence, the lack of clarity in this area is best summarized by *Tax Window* document 9202835 dated 17 July 1992. "We would caution that because of the lack of jurisprudence on this issue, it is not clear what the decision of a court would be in any particular case."

In *M.N.R. v. Holden*, 1 DTC 234 (SCC) the Supreme Court disregarded the residency of the beneficiaries as relevant in the determination of the residency of an estate.

In *M.N.R. v. Consolidated Holdings*, 72 DTC 6007 (SCC) in determining whether companies were associated, regard was had to the trust indenture to determine whether any co-executor could direct the other co-executors as to how to vote the shares held by the estate.

3. Sec. 248(25) ITA.
4. Report of the Royal Commission on Taxation (Ottawa: Queens Printer, 1966), Vol. 4, at 195-196 as reported in Richard A. Green, "The Residence of Trusts for Income Tax Purposes", *Canadian Tax Journal*, Volume XXI, No. 3, at 226.

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In *Robson Leather Co. Ltd. v. M.N.R.*, 77 DTC 5106 (F.C.A.) the court, in determining whether a person had control for purposes of the arm's length rules, had regard to the fact that one trustee retained the right to remove the other trustees. This factor was not cited in any subsequent decision.

In *Rostal Sales Agency Ltd. v. The Queen*, 83 DTC 5036 (F.C.T.D.) a company was owned by a trust having an arm's length trustee. The power of an individual to remove the trustee did not serve to associate the companies in question.

It is submitted that the mere power to appoint and remove trustees is not sufficient to control the trust or any action of the trustees. While a trustee may be hesitant to act in a manner which will offend the holder of such a power lest he be removed from office, the holder of the power may not veto any decisions of the trustees.

Thibodeau Family Trust v. The Queen, 78 DTC 6376 (F.C.T.D.) is viewed as the landmark decision in Canada. It is the only Canadian case directly on point. In *Thibodeau*, a trust was formed in Canada. The settlor, a Canadian resident, transferred a minority interest in a Canadian company to two trustees resident in Canada. One Canadian trustee subsequently resigned and was subsequently replaced by two trustees resident in Bermuda. There were then three trustees, one resident in Canada and two resident in Bermuda. The jurisdiction of the trust was moved to Bermuda. The share certificates were held in Bermuda. The books and records were in Bermuda and the trust was administered in Bermuda. The Canadian trustee delegated the administration to the trustees in Bermuda. The trust required a majority decision of trustees. It was not required that the Canadian trustee be in the majority. All trustees participated in the decisions of the trustees. As the trust owned a minority interest in the Canadian company, the value of the shares was discounted. It also indicated that the trustees did not control the business in Canada.

Although Section 104(1) treats a trust as an individual, the criteria applicable to determining the residence of individuals was dismissed. The court also rejected the "management and control" criteria which evolved for determining the residency of corporations. Finally, Mr Justice Gibson rejected the possibility of a trust being a dual resident on the basis that a trustee may not delegate its powers to the other trustees. The trust was found to be resident in Bermuda as the majority of trustees resided in Bermuda and administered the trust there.

As a result of the *Thibodeau* decision, the prevailing view in Canada is that the residency of a trust is determined by reference to the residency of the trustees. Revenue Canada in Interpretation Bulletin IT-477, discussed below, states that generally a trust will be resident where the trustee who manages and controls the trust resides. Concern has been expressed that Revenue Canada may seek to distinguish the case on its facts. For example, the outcome may have been different, if a unanimous decision of the trustees had been required or if the Canadian trustee plus one of the other trustees had to make all decisions.

D. Administrative practice

1. Interpretation Bulletin IT-477

In Interpretation Bulletin IT-447, dated 30 May 1980, Revenue Canada confirms that a trust will generally reside where the trustee who manages and controls it resides. The reference to management and control echoes the corporate test which was rejected in *Thibodeau*.

If a trust has more than one trustee, Revenue Canada takes the position that the trust will be resident where more than 50 per cent of the control is exercised. It is submitted that it may be difficult to quantify the percentage of control particularly where the duties and responsibilities are divided between the trustees. How is the percentage of control determined, based on time spent or on the number or significance of the activities. For example, if one trustee does the bookkeeping and the banking and another trustee regularly meets with investment advisors how is the percentage of control determined? It is unclear what would occur if all of the trust property was administered in one jurisdiction by a trustee, who resided in another jurisdiction, but travelled to the first jurisdiction to attend to the administration. Presumably, the trust would be resident where the administration occurred.

If there were three trustees and unanimous consent was required, would the trust be resident in Canada if it had one Canadian trustee on the grounds that he effectively had a veto power? The same argument may be made in favour of the trust being resident in the jurisdictions in which the other trustees reside.

If there are two trustees, unanimity would be required. Can it be argued that if both trustees participate equally in decision making that neither controls?

Revenue Canada indicates that the trustees need not have physical possession of the trust property. The Interpretation Bulletin also provides, in a possible contradiction, that if it is otherwise not possible to determine where the trust is resident, reference may be made to the location of the trust property. Given the fact that the trust may make investments in several jurisdictions and use different banks and investment advisors, it is submitted that this criteria should not be relevant. If this approach were correct, a trust having two trustees residing in different jurisdictions and all of its assets (being cash in this example) being in a bank account in a third jurisdiction, the trust may be resident in that third jurisdiction. This would be tantamount to making the bank a controlling trustee which would be a ridiculous result.

Revenue Canada will examine who exercises the following powers:

- control of the investment portfolio;
- management of the business or property of the trust;
- responsibility for banking or financing;
- control over any trust assets (if the trust owns a company having an independent board of directors does this mean the residency of the trust will be determined by the residency of the directors who control a trust asset?); and

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- responsibility for the preparation of trust accounts and reporting to beneficiaries and power to contract with trust advisors such as lawyers and auditors.

If an individual is a trustee, the residency of the individual must be determined as a first step in determining the residency of the trust. Similarly, the residency of a corporate trustee will be relevant in determining the residency of the trust. The residency of a corporate trustee will be determined based on central management and control. Presumably, if a corporate trustee resides in a treaty jurisdiction and is deemed to be resident in that jurisdiction (e.g. by virtue of incorporation) that would be determinative. Problems appear to arise where a corporate trustee, resident in one jurisdiction has a branch in another jurisdiction which acts as trustee. For purposes of determining the residency of the trust, Revenue Canada may regard the corporate trustee as resident where the branch office is located rather than where it is incorporated.

In some cases, Revenue Canada may also consider where the legal rights of the trust are enforceable. The governing law clause in the trust indenture may be self serving in this regard. Confirmation should be obtained that the governing law of the jurisdiction, chosen in the trust, would be enforceable in that jurisdiction if there is no other link to that jurisdiction; neither the settlor nor any of the trustees or beneficiaries reside in that jurisdiction and no trust property is located there.

Revenue Canada agrees that the residency of the beneficiaries (this is consistent with the *Holden* case) and of the settlor is irrelevant unless that person controls the trust (e.g. the settlor through an unusual letter of wishes retains control over all decisions and thus removes the powers from the trustees). The test is de facto control and requires that the individual controls the trust. In this regard, reference will be had to any person who controls (e.g. a protector).

Revenue Canada takes the position that a trust may be a dual resident for tax purposes. This is contrary to the comments of Mr Justice Gibson in *Thibodeau*. As discussed below, if the trust is resident in a treaty jurisdiction, the competent authorities may have the ability to determine that the trust is resident in one jurisdiction only.

2. Technical interpretations

There have been several technical interpretations respecting the residency of trusts. The following is a summary of several *Tax Window* files on this subject.

In a situation where a trust had non-resident trustees, a Canadian beneficiary and Canadian assets, Revenue Canada regarded the ability of the Canadian beneficiary to use the trust property as collateral as affecting the residency of the trust. It was a relevant factor in determining whether a substantial portion of the trust assets were managed by the beneficiary.[5] It is submitted that if the trustees, rather than the beneficiary, have the right (but not the obligation) to guarantee an obligation of the beneficiary, the beneficiary would clearly not control the trust.

In another technical interpretation in 1989, Revenue Canada indicated that based on *Thibodeau Family Trust*, there were three criteria of residency:

- residence of the majority of trustees;
- location of the trust property; and
- whether the trust carries on business in Canada.

The residency of the beneficiaries was irrelevant. A trust could be a dual resident and if a tax treaty applies, the competent authority may have to resolve the issue.[6] It is submitted that the location of trust property should not be relevant and based on *Thibodeau*, a trust should not be a dual resident.

In 1990, Revenue Canada confirmed that no Section 116 certificate was required on the sale of a building in Canada by an estate with Canadian resident trustees and having a non-resident beneficiary (i.e. the trust was resident in Canada).[7]

In 1990, Revenue Canada reviewed the residency of a trust having a non-resident settlor, a majority of non-resident beneficiaries and a trustee, which was a foreign branch of a Canadian corporate trustee. Revenue Canada was of the view that the trust may be resident where the branch was located.[8]

The place where the trustees meet regularly and manage the affairs of the trust may be more important than where the trustees reside.[9]

A trust would not be viewed as a resident in Canada notwithstanding that the sole trustee was deemed pursuant to Section 250(4) to be resident in Canada if:

- central management and control of the incorporated trustee was exercised outside of Canada;
- the trust received property from a non-resident of Canada;
- all or substantially all of the trust property is situated outside of Canada; and
- a majority of the beneficiaries are non-resident of Canada.[10]

E. Relevant statutory provisions

A person resident in Canada is taxable on worldwide income.[11] A non-resident person is taxable if the person carries on business in Canada or disposes of taxable Canadian property.[12] Person is defined to include the executors, administrators or other legal representatives of a person.[13] Section 104(1) of the Act provides that reference to a trust or an estate shall be read as a reference to the trustee or to the executor, administrator, heir or other legal representative having ownership or control of the trust property. A trust resident in Canada will therefore be taxable on its worldwide income

5. Residence of a Trust, *Tax Window,* 13 July 1989, Document 57905.
6. Residence of Trust, *Tax Window,* 3 October 1989, Document AC58480.
7. Question 21, *APFF* 1990.
8. Residence of Trusts and IT-447, *Tax Window,* 27 July 1990, Document ACC9376.
9. *Tax Window*, 21 February 1992, Document 9132102.
10. Revenue Canada Opinion Residency-General, 28 July 1993, *Tax Window*, Document 9309025.
11. Sec. 2(1) ITA.
12. Sec. 2(3) ITA.
13. Sec. 248(1) ITA.

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while a trust not resident in Canada will be taxable only on its Canadian source income (although the beneficiaries in Canada may, depending on whether the settlor of the trust was resident in Canada, be taxable on the income of the trust whether or not distributed).

A mutual fund trust must be a unit trust resident in Canada.[14] Similarly, a trust is a unit trust if throughout the year it was resident in Canada.[15] A registered education savings plan must be resident in Canada.[16]

It appears that every trust is subject to the deemed disposition every 21 years under Section 104(4). However, to the extent that a non-resident trust had no taxable Canadian property it would not be taxable in Canada.[17]

A trust may deduct in computing its income any amount paid or payable to a beneficiary.[18] However, in the case of a designated beneficiary (defined in Section 210 to include a non-resident person), no deduction may be made unless throughout the year the trust was resident in Canada.

A roll-over to a spouse trust will be available only if both the taxpayer and the transferee (the spouse trust) were resident in Canada at that time.[19]

Section 104(13) provides for the income of a beneficiary. In the case of a trust resident in Canada, the beneficiary must report an amount that, subject to the preferred beneficiary election, would be the trust's income for the particular year as became payable in the particular year to the beneficiary.[20] In the case of a non-resident trust, the beneficiary must include in income all amounts that became payable in the year by the trust to the beneficiary, otherwise than as proceeds of disposition of the beneficiary's interest in the trust or a capital distribution.[21] The distinction between a resident and a non-resident trust may be that the income payable may be a greater amount for a beneficiary of a non-resident trust as it appears to include all income payable whether or not paid.

A trust which is resident in Canada may elect to treat amounts as not being paid to beneficiaries in order to offset trust losses.[22]

A trust is generally a conduit for Canadian tax purposes and a trust resident in Canada may flow through taxable dividends,[23] non-taxable dividends,[24] taxable capital gains[25] and certain pension[26] and certain resource income.[27] Income may not retain its original charter when flowed through a trust not resident in Canada.[28]

Although Part XII.2 imposes a 36 per cent tax on rental or business income of a trust having non-resident beneficiaries, paragraph 210(1)(e) excludes a non-resident trust.

A Canadian beneficiary of a resident or of a non-resident personal trust will not be taxable on capital distributions in satisfaction of all or part of the taxpayers interest in the trust.[29] Section 107(5) generally denies the roll-over to the trust on a capital distribution to a non-resident beneficiary (other than for a property that would if the trust was not resident in Canada throughout the year be taxable Canadian property).

Section 94(1) determines the applicability of the foreign accrual property income rules to a non-resident trust. Generally if a trust has a Canadian settlor or a person in Canada who has provided financial assistance and a Canadian beneficiary, the rules will apply. In the case of a non-resident discretionary trust, paragraph 94(1)(c) deems the trust to be a person resident in Canada having only certain types of income. In the case of a non-discretionary trust, the trust is deemed, for the purpose of computing the foreign accrual property income of a beneficiary, to be a non-resident corporation.

Section 128.1 sets out the rules for immigration to and emigration from Canada. These rules will apply to a trust which becomes or ceases to be resident in Canada. As the residency of a trust is primarily determined by reference to the residency of the trustees, a change in trustees may subject the trust to the deemed disposition rules in Section 128.1.

Section 115(2) includes in the definition of taxable Canadian property a capital interest in a trust resident in Canada and an interest in a unit trust for the purposes of departure tax. Section 248(1) expanded the definition to include an income interest in a trust resident in Canada. The draft measures announced in 1995 would expand the departure tax to include capital interests in resident trusts. Interests in non-resident trusts have always been included.

A proposed amendment to paragraph 115(1)(b) would include in taxable Canadian property an interest in a non-resident trust where, at any particular time during the 12-month period that ends at the time of disposition of the interest in the trust, more than 50 per cent of the fair market value of all of its properties is comprised of taxable Canadian property, a Canadian resource property, a timber resource property, an income interest in a trust resident in Canada or an option in respect of the foregoing. This provision extends Canada's right to tax a non-resident on a disposition of an interest in a non-resident trust. The fourth protocol to the Canada–United States treaty would exempt US residents from this provision.

Section 94.1 operates to impute a return based on the designated cost to a taxpayer who has an interest in an offshore investment fund property. Property includes an interest in a non-resident entity. Entity is sufficiently broad to include an interest in a non-resident trust.

A non-resident trust may make the net election under Section 216(1) in respect of rental income and timber royalties.

14. Sec. 132(6)(b) ITA.
15. Sec. 108(2) ITA.
16. Sec. 146.1(2)(c) ITA.
17. Secs. 2(3) and 115(1) ITA.
18. Sec. 104(6) ITA.
19. Sec. 73(1) ITA.
20. Sec. 104(13)(a) ITA.
21. Sec. 104(13)(c) ITA.
22. Secs. 104(13.1) and (13.2) ITA.
23. Sec. 104(19) ITA.
24. Sec. 104(20) ITA.
25. Sec. 104(21) ITA.
26. Secs. 104(27) and 104(27.1) ITA.
27. Sec. 104(29) ITA.
28. Sec. 108(5) ITA.
29. Sec. 107(2) ITA.

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The tax treaties that Canada has entered into apply to trusts. For example, the term "person" is defined in the Canada–United States treaty as including a trust.[30] The Canada–United States treaty includes a tie-breaker clause designed to avoid double taxation and to deal with dual residency. It is not possible to apply the terms in Article IV, paragraph 2 of the Canada–United States treaty (e.g. location of permanent home, centre of vital interests, habitual abode and citizenship) for determining residency for purposes of the treaty. Article IV, paragraph 4 therefore provides that the dual residency of a trust would have to be resolved by the competent authorities. A non-resident trust, resident in a treaty jurisdiction, would get the benefit of the treaty reductions in Canada's treaties.

Article XXVI, paragraph 8 of the Canada–United States treaty deals with the ability of Canada to request enforcement from the United States in connection with a trust. The revenue claim must relate to a taxable period in which the taxpayer derived its status as such an entity (i.e. as a trust) from the laws in force in the requested state (i.e. the United States).

The foreign reporting requirements in Section 233.1 and following contain several references to trusts. Section 233.2(1) contains definitions of an exempt trust and a specified foreign trust. An exempt trust is a trust that is resident in a country under the laws of which an income tax is imposed, is exempt from tax in that country and is established principally in connection with a pension arrangement maintained primarily for the benefit of non-resident individuals. A specified foreign trust is a trust that is non-resident at that time and that meets other conditions. Section 233.2(4) deals with the reporting requirements for property transferred or lent directly or indirectly to a specified foreign trust.

Specified foreign property is defined to include an interest in a non-resident trust which was acquired for consideration.[31] A reporting entity in Section 233.4(1) includes a taxpayer resident in Canada in respect of which a non-resident trust is a foreign affiliate at any time in the year.

Section 233.6 sets out the reporting requirements for distributions or loans from a non-resident trust.

Section 212.1 could apply to deem a dividend to arise where a non-resident trust disposes of shares of a Canadian corporation to a Canadian corporation with whom the trust does not deal at arm's length.

F. Planning for residency

Based on the foregoing, it is possible to conservatively structure a trust in order that it be regarded, for Canadian tax purposes, as being resident in Canada or outside Canada.

Assuming that the desire is not to have the trust be resident in Canada, the use of Canadian trustees should be avoided to the extent possible. If there is to be a Canadian trustee, there should be at least two other trustees, resident outside of Canada, with a majority (rather than a unanimous) decision prevailing. The decisions of trustees should be made outside of Canada. In order to escape Canadian residency, a Canadian protector should not be used if the power of the protector goes beyond the appointment of trustees.

The settlor, if a Canadian resident, should not through a letter of wishes or otherwise, retain control over the investments and decision making of the trust. The residency of the beneficiaries should not be relevant.

Although it is not the author's view that the location of the trust's assets should be a factor, if the assets are managed and located outside of Canada, Revenue Canada will not be able to raise the issue. It would be unfair of Revenue Canada to restrict the ability of Canadian financial institutions and investment managers to manage funds owned by non-resident trusts without jeopardizing their residency status. A non-resident trust should be able to own the shares of a Canadian private company or a passive real estate investment in Canada while maintaining its status as a non-resident trust.

The trust indenture should clarify that the governing law of the trust is to be the law of the jurisdiction outside of Canada.

Conversely, if Canadian residency is important, the majority of trustees should reside in Canada. If a sole trustee is to depart Canada, he should resign prior to emigrating and another trustee resident in Canada be appointed in his stead.

30. Art. III of the Canada–United States treaty.
31. I.e. not an interest in a trust not acquired for consideration.

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SINGAPORE

TAX ISSUES FOR ENTREPRENEURS UNDERTAKING CORPORATE EXPANSION IN SINGAPORE AND MALAYSIA

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I. INTRODUCTION

Tax issues for entrepreneurs who carry out corporate expansion are generally complex and numerous. However such tax issues should not discourage globalization of business. Success in economic development depends on business expansion of various enterprises in the commercial, industrial and financial sectors.

There are many forms of business expansion in Singapore and Malaysia. Corporate expansion can be carried out locally or internationally by making use of the following structures or arrangements.

* Wholly owned subsidiaries
* Partnerships
* Joint ventures
* Agencies
* Distributorships
* Franchising
* Licensing
* Technical agreements
* Leasing
* Technology transfer
* Cooperative arrangements
* Other special arrangements

For entrepreneurs who have their businesses incorporated as legal entities under the Companies Act, it is quite common for their companies to undergo changes in corporate restructuring in several ways. Mergers and acquisitions are quite common.

II. CORPORATE RESTRUCTURING

For effective tax planning it is necessary to distinguish between mergers, acquisitions and schemes of arrangement.

In a merger, two or more companies are merged into one and the shareholding in the merged company will be spread among the shareholders of the two or more companies.

In an acquisition or takeover, the direct or indirect control over the assets of the acquired company passes to the acquirer.

A scheme of arrangement is an internal reorganization of a company. There are many kinds of arrangement which may be made with different classes of persons, e.g. an arrangement with shareholders or an arrangement with creditors pursuant to the provisions of Section 210 of the Singapore Companies Act (Chapter 50) or the Malaysian Companies Act 1985.

A. Mergers

A company or a group of companies may undergo changes in corporate structure by splitting one company into two or more companies or by merging two or more companies into one company under common control. The common types of mergers are:

- vertical mergers;
- horizontal mergers;
- conglomerate mergers;
- multi-mergers[1]

B. Acquisitions

Takeover bids – The acquiring company offers to buy the shares from the shareholders of the target company with a view to gaining control over the latter company.

Share purchases – An attempt by a company to acquire a significant number of shares in a target company in a short space of time by purchasing shares in the open market or through private placements.

Management buyout – Members of the management take over the company by acquiring the shares from the existing shareholders.

III. TAX ISSUES

In corporate restructuring involving mergers and acquisitions, there are tax factors and non-tax factors which have to be considered.

1. Mergers involving many companies undergoing complex corporate restructuring, some of which are horizontal or vertical or a combination of both. Multi-mergers can bring about monopolies with a high degree of absolute control over the industry.

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Some of the non-tax factors relate to production, marketing, finance, personnel or general management and administration. These issues are outside the scope of this paper.

Tax issues are numerous. The scope of this paper will be limited to only a few important income tax issues. The following issues relating to corporate restructuring will be considered:

- transfers of trading stocks;
- bad and doubtful debts;
- transfers of industrial buildings & structures;
- transfers of plant and machinery;
- trading losses;
- unabsorbed capital allowances;
- Section 44 credit balances (Singapore);
- Section 108 credit balances (Malaysia); and
- stamp duty implications.

A. Transfers of trading stocks

Corporate structuring may involve the disposal or transfer of trading stocks.

According to Section 32 of Singapore's Income Tax Act, there are two methods of valuation of trading stocks where the corporate restructuring involves the transfer of business:

- If the stock is sold or transferred for valuable consideration to a person who carries on or intends to carry on a trade or business and the cost whereof may be deducted by the purchaser as an expense in computing the gains or profits of that business, the value of the stock is taken to be the amount realized on the sale or the value of the consideration given for the transfer.
- In all other cases, the value of the trading stock is deemed to be the open market value at the discontinuance or transfer of the business.

In Malaysia, the provisions relating to valuation of stocks on discontinuance of trade are similar to those in Singapore.[2]

B. Bad and doubtful debts

For a bad or doubtful debt to qualify for tax deduction against taxable profits of a trade or business, certain conditions must be satisfied. The revenue authorities normally require the following information:

- the name and address of the debtor;
- the date on which the debt was first incurred;
- the nature of the debt;
- the amount of the debt written off as bad or irrecoverable; and
- the reasons for writing off together with supporting evidence.

The debt written off must relate to a continuing business or trade. If the business or trade has been discontinued, no deduction for bad or doubtful debts is allowed.

In corporate restructuring, the transferor's trade debts may be taken over by the transferee. If such arrangement exists, only the transferor and not the transferee can claim a deduction for irrecoverable trade debts before such debts are taken over by the transferee.

The transferee who has taken over the trade debts will not be allowed to claim deduction for the debts which are subsequently bad and irrecoverable.

Therefore, in any business transfer or company reconstruction, the transferor should ensure that reasonable specific provisions are made for all bad and irrecoverable trade debts and claim a tax deduction before the business is transferred or sold together with the debtors. It must be emphasized the revenue authorities do not allow any deduction for bad or doubtful debts of a discontinued business or trade.

C. Transfers of industrial buildings and structures

A person who incurs capital expenditure on an industrial building structure is entitled to claim industrial building allowance on the qualifying capital expenditure.

In Singapore, the industrial building allowance granted as initial allowance is 25 per cent of the qualifying capital expenditure and the annual allowance is 3 per cent.

In Malaysia, the current rates of the initial allowance and the annual allowance are 10 per cent and 2 per cent respectively.

2. [Malaysia: Sec. 35(5)] Sec. 35(5) provides as follows:
S.35(5) "Where during the relevant period the relevant person permanently ceases to carry on the business, then
(a) if –
  (i) at or about the time he so ceases any of what was the stock in trade of the business is sold or transferred for valuable consideration by that person to another person and that other person intends to use that transferred stock in the business or in another business of his; and
  (ii) the cost of that transferred stock to that other person is deductible as an expense in computing that other person's adjusted income for the basis period for a year of assessment from the business or from that other business of his,
  the value of that transferred stock at the time he so ceases shall be taken to be an amount equal to the price paid on the sale or to the value of the consideration, as the case may be, and shall be taken to be the value of the stock at the end of the relevant period;
(b) the value of any of what was at the time he so ceases the stock in trade of the business to which paragraph (a) does not apply shall be taken to be an amount equal to its market value at the time he so ceases and shall be taken to be the value thereof at the end of the relevant period;
(c) for the purposes of paragraph (a) –
  (i) where any of the stock in trade is sold or transferred for a consideration in cash or its equivalent with other assets of the business, the total consideration given for that transferred stock in trade and those assets shall be apportioned in such manner as is just and reasonable;
  (ii) where any of the stock in trade is transferred (with or without other assets) for a consideration other than cash or its equivalent, the value of the consideration shall be taken to be an amount equal to the market value of the consideration at the date of the transfer and, if that stock in trade is transferred with other assets, that amount shall be apportioned in such manner as is just and reasonable; and
  (iii) where any of the stock in trade is transferred (with or without other assets) for a consideration which partly does and partly does not consist of cash or its equivalent, the value of the consideration shall be taken to be an amount equal to that cash or its equivalent together with the market value of the rest of the consideration and, if that stock in trade is transferred with other assets, that amount shall be apportioned in such manner as is just and reasonable; and
(d) where any stock in trade is sold or transferred to another person in a case to which paragraph (a) applies, the cost to that other person of that stock in trade shall in computing the adjusted income of that person from the business (or from any other business of his in which he uses or intends to use any of that stock in trade) be taken to be an amount equal to its value as ascertained under that paragraph.

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However, when there is a change in the ownership of an industrial building or structure, the buyer or the new owner is entitled to only the annual allowance for the remaining years of the tax life of the building or structure. The annual allowance for the new owner is computed by reference to the residue of expenditure immediately after the transfer.

The transfer of ownership of an industrial building would also give rise to a balancing allowance or charge which is the difference between the sale proceeds (or the consideration for the transfer) *and* the residue value of the industrial building or structure.

D. Transfers of plant and machinery

Balancing allowances or charges arise when plant or machinery is disposed of or ceases to be used for the trade or business.

The amount of balancing allowance or charge is computed by reference to the sale proceeds and the tax written down value of the assets disposed of.

If the asset is transferred or sold at a price below market value, the Singapore Comptroller of Income Tax may invoke the power under Section 20(6) of the Income Tax Act and apply the "open-market price" for the purpose of computing the balancing allowance or balancing charge.

"Open market price" means the price which the machinery or plant would have fetched if sold in the open market. If the nature of the plant or machinery is so special that the Comptroller is unable to determine an open-market price, he may adopt such other value as he deems reasonable.

If the seller and buyer are associated persons, they may elect the option under Section 24 to avoid computing balancing allowances and charges for the seller. However, such transaction must not be solely for tax benefit, otherwise the provisions of Section 33 of the Income Tax Act of Singapore aiming at anti-avoidance may be invoked by the Comptroller, who will disregard the transaction and make such adjustments as he deems necessary.

If Section 24 provision is elected, the consideration for the sale would be an amount equal to the tax written-down-value of the asset disposed of or transferred. No initial allowance will be granted to the buyer.

The buyer will continue to claim the annual allowance as if no sale had taken place.

The buyer, however, will be subject to balancing adjustments on the subsequent disposal of the asset transferred to him under Section 24.

The Income Tax Act of Malaysia in Section 140 embodies similar anti-avoidance provisions. The Director-General of Inland Revenue will invoke Section 140 where an agreement or an arrangement has the direct or indirect effect of:

(i) altering the incidence of taxation;
(ii) relieving any person from any liability to pay tax or make a return;
(iii) evading or avoiding any duty or liability which is imposed on any person under the Income Tax Act; or
(iv) hindering or preventing the operation of the Income Tax Act in any respect.

The Director-General has the power to disregard the transaction and make such adjustments as he thinks fit with a view to counter-acting the whole or any part of such direct or indirect effect of the transaction.

E. Trading losses

According to the provisions of the Income Tax Act in Singapore, where the corporate reconstruction involves a substantial change in the shareholding of the reconstructed company, the accumulated trade losses carried forward will not be available for set-off against the future profits of the company.

To qualify for claiming deduction for losses carried forward, a company must satisfy the condition that its shareholders on the last day of the year in which the loss was incurred were substantially the same as its shareholders on the first day of the year of assessment in which the deduction is claimed – Section 37(5) of Singapore's Income Tax Act.

Section 37(8) empowers the Minister to exempt a company from the shareholders continuity requirement if he is satisfied that the change of shareholders was not for the purpose of gaining tax benefit.

Exemption may be given by the Minister where he is satisfied that the substantial change of shareholding is due to nationalization or privatization or due to shares of a public listed company being traded on the Stock Exchange.

For the purpose of Section 37(5) in respect of shareholders continuity, the shareholder of a company at any date shall not be deemed to be substantially the same as the shareholders at any other date unless, on both those dates, not less than 50 per cent of the paid up capital of the company was held by the same persons.

Presently the shareholders continuity requirement is not applicable in Malaysia.

F. Unabsorbed capital allowances

1. Singapore

According to the provisions of the Income Tax Act, where corporate restructuring involves the permanent cessation of a business and a substantial change in the shareholding of the restructured company or a change in the business, unabsorbed capital allowances carried forward will not be available for set-off against future profits of the company.

To qualify for claiming unabsorbed capital allowances, a company must satisfy the condition that its shareholders on the last day of the year in which the allowances arose were substantially the same as the shareholders on the first day of the year of assessment in which such allowances would be claimed – Section 23(2).

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Section 23(2A), however, empowers the Minister to exempt a company from the shareholders continuity requirement if he is satisfied that the change in the shareholding is not for the purpose of deriving a tax benefit or obtaining any tax advantage.

Exemption under Section 23(2A) may be given where the Minister is satisfied that the change of substantial shareholding is due to nationalization or privatization of a government-owned enterprise or due to the shares of a public listed company being traded on the Stock Exchange.

For the purpose of Section 23(2) in respect of shareholders continuity, the shareholders of a company at any date shall not be deemed to be substantially the same as the shareholders at any other date unless, on both those dates, not less than 50 per cent of the paid up capital of the company was held by the same persons.

In Malaysia, there are no similar provisions for continuity of shareholding requirement for carrying forward of unutilized capital allowance.

2. Malaysia

According to the provisions of the Income Tax Act, capital allowances which cannot be fully utilized may be carried forward for set-off against adjusted profit of the same business source arising in future years.

There is no time limit for claiming the unabsorbed capital allowances. The only restriction is that the allowances should only be used to set off against the adjusted profit of the same business for the next period and so on until the allowances have been absorbed in full.

The capital allowances in respect of one business are not allowable in calculating the statutory income from some other business. Therefore if a business ceases permanently and an amount of capital allowances remains unrelieved, such unabsorbed capital allowances will be lost forever. (Paragraph 75 of Schedule 3 to the Income Tax Act).

In the case of *DGIR v. ALB Co Sdn Bhd*, it was held that capital allowances in respect of one business source cannot be taken into account when computing the income from another business source.

G. Section 44 credit balances (Singapore)

Every company resident in Singapore is required to deduct from the amount of dividend paid to its shareholders tax at the rate of 26 per cent.

A company will be regarded as being resident in Singapore if the control and management of its business is exercised in Singapore.

A company may frank the dividend payment by using the tax previously assessed and paid. The tax assessed and paid and the dividend payment are respectively credited and debited to an account, known as the Section 44 account. Any credit balance in this account will be available for franking further dividend payments.

Upon liquidation, any Section 44 credit balance, which is not utilized to frank dividend payments before winding up, would be lost.

However, where a corporate reconstruction does not involve the dissolution of a company, the Section 44 credit balance will be maintained and is available for franking dividends payable to shareholders.

H. Section 108 credit balances (Malaysia)

Every company resident in Malaysia is required to deduct from the dividend paid income tax at a rate of 30 per cent. Only a company which is resident in Malaysia can declare Malaysian dividends.

A company which is resident in Singapore but derives income from Malaysia must declare itself a resident of Malaysia when paying Malaysian dividends out of Malaysian income.

The dividend franking credits of a Malaysian company are recorded in the Section 108 account. The tax paid and the dividend payment are respectively credited and debited to this account. Any credit balances in this account will be available for franking further dividend payments.

I. Stamp duty implications

Stamp duty is another important issue for entrepreneurs' to consider when tax planning for mergers or acquisitions.

Section 15 of the Stamp Duties Act in Singapore provides relief from stamp duties on transfer or sale of assets or shares where there is a scheme for the reconstruction or the amalgamation of one or more companies. For such relief, certain conditions must be satisfied. Briefly the conditions are:

- the transfer of shares as part of a share-for-share exchange;
- shares are not transferred for cash;
- non-share or cash consideration shall not exceed 10 per cent of the consideration.

In Malaysia, there are similar provisions for relief from stamp duties. The conditions to be satisfied are also similar.

IV. CONCLUDING REMARKS

In any corporate restructuring, it is important to ensure that all legislative requirements are complied with and that any merger or acquisition is not contrary to government policy.

Effective tax planning is usually one of the many important considerations for corporate restructuring. However no schemes should aim at maximizing tax benefits as the only objective. Whilst minimizing tax is important care must be taken not to invite the Revenue authorities to invoke the anti-avoidance provisions.

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The Listing Manual of the Stock Exchange

Conference diary

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

MARCH

European Branch Conference, Paris, France, 20 March 1998 (English):

The Chartered Institute of Taxation, Paul Connolly, Barclays Capital, Group Taxation, 5 The North Colonnade, Canary Wharf, London E14 4BB, the United Kingdom, Tel.: 44-171-773 2876, Fax: 44-171-773 4823, E-mail: post@ciot.org.uk

US Taxation of Corporate Reorganisations, London, the United Kingdom, 24-25 March 1998 (English):

The European-American Tax Institute, Falmer Court, London Road, Uckfield, East Sussex TN22 1HN, the United Kingdom, Tel.: 44-1825 760901, Fax: 44-1825 760903.

Leasing in Russia and a Review of Leasing Developments in Ukraine and Central Asia, The Renaissance Penta Vienna Hotel, Vienna, Austria, 25-26 March 1998 (English):

Business Seminars' International Ltd, Tanya Smirnov or Jessica Pumphrey, London, the United Kingdom, Tel.: 44-171-490 3774, Fax: 44-171-490 8932.

Trusts '98, The Westbury Hotel, London, the United Kingdom, 25-26 March 1998 (English):

EuroForum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

Tackling Customs and VAT in CEE and Russia, Sheraton Hotel, Warsaw, Poland, 25-27 March 1998 (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

Transfer Pricing and Controlled Foreign Companies, Hyde Park Hotel, London, the United Kingdom, 30 March 1998 (English):

IBC UK Conferences Limited, Gilmoora House, 57/61 Mortimer Street, London W1N 8JX, Tel.: 44-171-637 4383, Fax: 44-171-453 2036, E-mail: jennifer.mansour@ibcuk.co.uk

Optimising Tax, Regulatory and Accounting Strategies for Investing and Trading in Central and Eastern Europe, London, the United Kingdom, 30-31 March 1998 (English):

Risk Publications, 104-112 Marylebone Lane, London, W1M 5FU, the United Kingdom, Tel.: 44-171-487 0707, Fax: 44-171-487 0715, E-mail: conf@risk.co.uk

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TREATY NEWS

Prof. Dr Klaus Vogel

AMENDMENTS TO THE OECD MODEL TAX CONVENTION

In mid-December by way of a new instalment to its loose-leaf oeuvre on tax treaties OECD published the amendments to the Model Treaty and Commentary which had been adopted by the OECD Council on 23 October 1997. Moreover, a second loose-leaf binder was added to the work containing materials of importance for treaty interpretation.

To strengthen the influence of the Commentary on treaty application the Council's resolution recommended to the governments of the OECD member countries "that their tax administrations follow the Commentaries on the Articles of the Model Tax Convention, *as modified from time to time*, when applying and interpreting the provisions of their bilateral tax conventions that are based on these Articles" (emphasis added). The provision refers to the question, hitherto controversial, to what extent changes of the Commentary affect the interpretation of treaties which were concluded before those changes were made: tax administrations are "recommended" to follow the new version even if it differs from the position adopted by the Commentary at the time when the treaty was concluded.

This recommendation may bring administrations into conflict with the treaty as implemented by their domestic law. As a rule, the view expressed by the Commentary at the time of a treaty's conclusion will establish the "ordinary meaning" – or, if one prefers this, a "special meaning" – of a treaty term in the sense of Article 31 paragraph 1 resp. paragraph 4 of the Vienna Convention on the Law of Treaties. Therefore, it will determine the treaty's interpretation even if the Commentary is changed at a later time.

An amendment to the Commentary can affect the domestic application of an existing treaty only if the law of the country in question permits domestic legislation (including treaties that have been implemented) to refer to rules of an external document like the OECD Commentary and to include in this reference future modifications of that document. Such "ambulatory" reference is a delegation of legislative power to the body which decides on those modifications, in the present case to the OECD Council. The constitutions of most countries will not admit such delegation. To the extent, however, that the "ambulatory" reference to the Commentary is not admitted, the administration remains bound to the treaty as interpreted by the former version of the Commentary and so are the courts (see Vinelott, J., in *Sun Life Assurance v. Pearson*).

The present amendments to the text of the Model Convention are for the most part, if not exclusively, clarifications. Article 4 (1) as amended establishes expressly and in general terms that contracting states and their political subdivisions as well as local authorities are residents under the treaty. That states are residents of themselves does not seem logical, but it is consistent. A more specific application of the same rule in Article 11(5) was consequently deleted (by the way: without mentioning this deletion in the paragraph describing the history of the provision). In the tie-breaker rule of Article 4(2)(a) after "resident" the word "only" was inserted thus emphasizing that the taxpayer in question shall not be considered at the same time to be a resident of another state. In Article 12(1) "Royalties ... paid to a resident ... if such resident is the beneficial owner of the royalties" was replaced by "Royalties beneficially owned by ...". Here the new wording eliminates doubt in cases where the royalty is paid to an intermediary, e.g. a bank, which even may be a resident of a third state, but where the "real" recipient is entitled to treaty protection. On the other hand the new wording may be misleading by not mentioning payment any more in contrast to Articles 10 and 11 which are structured identically to Article 12. One might be induced to suspect that this difference is of material significance which indeed it is not. Rather, the new version of Article 12(a) like the former one applies as well to constructive royalties deemed to be paid in cases of transfer pricing. Finally, the insertion of the words "in particular with respect to residence" in Article 24(2) parallel to Article 24(1) again is only of a clarifying character.

In a similar way, many of the amendments to the Commentary are only of minor or no importance being just stylistic improvements, clarifications or new observations and reservations of the OECD member countries. The more important include: two comments regarding the taxation of associated enterprises, a topic with respect to which the Commentary in addition refers to the OECD Guidelines on transfer pricing; further, a few explanations regarding employment income, director's fees and remuneration for government service, in particular a clarification that benefits in kind are included under those articles; finally, a small but interesting addition to a provision which the Commentary suggests to states that want to secure equal treatment for proceeds received by a permanent establishment from sources in third countries.

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Moreover, in the introduction to the Model the OECD Committee on Fiscal Affairs reaffirms its position that a multilateral convention involving all OECD member countries would at the present time not be practicable.

The newly added second folder contains, firstly, comments on the Model Tax Convention by a number of non-OECD countries. These comments, called "positions", are mainly reservations, some of them observations. They may be of considerable importance in interpreting treaties concluded with the states that made these comments, viz. Argentina, Belarus, Brazil, China, Estonia, Israel, Latvia, Lithuania, Malaysia, Philippines, Romania, Russia, Slovak Republic, South Africa, Thailand, Ukraine and Vietnam. Secondly, 13 previous OECD reports are included in the folder which were published separately from 1982 to 1993, but are out of print meanwhile. The main results of those reports were later included in the Commentary, but their extensive reasoning is still of importance. Therefore, it is good that they have been reprinted.

RECENT TREATIES

Countries	*Date of Conclusion*
Mauritius–Thailand	1 October 1997
Nordic Convention (protocol)	6 October 1997 (in force 31 December 1997; effective 1 January 1998)
China–New Zealand (protocol)	7 October 1997
Ireland–South Africa	7 October 1997
Argentina–Norway	8 October 1997
Kyrgyzstan–Ukraine	15 October 1997
Estonia–France	28 October 1997
Norway–Venezuela	29 October 1997
Australia–Finland (protocol)	5 November 1997
Ireland–Latvia	13 November 1997
Bulgaria–Kazakstan	13 November 1997
Canada–Vietnam	14 November 1997
Armenia–Georgia	18 November 1997
Ireland–Lithuania	18 November 1997
Czech Republic–Singapore	21 November 1997
Germany–Kazakstan	26 November 1997
Georgia–Turkmenistan	5 December 1997
Armenia–France	9 December 1997
Canada–Croatia	9 December 1997
Georgia–Romania	11 December 1997
Egypt–Yemen	12 December 1997
Estonia–Ireland	16 December 1997
Falkland Islands–United Kingdom	17 December 1997 (in force 18 December 1997; effective 1 January 1997 (FI); 1/6 April (UK))
Norway–Singapore	19 December 1997
Russia–Turkmenistan	14 January 1998
Estonia–USA	15 January 1998
Latvia–USA	15 January 1998
Lithuania–USA	15 January 1998
Canada–Chile	21 January 1998
Belarus–Yugoslavia (Fed. Rep.)	23 January 1998

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TOWARDS A NEW UN MODEL?

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THE EIGHTH MEETING OF THE AD HOC GROUP OF EXPERTS: WHAT HAD GONE BEFORE

The Ad Hoc Group of Experts on International Cooperation in Tax Matters met in Geneva from 15 to 19 December 1997. The Group meets once in every two years and this was its eighth meeting since the publication of the UN Model in 1980. Revising and updating the UN Model and Commentary is seen by the Group as its primary mission.

The Group was set up in 1968 by the Secretary General of the United Nations[1] to investigate ways and means of facilitating the conclusion of tax treaties among developing countries. Today it consists of 24 tax officials and experts, both from developed and developing countries and representing a variety of regions and tax systems.[2] Although the Group looks after the interests of developing countries, only a few of them are represented there. Members are nominated by their governments, but act in their personal capacity. They are not bound by a mandate of their government, nor can they commit their government in any way.

Observers are usually invited to attend in order to enhance the potential of the Group. Observers may participate in the discussions but they do not have a right to vote. For the eighth meeting the Secretariat invited more than 50 observers from 22 countries,[3] the leading international organizations[4] and a number of universities.[5]

The following subjects were on the agenda of this meeting:
(a) updating of the UN Model and the Manual for Negotiation of Bilateral Tax Treaties;
(b) new financial instruments;
(c) transfer pricing; and
(d) tax havens, with special reference to exchanges of information.

The highly specialized points (b), (c) and (d) are also the subject of continuous and thorough study by the OECD. The general question submitted to the Group was whether the position of developing countries is sufficiently different to warrant the development of specific rules and guidelines in these areas.

This agenda was largely identical with the agenda of the Group's seventh meeting in December 1995. As very little progress was made in 1995, a steering committee was appointed to prepare the specialized subjects in order to make them suitable for a productive discussion in such a large group. The steering committee was convened by the Secretariat on 11 and 12 December 1997, two days before the Group's general meeting.

As for the 1995 meeting many papers were prepared for the 1997 meeting, some by the Secretariat and some by outside consultants at the request of the Secretariat.[6] These papers, amounting to approximately 550 pages, were not distributed to the participants until shortly before the meeting.

1. See Resolution 1273 (XLIII) of the Economic and Social Council of the United Nations.
2. They come from the following countries: Argentina, Brazil, Burkina Faso, People's Republic of China, Côte d'Ivoire, Egypt, Finland, France, Germany, Ghana, Israel, Jamaica, Morocco, Netherlands, Nigeria, Pakistan, Palestine, Spain, Switzerland, United Kingdom and United States.
3. Australia, Barbados, Belgium, Brazil, Cameroon, Canada, Chile, People's Republic of China, Denmark, Gabon, Guinea, Guyana, Israel, Jamaica, Jordan, Mali, Malta, Niger, Palestine, Russian Federation, Senegal and Sri Lanka.
4. *Inter alia*, the OECD, Caribbean Organisation of Tax Administrators (COTA), l'Association de Planification Fiscale et Financière (APFF), Commonwealth Association of Tax Administrators (CATA), Inter American Center of Tax Administrators (CIAT), International Chamber of Commerce (ICC), International Fiscal Association (IFA), International Bureau of Fiscal Documentation (IBFD), International Association of University Presidents (IAUP).
5. *Inter alia*, University of Valencia (Spain), University Santa Maria (Venezuela).
6. This concerns the following papers:
- A draft for an update and revision of the UN Model and its Commentary prepared by L. Lokken (225 pages);
- "United Nations Model in practice", a paper to assess the impact of the UN Model on current tax treaty practice prepared by W.F.G. Wijnen and M. Magenta (31 pages) and published in 51 *Bulletin for Fiscal Documentation*, 12 (1997);
- "Issues raised by the use of tax havens, with particular reference to the obtaining of information concerning tax haven transactions by tax authorities of other countries" prepared by D.R. Tillinghast (10 pages);
- "Taxation of derivatives and new financial instruments" prepared by L. Lokken (40 pages);
- "The globalization of capital markets" prepared by the Secretariat of the UN (10 pages);
- "The taxation of international income in developing countries" by the Secretariat of the UN (11 pages);
- "Review of the tax treaties between developing countries: a comparison with the UN Model" prepared by S. Crow (16 pages);
- "Tax Havens: the need to neutralize their distorting effects in the international context", prepared by A. Atchabahian (10 pages);
- "1996 Update to the OECD Report Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" prepared by the OECD (35 pages);
- "Transfer pricing and arm's length principle: Nigeria's experience" prepared by J.A. Arogundade (7 pages);
- "Comments on the revision of the UN Model Tax Convention and its commentaries prepared by Sun Yugang (5 pages);
- "Proposals about amendments to be introduced into the UN Model" prepared by A.H. Figueroa (15 pages);
- Descriptions of the 1994, 1995 and 1997 Updates to the UN Model Tax Convention" prepared by the OECD (10 pages);
- "The 1996 and 1997 Updates to the transfer pricing guidelines for multinational enterprises and tax administrations" prepared by the OECD (47 pages);
- "Innovative financial transactions: tax policy implications" prepared by the OECD (40 pages);
- "The UN Model Convention: Revision or Reform" prepared by l'Association de planification fiscale et financière (APFF) (6 pages);
- "Prevention of use and abuse of tax havens: exchange of information" prepared by A. Garcìa Prats (26 pages).

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THE RESULTS OF THE EIGHTH MEETING

The results of the eighth meeting are recorded in the minutes approved by the Group during its final session. These minutes are reproduced in their entirety below. (The article is continued after the report.)

REPORT OF THE AD HOC GROUP OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS ON THE WORK OF ITS EIGHTH MEETING

I. TAX HAVENS, WITH SPECIAL REFERENCE TO EXCHANGES OF INFORMATION

The subject of tax havens was introduced by the Secretariat, which noted that tax havens are threats to the tax systems of both developed and developing countries. Tax havens compromise the principle of tax neutrality because they cause tax considerations to inappropriately affect investment choices. Techniques were described that have been adopted by many countries as defences against tax haven activities, including controlled foreign corporation and foreign investment funds legislation. Bank secrecy and confidentiality rules in tax havens make it difficult for other countries to uncover tax fraud and other illicit activities, and some tax havens, not wishing to be viewed as having complicity in illicit activities, have agreed to exchange some tax information.

The Group of Experts generally agreed that the tax haven issue should not be viewed as developed countries against developing countries because developing, as well as developed, countries are injured by tax haven activity. An observer noted that the tax haven problem is worse now than it was five years ago and will probably get still worse because Internet commerce and electronic banking make it ever easier to move funds into tax havens, which, among other things, has made the use of tax havens feasible for people with only modest wealth.

The discussion of the topic began with an effort to define the concept of tax haven. One member suggested that, very broadly, any aspect of a country's laws or practices that is subversive of other countries' tax regimes could be considered a tax haven characteristic. Several speakers pointed to two basic features of tax havens: minimal or no tax on at least some types of income and lack of effective access to, and exchange of, tax information. A member and an observer elaborated further on these elements, summarized as follows:

1. Low or zero effective tax rate.
2. An unwillingness to make information available.
3. A lack of transparency.
4. Absence of real business activity.
5. In the case of a haven regime within a country with an otherwise acceptable tax system, a separation of the special regime from the domestic economy (a "ring fence").

The presence of more than one of these characteristics is a good indicator of a tax haven.

A. Low or no tax

Several members of the Group suggested that it is the effective rate of tax, not the nominal rate, that determines whether a country has the low-or-no-tax characteristic of a tax haven. A country with high nominal income tax rates may nevertheless be a tax haven with respect to some investments if it has special exemptions or allowances that reduce the effective rate of tax on income from particular types of investments, although some believe that it is not appropriate to label a country a tax haven merely because it has different tax regimes for different types of income. Moreover, the crucial factor is the practical application of the law, not the nominal terms of the law. In some countries, unpublished rulings are given that substantially erode the tax base, tax rates are varied by private negotiation, or the law may simply not be enforced as written. Such a lack of transparency – a policy of applying the law differently in practice from how it is stated in publicly available documents – is one of the most troublesome tax haven practices.

However, several members suggested that a country's failure to tax all income of all locally organized entities should not in all cases be considered a tax haven characteristic. For example, a country should not be considered a tax haven merely because it grants tax holidays or other concessions as means of attracting foreign investments to finance real economic activities within the country. Also, a country is not a tax haven merely because its overall policy on taxing business income is to impose tax at a low rate on a broad tax base. Moreover, exemptions and other reliefs given only as means of avoiding double taxation should not mark a country as a tax haven.

In response, it was suggested that the distinguishing characteristic of a low-or-no-tax haven is that the tax haven facilitates the avoidance of taxation worldwide on income from sources in other countries. Under this view, the characteristic of a tax haven is the ability to shift funds to that country's tax jurisdiction without shifting economic activity to the country.

Some members of the Group believed that even this conception of tax haven is too broad because it would classify as tax havens all countries with territorial tax systems and some exemptions intended only as relief from double taxation might be considered tax haven provisions by this view.

However, the Group reached consensus that lack of transparency is an invidious tax haven characteristic.

Several members of the Group noted that although the use of tax incentives to attract investment into a country should not be considered a tax haven characteristic, tax competition among countries for investment is often unhealthy, and this competition might usefully be considered by the Group on another occasion.

B. Information exchange

The Group quickly reached consensus that lack of access to tax information was a tax haven characteristic. This lack of access may derive, for example, from bank secrecy laws,

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other laws protecting the confidentiality of financial information, or laws facilitating the insurance of bearer shares and bonds.

It was also agreed that the best way to provide access to tax information is through tax treaties with provisions for information exchanges or separate international agreements on information exchanges. These provisions should deal explicitly with any bank secrecy laws of either country. It was suggested that countries with extensive experience in information exchanges should provide tools to help countries with less experience initiate exchange programmes. An additional approach is to urge countries to abandon laws and practices that are harmful to the tax systems of other countries.

It was pointed out that some countries have had some success in obtaining information on transactions in tax havens by indirect means. For example, if a country's laws require resident individuals and corporations to disclose to the tax administration all records and documents in their possession, including material kept outside the country, these laws may sometimes be used to obtain records on tax haven transactions. Also, a tax administrator's power to compel the production of documents may be extended to a foreign parent corporation of a domestic subsidiary corporation. Moreover, a taxpayer, particularly if accused of a tax crime, could be ordered by a court to waive secrecy rights under the laws of a tax haven country. If the taxpayer deals with banks having branches in the taxing country and in various other countries, the tax administrator may be able to compel the bank to produce records on transactions of branches in other countries, including tax havens. Finally, courts in non-haven countries may refuse to accept the defence that a disclosure of tax information would violate the criminal laws of a tax haven.

Some members of the Group from developing countries observed that although techniques such as these may be effective for large developed countries with great economic power and highly developed legal systems, they may be less practical for smaller countries, particularly developing countries.

II. INNOVATIVE FINANCIAL INSTRUMENTS

The subject of derivatives and other financial instruments was introduced by the Secretariat. It was pointed out that all financial instruments consist of or are constructed from three basic building-blocks: financial assets (stocks and bonds); options; and forward contracts. Options come in two forms: options to buy (call options) and options to sell (puts). A person may be either the holder of an option (the person entitled to buy or sell) or the writer of the option (the person required to honour the holder's right to buy or sell). Because the obligation is not reciprocal, the holder usually pays a premium to the writer when the option is issued. A forward [contract] is an agreement whereby one person agrees to buy designated property at a specified future date for a specified price and the other person agrees to sell. Because the obligations under a forward contract are mutual, no money changes hands when a forward is made if the contract price is the market forward price at that time. A futures contract is a type of forward that is traded on an organized exchange and subject to the rules of the exchange, which usually require that the contract be marked to market by an interim settlement each day. Options and forwards are called derivatives because their values fluctuate with the values of the underlying property, but they do not directly represent an ownership in that property.

Most countries are now in the process of developing their domestic rules for financial assets and derivatives. In doing so, it is important that the rules for various types of instruments be as consistent with each other as is possible. Because an option or forward contract economically duplicates (or is the opposite of) all or a portion of the ownership of the underlying property, it is possible, by combining derivatives or financial assets and derivatives, to achieve the economic equivalent of ownership of the property or any desired portion of the ownership. Thus, if the rules for the three types of building blocks are not fully consistent, taxpayers using derivatives for legitimate business reasons (principally, to manage risk) may find these uses upset by asymmetrical tax treatments, and other taxpayers will exploit these discontinuities to the detriment of tax revenues. Unfortunately, complete consistency is not practicably achievable because derivatives blur the lines between capital gains and other income, realized and other gains, dividends and interest, and various other categories commonly used in tax laws. Thus, a tax law could completely eliminate the asymmetries and arbitrage opportunities that derivatives facilitate only by eliminating all of these categories and simply imposing tax on net accretions to wealth, an approach that is only theoretical and not practicable. The objective thus must be to achieve consistency to the extent practicably achievable, recognizing that derivatives threaten all categorizations in a tax law affecting financial transactions and holdings.

According to the Secretariat, those who have studied the matter have generally agreed that income from cross-border derivative transactions can feasibly be taxed only on a residence basis and that withholding taxes at source on payments under such derivatives are not practical, if even theoretically appropriate. Derivatives transactions often exploit thin margins between prices available in different markets. For example, it may be possible for a person to borrow money at a variable rate, enter into an interest rate swap to exchange the variable rate obligation for a fixed rate obligation, and wind up with an interest obligation at a rate marginally lower than could have been obtained by borrowing directly at a fixed rate. However, the difference is usually very small. Even a small withholding tax (e.g. 5 per cent of the taxpayer's payments under the swap agreement) is likely to be larger than the margin exploited by the transaction. If so, the result of the withholding tax is that the transactions will not occur, and no withholding tax will be collected.

A representative of the OECD spoke of that organization's work on financial instruments. He noted that although the concept of derivatives is very old, the use of derivatives has grown greatly in recent years because of the globalization of financial markets and because of the financial risks (principally, currency and interest risks) that businesses increas-

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ingly encounter in international commerce. He further noted that a withholding tax on cross-border payments under derivatives simply causes derivatives transactions subject to the tax not to occur. Usually, the result is that the transactions move offshore and residents devise ways of participating in the offshore markets without incurring the withholding tax (e.g. through the use of offshore subsidiaries). Other observers confirmed that the experience of several countries has been that withholding taxes generally cannot be imposed at source on derivatives transactions.

Several members of the Group agreed that payments under cross-border derivatives transactions should not, as a general rule, be subject to withholding taxes. However, some members from developing countries noted that income tax treaties made by developing countries, following the United Nations Model, are generally based on the premise that the countries of source and residence should share tax jurisdiction over income from cross-border transactions; these members questioned whether this policy should not also be followed for derivatives transactions. In response, it was suggested that while such a sharing is appropriate where the income economically derives from the source country, the country from which a cross-border derivatives payment emanates is not usually the economic source of any income other than that reported on a residence basis by the payer. For example, if a business in country A enters into a swap with an investment bank in country B, the bank makes no investment in country A, but instead earns its income under the swap from activities and capital located in country B; payments by the country A business to the bank thus do not include any income of the bank from country A sources. If country A taxes all income of the country A business on a residence basis, it taxes all income from the transaction that originates in that country. One member of the Group made an analogy to cross-border sales of physical goods, where, if the seller carries on no activities in the buyer's country, no portion of the seller's income on the sale is considered to be from sources in the buyer's country. It was also noted that 1995 additions to the Commentaries to the OECD Model Double Taxation Convention clarify that because an interest swap is not a debt claim, payments under the swap are not subject to the interest article of the Convention.

The OECD representative noted that source taxation of derivatives is, however, appropriate in some circumstances. For example, if a derivatives transaction is made at arm's length, but at a price differing from the market price, a payment is made from one party to the other to compensate for this divergence; this payment may have the economic effect of a loan, the implicit interest on which may appropriately be taxed as such. Also, when derivatives contracts are made between related persons, the pricing may not be at arm's length, and withholding taxes on the excess payments may be appropriate. UK legislation on derivatives contains three anti-abuse rules directed at these and other transactions, including a rule that a derivatives transaction with a tax haven country is presumed not to be at arm's length. The United States also has rules to ensure that derivatives transactions do not inappropriately avoid withholding and other taxes. A 1995 addition to the Commentaries to Article 21 of the OECD Model suggests a provision that might be added to the article to ensure that the article does not inappropriately exempt income from derivatives contracts not at arm's length.

An observer noted that double taxation can result if a financial instrument is classified differently by two countries (e.g. if one country treats a swap as including an embedded loan and another finds no embedded loan). It was noted that the OECD has recognized the problems of inconsistent classification and is working on developing solutions to these problems.

Several members noted that the time was not ripe for the Group to be making recommendations on this subject and that the purpose of the discussion of the subject at this meeting should be considered to be an exchange of information. It was suggested that all countries are still on the learning curve on this subject.

III. TRANSFER PRICING

The subject of transfer pricing was introduced by the Secretariat. It was noted that, at the international level, transfer pricing has become a matter of concern to all countries, but efforts by tax administrations in this area have steadily evolved over the decades. The United States, which subsequently took a leading role in the development of transfer pricing rules, did not often question reported transfer prices in international transactions until the 1960s. After four years of deliberation, extensive transfer pricing regulations were issued by the United States in 1968, which confirmed the arm's length principle as the basic guide and elaborated on the application of that principle. In 1979, the OECD issued transfer pricing guidelines, which were generally consistent with the US regulations but put forward additional considerations. During the late 1980s and early 1990s, the US Treasury undertook an extensive revision of its transfer pricing regulations, which culminated in the issuance of new regulations in 1993 and 1994. The latter stages of the development of the new regulations was contemporaneous with the OECD's revision of its transfer pricing guidelines, which led to the issuance of new Guidelines in 1995 and the supplementation of the Guidelines 1996.

Transfer pricing distortions often arise from the desire to minimize taxes, but other factors can also be the source of the distortions. For example, political factors within a large corporation may cause income to be shifted artificially to favoured divisions, and some multinational corporations have shifted income away from foreign subsidiaries and to the parent corporation, principally to enhance the ability of the parent's management to control the funds.

The Group recognized that transfer pricing is a multilateral problem and that an international consensus is needed in dealing with it. The Group acknowledged that the arm's length standard is the base on which that consensus must rest. However, it noted that the arm's length principle is not easy to apply, and that nearly all of the detailed elaboration in the US regulations and the OECD Guidelines is an effort to meet

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the difficulties of applying this standard. One member of the Group suggested that these difficulties were especially great for developing countries because, given the limited markets in many types of goods and services, comparable prices often were not available. For example, in dealing with oil companies, world prices for oil can be used for transfers of oil, but comparables can generally not be found to test payments for services made by local corporations to their foreign parents and other affiliates. Members from developing countries suggested that all countries encounter these problems. However, an observer from a developing country noted that developing countries have special difficulty in gathering the administrative resources necessary to audit transfer prices.

It was suggested that because cross-border payments always involve at least two countries, cooperation and exchanges of information among countries was a key to managing transfer pricing problems.

Some developing countries have experimented with alternatives to the arms's length principle. A few countries have rules presuming a certain level of net income from particular activities. Other countries have enacted assets taxes, which are premised on the idea that net income can reasonably be expected to be at least a certain percentage of the taxpayer's investment and that a tax imposed on net asset values can reasonably approximate the effects of the income tax (e.g. one third of the expected return on net assets if the income tax rate is 33 per cent). The income tax may be allowed as a credit against assets tax, in which case the assets tax effectively functions as an alternative minimum tax. Members of the Group suggested that in some situations, especially those of companies with losses, these substitute mechanisms could result in excessive taxation and that the taxes may not be creditable in the taxpayer's home country. It was therefore suggested that, rather than resorting to these substitutes, countries should be encouraged to develop their abilities to apply the arm's length principle.

Over the last five years, several countries, beginning with the United States, have developed procedures for advance pricing agreement (APAs). These procedures have been received by the business community with some hesitation. An observer noted that, in his country, businesses have been afraid that information disclosed in the course of obtaining APAs would be used by the tax administration in auditing the businesses for prior years. This fear has been somewhat alleviated by assurances that the information would be so used only in cases of blatant abuse. It was observed that the APA procedure is time consuming, and the costs of formulating APAs are substantial for both the tax administration and taxpayers. Moreover, an effective APA programme can only be administered by a trained and specialized staff. However, these costs and staffing requirements are usually substantially less than the costs of an audit after the fact, particularly if the audit leads to litigation.

The members of the Group generally agreed that lack of expertise and resources was a major problem in the transfer pricing area for developing, and some smaller developed, countries. One possible solution to this dilemma was the creation of one or more multilateral organizations that would assist in auditing companies jointly on behalf of the member countries. This proposal was not considered by the Group.

One member of the Group suggested that a multinational arbitration framework was needed to aid developing countries in resolving transfer pricing issues and that the United Nations should assist developing countries in organizing such a framework. It was noted, however, that an arbitration forum would not solve what may be the major problem for developing countries – garnering the resources needed to develop transfer pricing cases – and that without a solution to this threshold problem, developing countries that brought arbitration cases would be overwhelmed by the preparation of the companies and would lose the cases. It was also noted that over the last decade, arbitration clauses had been included in some income tax treaties, which generally apply only if the competent authorities do not agree within a reasonable period of time and only if arbitration is consented to by both tax administrations and the taxpayer; moreover, the Member States of the European Union have concluded among themselves a multilateral arbitration convention, which became effective at the beginning of 1996. However, no arbitration proceedings have yet been brought under these procedures. In the view of several members of the Group, further ventures into arbitration should probably await the experience under existing arbitration procedures.

Several members of the Group expressed a need for training and other assistance to aid developing countries in gaining practical expertise in transfer pricing issues. Several speakers described efforts of the United Nations, the OECD, the International Monetary Fund, the US Internal Revenue Service, and other organizations to meet this need. A desire was expressed for the Group to extend its efforts in this area. The Secretariat has prepared a report on technical assistance that will be considered by the Group later in the meeting.

IV. UPDATING OF UNITED NATIONS MODEL

Discussion of the subject of the updating of the United Nations Model Double Taxation Convention was begun by a representative of the International Bureau of Fiscal Documentation, who described a study of the Model in practice. There are 27 provisions of the Model that are not found in the OECD Model or differ from the corresponding provisions of the OECD Model. The study covered 26 of them, examining whether each of the provisions was included in each of the 811 income tax treaties that have been concluded since the United Nations Model was published in 1980, of which 697 were made by developing countries with developed countries or other developing countries and 114 were between OECD countries.

The study found that six of the 26 UN provisions were included in more than 40 per cent of the treaties made by developing countries:

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Article	*Description*	*Percentage of inclusion*
5(3)(a)	Construction supervisory activities may be PE	59
5(3)(a)	Construction site less than 12 months	69
12(3)	Tapes for radio or television broadcasting	88
13(4)	Gains on shares of real property holding companies	44
13(5)	Major shareholdings in other companies	46
21(3)	Source taxation of other income	44

Several of the provisions were included in less than 10 per cent of these treaties:

Article	*Description*	*Percentage of inclusion*
7(5)	Omission of rule that no profits attributable to purchase	6
14(1)(c)	Source tax on services income exceeding specified amount	6
16(2)	Source tax on salaries of top level managerial officials	9
20(2)	Equal treatment of students	8
25(4)	Implementation of mutual agreement	6
26(1)	Disclosure of secret information	7
26(1)	Implementation of information exchanges	9

Some of the UN provisions were found as often or more often in treaties between OECD countries than in treaties with developing countries:

		Percentage of inclusion	
Article	*Description*	*OECD*	*Developing*
12(3)	Tapes for radio or television broadcasting	89	88
13(4)	Gains on shares of real property holding companies	58	44
13(5)	Major shareholdings in other companies	54	46
18	Social security payments taxable only in payer state	42	30

Only the following UN provisions were included significantly more often in treaties of developing countries:

		Percentage of inclusion	
Article	*Description*	*Developing*	*OECD*
5(3)(a)	Construction supervisory activities may be PE	59	34
5(3)(a)	Construction site less than 12 months	69	25
5(3)(b)	Services as PE	31	2
5(4)(a),(b)	Delivery not excluded as PE	26*	0
5(5)(b)	Dependent agents with stock of goods	34	8
7(1)	Limited force of attraction	22	8
7(3)	Elaboration on deduction of PE	28	5
14(1)(b)	Independent services/ 183 day rule	38	18

* Editor's note: read 24%

The members of the Group generally agreed that a revision of the United Nations Model was needed. Because the OECD Model and Commentaries have been revised in many particulars since the issuance of the United Nations Model in 1980, it is necessary that the United Nations Model be revised as mandated by the General Assembly (Programme budget for the biennium 1998-1999 – A/52/6/Rev. 1- Section 10: "Development Support and Management Services", para. 10.24). It was also suggested that the process of updating the Model should be ongoing because revision tends to become more and more difficult as time passes since the last updating. A representative of the OECD explained that the changes to the OECD Model and Commentaries since 1980 have been technical in nature, involving issues of application and interpretation rather than matters of fundamental substance and that because few of these technical changes involved questions peculiar to developed or developing countries, most of them should be equally useful in the developing country context. He also noted that the OECD has invited non-member countries to comment on the OECD Model and that the comments received from 17 non-member countries are reported in volume II of the 1997 updating of the OECD Model and Commentaries. The members agreed that the Group should consider the OECD changes for inclusion in the United Nations Model.

Some members cautioned that a revised United Nations Model should be issued only if the Group is able to reach consensus on substantially all issues of concern to developing countries that affect the Model and that if the Group only reached consensus on the inclusion of various of the OECD changes, publication of a new document as a United Nations Model would give the false impression of a comprehensive revision agreed to by the Group. These members suggested that the Group should only issue a report to supplement the 1980 Model if it is not able to reach consensus on substantially all of the relevant issues.

An observer suggested that revisions of the United Nations Model should take into account of how technological innovation can have the effect of eroding source taxation by, for example, making it possible to do extensive business with residents of a country without establishing a permanent establishment in the country.

Based upon informal consultations with members of the steering committee, the Chairman and the Secretary recommended that the Group proceed with the updating of the Model as follows: During this meeting, the Group would identify the OECD updates that are generally acceptable to the Group and those that require further discussion. The latter, and any other issues that should be considered in a revision of the Model, would be referred to a "focus group" consisting of the following five members of the Group: Mr Benbrik, Mr Gabay, Mr Feinberg, Mr Figueroa, and Mr Shepherd. Alternate members, to serve if any of the principal members is unable to serve, are Mr Alder, Mr Bunders, Mr Ishaq and Mr Skurnik. Members of the Group and observers may suggest additional issues directly to the focus group. The focus group would work on the updating project throughout 1998 by correspondence, at least two on-line conferences, and one meeting to be held in person. The results of this effort would be referred to the Group at least two months before the ninth meeting of the Group of Experts, to be held some time between June and October of 1999. After discussion, this proposal was accepted by consensus.

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Proceeding article-by-article, the Group discussed the changes made to the text of the articles of the OECD Model and other matters that should be considered in updating the United Nations Model. Some of the OECD article changes were found suitable for inclusion as such in the United Nations Model articles. The Group did not discuss the Commentaries and refers all potential changes to the Commentaries to the focus group, together with all other unresolved issues.

Article 9, paragraph 2, requires a country to make an "appropriate adjustment" (a correlative adjustment) to reflect a change in a transfer price made by the other country under Article 9, paragraph 1. It was suggested that if the transfer price corrected by the primary adjustment under paragraph 1 was fraudulent, no adjustment should be made. Another observer noted that a correlative adjustment under paragraph 2 could be very costly to a small country and suggested that a small country might consider not including paragraph 2 in its treaties. Several members of the Group responded that they believed paragraph 2 was an essential aspect of Article 9. However, a country appropriately could closely examine the primary adjustment under the paragraph 1 before deciding what correlative adjustment is appropriate to reflect the primary adjustment. Moreover, it may be possible in some instances to spread the correlative adjustment over a period of years. It was further observed that any fraud in connection with the transfer price was against the interests of the country making the primary adjustment, which may assess a penalty on the fraud.

In 1995, the OECD amended Article 10, paragraph 2, and Article 11, paragraph 2, to change "if the recipient is the beneficial owner of the dividends [interest]" to "if the beneficial owner of the dividends [interest] is a resident of the other Contracting State". The same substitution was made in Article 12, paragraph 2 of the draft revised United Nations Model presented for the Group's consideration. The purpose of these changes is to allow the benefits of these articles to a beneficial owner residing in a treaty country, regardless of the residence of any broker or other intermediary collecting the income on behalf of the beneficial owner, and correspondingly to deny treaty benefits when the beneficial owner is not a resident of the treaty country, even if the intermediary collecting the income is a resident. The Group agreed that these changes should be included in the United Nations Model. Since these changes deal with the issue of beneficial ownership, the 1997 OECD adjustment to Article 12, paragraph 1, which was made for the same purpose, need not be reflected in Article 12, paragraph 1 of the United Nations Model.

The draft revised United Nations Model proposes a new paragraph 6 to Article 10, dealing with branch taxes. The Group agreed that because this paragraph and the accompanying commentaries had not previously been considered by the Group, it should first be studied by the focus group. However, it was suggested that because not all countries have branch taxes, this paragraph might better be in the commentaries. Also, the focus group should consider whether the draft paragraph, which refers to "profits attributable to the permanent establishment," is broad enough, given that Article 7, paragraph 1 of the United Nations Model allows the source country to tax more than the profits attributable to the permanent establishment.

The OECD, in 1992, deleted the words "for the use of, or the right to use, industrial, commercial, or scientific equipment" from Article 12, paragraph 3 (editor's note: read para. 2) of its Model. The Group agreed that because of the broad substantive effect of this deletion, the issue of whether the same deletion should be made in the United Nations Model should be referred for study by the focus group. It was also suggested that the focus group should consider providing additional guidance in the commentaries on the indistinct dividing line between payments for know-how, which are royalties under Article 12, paragraph 3, and payments for technical assistance services, which are not royalties.

It was noted that Article 13, paragraph 4 – allowing taxation at source of gains on sales of shares of companies whose assets consist principally of immovable property – was commonly included in treaties, even treaties among OECD countries, although the paragraph is not found in the OECD Model. However, it was suggested that the focus group should consider strengthening the provision by making it applicable to interests in partnerships and trusts holding immovable property. On the other hand, the focus group might consider whether it should apply when the company is in an active business other than managing property (e.g. a hotel company). It was also suggested that paragraph 5 of Article 13 – which allows source taxation of gains on dispositions of substantial participations in a company – might be modified to limit source country tax to a rate less than that generally applied in that country.

It was suggested that in Article 14, paragraph 1(b) – which allows income from independent personal services to be taxed by the source country if the services performer is present in that country for at least 183 days – the 183 day threshold was too long. Although the 183 day rule may be seen as only a backup of the fixed base rule in paragraph 1(a), a member of the Group noted that it was often possible for substantial services to be rendered in a country without either a fixed base or 183 days of presence in the country. It was agreed that the issue should be studied by the focus group.

A member of the Group suggested that paragraph 2 of Article 16 – allowing salaries of top-level managers to be taxed in the country of which the company is resident – should be examined by the focus group.

Several speakers suggested that the focus group consider whether Article 18, relating to pensions and social security benefits, should be modified to reflect privatized social security systems adopted by several countries.

In paragraph 3 of Article 19, the OECD has added a reference to Article 17. The effect of this change is that remuneration of sportsmen and entertainers performing services for a contracting state in the other state are taxable at source under Article 17, rather than being taxable only in the employer state under Article 19, paragraph 1(a). It was agreed that the

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focus group should consider whether this change should be made in the United Nations Model.

The OECD Commentaries on Article 21 (Other Income) have been amended to suggest an additional provision to limit the application of the article to derivative transactions not at arm's length. The Group agreed that the focus group should consider this amendment, taking due note of the differences between the OECD and UN Models in the basic provisions of Article 21.

In the 1980 United Nations Model, the final sentence of Article 24, paragraph 4 is in brackets, indicating that the sentence should be omitted in a treaty that does not contain an article on capital taxes (Article 22). It was agreed that the brackets were included in error because Article 24 applies to all taxes, including capital taxes, even if capital taxes are not otherwise covered by the treaty.

Several members of the Group noted that some treaties contained provisions for collection assistance in Article 26, even though neither the United Nations Model nor the OECD Model contains such a provision. The Group agreed that the focus group, in its consideration of Article 26, should examine whether the United Nations Model or the commentaries should include provisions for collection assistance.

V. TECHNICAL TRAINING

The Secretariat presented a proposal for a series of training seminars in international taxation for tax administrators in developing and transitional economy countries. It was noted that with the growth of international commerce and investment, the tax administrations of all countries are faced with increasing challenges in assessing and collecting the taxes due [to] them from international transactions. For developing and transitional economy countries, this challenge is further complicated by limitations on their resources for developing practical expertise in international taxation, particularly such complex and quickly developing areas as transfer pricing and financial innovation. The Secretariat therefore proposed that the United Nations arrange a series of Interregional Workshops to improve the practical technical skills of tax administrators of developing and transitional economy countries in international taxation, including practical methods and strategies for combating tax evasion. The workshops would be taught by case studies and lectures presented by experts in international taxation and finance, including eminent tax administrators and university professors. The workshops would also provide an opportunity for participating tax administrators to share experiences and points of view on matters having a vital bearing on the tax systems of their countries. The Secretariat proposed a series of five workshops to be held in five locations dispersed among the regions of the world. Each workshop would be attended by about 50 representatives of 15 to 20 developing countries in the region. It is proposed that although funding for the workshops has not yet been obtained, the costs would be shared by the United Nations, UNDP, and the host countries.

The Group welcomed the initiative of the Secretariat. Several members indicated that they would urge their countries to serve as hosts of one of the workshops or to provide assistance in other ways. The members also suggested that financial support should be sought from other organizations. Members of the Group and observers made several suggestions for maximizing the effectiveness of the workshops. It was suggested that because all tax administrations lose personnel to the private sector, the workshops should be structured to train the workshop participants to train other members of their tax administrations in the matters covered in the workshops. Several members suggested that the workshops should be planned in careful coordination with the training efforts of other organizations in order to target the limited resources available for the workshops toward subjects and countries that are not covered by other training programmes. Also, it was suggested that the workshops would be more successful if each workshop were focused on one or a small number of topics and that it may not be desirable to mix in a single workshop participants from countries with tax administrations in widely differing stages of development. Also, those attending a workshop could be expected to participate actively in the discussion, rather than merely listening to lectures, only if the number of participants in each workshop was not greater than 25.

The Secretary thanked the members and observers for their suggestions and noted that the United Nations welcomed participation and assistance from other organizations.

(end of the Report)

EVALUATION OF THE RESULTS OF THE MEETING

It is evident from the minutes that this full week's discussion produced rather meagre results. As regards the three specific issues of financial instruments, transfer pricing and tax havens, the Group managed only to determine that it should await the results of the OECD studies and further developments, and that it is useful to examine whether there is a need for special rules and guidelines for developing countries. With respect to the main issue, the update and revision of the UN Model and its Commentary, the meeting got no further than deciding which of the recent changes of the OECD Model are prima facie acceptable to the members of the Group and which of those changes should be the subject of further study by a "focus group" set up for that purpose.

However it is hardly surprising that this meeting, like the 1995 meeting before it, produced such meagre results. A group of 75 does not easily lend itself to an efficient discussion of such highly specialized and detailed subjects, particularly if that group meets for only one week every two years. In these circumstances there is little opportunity for Group members to develop new ideas and even less chance that their points of view will gradually converge. These shortcomings could have been largely overcome by the steering committee set up in 1995, if the committee had been convened more often than just for the two days immediately preceding the plenary meeting.

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Perhaps the most unfortunate aspect of the meeting is the wasted opportunity that it represents, or perhaps the aims of the Group are simply overambitious. A group that meets only once in every two years cannot be expected to react fast enough to adapt and update a model convention to the rapidly changing times in which the Group finds itself. Developments in international tax law move swiftly. Globalization has increased the complexity of existing issues and brought new issues to the fore; tax haven issues, transfer pricing, financial instruments and electronic business are only some of the topics currently under discussion. The Group does not have the financial means to carry out substantive research, and therefore it has no choice but to await the results of the OECD's work on these subjects.

Yet it cannot be said that the UN is without any influence in international tax circles. In the course of the years the recommendations of the UN Model have played an important role in the negotiation of tax treaties. Many tax treaties concluded after the publication of the UN Model in 1980 have adopted UN provisions. This applies both to treaties concluded by developing countries, with either a developed or another developing country, and to treaties between developed countries.

On the other hand, the number of specific UN provisions is relatively small. In fact the UN Model consists of the OECD Model with 27 specific adaptations, some of which are more relevant to developing countries than the other provisions. Seven of the specific UN provisions are not that popular among developing countries.[7] They were included in less than 10 per cent of the treaties concluded by developing countries since 1980. Sixteen UN provisions are more popular, but only eight of those are significantly more popular in developing countries than in OECD countries.[8] Four UN provisions have been more often included in treaties between two OECD countries than in treaties concluded by developing countries.[9]

The following table gives an overall picture of the use of UN provisions by developing and developed countries in the period 1980-1997. Group A consists of treaties concluded by developing countries with either a developed or another developing country. Group B consists of treaties concluded between OECD countries. This table was included in the Article on "The UN Model in Practice" published in the December 1997 *Bulletin* but there the figures were not converted into percentages to make them more suitable for comparison.

UN Model	Tax treaties group A	%	group B	%
Art. 5(3)(a):				
supervisory activities	410	59	39	34
period < 12 months	484	69	29	25
Art. 5(3)(b)	219	31	2	2
Art. 5(4)(a) and (b)	167	24	–	–
Art. 5(4)(f) OECD	233	33	31	27
Art. 5(5)	234	34	9	8
Art. 5(6)	184	26	26	23
Art. 5(7)	243	35	–	–
Art. 7(1)	153	22	9	8
Art. 7(3)	195	28	6	5
Art. 7(5) OECD	45	6	–	–
Art. 8 B	105	15	3	3
Art. 12(3)	610	88	102	89
Art. 13(4)	308	44	66	58
Art. 13(5)	322	46	62	54
Art. 14(1)(b)	264	38	20	18
Art. 14(1)(c)	45	6	–	–
Art. 16(2)	62	9	6	5
Art. 18A(2) and B(3)	206	30	48	42
Art. B(1)(2)	259	37	36	32
Art. 20(2)	53	8	–	–
Art. 21(3)	308	44	36	32
Art. 25(4):				
implementation clauses	39	6	–	–
Art. 26(1):				
prevention fraud/evasion	146	21	8	7
secret information	50	7	–	–
implementation clause	65	9	–	–
Tax treaties 1980/1997	697		114	

These statistics prompt the question of whether it makes sense to maintain an entirely separate model for merely 16 provisions, only half of which produce a real difference of opinion between developing and developed countries in practice. Given that the meetings of the Group, in their current form, produce such meagre results, the obvious solution seems to be that the Group should concentrate its energies on the subjects of direct interest to developing countries. The great potential of the Group is being wasted since it does not seize the opportunity at its meetings to focus the minds of the participants, who include many renowned experts on international taxation, on the issues most crucial to the countries for which the Group was set up. This dissipation of the Group's energies is unlikely to best promote the interests of developing countries.

If the Group were to concentrate its energies on a limited number of specific issues it could make recommendations to the OECD which the OECD should not be allowed to ignore. These binding recommendations could be taken over by the OECD in three different ways. They could be adopted in (1) the body of the OECD Model, (2) the Commentary of the OECD Model, or (3) the new section of the OECD Model which offers room for non-member countries to set out their position on the Model and Commentary.

This approach would secure the continued existence of the Group. If the meetings of the Group are continued in their current form there is a real danger that the members of the Group will lose their voice in the international tax world. And that would be most regrettable. It is important that developing countries, like the OECD countries, have their own forum in which to pursue a lively and informed debate on the issues most vital to their interests.

7. I.e.: the omission of the rule that no profits are attributable to purchases (Art. 7(5)), source tax on services income exceeding a specified amount (Art. 14(1)(c)), source tax on salaries of top level managerial officials (Art. 16(2)), equal treatment of students (Art. 20(2)), implementation of mutual agreement (Art. 25(4)), disclosure of secret information (Art. 26(1)) and implementation of information exchanges (Art. 26(1)).

8. I.e.: construction supervisory activities may be PE (Art. 5(3)(a)), construction site less than 12 months (Art. 5(3)(a)), services as PE (Art. 5(3)(b)), delivery not excluded as PE (Art. 5(4)(a) and (b), dependent agents with stock of goods (Art. 5(5)(b)), limited force of attraction (Art. (7)(1)), elaboration on deduction of PE (Art. 7(3)), independent services/183 day rule (Art. 14(1)(b)).

9. I.e.: tapes for radio and television broadcasting! Art. 12(3)), gains on shares of real property holding companies (Art. 13(4)), major shareholdings in other companies (Art. 13(5)) and social security payments taxable in payer state (Art. 18).

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(B. 116.813)

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New and amended tax provisions as published in the Belgian Official Gazette up until 15 February 1997. This supplement updates the main volume "Fiscolex 1996".
(B. 116.522)

Denmark

Mutén, L.; Hagen, K.P.; Genser, B.
Towards a dual income tax? Scandinavian and Austrian experiences.
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Foundation for European fiscal studies, Erasmus University Rotterdam, No. 4, pp. 89. NLG 80. ISBN: 90 411 0928 5.
Brochure containing papers presented at a symposium on 19 May 1995, organized by the Foundation for European Fiscal Studies of the Erasmus University Rotterdam. The first paper by Leif Mutén examines the reasons for Sweden's move towards the dual income tax, noting the difficulties of separating capital and labour income accruing in proprietorships and closed companies. In the second paper ("Taxation of self-employed under a dual income tax") the authors dwell at length on this issue. In the last paper ("Austria's steps towards a dual income tax") Mr. Genser surveys and evaluates the Austrian income tax reform.
(B. 116.767)

European Union

Torres, H.
Pluritributação internacional sobre as rendas de empresas.
Sao Paulo, Editora Revista dos Tribunais Ltda. 1997, pp. 605. ISBN: 85 203 1468 6.
Corporate income international plural taxation. The book focuses on the general principles of international taxation, treaties to avoid double taxation and taxation in the European Union.
(B. 18.977)

Terra, B.J.M.; Wattel, P.J.
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The Hague, Kluwer Law International. 1997, pp. 380. ISBN: 90 411 0692 8.
The book offers a systematic survey of the tax implications of European integration and of Community tax harmonization policy, and a discussion of the Community tax rules in force and pending. It is divided into five parts: the consequences of general (non-fiscal) Community law for national tax law; Community tax harmonization policy; current pending secondary Community law concerning indirect taxes; current and pending secondary Community law concerning direct taxes and exchange of information between national tax administrations.
(B. 116.871)

Jovanović, M.N.
European economic integration. Limits and prospects.
London, Routledge, 11 New Fetter Lane, London EC4P 4EE, United Kingdom. 1997, pp. 390. GBP 19.99. ISBN: 0 415 09549 2.
An analysis of all the major aspects of economic integration in the EU. The author starts with an overview of the origins of European integration and then discusses in detail all the main policy areas, which are: monetary policy, competition policy, industrial policy, fiscal policy, trade policy, the Common agricultural policy, foreign direct investment and regional policy. He also pays attention to less well-known policy areas, such as social policy, environmental policy and transport policy. The book is an invaluable resource for students of international economics, international business and European studies.
(B. 116.872)

Smith, S.; Barents, R.
Neutrality and subsidiarity in taxation.
The Hague, Kluwer Law International. 1996.
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"Subsidiarity and neutrality in European tax policy: economic considerations". In this paper the author discusses the complex balance between neutrality and subsidiarity in the field of indirect taxation. "The principle of subsidiarity and the Court of Justice". In this second paper the author argues that subsidiarity is a vague political slogan without legal significance. He concurs with a former British judge of the Court of Justice who disqualified the subsidiarity principle as a "busted flush".
(B. 116.766)

Steuern und Sozialabgaben/Taxes and social contributions/Impôts et cotisations sociales 1983-1994.
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This publication contains details of tax revenue in the EU Member States, together with data on revenue from social contributions. The indirect taxes levied by the Member States for the institutions of the EC are also shown.
(B. 116.816)

Biering, P.; Holm, K.A.
Amsterdam-Traktaten.
Copenhagen, Jurist- og Okonomforbundets Forlag, Gothersgade 133, Box 2126, 1015 Copenhagen K., Denmark. 1997, pp. 156. ISBN: 87 574 6585 1.
A booklet containing the Danish text of the Amsterdam Treaty of 2 October 1997, together with the 13 protocols.
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Finland

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The Hague, Kluwer Law International. 1996.
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Brochure containing papers presented at a symposium on 19 May 1995, organized by the Foundation for European Fiscal Studies of the Erasmus University Rotterdam. The first paper by Leif Mutén examines the reasons for Sweden's move towards the dual income tax, noting the difficulties of separating capital and labour income accruing in proprietorships and closed companies. In the second paper ("Taxation of self-employed under a dual income tax") the authors dwell at length on this issue. In the last paper ("Austria's steps towards a dual income tax") Mr. Genser surveys and evaluates the Austrian income tax reform.
(B. 116.767)

France

Lopez, C.
Les pouvoirs d'investigation de l'administration fiscale en France et au Canada.
Paris, Editions L'Harmattan, 5-7, rue de l'Ecole-Polytechnique, 75005 Paris, France. 1997.
Collection "Logiques juridiques", pp. 361. FFR 190. ISBN: 2 7384 5496 8.
Comparative study into the various forms of tax investigation and audit and the role of the judiciary in maintaining a balance between the protection of the taxpayer and the interests of the Tax Administration.
(B. 116.720)

Nikolaus, F.
Unternehmenskauf über die Grenze. Steuergestaltung in Frankreich und Grossbritannien.
Düsseldorf, IDW Verlag GmbH. 1997, pp. 398. DEM 98. ISBN: 3 8021 0730 6.
Buying a business cross-border. Tax planning in France and the UK. Study of different ways of acquiring a business cross-border by German enterprises in France and the UK. The methods discusses are in particular an asset-deal, a share-deal, a fusion (France) and the combination-model (UK). A macroeconomical approach is applied, trying to maximize the depreciation basis, deductibility of the acquisition price, loss carry-over, minimize double taxation and deductibility of current expenses.
(B. 116.682)

Germany

Kühn, R.; Hofmann, R.; Hofmann, G.
Abgabenordnung. Finanzgerichtsordnung. Nebengesetze. 17. Auflage.
Stuttgart, Schäffer-Poeschel Verlag. 1995, pp. 1364. DEM 198. ISBN: 3 8202 0939 5.
Fiscal Code. Seventeenth edition of an extensive commentary to the German Fiscal Code, including all recent amendments.
(B. 116.840)

Lammerding, J.; Hackenbroch, R.
Steuerstrafrecht. Einschl. Steuerordnungswidrigkeiten und Verfahrensrecht. 7. Auflage.
Achim, Erich Fleischer Verlag, P.O. Box 1264, 28818 Achim, Germany. 1997.
Grüne Reihe, Band 15, pp. 204. DEM 48. ISBN: 3 8168 1157 4.
Criminal offences relating to tax. Textbook providing the basic structure of this field. It comprises the constitutional principles, general principles of criminal law, and the essentials of the most important offences. The structure of the offences is explained using the example of tax evasion (Steuerhinterziehung), the other offences covered in detail are cheating on

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subsidies ("Subventionsbetrug") and tax adviser-related offences.
(B. 116.828)

Knief, P.
Körperschaftsteuer 1997. Gesamtdarstellung. 4. Auflage.
Bonn, Stollfuss Verlag. 1997, pp. 328.
DEM 39.80. ISBN: 3 08 213104 2.
1997 Corporate taxes. 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. The law is stated as of 1 January 1997.
(B. 116.837)

Wolter, C.E.
Gesellschafterfremdfinanzierung. Verdeckte Einlagen, verdecktes Stammkapital, Drittaufwandseinlage.
Berlin, Duncker & Humblot GmbH. 1997.
Schriften zum Steuerrecht, Band 54, pp. 253.
DEM 98. ISBN: 3 428 08843 3.
Thin capitalization – hidden contributions, hidden equity, third party debt. Dissertation on the civil and tax law of thin capitalization. The author reaches the conclusion that the German thin cap rule (Section 8a Corporate Income Tax Law) is not sufficient for solving the problems arising in this field of tax law. With regard to shareholders who do not take part in the imputation system, the author alleges a violation of the constitutional principle of equality.
(B. 116.704)

Patt, J.; Rasche, R.
Steuertips zum Jahresende 1997.
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DEM 45.80. ISBN: 3 08 319097 2.
Tax hints for the end of 1997. Includes important tax saving and planning advice.
(B. 116.836)

Starke, P.; Schroer, A.
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Achim, Erich Fleischer Verlag, P.O. Box 1264, 28818 Achim, Germany. 1997.
Steuer Seminar, Band 12, pp. 366. DEM 59.
ISBN: 3 8168 3123 0.
131 Case studies on German international tax law designed particularly for students.
(B. 116.827)

Investitionszulagengesetz 1999, Investitionszulagengesetz 1996, Fördergebietsgesetz. Bearbeitet von H. Cattelaens, W. Niermann und W. Tausch.
Düsseldorf, IDW Verlag GmbH. 1997, pp. 336. DEM 58. ISBN: 3 8021 0750 0.
Investment Premium Law 1999, Investment Premium Law 1996, Development Area Law. Statute texts, decisions, decrees and parliamentary material relating to the specified laws. No commentary. The book takes account of the 1997 Law continuing the promotion of the economy of the new Länder. State of affairs: July 1997.
(B. 116.684)

Knobbe-Keuk, B.
Bilanz- und Unternehmenssteuerrecht. 9. Auflage.
Cologne, Verlag Dr. Otto Schmidt. 1993, pp. 1099. ISBN: 3 504 20067 7.
Enterprise taxation with special emphasis on its effect on the commercial and fiscal balance sheets. This ninth revised edition contains detailed information on participations, negative capital accounts and limited partnerships, anticipated succession, inheritance, the EC Parent-Subsidiary and Merger Directives, and much more.
(B. 116.842)

Nikolaus, F.
Unternehmenskauf über die Grenze. Steuergestaltung in Frankreich und Grossbritannien.
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Buying a business cross-border. Tax planning in France and the UK. Study of different ways of acquiring a business cross-border by German enterprises in France and the UK. The methods discussed are in particular an asset-deal, a share-deal, a fusion (France) and the combination-model (UK). A macroeconomical approach is applied, trying to maximize the depreciation basis, deductibility of the acquisition price, loss carry-over, minimize double taxation and deductibility of current expenses.
(B. 116.682)

Stephan, R.
Die Wohneigentumsförderung. Eigenheimzulage. Grundförderung und Übergangsregelungen. 5. Auflage.
Stuttgart, Schäffer-Poeschel Verlag. 1996, pp. 723. DEM 98. ISBN: 3 8202 1028 8.
Promotion of residential buildings, subsidy for dwelling houses. Standard book which also covers land property, houses owned by businesses, shared ownership; the whole complex field of advancement of house building and providing residential housing. Developments covered until January 1996.
(B. 116.792)

Reuter, H.P.
Die Lebensversicherung im Steuerrecht. 9. Auflage.
Herne, Verlag Neue Wirtschafts-Briefe. 1997, pp. 386. DEM 110. ISBN: 3 482 41189 1.
Revised edition of monograph dealing with life insurance in tax law (corporate tax, individual income tax, net wealth tax, trade tax, inheritance tax, VAT). The material is updated as of 30 June 1997.
(B. 116.797)

Stuber, H.; Nägele, G.
Reisekosten, Bewirtung, Repräsentation im Steuerrecht. 24. Auflage.
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Travel expenses, entertainment of business partners, marketing in tax law. Deductibility of mixed business personal related expenses. From business trips to the fringe benefit of using a business car, from congresses to gifts, from double household to moving expenses. Developments followed until February 1997.
(B. 116.791)

Loy, H.
Schenken und Vererben. 3. Auflage.
Cologne, Peter Deubner Verlag. 1997.
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DEM 62.80. ISBN: 3 88606 204 X.
Arrangements to pass on property and to reduce the gift or inheritance tax thereon. Including all changes brought about by the 1997 Tax Amendment Act.
(B. 116.829)

Lang, M.; Schuch, J.
Doppelbesteuerungsabkommen Deutschland/Österreich.
Munich, Verlag C.H. Beck; Vienna, Linde Verlag Wien GmbH. 1997, pp. 620. DEM 158.
ISBN: 3 85122 723 9.
Germany–Austria tax treaty. Hardcopy commentary, identical with the version published in the loose-leaf "Debatin on German tax treaties", with abundant references to literature, decrees, letters, decisions. Exchange of notes, further agreements (mutual assistance, inheritance tax treaty) and the most important decrees and letters are exhibited in an annex. With index.
(B. 116.789)

Italy

Adonnino, P.
Riflessioni in tema di pianificazione fiscale internazionale.
From: Pietro Adonnino. 1997, pp. 54.
Brochure on international tax planning. It deals with anti-avoidance rules provided by the domestic law of certain states (in particular Italy) and bilateral tax treaties.
(B. 116.739)

Netherlands

Arts, J.H.M.
Kapitaalstortingen voor de vennootschapsbelasting.
Lelystad, Koninklijke Vermande B.V. 1997, pp. 272. ISBN: 90 5458 469 6.
This thesis contains a systematic overview of the corporate income tax consequences of the different ways of contributing paid-up capital from the company's point of view. Ways of capital supply explained are paid-up agio, informal capital, transfer of a business to a company, services provided at a profit right, a loan and stock (options) granted to employees. The book contains an overview of all aspects of the term capital and its supply to a company. Moreover all aspects of the fiscal profit concept are explained.
(B. 116.846)

Gerrits, P.M.; Tilburg, J. van.
Tegengaan uitholling belastinggrondslag en versterking fiscale infrastructuur.

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The Hague, Moret Ernst & Young; Delwel Uitgeverij BV. 1997.
Serie Wetgeving actueel, No. 1, pp. 247.
NLG 80. ISBN: 90 6155 809 3.
Regulation to counteract base erosion and to strengthen the competitiveness of the Dutch tax system. The book contains a systematic overview of the regulations, the parliamentary history and the reports of various commissions.
(B. 116.810)

Kluwer vennootschapsbelastinggids 1997.
Deventer, Kluwer. 1997, pp. 464.
ISBN: 90 200 1906 6.
This book contains a comprehensive overview of all aspects of the corporate income tax, the dividend withholding tax, legal protection and tax havens. The most important jurisprudence is included and it also contains a lot of practical examples.
(B. 116.800)

Studiepocket belastingwetten 1997/1998.
1,2,3,4,7,8
Editors L.G.M. Stevens and S.R.A. van Eijck.
Deventer, Kluwer. 1997, pp. 528.
ISBN: 90 200 1930 9.
The book contains texts of the most important tax regulations of the Netherlands.
(B. 116.786)

Stevens, L.G.M.
Elementair belastingrecht voor economen en bedrijfsjuristen. Theorieboek. 13th Edition.
Deventer, Kluwer. 1997, pp. 513.
ISBN: 90 200 1924 4.
This book contains an introduction to the main aspects of Dutch taxation. One of the main aspects concerns the profit calculation for entrepreneurs in the income tax and the corporate income tax. Furthermore the book focuses on special issue, such as partnerships, the participation exemption, merger, transfer of a business or partnership into an unlimited or private partnership, entrepreneurship facilities and roll-over relief.
(B. 116.783)

Stevens, L.G.M.; Eijck, S.R.A. van.
Elementair belastingrecht voor economen en bedrijfsjuristen. Praktijkboek.
Deventer, Kluwer. 1997, pp. 318.
ISBN: 90 200 1923 6.
This book is complementary to the theoretical edition of "Elementair belastingrecht, 13th Edition" by L.G.M. Stevens and contains questions concerning the most important tax regulations.
(B. 116.783)

Zwemmer, J.W.
Fiscaal- en civielrechtelijke aspecten van voorwaarde en tijdsbepaling.
Deventer, Fed. 1997.
Fed fiscale brochures, pp. 89. NLG 54.
ISBN: 90 6002 746 9.
The author gives an extensive overview of the problems arising from terms and time limit provisions. Of importance are an resolve condition and an resolving time limit provision. The fiscal definition of the clauses is dominated by civil law. The usufruct rules apply to a transfer with a time limit provision. Finally the book explains the aspects of terms and usufruct within various tax laws.
(B. 116.612)

Verdragsteksten internationaal belastingrecht.
Lelystad, Koninklijke Vermande B.V. 1997, pp. 288. ISBN: 90 5458 311 8.
1997 compilation of texts of selected Dutch tax treaties concluded with Belgium, Brazil, Canada, Germany, France, Italy, the United Kingdom, USA and Switzerland. Texts of the OECD Model, international tax law, Dutch "standaardverdrag" and some relevant EC Directives are appended.
(B. 116.785)

Blaakman, R.A.M.; Dijkstra, A.S.; Driece, H.
Expat toolkit '97. A guide to the Dutch workplace.
Alphen a.d.Rijn, Samsom Bedrijfsinformatie. 1997, pp. 250.
This book contains a comprehensive overview of all consequences related to establishing in the Netherlands. The book deals with the social and cultural aspects of the Netherlands and the Dutch education system. Moreover the book contains an overview of the most important aspects of social security law and fiscal law for foreigners.
(B. 116.845)

Kluwer gids voor de invordering 1997.
Deventer, Kluwer. 1997, pp. 481.
ISBN: 90 200 1864 7.
This book contains a comprehensive overview of the collection of taxes and premiums. Furthermore the book contains an overview of the civil law aspects related to this subject. Finally the book contains an explanation of all appeal possibilities concerning tax collection.
(B. 116.799)

Norway

Mutén, L.; Hagen, K.P.; Genser, B.
Towards a dual income tax? Scandinavian and Austrian experiences.
The Hague, Kluwer Law International. 1996.
Foundation for European fiscal studies, Erasmus University Rotterdam, No. 4, pp. 89.
NLG 80. ISBN: 90 411 0928 5.
Brochure containing papers presented at a symposium on 19 May 1995, organized by the Foundation for European Fiscal Studies of the Erasmus University Rotterdam. The first paper by Leif Mutén examines the reasons for Sweden's move towards the dual income tax, noting the difficulties of separating capital and labour income accruing in proprietorships and closed companies. In the second paper ("Taxation of self-employed under a dual income tax") the authors dwell at length on this issue. In the last paper ("Austria's steps towards a dual income tax") Mr. Genser surveys and evaluates the Austrian income tax reform.
(B. 116.767)

Russia

Doing business in the Russian Federation.
Amsterdam, Price Waterhouse. 1997, pp. 261.
Second edition of guide providing relevant information on the business environment in Russia to those contemplating doing business in this new, exciting, and fast-growing marketplace. The material in this guide was assembled at 1 March 1997 and covers information on foreign investment, banking and finance, auditing and accounting, labour relations and social security, tax system, taxation of corporations and individuals, VAT and other indirect taxes.
(B. 116.769)

Sweden

Mattsson, N.
Svensk internationell beskattningsrätt. 12th Edition.
Stockholm, Norstedts Juridik AB. 1997, pp. 203. ISBN: 91 39 00285 3.
Revised and updated edition of handbook on Swedish tax law regarding international taxation of income and capital. The book describes the taxation of foreign income of Swedish residents and the taxation of the (Swedish) domestic source income of non-residents. Topics covered include determination of residence, sources of income, deduction for foreign tax, credit for foreign tax and double taxation treaties.
(B. 116.821)

Mutén, L.; Hagen, K.P.; Genser, B.
Towards a dual income tax? Scandinavian and Austrian experiences.
The Hague, Kluwer Law International. 1996.
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NLG 80. ISBN: 90 411 0928 5.
Brochure containing papers presented at a symposium on 19 May 1995, organized by the Foundation for European Fiscal Studies of the Erasmus University Rotterdam. The first paper by Leif Mutén examines the reasons for Sweden's move towards the dual income tax, noting the difficulties of separating capital and labour income accruing in proprietorships and closed companies. In the second paper ("Taxation of self-employed under a dual income tax") the authors dwell at length on this issue. In the last paper ("Austria's steps towards a dual income tax") Mr. Genser surveys and evaluates the Austrian income tax reform.
(B. 116.767)

Switzerland

Suisse. Juridique, fiscal, social, comptable.
4th
Edition.
Levallois-Perret, Editions Francis Lefebvre. 1997.
Dossiers Internationaux Francis Lefebvre, pp. 448. FFR 453.

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Revised and updated edition of monograph describing the Swiss company law, accounting law, labour law, taxation and social aspects, as of March 1997. The book also covers the France–Switzerland tax treaty.
(B. 116.777)

Schärer, B.F.
Verlustverrechnung von Kapitalgesellschaften im interkantonalen Doppelbesteuerungsrecht.
Zurich, Schulthess Polygraphischer Verlag. 1997.
Schweizer Schriften zum Handels- und Wirtschaftsrecht, Band 179, pp. 375. CHF 72.
ISBN: 3 7255 3612 0.
Offsetting losses in companies and the intercantonal law on the avoidance of double taxation. Losses of companies, losses of their subsidiaries or permanent establishments or of real property in other cantons, and how the losses can be used against profits, in particular when writing off a shareholding or re-establishing sound conditions ("Sanierung"). Most of the intercantonal double tax avoidance law is contained in Federal Court decisions. The promise of Article 46 of the Constitution, i.e. the establishment of a written law, has not been fulfilled so far.
(B. 116.793)

United Kingdom

Saunders, G.; Scott, J.; Watterston, J.M.
Tolley's corporation tax 1997-98.
Croydon, Tolley Publishing Company Ltd. 1997, pp. 596. GBP 49.95.
ISBN: 1 86012 503 4.
The book is the companion to "Tolley's income tax" and is a comprehensive guide to corporation tax up to and including the 1997 Finance Act. With cross references to "Simon's Direct Taxes and other Butterworth services.
(B. 116.757)

Watterston, J.M.
Tolley's capital gains tax 1997-98.
Croydon, Tolley Publishing Company Ltd. 1997, pp. 744. GBP 47.95.
ISBN: 1 86012 507 7.
A comprehensive detailed guide to the statutes and case law up to and including the 1997 Finance Act. This edition covers cross-references to "Sumption: capital gains tax", many additional worked examples, and a summary of all the leading cases relating to capital gains tax.
(B. 116.756)

Grundy, M.; Briggs, J.; Field, J.A.
Asset protection trusts. 3rd Edition.
London, Key Haven Publications PLC., 7 Crescent Stables, 139 Upper Richmond Road, London SW15 2TN, United Kingdom. 1997, pp. 176. ISBN: 1 870070 80 1.
This third edition updated the description of 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 12 August 1997.
(B. 116.790)

Nikolaus, F.
Unternehmenskauf über die Grenze. Steuergestaltung in Frankreich und Grossbritannien.
Düsseldorf, IDW Verlag GmbH. 1997, pp. 398. DEM 98. ISBN: 3 8021 0730 6.
Buying a business cross-border. Tax planning in France and the UK. Study of different ways of acquiring a business cross-border by German enterprises in France and the UK. The methods discusses are in particular an asset-deal, a share-deal, a fusion (France) and the combination-model (UK). A macroeconomical approach is applied, trying to maximize the depreciation basis, deductibility of the acquisition price, loss carry-over, minimize double taxation and deductibility of current expenses.
(B. 116.682)

Saunders, G.; Smailes, D.; Scott, J.; Harvey, E.L.
Tolley's income tax 1997-98. 82nd Edition.
Croydon, Tolley Publishing Company Ltd. 1997, pp. 1119. GBP 49.95.
ISBN: 1 86012 501 8.
Comprehensive detailed guide to income tax with relevant statute and case law etc. up to and including the 1997 Finance Act. This latest edition includes a chapter on key dates for self-assessment, additional worked examples, and is cross referenced to "Simon's Direct Tax Service" and other Butterworth publications. Much of the material is of relevance to companies, especially as computations of income amounts forming part of taxable profits for corporation tax purposes are based on income tax law.
(B. 116.755)

Golding, J.
Tolley's inheritance tax 1997-98.
Croydon, Tolley Publishing Company Ltd. 1997; pp. 405. GBP 45.95.
ISBN: 1 86012 505 0.
A detailed guide to the inheritance tax provisions up to and including the 1997 Finance Act. Includes worked examples and is fully cross-referenced to Butterworth's "Simon's Direct Tax Service".
(B. 116.758)

INTERNATIONAL

International

Chennells, L.; Griffith, R.
Taxing profits in a changing world.
London, IFS The Institute for Fiscal Studies. 1997, pp. 178. GBP 12.50.
ISBN: 1 873357 73 7.
The book presents information on how corporate income taxes have changed in Australia, Canada, France, Germany, Ireland, Italy, Japan, Spain, the UK and the USA in the years 1979 to 1994. How corporate income taxes have effected incentives for both domestic and international investment is discussed using a number of alternative measures, including statutory tax rates, effective marginal and average tax rates, average tax rates calculated from firm level accounting data and tax revenue statistics.
(B. 116.765)

Adonnino, P.
Riflessioni in tema di pianificazione fiscale internazionale.
From: Pietro Adonnino. 1997, pp. 54.
Brochure on international tax planning. It deals with anti-avoidance rules provided by the domestic law of certain states (in particular Italy) and bilateral tax treaties.
(B. 116.739)

Ginsberg, A.S.
International tax havens. 2nd Edition.
Durban, Butterworths. 1997, pp. 646.
ZAR 249.66. ISBN: 0 409 11518 5.
This comprehensive investment and tax strategy handbook explains how to take advantage of the benefits offered by international tax havens to increase returns, decrease tax exposure and maximize wealth. It offers invaluable insight into the world of offshore financial centres and the various techniques available to both the company and the individual. This second edition is completely up-to-date, practical and user-friendly for all who deal with or would like to know more about today's leading tax havens (offshore financial centres). Besides the well known Caribbean and European tax haven countries, this edition also covers a part on Labuan (Malaysia), the Cook Islands, Vanuatu, and a part on how the South African emigrant can use tax havens.
(B. 116.781)

Transfer pricing documentation guide.
London, Deloitte & Touche. 1997, pp. 170.
This guide aims to help companies to manage their transfer pricing affairs in relation to all of their cross-border transactions. It contains guidelines to be used to meet the transfer pricing documentation expectations of the UK Inland Revenue. Based on OECD guidelines it will be useful in compiling transfer pricing documentation in many other countries.
(B. 116.830)

Sandler, Daniel.
The taxation of international entertainers and athletes. All the world's a stage.
The Hague, Kluwer Law International. 1997, pp. 356. NLG 235. ISBN: 90 4110 1187.
The purpose of this study is to review the taxation by source countries of non-resident entertainers and athletes. The book provides a comprehensive and detailed analysis of the taxation (including VAT aspects) of non-resident entertainers and athletes in Australia, Canada, France, Germany, Japan, the UK and

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the USA. It deals with the many sources of income which such individuals can derive, including income from live performances, television appearances, commercials, product endorsements, royalties for record sales or "needle time", and merchandising of concert paraphernalia.
(B. 115.181)

1997/98 Worldwide tax treaty index.
Arlington, Tax Analysts. 1997, pp. 247.
ISBN: D 918255 03 1.
This Tax Analysts collection includes over 3,500 treaties, protocols, and similar documents from 181 countries. In addition to comprehensive treaties concerning taxes on income and capital, this collection includes estate, inheritance, and gift tax treaties, limited agreements concerning taxation of income derived from shipping and air transport, and information exchange and administrative assistance agreements. It also includes model tax treaties and US social security totalization agreements. These are electronic and microfiche database citations. The index is current through 1 September 1997.
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UNITED KINGDOM

BOUGHT IN FOREIGN TAX: A SWIFT RESPONSE TO A TAX AVOIDANCE SCHEME

Paul Brown*

I. INTRODUCTION

In an article on 5 June 1997 the national head of tax for Ernst & Young noted that there had been a shift in attitudes over the last year or so with regard to tax avoidance and that there had evolved:

> a belief that, first, there is a "right" amount of tax to pay and, secondly, that the "right" amount is the amount you pay on the tax authorities' interpretation of the facts and the law.

He went on to add that:

> at best, the response to new tax planning schemes will be quicker off the mark and more complete, and tax advisers and their clients will simply have to accept that.

In September 1996, the Department became aware of the mechanics of a tax avoidance scheme which is described in detail below. Within six weeks, legislation had been designed to counteract the effects of the scheme. The story which follows is by no means a unique example of how cooperation between the Network and Head Office can result in the swift preparation of legislation, but it does offer a detailed account of how the process works in practice. The text is based on a presentation given at the Departmental Technical Conference, where some observers thought that the story merited wider circulation.

This article describes how UK companies entered into a tax avoidance scheme which involved buying in foreign tax credits from unconnected third parties and using those credits to reduce the UK company's tax bill. The credits could not be used by the third parties and the aim of the scheme promoters was to transfer the credits to UK taxpayers who could use them in a claim to double taxation relief and to share the UK tax saved equally between the UK taxpayer, the promoters and the foreign taxpayer. The article details the investigation which brought this abuse to light, the use of the legislation then in place to counter the scheme and to secure a settlement with the UK group, and finally the design and implementation of new legislation which dealt with the scheme.

The article does not attempt to give an overview of how the Revenue generally deals with tax avoidance schemes. It is simply the story of how the Revenue investigated one case, used existing legislation to secure a settlement, and finally how Parliament passed legislation at Section 90 of the Finance Act 1997 (which introduced the new Section 801A ICTA 1988). We are able to show that the particular case we saw fell foul of the legislation (as it then stood) in a number of respects (detailed at the end of this article) but we could see a danger that, in a slightly different form, it was possible that the scheme might achieve the results planned by the avoidance promoters.

II. THE SCHEME

The case was worked in partnership between the District responsible for dealing with the affairs of the company and International Division ("ID"), through to the eventual settlement of the investigation. The investigation brought together the District's knowledge of the taxpayer with the Division's knowledge of avoidance schemes and its access to Specialists within the Division and across Head Office. Whilst this article explores the working of an investigation case prior to the November 1996 Budget, the way the case was worked might be seen as an example of how the Inland Revenue compliance work might increasingly operate in the future. It shows how districts can work in partnership with Head Office which can in turn work with colleagues across Head Office, communicate with the rest of the Department and prepare legislation for Ministers to recommend to Parliament.

The case began in the Network. The inspectors dealing with the UK group of companies thought that *something* was seriously wrong with the tax computation submitted by one of the companies in the group. The main difficulty with tax avoidance schemes is often that the first use of a scheme is very difficult to spot because it lies outside our experience – we may believe that *something* is amiss but we don't know *what* is wrong. The apparent problem involved cross border transactions and so the inspector sought the advice of ID. ID had not seen this type of scheme before and so a joint investigation team was established.

The basic problem was a claim to double taxation relief ("DTR") which looked inflated in amount and artificial in nature. The UK company provided vouchers for tax actually paid, and so it appeared that the tax had been suffered. The UK company's tax computations looked like this:

Dividend from SPC	GBP 45 million
UK CT @ 33%	GBP 14.85 million
less DTR	(GBP 14.85 million)
Net UK tax	NIL

The UK company ("PLC") had received a dividend from a foreign company ("SPC") and corporation tax was chargeable on receipt of that dividend under Case V of Schedule D. From what we knew, SPC appeared to be a haven company.

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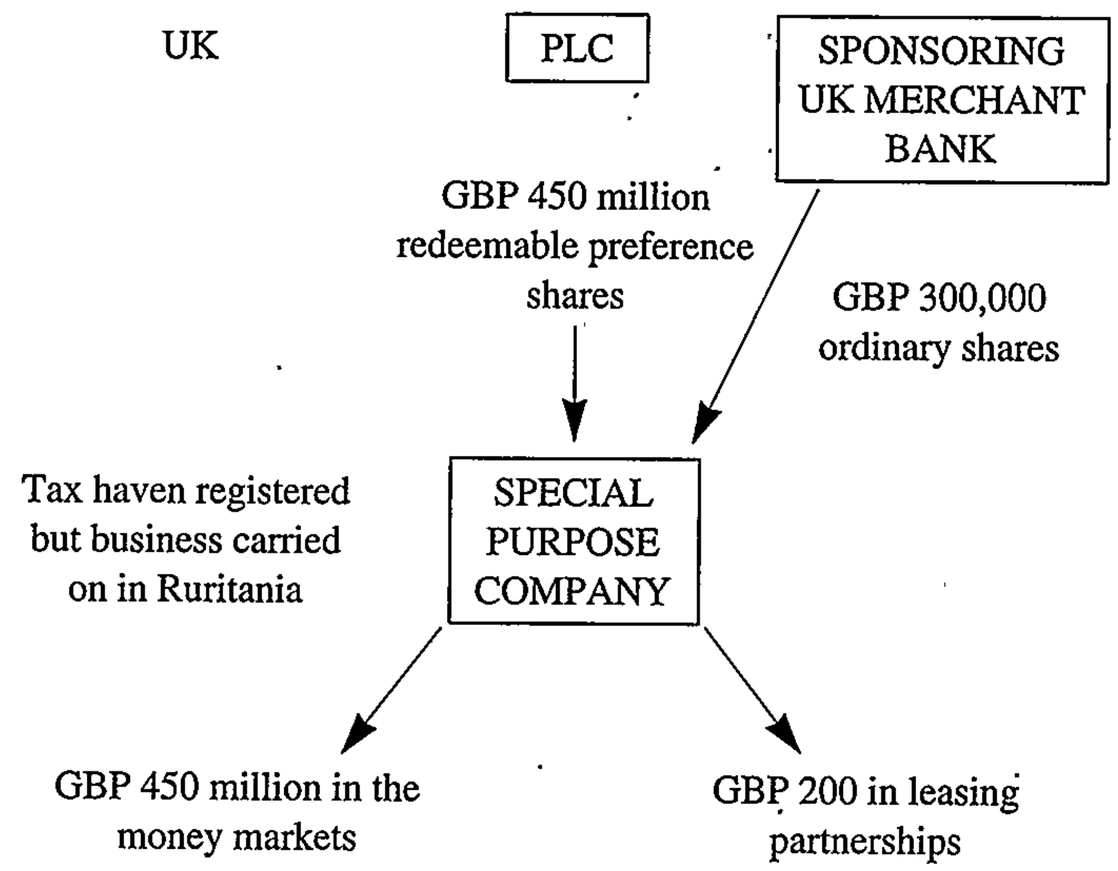
Suspicion was aroused because the haven company appeared to have paid large amounts of foreign tax, and with this in mind the inspector was prompted to ask further questions.

Whilst much of what emerged seems relatively straightforward and obviously offensive, it did not appear so at the time because most of the facts were unknown to the Revenue. Those of you unfamiliar with the scheme may have equal difficulty in following all the steps at first. However, further correspondence revealed that the basic situation was this:

Diagram 1



PLC invested GBP 450 million in redeemable preference shares in an offshore special purpose company ("SPC"). It was this company which had paid the dividend of GBP 45 million up to PLC and which paid the tax upon which PLC had based its claim to DTR of around GBP 15 million. The only other shareholder in SPC was the merchant bank which had set up the tax avoidance scheme by bringing together the different parties, whose function is described below. The merchant bank held all the ordinary share capital ("OSC"). Papers which emerged during the investigation indicated that the reason for the merchant bank holding all the OSC was to avoid a Revenue enquiry into the tax residence of SPC. It would look as if SPC had nothing to do with PLC and, perhaps, the Revenue would look no further. This hope was misplaced. The residence of SPC would be established by the place of management and control of the business, not the identity of the shareholder and so enquiries proceeded. As an aside, the GBP 300,000 invested by the merchant bank was tied up in such a way that it was at no risk of losing its money.

SPC was an investment company and had only two investments:

- GBP 450 million was invested in secure instruments in the UK money markets producing a return of around 10 per cent per annum;
- GBP 200 (that is two hundred pounds – not a misprint) was invested in a series of Ruritanian limited partnerships. The partnerships were involved in leasing.

It would be in an inspector's nature to be suspicious of any company which invests such a paltry sum as GBP 200 in a partnership of this kind, especially in the context of what follows. It is therefore worth pointing out that the figure of investment in the Ruritanian partnerships was very low but because of the particular accountancy methods adopted appeared much higher (GBP 17 million) in the accounts of SPC. Had we known that only GBP 200 had actually changed hands in respect of the Ruritanian investments, we would have been a great deal more suspicious much earlier.

It took just over a year to establish the facts in this case. This story will be familiar to all inspectors who have asked difficult questions. We were investigating the residence of SPC, the CFC aspects of the case and the validity of the DTR claim within existing legislation. We needed to review all the Board papers of SPC, the partnership agreements, the tax payments made, the papers in the hands of individuals at PLC and all the other agreements etc. There was a large amount of paper and a great deal of investigation to be done.

As the documents were examined, more questions arose and the other side became slower at answering. There was dogged resistance in providing information – everything the Revenue needed appeared to be in Ruritania! The resistance was broken by the Revenue's resolve and by a stated willingness to use the powers of Section 20. It emerged that PLC had entered into a series of agreements with a merchant bank (the bank which held all of SPC's ordinary shares) and with another company and that it was these agreements which underpinned the existence of SPC and its operations. It appeared to be these agreements which produced the large claim to DTR. The steps were as follows:

- Sponsoring UK merchant bank sets up SPC with ordinary share capital.
- PLC invests GBP 450 million in redeemable preference shares in SPC. The investment is entirely in the form of money market instruments previously owned by PLC.
- SPC continued to invest GBP 450 million in the money markets producing a return of around 10 per cent per year. It was this "real" investment income of around GBP 45 million a year which PLC sought to shelter from UK tax.
- In addition to money market investments, SPC invested GBP 200 in a series of foreign partnerships. All of these partnerships were in Ruritania.
- As a result of investing in these partnerships, SPC became liable for tax of GBP 15 million in Ruritania.
- The partnerships produced a distribution of GBP 10 million per year to SPC which had to use this money (and some more from its own resources) to pay Ruritanian tax of GBP 15 million per year.
- Each year SPC paid a dividend to PLC and PLC claimed DTR in respect of underlying Ruritanian tax paid by the leasing partnerships.
- The other company in the Ruritanian partnerships was Company A.

At this stage, the last four steps don't make sense. How could there be GBP 15 million of Ruritanian tax when only GBP 200 was really invested? Why should SPC invest in partnerships that produced less income (GBP 10 million) than the attached tax charge (GBP 15 million)? Further investigation

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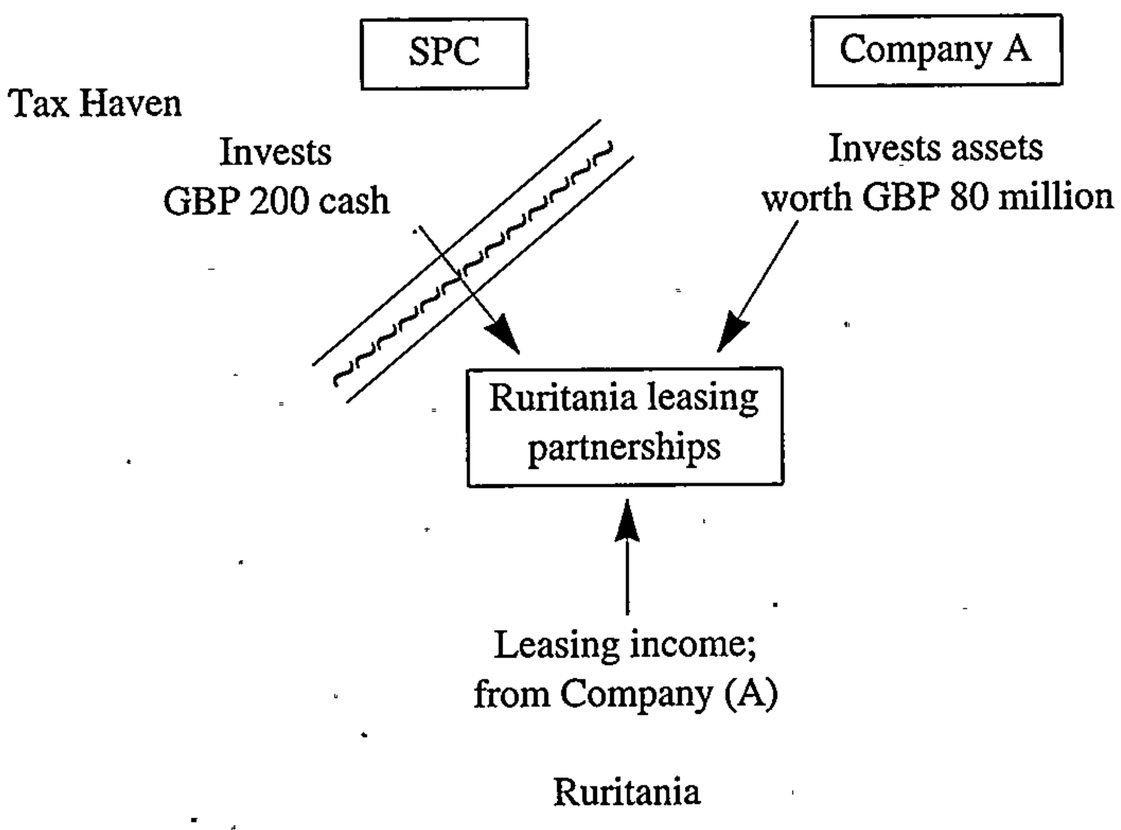
was required, and it was after this investigation that the full extent of the problem became clear.

SPC had financed the annual dividend to PLC of GBP 45 million from its investment income – the deposits in the UK money market. SPC did not pay tax on this investment income, since it was incorporated in a tax haven. However, when the UK tax computation for PLC was submitted showing the dividend of GBP 45 million there were vouchers from the Ruritanian tax authorities to show that SPC had paid tax of GBP 15 million there.

For the purposes of the controlled foreign companies legislation (Section 747 et seq. ICTA 1988) SPC was a controlled foreign company of PLC and that company was in some danger of a charge under the legislation. This was anticipated by SPC which paid a dividend amounting to 100 per cent of its accounting profits (which also amounted to 100 per cent of its taxable profits) thereby ensuring that it had pursed an acceptable distribution policy for the purposes of the CFC legislation. The problem arose not because of the manipulation of SPC's profits, but because of the effective sheltering of those profits which arose because of the DTR claim.

Diagram 2

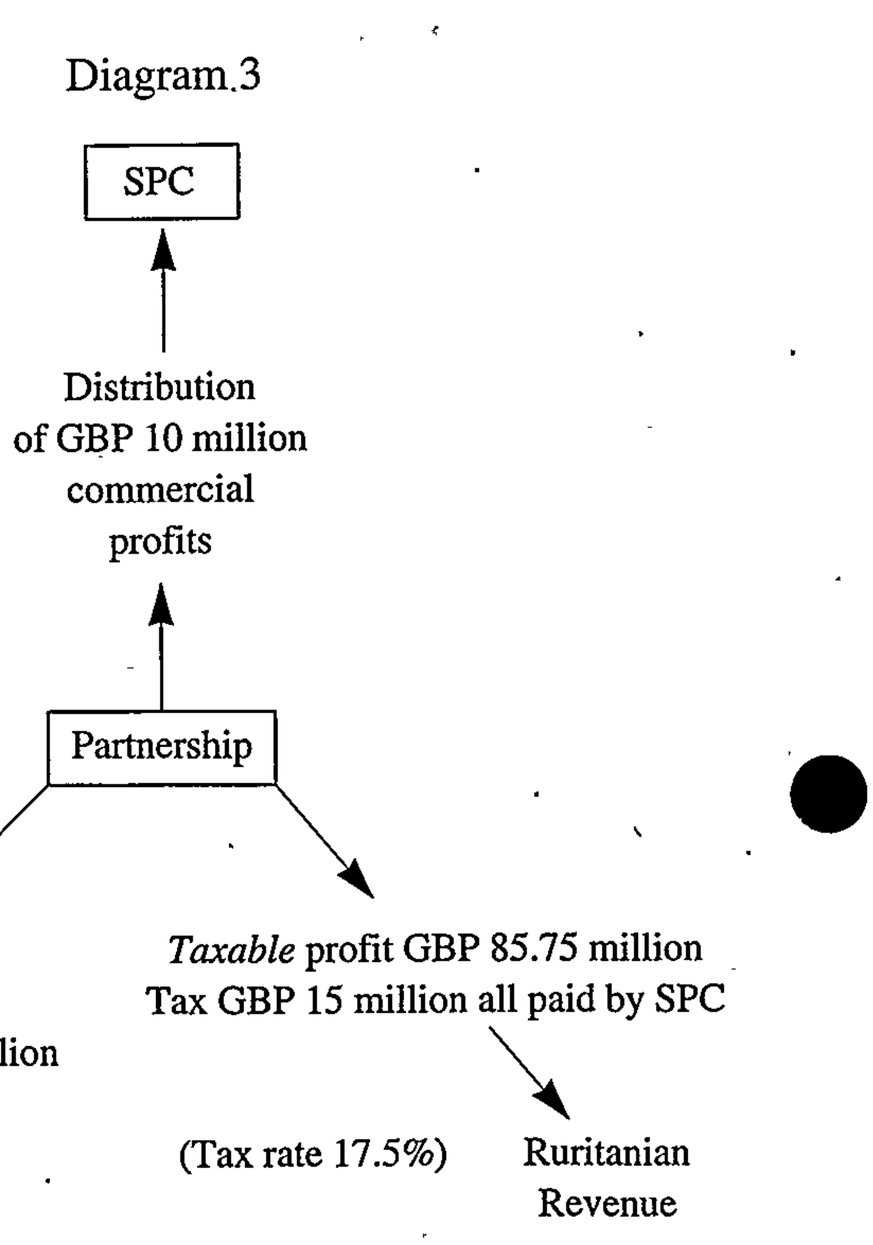


The suspicious nature of the claims to DTR led the inspectors to look more closely at the investment which had produced it. The Ruritanian partnerships in which SPC had invested were all involved in leasing. The other partner in each of the partnerships was a company ("Company A") which leased assets from the partnership. Company A carried on a real business in Ruritania and was liable to Ruritanian tax on the profits of its business. In effect, Company A temporarily sold the profits it was making to SPC in such a way that Company A retained control of the business and assets, but SPC was liable to pay the Ruritanian tax on the profits made by the business. This was the mechanism used to secure the DTR claim in the UK computations of PLC. Company A had itself previously owned the leased assets which now belonged to the partnership.

The capital of the partnerships was made up of a nominal sum of money from SPC (the GBP 200 referred to above) and a very large sum from Company A whose investment was in the form of the assets. Company A sold the assets to the partnership which then paid interest each year in respect of the money it owed Company A for the assets. The partnership leased the assets back to Company A which paid lease payments to the partnership. Because of depreciation of the assets and interest paid to Company A, the commercial accounting profits of the partnerships were less than the taxable profits. The taxable profits of the partnerships (the profits subject to Ruritanian tax at 17.5 per cent) did not include deductions for interest and depreciation and so in fact amounted to GBP 85.75 million producing an annual Ruritanian tax charge of GBP 15 million. However, there was a genuine business in Ruritania making genuine profits on which a real Ruritanian tax charge arose. The accounting and tax profits were materially different because the Ruritanian Revenue looked through the sale and leaseback and effectively taxed the partnership on the true profits before interest and depreciation charges had been manufactured.

Under the terms of the partnership agreement between SPC and Company A, all the tax liabilities of the partnership were to be paid by SPC. SPC was also entitled to all the commercial profits of the partnerships, although these were small despite the high tax bill so that the profile of the investment looked like this:

Diagram 3



SPC, which had received only GBP 10 million from the participation, was claiming DTR in respect of the full GBP 15 million paid to the Ruritanian Revenue. What was clear was the following:

- Prior to entering the scheme, Company A through its genuine commercial activities generated real taxable profits in Ruritania which attracted a Ruritanian tax charge of GBP 15 million.
- PLC had around GBP 450 million invested in the UK money market; this produced a return of 10 per cent or

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GBP 45 million which attracted a GBP 15 million tax charge in the United Kingdom.
- In essence, Company A and PLC entered a partnership. The partnership was based in Ruritania.
- As a result of the partnership agreement, PLC (or rather its creature, SPC) paid the Ruritanian tax of GBP 15 million that would in the absence of the scheme have been paid by Company A.
- PLC then claimed DTR in respect of all the GBP 15 million.

At first sight the transaction was neutral to PLC and SPC taken together – SPC paid GBP 15 million in Ruritanian tax and PLC claimed DTR in the same amount. In substance they paid Ruritania GBP 15 million tax rather than the UK CT bill of GBP 15 million. So why did PLC bother? In order to establish what was in the scheme and for whom we had to ascertain the cash flows – whilst we knew that GBP 15 million flowed to the Ruritanian Revenue and GBP 15 million flowed away from the UK Revenue as a result of DTR, we wanted to know what was in it for:
(i) PLC
(ii) Company A and
(iii) The sponsoring merchant bank.

III. WHAT WERE THE CASH FLOWS AND WHO WAS BENEFITING?

In short the position was this. PLC, a UK resident, had real investment income from the UK money markets of GBP 45 million a year. UK tax of about GBP 15 million should be due on that income (actually GBP 14.85 million at 33 per cent). But PLC effectively bought DTR of GBP 15 million from an unconnected party for a net outlay of GBP 10 million to cover the UK CT bill. The GBP 15 million tax was in substance the liability of the Ruritanian resident, Company A. It was made to appear as the liability of SPC and so, allegedly, it was underlying tax for which DTR was due to PLC. But really it had nothing to do with the United Kingdom. Of the GBP 10 million spent by PLC half went to Company A and half went to the scheme promoters.

In more detail what emerged was this:
- The sponsoring merchant bank received fees of GBP 5 million. These were paid by SPC.
- The partnership (which in essence belonged to Company A) paid a distribution of GBP 10 million to SPC, instead of paying tax of GBP 15 million to the Ruritanian Revenue. Company A therefore saved GBP 5 million.
- The Ruritanian Revenue still got its GBP 15 million.
- SPC: gets from Company A's business GBP 10 million
  pays tax to Ruritanian Revenue (GBP 15 million)
  pays fees to merchant bank (GBP 5 million)
  net result is a loss of (GBP 10 million)

The net loss of GBP 10 million from the scheme is borne by PLC but PLC is happy because there is a GBP 15 million saving on the UK tax bill, giving a net profit of GBP 5 million.

It is worth pointing out that whilst we had explored only one year, the scheme was to run for five years. The tax loss on this scheme alone would have been GBP 75 million over the life of the scheme (five years x GBP 15 million). There was a serious problem and there were substantial sums involved. It is sobering to find that a major UK PLC, a High Street name, was prepared to deprive the UK Exchequer of a large amount of tax in a way which provided a very substantial benefit to a foreign resident. For PLC all that mattered was its own bottom line. This is worth bearing in mind when faced with claims that X doesn't go in for tax avoidance. It might, of course, be true but it may be necessary to test the proposition.

The scheme promoters confirmed these steps and the figures involved. We now understood what had happened. The next step was to see if the scheme had the consequences that its promoters intended. The promoters argued that:
(i) SPC was not resident in the United Kingdom.
(ii) SPC was formally entitled to the profits of the partnerships.
(iii) SPC was liable to tax on those profits under the law of Ruritania and
(iv) The Ruritanian tax qualified for relief as underlying tax within the terms of Section 790(6) ICTA 1988.

Further investigation led us to disagree with these claims and our counter arguments are considered at the end of the article.

IV. THE NATURE OF THE AVOIDANCE

This avoidance scheme was a mutation of the more common form of DTR practice – what is known as "mixing". This involved funnelling various streams of foreign income through an offshore intermediate holding company. This process effectively provides an average rate of DTR on the dividend paid up by the holding company (the sum of the individual sources). Thus high foreign tax charges on the individual income streams are not wasted by the UK rule limiting DTR to the UK tax on the foreign source. Mixers have long been a feature in the organization of multinational enterprises.

SPC, which was to all means and purposes a creature of the UK PLC, received large amounts of investment income which were untaxed. The UK company, PLC, through SPC, appeared to acquire temporarily for UK tax purposes a stream of highly taxed foreign income. This is the GBP 10 million a year earnings from the partnership on which GBP 15 million of Ruritanian tax was paid. The effective rate of foreign tax was over 150 per cent! This highly taxed foreign income was mixed with the investment income of GBP 45 million upon which no tax had been paid. The two sources of income were used to fund payments on the dividend to the UK parent. Relief was then claimed in the United Kingdom for all the underlying tax, that is, GBP 15 million.

V. REACTION TO THE SCHEME

We now needed to know how many other cases of a similar nature there were around the country. Because of the restricted time available to gather information and design a

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legislative solution, the Department had to act swiftly. We decided to use a Department memo to alert other inspectors. The memo was issued in October 1996. The draft was ready by the first Wednesday in October and it was on the desk of every fully trained inspector in the country by the following Monday morning. Inspectors reacted very quickly – by the Friday we had received responses from around the country and had more details of the abuse and of the amounts of tax at risk. The speed in getting information out to inspectors and the speed of their response proved vital in designing counteraction in time for inclusion in the Finance Bill.

Typically we saw cases which followed the same pattern as PLC. That is, where the UK corporate tax saving went three ways; a third went to the UK company which had bought in the foreign tax, a third went to the foreign company selling the tax and around a third went to the merchant bank who had introduced buyer and seller to each other.

ID had now to consider the policy options. It was mid-October of 1996 and a working party was set up to:
- define the characteristic features of the abuse;
- consider the most appropriate counteraction; and
- make recommendations to Ministers.

It became apparent that the real abuse was in the manipulation of the rules on relief for double taxation.

A submission was made to Ministers at the end of October. It was agreed that the scheme should be negated as soon as possible. Space was found in the forthcoming Finance Bill. The Revenue working party was instructed to work with Parliamentary Counsel on the drafting of counteractive legislation. This became Section 90 of the 1997 Finance Act. It was part of the "package of measures to stamp out tax abuse" to which the Chancellor referred in his November 1996 Budget Statement.

VI. NATURE OF COUNTERACTION

The avoidance schemes we discovered featured groups buying in highly taxed foreign income from a previously unconnected person. The legislation restricts the amount of relief that a UK company can have where it has entered into an avoidance scheme. An "avoidance scheme" is defined as a scheme or arrangement the main purpose, or one of the main purposes, of which is to enable a claim for underlying tax to be made. The legislation, in effect, removes the bought in foreign tax from the DTR calculation. This leaves the company with the same corporation tax liability that it would have had if the scheme had not been entered into. The new rules apply to dividends paid to the United Kingdom on or after 26 November 1996. There is more information at paragraph 967 of the Double Taxation Relief Manual.

It is universally accepted that the legislation does what it set out to do, in that it caught the schemes current within the avoidance community at the time. Of course, we were aware that further mutations of the scheme might evolve in the future. There was some surprise at the precision of the legislation (and some concern that it might have gone too far) since the other side realized all too well how swiftly the Revenue had acted. A partner in one of the big City firms of accountants noted that she had received the marketing literature for this tax avoidance scheme just before the Budget only to find that it was irrelevant on Budget day when the scheme was effectively countered.

The largest case we unearthed involved investments of GBP 1.2 billion by one company in an SPC producing DTR claims in the United Kingdom of around GBP 50 million per year. Again it appears it was a five-year scheme so the amount of actual tax at risk was quickly approaching GBP 250 million on this scheme, and around half a billion when taken with other cases of which we were aware. The cases we have seen all resulted in the companies unwinding the arrangements after the November 1996 Budget. Once the DTR advantages had been removed the structures were swiftly dismantled.

In making representations on the proposed legislation another of the big six accountants wrote to us that:

> we fully understand the Revenue's objections of such schemes and agree that it is right to introduce legislation to counteract them.

By working in partnership, the District's knowledge of the case and ID's knowledge of international investigation led to a quick solution to the abuse presented by the schemes we discovered.

VII. HOW THE PLC CASE WAS SETTLED

The contribution of the District and HO partnership to the detailed theory and design of policy also worked well in persuading PLC that the scheme they executed did not achieve what it set out to do, and that (on the facts):

(1) SPC might be resident in the United Kingdom;
(2) SPC may have traded here, and may be liable to tax here on its profits;
(3) Consent under Section 765 should have been sought when SPC issued shares to PLC; and
(4) The claim to DTR could not succeed under the pre-FA 1997 legislation.

The PLC made a substantial payment in Autumn 1997 to settle the case.

VIII. NEW ABUSE IN THIS FIELD

ID has become aware that at tax planning conferences new schemes are being promised for getting around the legislation. We need inspectors in districts to let ID know of any variations or oddities – remember, it's good to talk!

ID, working with inspectors in districts, will advise Ministers on any such schemes. However, it might occasion less stress if perhaps the next time we could approach Ministers rather earlier than six weeks before the Budget.

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CANADA

RESIDENCE OF CORPORATIONS FOR CANADIAN TAX

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I. INTRODUCTION

A corporation resident in Canada is taxable on global income. A non-resident corporation is only taxable in Canada to the extent that the non-resident carries on business in Canada, or disposes of taxable Canadian property. A non-resident is also subject to Canadian withholding tax on interest, rents, royalties, dividends and management fees paid or credited to the non-resident.

I will attempt to summarize the law on residency and the administrative practice of Revenue Canada and to draw conclusions. I will briefly review the statutory references to residency and the jurisprudence. I will consider the impact of technology on the issue of residency (e.g. the use of e-mail).

Although the topic is not new, the increase in international trade both to and from Canada has resulted in an increase in the use of international structures designed to be tax effective and to allow businesses to remain competitive in the international marketplace. While historically the use of international corporations was the domain only of a select few wealthy individuals and international companies, it is now available to small and medium sized businesses, owner-managers and persons of more modest means.

The residency of a corporation is determined by a combination of statutory provisions and the common law. The Income Tax Act sets out certain deeming provisions in Sections 250(4) to (6). In addition, the common law tests of central management and control must be considered. A corporation shall be deemed to have been resident in Canada throughout a tax year if it was incorporated in Canada after 26 April 1965. If the corporation was incorporated in Canada before 27 April 1965 it will be deemed to be resident in Canada if at any time after 26 April 1965, it was resident in Canada or carried on business in Canada. For example, such a corporation may be deemed to be resident in Canada by virtue of the common law doctrine of central management and control.

Section 250(4)(b) will also deem a corporation incorporated in Canada before 9 April 1959 to be resident in Canada if prior to 18 June 1971 it was a foreign business corporation that was controlled by a corporation resident in Canada during the ten year period ending on 18 June 1971 and carried on business in a country other than Canada and during that period paid dividends to shareholders resident in Canada upon which the shareholders paid tax to the government of the other country and at any time in the tax year or in any preceding tax year commencing after 1971, was resident in Canada or carried on business in Canada. A corporation meeting these tests would be deemed to be resident in Canada.

Section 250(5) confirms that residency under a treaty shall prevail. It provides specifically that a corporation, other than a prescribed corporation, shall notwithstanding the deeming provision based on incorporation in Canada, be deemed not to be resident in Canada at any time if, by virtue of an agreement or convention between the government of Canada and the government of another country that has the force of law in Canada, it would at that time, if it had income from a source outside Canada, not be subject to tax on that income under Part I. In determining the residency of a corporation for treaty purposes, regard must be had both to the provisions dealing with residence for purposes of the treaty and the tie breaker clause (this will be discussed further below).

Where a corporation is at any time granted articles of continuance in a particular jurisdiction, the corporation shall for the purposes of applying the Income Tax Act from the time of continuation in a different jurisdiction be deemed to have been incorporated in the particular jurisdiction and not to have been incorporated in any other jurisdiction. For the purposes of applying the deeming provisions for Canadian corporate residency from the time of continuation, the corporation shall be deemed to have been incorporated in the particular jurisdiction at the time of continuation and not to have been incorporated in any other jurisdiction.

Section 250(6) provides for the residence of an international shipping corporation. A corporation that was incorporated outside of Canada shall be deemed to be resident in that country throughout a taxation year and not to be resident in Canada at any time in the year, provided the corporation's principal business (more than 50 per cent) in the year consists of the operation of ships that are used primarily (more than 50 per cent) in transporting passengers or goods in international traffic, all or substantially all (more than 90 per cent) of the corporation's gross revenue for the year is from the operation of ships in transporting passengers or goods in such international traffic and the corporation was not granted articles of continuance in Canada before the end of the year. A proposed amendment to this provision would treat the holding of shipping subsidiaries as the equivalent of carrying on a shipping operation directly. Dividends from subsidiary wholly owned corporations would qualify as international shipping revenue.

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II. CENTRAL MANAGEMENT AND CONTROL

Central management and control or de facto control is a test which had arisen from the UK *jurisprudence*. It is relevant in determining the residency of a corporation which has been formed outside of Canada. Unless an income tax convention deems the corporation to be resident in the other jurisdiction, care must be exercised to ensure that the corporation not be factually controlled from Canada. As will be seen, de facto management is based primarily on the residency of the directors and the place where director's meetings are held. However, if the directors are not the persons who, in fact, make the major decisions of the corporation, then the place of residency of the persons making such decisions would be relevant. The existence of a shareholders agreement whereby the shareholders assume much of the responsibilities normally borne by directors would be important. The location of the office, the place where the books and records of the corporation are maintained and the place where the principal business of the corporation is carried on would all have to be considered. The corporation should have an employee outside of Canada who has the authority to make major decisions. The place of incorporation is not, in the absence of treaty protection, relevant for the determination of where management and control is exercised. If a Canadian corporation forms a wholly owned subsidiary outside of Canada, care must be exercised to ensure that the Canadian parent not be viewed as controlling the foreign subsidiary so as to deem the foreign subsidiary to be resident in Canada.

III. JURISPRUDENCE

The following is a review of the major cases dealing with central management and control.

In *DeBeers Consolidated Mines Limited v. Howe*, [1906] A.C. 455 Lord Loreburn, L.C. enunciated the central management and control test. He stated that a company resides for purposes of income tax where its real business is carried on. Real business is carried on where the central management and control actually abides.

In *Gramophone and Typewriter Co. Ltd. v. Stanley* [1908] 2 K.B. 89, the residence of the shareholders was not regarded as relevant in determining where a company was controlled.

In *Swedish Central Railway Co. Ltd. v. Thompson* [1925] A.C. 495, it was held that a corporation could be a dual resident. The board of directors met in Sweden although some of the directors dealt with certain matters in England. It was held that the company was resident in the United Kingdom as well as in Sweden.

In *Koitaka Para Rubber Estates Ltd. v. Federal Commissioner of Taxation* [1940] 65 C.L.R. 15 (Australia H.C.), it was held that a company was resident only in Australia where it owned rubber companies in Papua which were managed by an employee resident in Papua. The Court regarded the test as being one of who exercises the "superior or directing authority". The board of directors of the parent corporation and the shareholders did have an influence because they were empowered to fire the board of directors. In other cases, the power of the shareholders to remove directors has been ignored.

In *Union Corporation Ltd. v. Inland Revenue Commissioners Cases* [1952] 1 ALL E.R. 646, the Court rephrased the test of control as being whoever exercises "superior and directing authority". In Union Corporation, a South African company had 16 subsidiaries. The head office was in South Africa and 13 of the companies were managed from South Africa. Three other companies were managed from England. Policy issues respecting the company were dealt with by the directors who resided in England. The company was therefore resident in England. A minority of the directors resided in South Africa and the meetings of the Board took place in South Africa. It was held that the company was resident in both South Africa and in England.

In *Unit Construction Co. Ltd. v. Bullock* [1960] A.C. 351, a United Kingdom parent had three subsidiaries in Kenya. The companies were regarded as not resident in Kenya because de facto control was exercised in the United Kingdom. The seat of management and control was in the United Kingdom. The Court was not restricted to a review of the company's regulations and looked at the de facto control.

In *Yamaska Steam Ship Company Limited. v. M.N.R.* 61 DTC 716 (TAB), the company was formed in Canada and had Canadian directors. Its only asset was a ship used for carrying freight between England and West Africa. The company's controlling shareholder was resident in the United Kingdom and made all decisions concerning the company's policies. Canadian directors only dealt with the deposit of funds. It was held that the company was not a resident of Canada nor did it carry on business in Canada. The Court followed the *Unit Construction* case which established the fact that a company is resident in the country where de facto central management and control are exercised which in this case was in England.

In order to be found to be a dual resident, there must be a division of policy making decisions. The day to day management of the business in one jurisdiction will not be sufficient for the company to be viewed as managed and controlled in that jurisdiction.

In *M.N.R. v. Crossley Carpets (Canada) Ltd.* 69 DTC 5015 (Exch. Ct.), a company incorporated in England took over a merchandising business in Canada. The United Kingdom company provided advice on financing and the annual meetings of shareholders and directors were held in the United Kingdom. The Canadian company managed its affairs on its own. The Executive Vice-President was a resident of Canada and was responsible for the day to day operations. On matters of policy, another director who spent some time in Canada was consulted. It was held that the company was resident in Canada. It was resident in the country where its central management and control is exercised and the place of central management and control is the place of paramount authority. However, if the place of exercise of paramount authority is divided between two or more countries, then the corporation is resident in each of those countries. The company was

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therefore a dual resident being both resident in Canada and England.

In *Bedford Overseas Freighters Ltd. v. M.N.R.* 70 DTC 6072 (Exch. Ct.), the majority of the shares of a Canadian corporation engaged in shipping operations was owned by a non-resident. The directors of the company were all resident in Canada. However, all major decisions were made by the non-resident shareholder. The Canadian directors negotiated and signed agreements and operated the bank account. It was held that the company was resident in Canada on the basis of central management and control. The residence of and powers of the shareholder were not relevant. The management of the business and the controlling power and authority over its affairs were vested in the Canadian directors who exercised that power in Canada albeit largely to carry out decisions made elsewhere.

In *Tara Exploration and Development Co. Ltd. v. M.N.R.* 70 DTC 6370 (Exch. Ct.), a corporation, formed in Ontario, carried on business in Ireland. The corporation acquired a new Canadian subsidiary to develop an Irish mining property adjoining its properties and sold the shares at a profit. In determining that the Appellant was not taxable in Canada, the Court concluded that the company was not resident in Canada. Although the company had a head office in Canada and other facilities and activities in Canada, the central management and control was in Ireland and was not divided between Canada and Ireland. The company had lawyers, auditors and bank accounts in Canada.

In *Victoria Insurance Company Ltd. v. M.N.R.* 77 DTC 320 (T.R.B.), an Ontario public company incorporated a subsidiary in the Bahamas to engage in the reinsurance business. Originally, the corporation had five Bahamian directors and four Canadian directors. The Canadian directors subsequently resigned with the exception of one who became a Bahamian resident. All meetings were held in the Bahamas where the books, minutes and shareholders registry were kept and where all corporate housekeeping activities were carried out. The Canadian corporation entered into contracts of reinsurance with the Canadian insurance companies. The company was reassessed on the basis that the management and control resided in Canada. The taxpayer was successful on the basis that the independence of action and sense of permanence in the Bahamas was sufficient to indicate that management and control were in the Bahamas. The office, the books, the majority of the directors, the lawyer and the auditor and the bank accounts were all in the Bahamas. All meetings of the board of directors, reports to government departments, investment of funds and banking were carried on in the Bahamas.

In *Dominion Bridge Company Limited v. The Queen* 77 DTC 5367 (F.C.A.), a Canadian company engaged in the manufacture of steel formed a wholly owned subsidiary in the Bahamas to act as its supplier. The operations were controlled and approved by the taxpayer's vice-president, a resident of Canada, who became a director of the subsidiary. The Canadian company was the Bahamian company's only customer and it purchased steel from it at inflated prices. The approach taken by the court was not to deal with the issue of central management and control but instead, to argue that the alleged operations of the subsidiary were a sham, intended to enable the taxpayer to avoid tax by transferring part of its profits to a tax haven. As the Trial Judge concluded that "the hand and brain" of the Bahamian corporation was the vice-president of the Canadian corporation who engineered the plan and saw to it that it was implemented in its minutest details, the argument of central management and control in Canada certainly could have been made.

In *Capitol Life Insurance Company v. The Queen* 84 DTC 6087 (F.C.T.D.), a US insurance company with its head office in the United States expanded into Canada. It obtained federal and provincial registrations and used an agent in Canada and made deposits in Canadian bank accounts. It never solicited a policy in Canada although group policies were issued in the United States under the terms of which Canadian residents were insured. It was held that the taxpayer was not resident in Canada and did not carry on business in Canada. The company was not held to be resident in Canada.

In *Spur Oil Ltd. v. The Queen* 81 DTC 5168 (F.C.A.), Spur was a wholly owned subsidiary of a Canadian company. Spur paid a transportation charge to a related Bermuda company. At issue was whether the charge was excessive. As the price was slightly less than fair market value, the charge was allowed. The court did not address the management and control issue, notwithstanding the fact that there was a Canadian parent corporation.

In *The Queen v. Crown Forest Industries Limited* 85 DTC 5389 (F.C.A.), the corporate taxpayer rented certain barges from Norsk, a non-resident corporation formed in the Bahamas but carrying on business in the United States. Reliance was placed on Article XIII of the Canada–United States Income Tax Convention (1980) which provided for a reduction in withholding tax on rental payments. The issue was whether Norsk was a "resident" of the United States within the meaning of the Convention so as to be entitled to a reduction in Canadian withholding tax. The company was incorporated in the Bahamas and managed in the United States. Norsk was liable for tax in the United States to the extent it carried on a trade or a business and had effectively connected income. It was taxed on US source income. It was held that the treaty residency, which was essential for the treaty to apply, required that the corporation be taxable on its worldwide income and not just on a source basis. The court concluded that a corporation is not taxable in the United States solely by reason of its residency or place of management. Therefore, Norsk was not entitled to the treaty reduction.

The *Crown Forest* case has also raised some concern about the necessity of having an offshore corporation, which is located in a jurisdiction which has a treaty with Canada, meeting the common law test of management and control in that jurisdiction in order for the corporation to be able to earn exempt surplus. It is interesting that Canada and the United States regard an S corporation as being eligible for treaty relief notwithstanding the fact that it is a flow-through vehicle. However, an LLC which is treated as a partnership for US purposes does not meet the test of being resident for US

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tax purposes as it is not liable for tax in the United States. Instead, its shareholders are taxable on the income. This has caused concern for Canadian corporations using US LLCs to finance US corporations as a recent amendment in the US Legislation increases the rate of US withholding tax to 30 per cent. It is also of concern as Americans are using LLCs with increased frequency to carry on business and may inadvertently acquire Canadian investments with such an entity only to discover that Canada will not permit the LLC to benefit from any reduction in Canadian withholding tax provided in the Canada–United States Income Tax Convention.

In *Consolidated-Bathurst Limited v. The Queen* 87 DTC 5001 (F.C.A.), the taxpayer incorporated a subsidiary to carry on the insurance business in Bermuda. The offshore corporation was initially a Panamanian corporation, the assets of which were transferred to a Bermudian corporation which was then licensed to carry on the insurance business in Bermuda. All the directors and officers of the corporation were residents of Bermuda. The company in Bermuda was managed pursuant to a contract with a Bermudian corporation owned by Canadian insurance brokers. The Bermuda manager had a substantial staff. The Canadian corporation insured certain risks with domestic insurers who then reinsured these risks with the Bermuda subsidiary. The domestic insurers required indemnities and letters of credit backed by the Canadian parent corporation's guarantees in order to reduce the risk assumed by the domestic insurers. After seven years, the guarantees were no longer required. Revenue Canada disallowed a substantial portion of the insurance premiums deducted by the taxpayer in the years where the guarantees were provided on the basis that it would artificially reduce the taxpayers income. The Court agreed that when the guarantees were in place, the Canadian taxpayer could have been required to absorb a loss it had purported to insure against. It therefore concluded that the deduction of premiums resulted in an artificial reduction in the taxpayers income for those years. The Court did not raise the issue as to the residency of the corporation.

In *Indalex Limited v. The Queen* 88 DTC 60530 (F.C.A.), a Canadian corporate taxpayer was indirectly controlled by a UK corporation. The British company had another subsidiary which was resident in Bermuda. The Canadian corporation would send a purchase order to the Bermuda corporation with a copy being forwarded to the Canadian supplier. The supplier would subsequently receive a formal purchase order from the Bermuda corporation but it would act on the copy earlier received from the Canadian corporation. The supplier would ship the goods directly to the Canadian corporation and send the invoice to Bermuda. The Bermuda company would then invoice the Canadian corporation for an identical amount. The Canadian company would credit the Bermuda bank account with the invoice price. The Bermuda company would credit the Canadian supplier's account with an identical amount and the supplier's parent company would credit the Bermuda bank account for any discounts attributable to the purchase price. The amount of the discounts paid to the Bermuda company were included in the Canadian company's income. The taxpayer lost on the basis that part of the discount retained by the Bermuda company had to be attributed to the Canadian corporation. The issue of corporate residency was again not discussed.

In *Alberta Gas Ethylene Company Ltd. v. The Queen* 90 DTC 6419 (F.C.A.), a Canadian company formed a wholly owned US subsidiary. The US subsidiary borrowed from US lenders and deposited the proceeds in Canadian chartered banks which, in turn, made a loan to the Canadian corporation against such deposits. The court concluded that the US corporation was not a sham, a "straw man" or mere borrowing arm of the taxpayer, but a separate corporate entity set up for the valid business purpose of obtaining US financing at preferential lending rates. Nor was the US corporation viewed as the agent of the taxpayer. It was also said to be carrying on business in Canada. In this case as well, Revenue Canada did not choose to proceed on the basis of central management and control.

In *Canada Trustco Mortgage Company* v. *M.N.R.* 91 DTC 1312 (T.C.C.), Canada Trustco formed a wholly owned subsidiary in the Netherlands. There were three managing directors, two individuals resident in Holland and one in Barbados. Coopers & Lybrand (Amsterdam) were the auditors. The issue was whether the interest income received by the Dutch subsidiary, arising out of bank deposits and payments made under mortgages held by it on properties in Canada, was income from an active business. In that case, it was held that the Dutch company was engaged in an active business. The court did not pursue the issue as to whether the Canadian parent corporation controlled the Dutch subsidiary so as to make it resident in Canada under the common law principal of management and control.

In *The Queen v. Irving Oil Limited* 91 DTC 5106 (F.C.A.), an offshore trading company known as Irvcal was formed in order to acquire crude and transportation for a refining company and to acquire products and transportation for an oil company. A retired executive became the president of Irvcal. He was its only full-time employee and received an annual salary of USD 30,000. The only other employee was a part-time secretary. Office space was obtained. Irvcal's functions were performed. The company made approximately 141 oil purchases all for resale to Irving Oil (its 50 per cent shareholder). Irvcal never took possession of the oil and never insured it. The price paid by Irving Oil for the crude was its fair market value. It was held that the tax avoidance scheme did not offend the Income Tax Act. The court did not attempt to impute control to Canada.

In *Birmount Holdings Ltd. v. The Queen* 78 DTC 6254 (F.C.A.), a corporation was incorporated in Canada in 1960 with the head office being in Toronto. Three common shares were issued to three directors resident in Toronto; a lawyer and two trust company officers. The directors signed declarations of trust stating that they were holding the beneficial interest in such shares for a Swiss bank. The beneficial holder of the corporation was a non-resident of Canada who was a Greek citizen. As the corporation was incorporated before 27 April 1965, the case dealt with the issue as to whether the corporation was resident in Canada or carried on business in Canada after 26 April 1965. (Section 250 (4)(c)). The Trial Judge had made a finding of fact that the corporation was car-

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rying on business in Canada. The Court of Appeal addressed the issue as to whether the corporation could be resident on a de facto basis. Reference was made to the *DeBeers* case and to the central management and control test. The Court focused on the following facts in support of the conclusion that the corporation was resident in Canada:

- the company was incorporated in Canada and had Canadian shareholders and directors (although as noted above there was a declaration of trust);
- all the business was in Canada and it had Canadian auditors, solicitors and a Canadian agent managing its affairs. Its head office was in Toronto. Its sole object was to purchase property in Canada. It dealt with Canadian tenants on the property it had acquired;
- Royal Trust in Toronto opened a trust account for the Canadian corporation;
- the seal and minute books were kept in Canada;
- Ontario corporate tax returns were filed in Toronto without consulting the non-resident shareholder;
- the company filed income tax returns in Canada and no income tax returns in any other country;
- the two directors from the Canadian trust company would change without consultation with the non-resident shareholder;
- the non-resident shareholder relied on the Canadian representative for advice in dealing with the company's affairs; and
- the non-resident shareholder admitted that he never overruled the Canadian directors.

The Court concluded that the "real business" and the "only business" of the taxpayer is carried on in Canada and that it "kept house" in Canada and the "central management and control" of the taxpayer was in Canada.

IV. STATUTORY PROVISIONS

The definitions of "Canadian corporation", "private corporation", "public corporation" and "taxable Canadian corporation" all require that the corporation be resident in Canada.

A "Canadian corporation" is a corporation that is resident in Canada at that time and was either incorporated in Canada or resident in Canada throughout the period that began on 18 June 1971 and ends at that time.

A "private corporation" means a corporation that, at the particular time, is resident in Canada, is not a public corporation and is not controlled by one or more public corporations.

A "public corporation" means a corporation that was resident in Canada at the particular time, if at the particular time a class or classes of shares of the capital stock of the corporation were listed on a prescribed stock exchange in Canada or after 18 June 1971 it elected in the prescribed manner to be a public corporation.

A "taxable Canadian corporation" means a corporation that was a Canadian corporation and is not, by virtue of a statutory provision, exempt from tax under Part I.

A corporation that is not a private corporation does not have refundable dividend tax on hand (Section 129(1)), is not subject to Part IV tax (Section 186(1)) and cannot pay tax free capital dividends to its shareholders (Section 83(2)).

A corporation which is resident in Canada will be taxable on its global income (Section 2(1)). A non-resident corporation will be taxable in Canada, only if it carried on business in Canada or disposed of a taxable Canadian property (Section 2(3)) a non-resident corporation will therefore be taxable on its Canadian source income (Section 115(1)).

Every corporation that is non-resident in the taxation year may also be subject to Canadian tax under Part XIV known as "branch tax". The intention is to provide a tax similar to the withholding tax on dividends that would be collected by Canada if the Canadian business was carried on by a subsidiary and dividends were paid. It is not necessary that the corporation have carried on business in Canada although the computation will result in the Canadian-source business income and related taxable capital gains being subject to the tax.

The Income Tax Act provides for several roll-overs relating to corporations. A roll-over is available only for assets transferred to a taxable Canadian corporation (i.e. to a corporation resident in Canada) (Section 85(1)). The share-for-share exchange provisions in Section 85.1 only apply to shares of a Canadian corporation that are issued in exchange for shares of another corporation that is a taxable Canadian corporation. There is a limited roll-over in Section 85.1(3) where shares of a foreign affiliate are disposed of.

It is possible to benefit from the roll-over under Section 86 which provides for shares received in the course of a reorganization as no reference is made to the residency of the corporation or to the terms Canadian corporation or taxable Canadian corporation.

Section 87 of the Income Tax Act provides for tax-free roll-over on an amalgamation of taxable Canadian corporations. Section 88(1) provides for tax-free wind-up of a 90 per cent owned taxable Canadian corporation.

The partnership rules provide for roll-overs to or from a Canadian partnership (Sections 97(2) and 98(3), (5) and (6)). A Canadian partnership is defined in Section 102 as a partnership all of the members of which were, at the relevant time in respect of which the expression is relevant, resident in Canada. This provision is a problem for international joint ventures where a Canadian corporation is to participate with non-resident corporations in a partnership-type arrangement.

Section 52(8) provides for the cost of shares on the immigration of a corporation. Where at any time a corporation becomes resident in Canada, the cost to any shareholder, that is not at that time resident in Canada of any share of the capital stock of the corporation shall be deemed to be equal to the lesser of that cost otherwise determined and the paid up capital in respect of the share immediately after that time.

Section 89(1.1) prohibits the sale of a capital dividend account for a corporation that was at a previous time, a private corporation controlled directly or indirectly in any man-

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ner by one or more non-resident persons where it becomes a Canadian-controlled private corporation.

A "Canadian-controlled private corporation" is defined in Section 125(7) as a private corporation that is a Canadian corporation other than a corporation controlled, directly or indirectly, in any manner whatsoever, by one or more non-resident persons, by one or more public corporations (other than a prescribed venture capital corporation) or by any combination thereof. The Canadian-controlled private corporation is entitled to benefit from a small business deduction which is a low rate of tax on the first USD 200,000 of annual active business income.

The definitions of mortgage investment corporation (Section 130.1(6)) and mutual fund corporation (Section 131(8)) require that such corporations be Canadian corporations. As a result, the corporations must be resident in Canada.

A Canadian individual receiving taxable dividends from a corporation resident in Canada is entitled to benefit from the gross up and credit mechanism which provides for favourable tax treatment on the dividend (Sections 82(1) and 12(1)(j)). A dividend received from a corporation not resident in Canada is fully taxable under Sections 12(1)(k) and 90.

Section 84 provides for deemed dividends where a corporation resident in Canada has increased its paid-up capital in certain circumstances, redeemed its shares or is wound-up. If the shares of a corporation not resident in Canada are redeemed, a Canadian resident would realize a capital gain rather than a deemed dividend.

Section 84.1 provides for a deemed dividend where a non-corporate taxpayer resident in Canada disposes of shares that are capital property of a corporation resident in Canada to a non-arm's length corporation. Section 212.1 provides for a deemed dividend on a non-arm's length sale of shares of a Canadian corporation by a non-resident to another Canadian corporation.

The employee stock option rules in Section 7(1.1) offer more favourable treatment where the corporation is a Canadian-controlled private corporation. In that case, the taxable benefit is deferred until the shares are sold, provided the employee has retained the shares for a minimum period of two years.

The Income Tax Act contains rules known as the foreign accrual property income or FAPI rules designed to ensure that Canadians pay tax on an undistributed basis in respect of passive income earned by a corporation that is not resident in Canada. A foreign affiliate is defined in Section 95(1) as a non-resident corporation in which, at that time, the taxpayer's equity percentage is not less than 1 per cent and the total equity percentage of the taxpayer and of each person related to the taxpayer is not less than 10 per cent. Section 91(1) of the Income Tax Act requires a taxpayer resident in Canada to include in respect of each share owned by the taxpayer in the capital stock of a controlled foreign affiliate (a defined term) of the taxpayer, as income from the share, his percent of the foreign accrual property income.

The Canadian foreign affiliate rules are designed to provide beneficial tax treatment for active business income earned in a designated treaty country. Regulation 5907(11) provides that a country is a designated treaty country where Canada and a country have entered into a comprehensive agreement or convention. In that case, the active business earnings of a foreign affiliate may be repatriated to a Canadian corporate shareholder as a dividend out of exempt surplus. The foreign affiliate must be resident in a designated country for exempt surplus to apply. Such a dividend will not be taxable to a corporation resident in Canada as a result of the deduction under Section 113 of the Income Tax Act.

Regulation 5907(11.2) provides rules for determining when a foreign affiliate is to be considered to be a resident of a particular designated treaty country. An affiliate will be considered a resident of such a country only where it is a resident of that country for purposes of Canadian income tax rules and for the purpose of the ratified agreement or convention with that country. Regulation 5907(a)(i)(A) provides that corporate earnings from active business are determined in accordance with the tax laws of the country of residence. There is a concern that as a result of the Crown Forest case and regulation 5907(11.2) that a corporation must not only be resident in a country for purposes of the tax treaty between Canada and the country but must also have its management and control in that jurisdiction. For tax treaties entered into before 1995, regulation 5907(11.2)(c) provides that an affiliate will qualify if it was resident in that country for purposes of the agreement notwithstanding the fact that the agreement or convention does not apply to that affiliate. This would provide relief for a Barbados IBC or a company formed in Cyprus or Luxembourg which is excluded from the particular treaty.

Regulation 5907(2.1) provides for an election to use book depreciation. The election is available only to an affiliate that is resident in the treaty jurisdiction.

For the purposes of computing large corporations tax liabilities, different calculations are required for corporations that are resident in Canada and for non-resident corporations.

Section 94.1 provides for an imputed return to a taxpayer who holds an interest in property that is an offshore investment property. This would include a share of the capital stock or a debt of a non-resident entity (other than a controlled foreign affiliate of the taxpayer or a prescribed non-resident. There is no requirement that there be a minimum shareholding for this provision to apply.

The information reporting requirements set out in Section 233.1 require that every corporation that, at any time in a taxation year, was resident in Canada or carried on business in Canada shall, in respect of each non-resident person with whom it was not dealing at arm's-length at anytime in the year, file with the minister within six months of the end of the year an annual information return for the year (form T106).

An individual having an investment in a specified foreign property having a value in excess of USD 100,000 must also file an annual report. Specified foreign property includes a share in the capital stock of a non-resident corporation.

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A return (Form T1134) is required with respect to each foreign affiliate pursuant to Section 233.4(4).

Section 128.1(1) provides for a deemed disposition and reacquisition where a taxpayer becomes resident in Canada. This would also apply to a corporation. Section 128.1(4) provides for a deemed disposition where a taxpayer ceases to be resident in Canada. Corporate emigration can apply to a corporation which is incorporated outside of Canada but which is resident in Canada and then ceases to be resident in Canada. The deemed disposition applies to all capital property other than Canadian real estate. In addition, Section 219.1 imposes a departure tax where a corporation ceases to be resident in Canada. Prior to 1996, it applied where a corporation ceased to be a Canadian corporation. The tax is the equivalent of a branch tax of 25 per cent of the amount, if any, by which the fair market value of the property exceeds the total of the paid up capital in respect of the shares and the corporation's debts and obligations other than certain amounts payable in respect of dividends. Section 219.1 is intended to equate to the withholding tax on a dividend on the winding up of a subsidiary. Regulation 5907(13) deals with the situation for which reason an affiliate becomes resident in Canada.

Section 17 of the Income Tax Act will impute an income to a Canadian corporation that lends money to a non-resident person (including a corporation) unless the loan was made to a subsidiary controlled corporation and it is established that the money that was lent was used in the subsidiary corporation's business for the purpose of gaining or producing income.

Section 93(1) permits an election to be made by a Canadian corporation that disposes of shares of a foreign affiliate in order to treat the proceeds of disposition as a dividend out of exempt surplus (to the extent it is available).

Section 128.2 applies to cross-border mergers. Where a corporation formed by an amalgamation or merger is resident in Canada, a predecessor that was not immediately before the particular time resident in Canada shall be deemed to have become resident in Canada immediately before that time. If the amalgamated corporation is not resident in Canada, a predecessor that was immediately before the particular time resident in Canada shall be deemed to have ceased to be resident in Canada immediately before that time. These rules would not apply to a wind-up.

V. MEANING OF THE TERM CORPORATION

Interpretation Bulletin IT-343R dated 26 September 1977 defines the term "corporation" as it applies for the purposes of determining a "foreign affiliate". It provides that a corporation is an entity created by law having a legal personality and existing separate and distinct from the personality and existence of those who caused its creation or those who own it. A corporation possesses its own capacity to acquire rights and to assume liabilities, and any rights acquired or liabilities assumed by it are not rights or liabilities of those who control or own it. As long as an entity has such separate identity and existence, the Department will consider such an entity to be a corporation even though under some circumstances or for some purposes the law may ignore some facet of its separate existence or identity (IT-343R paragraph 2).

Paragraph 3 of the Interpretation Bulletin provides that the Department considers a corporation as including a joint stock corporation, any limited liability company, as well as certain entities organized under the laws of the countries which are listed. For example, an Anstalt in Liechtenstein or a GmbH in Germany would be viewed as a company.

Revenue Canada has repeatedly issued technical interpretations that a limited liability corporation formed under most US states would be regarded as a foreign affiliate. The primary consideration in determining whether an LLC is a corporation is whether the entity has a separate legal personality under the legislation where the entity was formed (see for example, technical interpretation, reorganization and international division, Revenue Canada file No. 9610765). For US tax purposes, the LLC is treated in a manner similar to a partnership with the shareholders of the LLC, rather than the LLC being taxable. Under the Canada–United States Tax Convention, the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes. The term "resident" of a contracting state means any person that, under the laws of that state, is liable to tax therein. As an LLC is not liable to tax in the United States, Canada takes the position that an LLC is not entitled to any of the benefits under the Canada–United States Tax Convention. Recent US legislation deals with hybrid entities where the non-US jurisdiction does not treat the entity in the same manner as the United States. As a result of this legislation which came into law in August 1997, interest paid by a US subsidiary of a Canadian corporation to an LLC owned by Canadian residents will be subject to withholding tax in the LLC at the rate of 30 per cent rather than 10 per cent.

On 13 April 1992, Revenue Canada issued a technical interpretation on the tax status of an Anstalt for Canadian purposes. On the basis that the Anstalt is a distinct legal entity, it would be treated as a corporation under the Income Tax Act including Section 95. If central management and control of the Anstalt is in Canada, Section 250(5) does not apply. Revenue Canada would consider the Anstalt to be a person resident in Canada within the meaning of Section 2(1). However, it will not necessarily be a Canadian corporation (as defined in Section 89(1)). The distribution of an Anstalt's income and capital gains amongst the bearers of the Anstalt's founders rights would generally be treated as a dividend for purposes of the Income Tax Act. (Revenue Canada file No. 9203695, Window on Tax).

Article IV paragraph 3 of the Canada–United States Tax Convention deems a corporation which would otherwise be a dual resident to be deemed to be a resident of the country in which it was incorporated.[1] As a result, the central management and control is no longer an issue for a US subsidiary of

1. For example, Canada's treaties with Liberia, Malaysia and Thailand refer to place of incorporation. See the article by Edwin Kroft,"Jurisdiction to Tax: An Update" 1993 (MTC 1:1) for an interesting comparative analysis of the residency provisions of Canada's treaties.

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a Canadian corporation as the treaty will override the common law test. Other treaties refer to the place of management or competent authority. In the US treaty, there is a limitation of benefits provision whereby the United States will look to the residency of the shareholders of the corporation in order to determine whether the corporation should be allowed to access the favourable treatment under a particular treaty. The limitation of benefits provision is intended to discourage if not preclude treaty shopping. There are interesting issues such as whether a Canadian resident who forms an entity in say Barbados that is a flow-through vehicle which invests in the United States could take the position that as the Barbados entity qualifies as a flow-through vehicle for US purposes that the benefits of the Canada–United States Tax Convention should apply.

Many of Canada's treaties specifically exclude a corporation that is not fully liable to tax. For example, the treaties with Barbados, Cyprus, Jamaica and Luxembourg contain such exclusions.

VI. ELECTRONIC COMMERCE

On 10 April 1997, Revenue Minister Jane Stewart announced the establishment of an advisory committee on electronic commerce. The objective is to examine trends in electronic commerce, including the growing use of the Internet, to determine the implications of revenue administration and make recommendations for changes in order to ensure continued compliance with Canada's tax laws.

The determination of where activity takes place is unclear. For example, in an Internet transaction, does the transaction take place where the individual turns on the computer or where the information is relayed.

Internet and electronic commerce have raised many tax issues. Most governments are taking the approach that there is the concept of neutrality. Tax should be levied based on the type of income earned and not the method of transmission. For example, the treatment should be the same whether goods are purchased by letter, telephone, fax or over the Internet. In other words, existing principles of taxation should, to the extent possible, be applied to electronic commerce. This would ensure that the existing provisions of double taxation agreements would apply.

Although it may be difficult for a government to trace e-mail transmissions, if a Canadian resident, who is a shareholder or a director of an offshore corporation, directs the companies operations from a computer in Toronto by way of e-mail, there is a risk that Revenue Canada would take the position that the company is being managed and controlled in Canada. While there may be a technical argument that the computer message travels to the other jurisdiction, Revenue Canada would likely argue that control was "in Canada". The concern should be no different than where an individual resident in Canada participates in Canada in directors meetings or other policy decisions of an off-shore company by way of telephone calls. Several international banks offer a computerized service whereby a business in Toronto can monitor the daily activities in its bank accounts around the world. It is submitted that the monitoring, rather than the control of the international bank accounts from Toronto should not constitute a threat as to the residency of the offshore corporation.

VII. CONCLUSIONS AND RECOMMENDATIONS

The issue as to the residency of a corporation may not be as great where a corporation is formed in a high tax jurisdiction. As foreign tax credits would be available for the foreign tax paid by the offshore corporation should it be regarded as resident in Canada, there may not be any additional tax available for Revenue Canada after allowing such credits. It is therefore likely that the concern of the taxing authorities will be elevated where the corporation in question is formed in a tax haven or a jurisdiction which provides for very low corporate tax rates.

The residence of the shareholders should not be relevant as long as the directors make the major decisions. The fact that the shareholders elect the directors does not impact on residency. Care must be exercised if there is to be a shareholders agreement under the terms of which any of the powers are taken away from the directors and given to the shareholders.

As residency is a question of fact, there are certain steps which are advisable to ensure non-residency. They are as follows:

- the majority, if not all of the directors should not be resident in Canada. A majority decision, rather than unanimity of the Board, should be required if there is to be a Canadian director;
- all meetings of the directors should be held outside of Canada;
- the directors should make policy decisions without requiring prior approval of the shareholders;
- the head office of the company should be outside of Canada;
- the company should have an employee knowledgeable in the business who will sign all contracts on behalf of the company outside of Canada;
- the company should have its own letterhead, fax and phone number;
- all banking should be done outside of Canada;
- persons resident in Canada should not send instructions on any major decisions and day-to-day business activities to the non-resident corporation by e-mail, fax or telephone;
- all accounting should be done outside of Canada;
- all sales should be negotiated outside of Canada;
- no persons resident in Canada should use business cards of the corporation.

The right to remove the directors will not be relevant for this determination as it may only occur after the directors have made decisions.

It is possible for a corporation to be a dual resident. This should occur only where the right to control the company is divided between more than one jurisdiction. If the corpora-

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tion is considered to be a resident both in Canada and in another country which has a tax treaty with Canada, reference should be made to the tie-breaker clause in the treaty to determine if relief is available.

Planning is available for a corporation which is to become resident in Canada. It may be possible to increase the paid up capital or the adjusted cost base of the shares prior to coming to Canada. It may also be possible to pay a dividend equal to the retained earnings and loan the funds back to the corporation before the corporation is subject to any Canadian withholding tax. Obviously, planning in this area depends upon residency of the corporation and of the shareholders.

Based on the jurisprudence, the residency of a foreign subsidiary of a Canadian parent company will be determined in the same manner as the residency of any other foreign corporation. In other words, there will not be any type of presumption that the foreign corporation is controlled by the Canadian parent.

Conference diary

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

APRIL

International Tax Planning Techniques, Amsterdam, the Netherlands, 6-7 April 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

US Taxation of Corporate Reorganisations, Frankfurt, Germany, 8-9 April 1998 (English):

The European-American Tax Institute, Falmer Court, London Road, Uckfield, East Sussex TN22 1HN, the United Kingdom, Tel.: 44-1825 760901, Fax: 44-1825 760903.

Intermediate US International Taxation, London, the United Kingdom, 14-15 April 1998 (English):

The European-American Tax Institute, Falmer Court, London Road, Uckfield, East Sussex TN22 1HN, the United Kingdom, Tel.: 44-1825 760901, Fax: 44-1825 760903.

The China Customs Tariff Conference '98, Shanghai Hilton, 250 Hua Shan Road, Shanghai 200040, China (People's Rep.), 16-17 April 1998 (English):

IBC Asia Limited, No. 1 Grange Road, #08-02, Orchard Building Singapore 239693, Tel.: 65-732-1970, Fax: 65-733-5087, E-mail: rochelle@ibcasia.com.sg

European Tax Update Conference, The Marriott Marquis, New York, New York, the United States, 20-22 April 1998 (English):

CITE, the Council for International Tax Education, P.O. Box 1637, White Plains, NY 10602, the United States, Tel.: 914-328-5656, Fax: 914-328-5757.

Corporate Tax Manager, St. James Court Hotel, London, the United Kingdom, 27-28 April 1998 (English):

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

The 1998 China Tax & Accounting Summit, The Hong Kong Hotel, Hong Kong, 27-29 April 1998 (English):

Insight, 1/F Chinachem Hollywood Centre, 1-13 Hollywood Road, Hong Kong, Tel.: 852-2520 1481, Fax: 852-2866 7340.

Tax-Efficient Financial Tools in Central and Eastern Europe, Hilton Hotel, Budapest, Hungary, 27-29 April 1998 (English):

Vision in Business, 41 Whitcomb Street, London, the United Kingdom, Tel.: 44-171-839 8391, Fax: 44-171-839 3777, E-mail: postmaster@visibis1.demon.co.uk

MAY

International Tax Aspects of Financial Derivatives, Amsterdam, the Netherlands, 14-15 May 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

School of Transfer Pricing, 86 Park Lane (at Grovesnor House), London W1, the United Kingdom, 20-21 May 1998 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

JUNE

International Tax Aspects of Permanent Establishments, Amsterdam, the Netherlands, 18-19 June 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

AUGUST

Summer Course on the Principles of International Taxation, Amsterdam, the Netherlands, 17-28 August 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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ITALY

TREATMENT OF DIRECTORS' FEES PAID TO NON-RESIDENT ALIENS UNDER THE UNITED STATES–ITALY CONVENTION AGAINST DOUBLE TAXATION

Edward F. Greco

I. INTRODUCTION

This paper analyses the treatment of relevant directors' fees paid by a US company to a director who is an Italian resident[1] under the United States–Italy Convention for the avoidance of double taxation (the "Treaty").

Usually, directors are required to attend meetings periodically at the company's headquarters and receive compensation for their duties. These fees, generally plus reimbursement of travel expenses may be paid in a fixed amount or per meeting attended. Since the jurisdiction in which meetings are held causes different consequences, this paper focuses on the case in which board meetings are held in the United States.

Under Section 864(b) of the Internal Revenue Code,[2] the performance of personal services constitutes a US trade or business. To be engaged in a trade or business there must be a continuity of activity and the active pursuit of profit.[3] Thus, if these criteria are met, the performance of personal services described above constitute a US trade or business. Fees paid for such services are treated as income effectively connected with the US trade or business and are subject to US tax at the regular rates imposed on US citizens and residents.[4] Moreover, a person making a payment of compensation for personal services performed in the United States to a non-resident alien not engaged in a trade or business must generally withhold 30 per cent of the amount of such payment,[5] unless an exception from withholding applies.[6] An exception is provided for payments of income that would be exempt from tax under the provisions of a treaty.[7]

II. DIRECTORS' FEES PROVISION

Article 16 of the United States–Italy Treaty[8] provides that:

> Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is resident of the other Contracting State may be taxed in that other State.

According to the language of Article 16, the company's state of residence has then the right to tax directors' fees paid to a foreign resident, while at the same time the director's country of residence retains its right to tax this income. To avoid the possibility of double taxation, contracting states have limited the scope of Article 16, by inserting in the Protocol[9] to the Treaty that:

> Directors' fees and other similar payments derived by a resident of a Contracting State which are described in Article 16 (Directors' fees) of the Convention may be taxed in the other Contracting State only to the extent that fees and other payments are attributable to services performed in such other State.

This provision was necessarily introduced to adopt the OECD pattern of Article 16 to the US source of income principles, and effectively amends Article 16. In fact, the United States taxes directors' fees only if income arises from personal services performed in the United States, and generally so provides in its treaties.[10] With respect to income qualification stemming from services performed in the United States, Article 16 is governed by the relevant personal service provision.[11] Thus, the question comes to be whether the services

1. Not a US citizen.
2. Unless otherwise indicated all section references are to the Internal Revenue Code (I.R.C.) of 1986, as amended (the "Code").
3. Sidney I. Roberts, William C. Warren, *U.S. Income Taxation of Foreign Corporations and Nonresident Aliens,* chap. V/2.
4. I.R.C. Sec. 864(c) and Sec. 871(b)(1).
5. This assumes the personal services performed are not of a dependent nature where remuneration constitutes "wages" and the regular withholding tax rate applies. The matter is discussed below.
6. I.R.C. Secs. 1441(c)(1), (c)(4).
7. Treasury Regulation Sec. 1.1441-6(a).
8. Convention between the Government of the United States of America and the Government of the Republic of Italy for the avoidance of double taxation with respect to taxes on income and the prevention of fraud or fiscal evasion, signed 17 April 1984.
9. Art. 1, para. 13 of the Protocol clarifying and supplementing the DTC, the "Protocol".
10. Consistent with US source of income principles, remuneration arising from independent personal services rendered to a US company, but performed outside the United States should not be taxed in the United States. To this effect a Preservation of Benefits clause was introduced in the Protocol (Art. 3) stating that the Treaty will not restrict any benefit for taxpayers under US or Italian domestic law or under any other agreement between the two Contracting States. See also, Art. 1 para. 2 of the 1995 US Model Treaty.
11. With regard to income qualification, according to the Preservation of Benefits clause discussed above, the Treaty cannot operate to the detriment of the taxpayers covered by the Treaty. That is to say, the Treaty cannot recharacterize an item of income that following internal law qualifies under a more favourable provision, i.e. independent personal services. It is useful to note that Code Sec. 7852 (d)(1) as amended in 1988, reads: "For the purpose of determining the relationship between a provision of a treaty and the law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or the law". In addition, Sec. 894(a) which previously to the Technical and Miscellaneous Revenue Act of 1988, stated expressly that any income exempted by treaty remained exempt despite any Code provision to the contrary, was amended to state only that Code provisions should be applied with "due regard" to US treaty obligations. See: Paul R. McDaniel, Hugh J. Ault, *Introduction to United States International Taxation,* chap. 11.

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rendered by the directors are of an independent or dependent nature.

III. INDEPENDENT PERSONAL SERVICES

Article 14 of the Treaty deals with compensation for "independent personal services", and provides:

> Income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State unless such services are performed in the other Contracting State and (a) the individual has a fixed base regularly available to him in that other State for the purpose of performing his activities but only so much of the income as is attributable to that fixed base may be taxed in that other State; or (b) the individual is present in that other State for a period or periods aggregating more than 183 days in the fiscal year concerned. The term "personal services in an independent capacity" includes but is not limited to, scientific, literary, artistic, educational, and teaching activities as well as independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Under Article 14, an Italian citizen and resident who performs independent personal services in the United States will not be subject to US tax on the income from such services unless he has a "fixed base regularly available to him" in the United States (and then only to the extent such income is attributable to the fixed base), or is present in the United States for more than 183 days during the relevant fiscal year. This provision is in contrast to the rule for income from "dependent personal services", which generally subjects such income to US tax unless the remuneration is paid by, or on behalf of, an employer who is not a resident, or the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the United States.[12]

In response to the specific provision for directors' fees provided in the 1977 OECD Model Convention, the United States stated its position that directors' fees should be subject to tax under the article governing independent personal services.[13] In fact, in dealing with directors' fees, the United States has treated them as fees for "independent personal services". The Internal Revenue Service has also published a ruling taking this position.[14] However, only fees paid to a director for services rendered in his capacity as a director fall within this rule. If a member of the board of directors is also a shareholder, any remuneration dependent on the profits made by the company might be considered to be a distribution in respect of his interest in the company. Revenue Ruling 74-163 notes that directors' fees might, under different circumstances, be recharacterized as amounts paid for services performed as an employee or as payments in the nature of a distribution of profits. Such recharacterized amounts would be then governed by the relevant treaty provision.

Where the directors of the US companies do not function like typical corporate directors but undertake managerial involvement in the operating decisions of the company, for instance, in the form of an unusual number of meetings they attend, the Internal Revenue Service might argue that the directors are more like employees than independent contractors, and that their compensation should therefore be governed by Article 15 dealing with dependent personal services.

IV. DEPENDENT PERSONAL SERVICES

Broadly speaking, the scope of Article 15 is to tax remuneration derived by a resident of a Contracting State in respect of employment activities carried on in the other Contracting State. This article is modified in some respects for directors' fees[15] and effectively excludes directors' fees from being regarded as dependent personal services.[16] As I have pointed out previously, if activities performed by the board of directors fall short of the independent services qualification then they will be viewed as deriving from other sources, for instance employment. Whether a director of a corporation can be an employee of the corporation depends primarily upon whether or not he performs services which are not directorial in nature, and whether or not those services are performed under an employer-employee relationship.[17] It is a question of fact whether the board members are performing solely directorial activities. In respect of dependent personal services Article 15 of the Treaty states that:

> ... salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

The contracting state where employment is exercised has then the right to tax. Accordingly, US domestic tax law provides that if payments include remuneration for services performed as an employee, as well as a director, fees are subject to US withholding tax at the regular rate.[18]

V. FIXED BASE

Assuming Article 14 of the Treaty applies, and the Italian director will not be present in the United States for more than 183 days, directors' fees will be subject to US tax only if the director "has or had a fixed base regularly available to him" in the United States. The question is whether the facilities, usually meeting rooms or corporate offices made available for the use of all the directors, constitute a "fixed base regularly available to the director". If they do, the fees will not be

12. "Dependent personal services" are governed by Art. 15 of the Treaty.
13. 1977 OECD Commentary, Art. 16, para. 5.
14. Revenue Ruling 74-163, 1974-1 CB 374. (Directors' fees paid to a director of a Norwegian corporation in his capacity as such are payments for independent personal services). See also Private Letter Ruling 8204098 (18 October 1981) and 8151117 (28 September 1981) (Ruling on different issues but stating that generally services rendered as a director of a corporation are "independent personal services").
15. And other items of income such as pensions (Art. 18) and compensation as a government employee (Art. 19).
16. Art. 16 reads; "Subject to the provisions of Art. 16 (directors' fees) ..."
17. The guidelines for determining whether a common law employment relationship exists are found in Sec. 31.3401(c)-1(b) of the Regulations. See also Sec. 31.3401(c)-1(f)(Corporate officers are employees, but directors as such are not).
18. I.R.C. Sec. 3402 (a).

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exempt from tax.[19] The "fixed base "language first appeared in the OECD Draft Convention of 1963. The theory behind the shift from "permanent establishment" to "fixed base" was explained as follows:

> ... the concept of permanent establishment should be reserved for commercial and industrial activities. The term "fixed base", which is not to be found in various Conventions, has therefore been used. It has not been thought appropriate to try to define it, but it would cover, for instance, a physician's consulting room or the office of an architect or a lawyer. A person performing professional services would probably not as a rule have premises of this kind in any other State than that of his residence. But if there is in another State a centre of activity of a fixed and permanent character, then that State should be entitled to tax the person's activities.[20]

Since the fixed base need only be "regularly available", it is clear that a person may have a fixed base without owning it. One commentator has suggested, for instance, that "a physician would be setting up a fixed base [by virtue of] entering into an agreement under which a foreign colleague would allow him to use the latter's premises for his own medical purposes".[21] The person providing the independent personal services should be able to exercise some amount of control over the fixed base if it is to constitute his fixed base.[22] This also relates to the requirement that the base be "regularly available" to the person providing the services. A fixed base should be deemed "regularly available" only if it is "never or seldom withdrawn from the power of control of the person performing the independent personal services".[23]

To my knowledge, there is no US or Italian authority that explains what constitutes a fixed base of a corporate director. There are however, several US private rulings dealing with the fixed base requirement in the context of movie and stage productions, which conclude that the fees paid to non-resident aliens for directing and other services are exempt from US tax under the independent personal services article of the relevant treaty.[24]

VI. CONCLUSIONS

Services performed by directors in attending board meetings are deemed to be services performed in the capacity of director, as such, and ordinarily do not constitute employment under US domestic law.

Article 16, as limited in its scope by the Protocol to the Treaty, provides that directors' fees should be taxed in the state where services are performed. In response to the specific provision for directors' fees contained in the 1977 OECD Model Convention, the United States made reservations stating that it will treat directors' fees under the independent service provision of Article 14. The Internal Revenue Service has also published a ruling taking this position. Therefore, as long as the directors are acting in their capacity as directors, and have not a fixed base regularly available to them within the meaning of Article 14 of the Treaty, their compensation will be for providing "independent personal services", and should be exempt from US tax.

Italian resident directors will be subject to tax in Italy under Article 49 paragraph 2(a) of the applicable Italian Consolidated Rules on income.[25]

19. Fees governed by Art. 14 but not exempt from tax because there is a "fixed base" are subject to withholding under Sec. 1441 of the Code.
20. 1963 OECD Commentary, at 130.
21. *Klaus Vogel on Double Taxation Conventions*, at 768.
22. Bundesfinanzhof, 3 February 1988 – IR 369/83. Recht der International Wirtschaft, 1988, at 409. (German board of directors member of Italian Società per Azioni deemed not to have a fixed base in Italy under the treaty).
23. Vogel, Shannon & Doernberg, *United States Income Tax Treaties*, Part II. Commentary Art. 14-33.
24. See Private Letter Rulings 8339012 (23 June 1983) (director), 8204099 (29 October 1981) (production designer).
25. Presidential Decree dated 22 December 1986, number 917, as amended.

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MALAYSIA

A REVIEW OF RECENT TAX DEVELOPMENTS

Veerinderjeet Singh

Arthur Andersen

I. INTRODUCTION

The National Budget presented by the Minister of Finance on 17 October 1997 was the most significant tax event in 1997. The 1998 Budget has been described as a tough and slightly painful budget.

The strength of the Malaysian economic fundamentals in 1997 is reflected in the expansion of Gross Domestic Product (GDP) which is expected to grow for the tenth consecutive year, by 8 per cent. The rate of inflation remains low at 3 per cent. The rate of growth in national savings is amongst the highest in the world at 39.8 per cent of Gross National Product (GNP). For the past five years (1993 to 1997), Government finances have recorded surpluses. For 1997, a surplus of MYR 5.066 billion or 1.9 per cent of GNP is expected. The nation's reserves as at 30 September 1997 stood at MYR 61.9 billion sufficient to finance 3.7 months of retained imports.

The major challenge facing the Malaysian economy following the economic problems in Thailand is that of restoring economic stability and investor confidence. A major issue in addressing this challenge is the current account deficit of the balance of payments. The deficit was 10.5 per cent of GNP in 1995, 5.2 per cent in 1996 and is expected to decline to 5 per cent in 1997. The problem of the balance of payments is the continuing deficit in the services account and significant increases in imports.

The crisis in the financial markets that occurred in the second half of 1997 is seen as a test of economic resilience. Thus, as stated by the Minister of Finance, concrete measures were needed to strengthen economic fundamentals so that the nation can face external shocks and pressures in the future.

Against this backdrop, the 1998 Budget was aimed at:
- strengthening economic fundamentals and stabilizing financial markets;
- maintaining sustainable growth;
- continuing the process of deregulation and liberalization of the economy; and
- continuing the social agenda for further overall development.

This article examines the various measures introduced in the Budget and the Finance Act 1998 (the Bill) with regard to direct taxation as well as other recent developments in the Malaysian tax system.

II. THE 1998 BUDGET CHANGES

A. Business taxation

1. Corporate tax rate

As a measure to maintain sustainable growth and to increase investment, productivity and export competitiveness with effect from the year of assessment (Y/A) 1998, the rate of corporate tax has been reduced from 30 per cent to 28 per cent.[1]

As a result of this reduction, the Malaysian corporate tax rate is one of the lowest in Asia as shown in Table 1 below.

Table 1

Country	Corporate tax rate (%)
Singapore	26
Malaysia	28
Brunei	30
Thailand	30
Indonesia	30 *
Philippines	35
Vietnam	25/45 **
Hong Kong	16.5
China	33

* Graduated rates of tax apply, ranging from 10 per cent to 30 per cent
** Depends on type of industry/project

With this reduction in the corporate tax rate, dividends paid, credited or distributed in the year 1997 will be deemed to have suffered tax of 28 per cent at source.[2]

Dividends which have suffered tax of 30 per cent at source will have to be re-grossed to adjust for a tax credit of 28 per cent. The dividend franking account of the company distributing the dividend will likewise be adjusted to account for the reduced corporate tax rate of 28 per cent.

The new rate of 28 per cent will also apply to trust bodies, executors of estates of deceased individuals domiciled outside Malaysia at the time of death and receivers appointed under the direction and control of a court in Malaysia.

2. Tax set-off

With effect from 25 October 1996, failure to withhold tax on payments of interest, royalty, technical advice, assistance or

1. Amendment to Part 1 Sch. 1 of the Income Tax Act, 1967 (ITA 1967).
2. Via introduction of Secs. 108(2E), 108(4E) as well as Sec. 110(1E) to ITA 1967.

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rental of moveable property to non-residents will result in a penalty of 10 per cent on the gross amount of such payments.

Under the amendment to Section 110, the penalty of 10 per cent will not be available for set-off against the tax payable on such income.[3] This amendment is effective from Y/A 1998 and is aimed at clarifying that a penalty (unlike the actual tax withheld) is not available as a set-off.

3. Warehousing facilities

A building used solely for the purpose of storage of goods for export or for storage of imported goods for further processing and re-export qualifies for industrial building allowance at the initial and annual rates of 10 per cent and 2 per cent respectively.

To encourage the setting up of warehousing facilities and to facilitate exports, such warehouses (including those used to store imported goods for distribution) will qualify, from Y/A 1998, for industrial building allowance at the rate of 10 per cent over ten years.[4]

As such, the cost of the warehouse would be written-off in ten years compared to 45 years under the existing provisions. Further, the scope is widened to cover distribution (presumably to the domestic market) as well as re-exporting.

4. Heavy machinery

Heavy machinery used in the construction sector and the primary industries (such as mining, logging and forestry) qualifies for initial allowance of 20 per cent and annual allowances of 12 per cent, 16 per cent or 20 per cent.

To reduce the import of such heavy machinery with effect from 17 October 1997, the initial and annual allowance rates for imported machinery have been reduced to 10 per cent.[5] The current initial and annual allowance rates for local heavy machinery remain unchanged. Thus, imported machinery would be tax depreciated over a longer period of time.

5. Contributions to approved schemes

The maximum deduction for tax purposes in respect of the employer's contribution to an approved scheme is 17 per cent of the employees' remuneration.

With effect from Y/A 1998, the maximum tax deduction allowed for the employer's contribution has been increased to 19 per cent of the employees' remuneration.[6] Thus, after taking into account the statutory contribution rate of 12 per cent to the Employees' Provident Fund, an employer can contribute another 7 per cent to an approved pension or provident fund, if the employer wishes to do so.

6. Donations to promote local works of art

Presently, a tax deduction is allowed for contributions of artefacts and manuscripts to the Government or State Government to promote national culture and heritage.

To encourage preservation and exhibition of high quality works of art, a tax deduction will be allowed, with effect from Y/A 1998, for contributions of local works of art by the private sector to the National Art Gallery or any state art gallery.[7] The value of these contributions will be determined by the relevant bodies.

7. Bonus restriction

With effect from 17 October 1997, the tax deduction on bonuses will be restricted to an amount not exceeding two twelfths of the wages/salary of an employee.[8]

It should be noted that a similar restriction existed prior to Y/A 1990.

8. Offshore income

From Y/A 1995 income arising from sources outside Malaysia and received in Malaysia by a resident company (except a company carrying on the business of banking, insurance, shipping and air transport) was exempt from income tax by virtue of Section 3C of the Income Tax Act 1967.

With effect from Y/A 1998, the exemption has been withdrawn.[9] As such, the scope of charge for a resident company (other than a company carrying on the business of banking, insurance, shipping and air transport) has reverted to the derived and received basis. Subsequently the exemption of offshore income has been granted via an exemption order with effect from Y/A 1998. In addition, this exemption also covers unit trusts.

9. Donations to promote cultural performances

Expenditure incurred in establishing and managing a musical or cultural group approved by the Minister is allowed as a deduction.

To further encourage private sector participation in such activities, with effect from Y/A 1998, cash contributions to sponsor local and foreign cultural performances approved by the Ministry of Culture, Arts and Tourism will be allowed as a tax deduction. Foreign cultural performances will only be considered if the activities are performed in Malaysia. The tax deduction is limited to a maximum amount of MYR 200,000.[10]

10. Life reinsurance business

Prior to Y/A 1998 the Income Tax Act, 1967 did not have separate provisions to deal with the taxation of life reinsurance or inward life reinsurance businesses.

As a measure to develop the life reinsurance industry, with effect from Y/A 1998, life reinsurance and inward life reinsurance businesses will be treated in the same manner as a general insurance business.

3. Amendment to Sec. 110(1) of ITA 1967.
4. Amendment to para. 37C, Sch. 3 of ITA 1967.
5. This change is expected to be made by way of a statutory order.
6. Amendment to Sec. 34(4)(a) of ITA 1967.
7. Via introduction of Sec. 44(11) to ITA 1967.
8. Via introduction of para.(h) to Sec. 39(1) of ITA 1967.
9. Via deletion of Sec. 3C of ITA 1967.
10. Via introduction of para.(k) to Sec. 34(6) of ITA 1967.

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Under this tax treatment, the taxable income arising from the life reinsurance business will be taxed at the normal corporate tax rate.

However, inward life reinsurance business will be given a concessionary tax rate of 5 per cent. Inward life reinsurance is generally defined as the re-insurance of risk under a life policy where the risk is outside Malaysia and the original insurance policy is issued by a non-resident insurer (excluding policies issued by its branch in Malaysia) or by a branch outside Malaysia of a resident insurer.[11]

11. Assessments and additional assessments

Currently, the Director General is empowered to raise an assessment or additional assessment (as the case may be) if he is of the opinion that no or insufficient assessment has been made on a chargeable person. Such an assessment may be raised within 12 years from the expiration of a particular year of assessment.

It is proposed that the time frame for the Director General to make an assessment or additional assessment be reduced from 12 to six years after the expiration of a particular year of assessment. The reduced time frame is also applicable to the raising of an additional assessment on an approved operational headquarters(OHQ) company following the withdrawal of its approved OHQ status. Furthermore, the six-year limit applies to situations where tax had been repaid to a person by mistake.[12]

This proposal is effective from 1 January 1999 and is an important step in reforming the tax administration system. It reduces the onerous burden of responsibility on taxpayers to keep records for at least 12 years. These changes are now in line with the Companies Act, 1965, which requires companies to keep records for seven years. Of course, it should be noted that the six-year limitation would not apply in the case of fraud, wilful default or negligence.

B. Personal tax

1. Tax rebate on foreign workers' levy

A levy is imposed by the Immigration Department for the issue of an Employment Pass, Visit Pass (Temporary Employment) or Work Pass to enable foreigners to work in Malaysia. This levy is paid in advance and is not given as a rebate against the personal tax payable by the foreigner in Malaysia.

With effect from Y/A 1998, the income tax charged on the individual will be rebated by any levy paid during the basis year for that year of assessment. This rebate is deducted before any set-off under Section 110 and any credit allowed under Sections 132 or 133. Where the rebate exceeds the income tax charged for a year of assessment, the excess is not refundable to the individual nor can it be carried forward for set-off against his future tax liability.[13]

It was expected that the rebate would have been retrospective in nature as the levy has been imposed for a few years.

2. Tax rebate for purchase of computer

To encourage computer literacy among Malaysians, with effect from Y/A 1998, a tax rebate of MYR 400 will be given to individuals who purchase a personal computer. This rebate can only be enjoyed once every five years and is limited to one computer per family. Further, the computer cannot be used for the purpose of the individual's business.[14]

3. Personal deductions

a. *Child relief*

An individual is entitled to claim relief of MYR 1,600 for each unmarried child above 18 years of age who is studying full time at an overseas institution of higher learning.

To reduce the number of students pursuing higher education overseas, from Y/A 1998, the relief will be reduced to MYR 800. However, an individual whose child commenced studies abroad between 1 January 1994 and 16 October 1997 is entitled to a tax relief of MYR 1,600 per year until the child completes his studies.[15] The amendment is intended to encourage parents to enrol their children in local colleges/universities, thus curtailing the outflow of funds.

b. *Provision of facilities for disabled persons*

Although the public is encouraged to contribute towards providing facilities for disabled persons in public places, the law currently does not allow an individual to claim a tax deduction on contributions towards this cause.

Therefore from Y/A 1998, expenses incurred by individuals in setting up such facilities will be allowed as a tax deduction. These expenses may be in cash or in kind (the value is to be determined by the relevant local authority).[16]

c. *Contribution to health care facilities*

Currently, the law does not allow an individual (unlike companies) to claim an income tax deduction on contributions made to approved welfare and community projects in the fields of education, health, housing, infrastructure and public amenities.

To encourage individuals to contribute to health care facilities, from Y/A 1998, individuals will be allowed to claim a tax deduction of up to MYR 20,000 on contributions made to health care facilities approved by the Ministry of Health. Contributions can be either in the form of cash or medical equipment.[17]

d. *Contribution to the arts*

To encourage the preservation of high quality works of art, from Y/A 1998, the value of any gift of a painting made by an

11. Amendment to Sec. 60 of ITA 1967.
12. Amendment to Secs. 60E(4) and 91 of ITA 1967.
13. Via introduction of Sec. 6C to ITA 1967.
14. Via introduction of subsection (3A) to Sec. 6A of ITA 1967.
15. Amendment to Sec. 48 of ITA 1967.
16. Via introduction of subsection (9) to Sec. 44 of ITA 1967.
17. Via introduction of subsection (10) to Sec. 44 of ITA 1967.

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individual to the National Art Gallery or any state art gallery will be given an income tax deduction. This amendment is similar to the one for companies mentioned earlier.[18]

4. Employers' responsibilities

Presently, an employer is required by law (Section 83 (5)) to withhold any monies due to an employee who has ceased to be employed by him and notify the Director General of the employee's cessation of employment unless:

- the income from the employment of the employee is subject to monthly Schedular Tax Deduction (STD); or
- 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.

Further, the employer may be directed by the Director General to remit the monies withheld for full or partial settlement of the employee's taxes.

The law does not impose a penalty for non-compliance with these provisions. However, where the employer fails to withhold accordingly, the Director General is empowered to direct him to pay the full amount of tax due from the employee and later recover it from the employee as a debt.

Such non-compliance by the employer would not render him guilty of an offence. On conviction, the employer will be liable to a fine of not less than MYR 200 and not more than MYR 2,000, or to imprisonment for a term not exceeding six months, or to both. This amendment is to take effect from the date the Finance Act comes into force (i.e. when it is gazetted).[19]

5. Assessments and additional assessments

The proposed changes have been discussed above in relation to business taxation.

In addition, where an employee receives a lump sum by way of gratuity or deferred pay upon cessation of employment, that payment is spread back evenly over the period of employment up to a maximum of six years (instead of the current ten years).[20] This proposal is to take effect from 1 January 1999.

C. Petroleum income tax

1. Tax rate

As a measure to encourage further exploration and the development of marginal fields, the petroleum income tax rate has been reduced from the current rate of 40 per cent to 38 per cent. The reduction in the petroleum income tax rate will have a positive impact on exploration projects in the oil and gas industry. This is effective from the year of assessment 1998.[21]

2. Approved contributions

Consistent with the Government's aim of promoting the arts and cultural activities, a deduction against gross income is to be given for expenditure incurred for sponsoring any arts or cultural activity approved by the Ministry of Culture, Arts and Tourism (provided that the amount deducted shall not exceed MYR 200,000).[22]

In addition to the above, deductions against assessable income will be given for the following:

- paintings (as valued by the Department of Museums and Antiquities or the National Archives) donated to the Government or State Government;[23]
- any gift of money or contribution in kind (the value to be determined by the relevant local authority) for the provision of facilities in public places for the benefit of disabled persons;[24]
- any gift of money or the cost or value (as certified by the Ministry of Health) of any gift of medical equipment to any health care facility approved by that Ministry (provided that the amount deducted shall not exceed MYR 20,000);[25] and
- any gift of a painting (the value to be determined by the National Art Gallery or any state art gallery) to the National Art Gallery or any state art gallery.[26]

These changes are effective from the year of assessment 1998.

3. Contribution to approved schemes

The change is similar to that discussed under 'Business Taxation' above.[27]

4. Bonus restriction

The proposed change is similar to that discussed under 'Business Taxation' above.[28]

5. Assessments and additional assessments

It is proposed that, with effect from 1 January 1999, the time frame for the Director General to make an assessment or additional assessment as well as to recover tax repaid by mistake be reduced from 12 to six years after the expiration of a particular year of assessment.[29]

6. Time limit for repayments

Currently, a chargeable person is entitled to claim a refund for tax overpaid provided that such claim be made within 12 years after the end of the year of assessment to which the claim relates.

18. See *supra* note 7.
19. Amendment to Sec. 120 (e) of ITA 1967.
20. Amendment to Secs. 25 and 27 of ITA 1967.
21. Amendment to Sec. 23 (1) of the Petroleum Income Tax Act, 1967 (PITA).
22. Via introduction of subsection (7E) to Sec. 16 of PITA.
23. Amendment to Sec. 22 (1A) of PITA.
24. Via introduction of subsection (1B) to Sec. 22 of PITA.
25. Via introduction of subsection (1C) to Sec. 22 of PITA.
26. Via introduction of subsection (1D) to Sec. 22 of PITA.
27. Amendment to Sec. 16(3)(a) of PITA.
28. Via introduction of para. (l) to Sec. 18(1) of PITA.
29. Amendment to Sec. 39 of PITA.

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It is proposed that, with effect from 1 January 1999, the time limit to claim a tax refund be reduced to six years after the end of the year of assessment to which the claim relates.[30]

D. Tax incentives

1. Promotion of exports

Presently, there are certain incentives available for the promotion of exports. These include a double deduction for certain expenditure incurred in the promotion of exports, a double deduction for insurance premiums paid to a Malaysian incorporated insurance company on export of goods as well as a double deduction for export credit insurance premiums.

To further encourage the promotion of exports, it was announced that, from 1 January 1998, companies in the manufacturing, agricultural and services sectors which export goods (having a value-added element) or services, will be given a partial exemption from income tax. The exemption will be given on statutory income of an amount equal to 10 per cent or 15 per cent of the value of increased exports.

Details of the exemption are as follows:

- exemption of statutory income equivalent to 10 per cent or 15 per cent of the value of increased exports for manufacturers, provided that the goods exported attain at least 30 per cent or 50 per cent value added respectively;
- exemption of statutory income equivalent to 10 per cent of the value of increased exports to companies which export fruits and cut flowers; and
- exemption of statutory income equivalent to 10 per cent of the value of increased exports to the following types of companies in the services sector:
  - legal;
  - accounting;
  - engineering consultancy;
  - architecture;
  - marketing;
  - business consultancy;
  - office services;
  - construction management;
  - building management;
  - plantation management; and
  - health and education.

While this incentive is welcomed, it does not stipulate how 'value added' is to be determined nor does it indicate how 'increased exports' is to be measured. It is also uncertain as to when a service is deemed to be exported. This is expected to be clarified when the relevant bill to amend the Promotion of Investments Act is tabled.

2. Malaysian brands

At present, certain advertising expenditure incurred on the advertising of Malaysian products and brands overseas is eligible for a double deduction.

From Y/A 1998, the double deduction be extended to advertising expenditure incurred in Malaysia to promote Malaysian branded products. Such expenditure might, for example, include advertisements on billboards at strategic locations. To qualify, the following requirements must be satisfied:

- the local branded products must be produced by a company that is at least 70 per cent Malaysian owned;
- the brand must be owned by the company and must be registered in Malaysia; and
- the company's products must achieve export quality standards.

Further details/clarifications are expected to be issued later.

3. Research and development (R&D)

Presently, companies undertaking R&D activities may qualify for Pioneer Status (PS), Investment Tax Allowance (ITA) or for double deductions on revenue expenditure for R&D, depending on the nature of their activities. The definition of R&D under the Promotion of Investments Act, 1986 is as follows:

> "... any systematic or intensive study carried out in the field of science or technology with the object of using the results of the study for the production or improvement of materials, devices, products, produce or processes ...".

The definition goes on to specifically exclude quality control or routine testing, routine data collection, etc. Based on the above definition, a company undertaking only designing, prototyping or testing would not qualify for the incentives.

To encourage R&D activities, with effect from Y/A 1998, the incentives will be extended to companies undertaking designing and prototyping as an independent activity. The incentives are PS, ITA, or a double deduction on expenditure for in-house R&D and expenditure on R&D undertaken in an approved R&D institution. Companies undertaking testing alone will not qualify for the incentives. The precise details of the incentives are not available as yet.

4. Multimedia faculties

Currently, companies with Multimedia Super Corridor (MSC) status enjoy the following tax incentives:

- five-year exemption from tax under PS (renewable to ten years) or the ITA of 100 per cent on its qualifying capital expenditure; and
- exemption from all duties on multimedia equipment.

To encourage the success of the MSC, and to ensure that there are sufficient knowledge-workers for the multimedia and information technology sectors of the economy, from Y/A 1998, the tax incentives accorded to MSC status companies, will be extended to multimedia faculties in institutions of higher learning.

A multimedia faculty is referred to as a centre of learning, which provides courses in media, computers, information technology, telecommunications, communications and contents relating to data, voice, graphics and images.

The PS and ITA incentive would only be relevant to private universities which are taxable persons. Where a university is not subject to income tax, such incentives are not relevant (other than exemption of duties on multimedia equipment).

30. Amendment to Sec. 50(2) of PITA.

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5. Private hospitals

At present, the lower income group tends to have to rely on the Government health service, given the relatively higher cost of private hospitals and private health care providers. The Government recognizes that the health services provided by it are insufficient to meet the needs of the people.

To encourage the assistance of private hospitals in meeting the health needs of the lower income group, a tax incentive has been announced for private hospitals which provide special wards for the lower income group. The incentive will be an investment allowance of 60 per cent on qualifying capital expenditure incurred for the purpose of setting up such wards. This is effective from the year of assessment 1998. It is expected that this incentive would be provided under the existing schedule 7B of the ITA 1967.

6. Reinvestment allowance (RA)

The RA, in its present form, is granted to companies in the manufacturing and agricultural sectors. The allowance provides for relief on 60 per cent of qualifying capital expenditure which is abated against 70 per cent of statutory income (or against 100 per cent of statutory income for companies located in the Eastern Corridor of Peninsular Malaysia, Sabah and Sarawak). Qualifying capital expenditure refers to capital expenditure incurred on any 'qualifying project', which includes a project for manufacturing or processing undertaken by a company, in expanding, modernizing, or diversifying its existing business into any related product within the same industry.

The changes to this incentive from Y/A 1998 indicate that the Government is streamlining the RA incentive with a view to encouraging companies to increase productivity. In line with this, the definition of 'qualifying project' has been extended to include 'automation'.

In addition, several other changes have been made to this incentive which include the following:

- an increase in productivity must be shown (Refer to the comments below);
- the company must be in operation for at least 12 months;
- the RA will only be given for five consecutive years from the year of assessment in which the capital expenditure (reinvestment) was first incurred on a project; and
- the term 'incurred' is now aligned to the definitions applicable for capital allowance purposes. For assets acquired on hire purchase, the RA is claimable on the capital portion of the instalment payments. For plant and machinery, the date expenditure is incurred is the date the plant is capable of being used. For a building, the date of completion or date of purchase is the date the expenditure is incurred.
- where an asset is disposed of within two years from the date of acquisition, there will effectively be a 'claw-back' of the allowances to which the company would otherwise have been entitled (with effect from the year of assessment 1999 only).[31]

The changes to the legislation do not specify how the increase in productivity will be determined. However, in the Budget speech, it was stated that productivity will be measured by using a Process Efficiency Ratio (PER) as shown below:

$$PER = \frac{\text{Total output} - \text{Bought in materials and services}}{\text{Total input} - \text{Bought in materials and services}}$$

It is unclear at this stage as to how the above formula will be applied in practice and whether its application will be dictated in the RA application forms. Thus, a company is required to show that its PER has increased after the investment was made. A grace period of two years will be given to show the increase in PER. A further point that is not noted in the legislation, but which was announced in the Budget, is that PER will also be used to measure a "significant increase" in productivity, for the purposes of qualifying for the deduction against 100 per cent of statutory income (as is permitted for companies located in the Eastern Corridor of Peninsular Malaysia, Sabah and Sarawak). In this connection, a company is required to show that its PER has increased by at least the same rate as the GDP growth rate for that industry and it will be given two years to show the increase in PER.

The impact of the changes indicated a tightening of the RA to encourage companies in the manufacturing and agricultural sectors to increase productivity. This tightening has also come about as the authorities felt that there was a degree of abuse in claiming the incentive.

E. Real property gains tax

1. Acquisition of shares in real property companies

a. *Date of acquisition*

Presently, the shares in a real property company (RPC) (chargeable asset) are deemed to be acquired on the date the company becomes a RPC or on the date of acquisition of the chargeable asset. (where the company is already a RPC).

However, where a RPC acquires additional real property or RPC shares or both, the defined value of which is at least 50 per cent of the defined value of the real property or RPC shares or both it already owns, then the date of acquisition of the chargeable asset shall be deemed to be the date of acquisition of the additional real property or RPC shares or both.

With effect from 17 October 1997 an amendment has been introduced whereby the date of acquisition of the shares in a RPC will not shift in the event that additional real property or RPC shares are acquired by the company.[32] This is aimed at eliminating the possibility of increasing the acquisition price of the shares in the RPC.

b. *Acquisition price*

Currently, the acquisition price of shares deemed to be acquired on the date the company becomes a RPC or on the

31. Amendment to Sch. 7A of ITA 1967.
32. Via deletion of Para. 34A(2), Sch. 2 of the Real Property Gains Tax Act, 1976 (RPGT Act).

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date of acquisition of the chargeable asset shall be determined in accordance with the formula:

$$\frac{A}{B} \times C$$

where

A is the number of shares deemed to be a chargeable asset;

B is the total number of shares in the relevant company at the date of acquisition of the chargeable asset; and

C is the defined value of the real property or RPC shares or both owned by the relevant company at the date of acquisition of the chargeable asset.

From 17 October 1997, the above-mentioned formula shall continue to apply only to shares that existed on the date the company became a RPC.[33]

Once a company is designated a RPC, the acquisition price of the company's shares in subsequent transactions will not be calculated based on the above formula. Instead, the acquisition price will be determined based on existing provisions applicable to the acquisition of real property (i.e. either the amount or value of the consideration in money or money's worth or market value, under certain specified circumstances listed in paragraph 9, Schedule 2 of the Real Property Gains Tax Act, 1976). In this respect, where bonus shares are issued, the acquisition price will be zero since there is no consideration for the acquisition of bonus shares. The change has been introduced to specifically correct the anomaly existed whereby even though there is no consideration for bonus shares, an acquisition price would be computed based on the formula which would thus lower chargeable gains upon disposal of such bonus shares.

2. Tax rate

At present, an individual who is not a citizen or not a permanent resident is assessed at a flat rate of 30 per cent in respect of gains derived from the disposal of real property, regardless of the holding period of the asset.

In line with the process of liberalization in the property market, a disposal by such an individual after five years will be subject to real property gains tax at the rate of 5 per cent instead of 30 per cent.[34] This is effective from 17 October 1997.

3. Assessments and additional assessments

The proposed change is the same as that suggested for income tax purposes i.e. reducing the time frame for issuing an assessment.[35]

III. OTHER DEVELOPMENTS

A. Valuation of benefits-in-kind

The Inland Revenue Board recently issued an Income Tax Ruling on the Valuation of Benefits-In-Kind (ITR 1997/2). This ruling supersedes the 1987 Guidelines for Valuation of Benefits-In-Kind Provided to Employees and takes effect from the year of assessment 1998.

The valuation of benefits-in-kind based on the above ruling is as follows.

1. Motor cars and related benefits

Motor cars and fuel provided

Cost of car when new (MYR)	Annual value of BIK (MYR)	Fuel per annum (MYR)
up to 50,000	1,200	600
50,001 – 75,000	2,400	900
75,001 – 100,000	3,600	1,200
100,001 – 150,000	5,000	1,500
150,001 – 200,000	7,000	1,800
200,001 – 250,000	9,000	2,100
250,001 – 350,000	15,000	2,400
350,001 – 500,000	21,250	2,700
500,001 and above	25,000	3,000

Fuel provided without motor car

The assessable value of the benefit is equivalent to the actual value of fuel provided.

Driver provided

Where a driver is provided, the annual value of the benefit is MYR 3,600.

2. Household furnishings, apparatus and appliances

The value of the benefit comprising household furnishings, apparatus and appliances provided to the employee is as follows:

Types of benefits	Annual value of BIK (MYR)
1. Semi-furnished with furniture in the lounge, dining room or bedrooms	840
2. Semi furnished with furniture as (1) above and air-conditioners, curtains and/or carpets	1,680
3. Fully furnished with benefits as in (1) and (2) above plus kitchen equipment, crockery, utensils and/or appliances	3,360
4. Service charges and other utility bills for water, electricity and telephone	Service charges and bills paid by the employer

3. Other benefits

Types of benefits	Annual value of BIK
1. Mobile telephone (including rental and telephone charges)	MYR 600 per annum
2. Gardeners	MYR 3,600 per annum
3. Domestic servants	MYR 4,800 per annum
4. Interest free loan	Value of interest paid by employer

33. Amendment to Para. 34A(3), Sch. 2 of the RPGT Act.
34. Amendment to Part III of Sch. 5 of the RPGT Act.
35. Amendment to Sec. 50(2) of the RPGT Act.

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5.	Subsidized loan/loan at below market value interest rate	Subsidized loan interest paid by the employer
6.	Insurance premium	Annual insurance premium paid by the employer (excluding insurance premiums for foreign workers and Group Policy Insurance)
7.	School/tuition fees	Actual school/tuition fees paid by the employer
8.	Membership in recreation clubs	Membership fees paid by the employer

B. Interest restriction

In 1994, the case of *P Securities Sdn Bhd v. Director General of Inland Revenue* was brought before the Special Commissioners of Income Tax. In the above case, the principal activity of the Company was the holding of investments in the form of shares. The shares were acquired with interest bearing loans. Some of the investments produced income in the form of dividends whilst others did not.

The company was assessed to income tax on dividends received on the grounds that each investment counter constituted a separate source of income. Accordingly, the interest deductions were apportioned between income producing and non-income producing investments. It was held that each investment counter did not constitute a separate source given that each source of income (i.e. interest, dividends, etc.) is already clearly defined in the Income Tax Act, 1967.

The Special Commissioners decision on the above case was recently upheld by the High Court. No further appeal has been made by the Inland Revenue Board. As such, the Inland Revenue Board has conceded that the 1989 guidelines issued on allocation of interest expense among various investments does not apply. Nevertheless the Inland Revenue Board appears to consider that the decision is specific to the circumstances of that particular case and may be taking up another case through the appeal process.

C. Double tax agreements

To date, Malaysia has signed 48 double tax agreements, the most recent being with Egypt and Kuwait. In addition, negotiations with the United States of America to finalize a comprehensive tax agreement are continuing.

The new agreement with the United Kingdom was gazetted on 26 June 1997. However, it has not yet been ratified. Under this agreement, the tax rate on interest would be 10 per cent and that on royalties and technical fees would be 8 per cent. Tax sparing relief would generally no longer be granted after 31 December 2005.

As for the proposed protocol with the Netherlands, the changes include:

- tax rate on interest to be restricted to 10 per cent;
- tax rate on royalties and technical fees is to be restricted to 8 per cent;
- tax sparing relief will cease to have effect from 1 January 2006 unless both countries agree to an extension.

D. Double deduction for freight charges

As announced in the 1997 Budget, the double deduction for freight charges paid to Malaysian shipping companies for transportation on board Malaysian registered ships was revoked via the Income Tax (Deduction for Freight Charges) (Revocation) Rules 1997 with effect from Y/A 1998.

E. Inland Revenue Board of Malaysia

Amendments were made via the Income Tax (Amendment) Act 1997 and the Inland Revenue Board of Malaysia (Amendment) Act 1997 to provide for a Chief Executive Officer to be appointed to be responsible for the day-to-day administration of the Board. The Chief Executive Officer will also be the Director General of Inland Revenue.

F. Taxation of remisiers

In April 1997, the Inland Revenue Board issued an Income Tax Ruling (ITR 1997/1) in respect of the tax treatment of the income and expenses of remisiers (i.e. share brokers). It states that commission income, recovery of contra losses (which had been deducted earlier) and interest income received on security deposit placed with the stockbroking company is treated as business income.

Deductibility of expenses follows the normal principles and the ruling specified the common types of expenses that would be allowed as deductions. The ruling also specified the information required to substantiate a deduction of expenses.

G. Labuan

1. Legislative amendments

To further enhance Labuan as an international offshore financial centre, the various legislations were amended and gazetted in March/April, 1997. A summary of the main changes/provisions is shown below.

a. *Offshore Companies Act*

Residents are now permitted to hold shares, debt obligations or other securities in an offshore company. However, such an offshore company (owned by residents) may not hold shares, debt obligations or other securities in a domestic company.

Other offshore companies or foreign offshore companies are now permitted to hold shares, debt obligations or other securities in a domestic company other than a trust company so long as such holding does not amount to a controlling interest in the domestic company and is approved by the Labuan Offshore Financial Services Authority (LOFSA).

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The previous mandatory requirement for all offshore companies to carry the word "(L)" as part of their names has been removed (with the exception of offshore companies carrying the word "Berhad" or "Bhd" in their names).

b. *Offshore Banking Act*

The definition of 'offshore banking business' has been expanded so as to allow entry of specialized banking institutions into Labuan to focus on amongst other things, the business of offshore investment banking, Islamic banking, leasing and factoring.

Offshore banks have been granted exemption from complying with some of the requirements of domestic securities legislation.

c. *Offshore Insurance Act*

The minimum capital requirement for obtaining a licence to carry on offshore insurance business has been reduced from MYR 1 million to MYR 300,000. This is intended to encourage the setting up of offshore captive insurance companies.

The Registrar has been granted more powers to order disclosure of information and to vary the current scope of permitted activities for offshore insurance companies as well as to make regulations pertaining to the supervision of offshore insurance business in Labuan.

d. *Offshore Limited Partnerships Act*

The Labuan Offshore Limited Partnerships Act 1997 was passed by Parliament to provide for the establishment, regulation and dissolution of offshore limited partnerships. The Act deals with registration requirements, liabilities of partners as between themselves, the partnership and creditors, secrecy provisions and other legal implications.

2. Offshore Securities Industry Legislation

The Labuan Offshore Securities Industry Bill was tabled in Parliament at the end of 1997. It is intended to provide the necessary framework for the development of the securities industry in Labuan and thus make LOFSA a truly "one-stop centre" for all financial services in Labuan.

3. New guidelines

LOFSA has recently issued guidelines on the establishment of an offshore leasing company and the conduct of leasing business in Labuan.

4. Exemption

The Income Tax (Exemption) (No.2) Order 1997 grants an exemption from tax from Y/A 1997 to Y/A 2000 on income derived by a person from providing qualifying professional services rendered in Labuan to an offshore company. The exemption is for an amount equivalent to 65 per cent of the statutory income.

It was also announced in June 1997 that housing allowances, regional allowances and special Labuan allowances paid to Malaysians working in the offshore financial industry and the public sector in Labuan will be exempted from tax with effect from Y/A 1998. This has not yet been gazetted.

5. Pending changes

This includes the possibility of the Labuan Offshore Business Activity Tax Act being amended to allow a flexible rate of tax ranging from 3 per cent to 28 per cent. This is intended to overcome possible restrictions on the utilization of the benefits available under double tax agreements. It may also be possible for a tax rate of 10 per cent or 15 per cent to be imposed. This may be more acceptable as currently, approved operational headquarters companies are taxed at 10 per cent as are foreign fund management companies.

It has been pointed out to the Ministry of Finance that an exemption should be granted for Malaysian companies (owning Labuan offshore companies) which would enable the pass-through of dividends from Labuan offshore companies to their shareholders as exempt dividends. It is understood that this is being looked into by the Ministry of Finance.

IV. CONCLUSION

The measures announced in the 1998 Budget will assist in reducing the current account deficit through selective imposition of import duties on heavy equipment and other goods. At the same time, tax exemptions based on export performance provided to the manufacturing, agricultural and services sectors are intended to make Malaysian exports more competitive.

One of the major proposals in the Budget is the 2 per cent reduction in the corporate tax rate as well as the petroleum income tax rate. This is expected to make Malaysia more competitive and will assist in encouraging a greater inflow of direct investment.

While the 1998 Budget focuses on reducing the current account deficit and sustaining growth, measures to further develop art and culture and to reduce poverty have not been forgotten.

All in, the Malaysian economy is expected to grow by around 4 to 5 per cent in 1998 against an average growth rate of 4.3 per cent in the world economy. The current account deficit is expected to fall to around 4 per cent of GNP. The Budget sets the pace for the country to achieve sustainable growth rates in the coming years.

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IRELAND

THE ABOLITION OF ADVANCE CORPORATION TAX: TOWARDS A NEW INTERNATIONAL HOLDING COMPANY REGIME?

William Cunningham

Arthur Andersen

I. INTRODUCTION

On 3 December 1997, the Irish Minister of Finance announced the government's intention to phase out Advance Corporation Tax (ACT) and the tax credit accompanying dividends and distributions by Irish resident companies. This intention was enacted as Section 51 of the Finance Act 1998. This article surveys the Irish system of ACT and tax credits on corporate distributions, and assesses the practical impact of their abolition.

II. THE IMPUTATION SYSTEM IN IRELAND

Corporation tax was introduced in Ireland on 6 April 1976. It replaced the previous two-tier system, under which companies were liable to income tax and corporation profits tax.[1] Under the old system, dividends of Irish companies suffered withholding tax which was retained by the distributing company as a form of relief for the income tax incurred on the related profits. Recipients were liable to income tax with a credit for the tax retained. In this way, a credit for the income tax component of the company's tax liability was passed to the shareholder, partly avoiding double taxation of the same income. However, income tax was only part of the tax burden of both companies and individuals. Corporation profits tax for companies and surtax for individuals ensured that full credit for the overall corporate tax liability was not passed to the individual taxpayer. The current changes mark the abandonment of any pretence at an imputation system, except, curiously, in relation to foreign-source dividend income.

A. Tax credits under corporation tax

The corporation tax continued this tradition of less-than-full elimination of economic double taxation. The initial amount of the tax credit was $^{35}/_{65}$ for dividends out of profits taxable at the standard rate of corporation tax. Under Section 88(2) CTA 1976,[2] the numerator of this fraction was linked by a formula to the standard rate of income tax of 35 per cent. This attempted to preserve the after-tax yield on dividends from Irish resident companies. The standard rate of corporation tax was initially 50 per cent, and this 15 per cent differential between the tax credit rate and the corporate tax rate was maintained until the current tax year, as the following table shows:

Relationship between standard rates of corporation tax and tax credit 1976-1998

Date	Corporation tax rate (%)	Tax credit
6 April 1976	50	$^{35}/_{65}$
1 January 1977	45	$^{30}/_{70}$
1 January 1982	50	$^{35}/_{65}$
1 April 1988	47	$^{32}/_{68}$
1 April 1989	43	$^{28}/_{72}$
1 April 1991	40	$^{25}/_{75}$
1 April 1995	38	$^{23}/_{77}$
1 April 1997	36	$^{21}/_{79}$
3 December 1997	36	$^{11}/_{89}$
1 January 1998	32	$^{11}/_{89}$

With the exception of the most recent change, the table does not attempt to show the time lags between the change in the corporate tax rate, which, with some exceptions, usually took effect from 1 April, and the rate of tax credit, which took effect immediately.

The sensitivity of the tax credit to corporate tax rates is also evident in the reduced rates of tax credit applicable to distributions out of tax-relieved profits. These include distributions by companies eligible for:

- manufacturing relief – i.e. the 10 per cent rate of corporation tax for manufacturing profits, profits from deemed manufacturing activities, as well as from licensed activities carried on in the Shannon or Dublin Custom House Docks areas, to which a tax credit rate of $^{1}/_{18}$ applies;[3]
- export sales relief, Shannon exemption,[4] the patent income exemption,[5] the stallion fee exemption,[6] the greyhound stud fee exemption,[7] the pre-1974 farming exemp-

1. The pre-1975 system was remarkably close to the two-tier system advocated by Dr Peter A. Harris in his book: *Corporate/Shareholder Income Taxation – A Comparison of Imputation Systems*, IBFD Publications BV, 1996.
2. Now Sec. 136(2) Taxes Consolidation Act 1997.
3. Sec. 45 FA 1980, now Sec. 145 TCA 1997.
4. Sec. 76 CTA 1976, now Sec. 144 TCA 1997.
5. Sec. 34 FA 1973, now Sec. 234 TCA 1997.
6. Sec. 18 FA 1969, now Sec. 231 TCA 1997.
7. Sec. 25 FA 1996, now Sec. 233 TCA 1997.

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tion[8] or the woodlands exemption,[9] to which no tax credit applies.

The absence of a tax credit accompanying dividends out of exempt income caused no hardship to recipients, as these dividends were exempt from tax. However, from 1980, the benefit of tax incentives was no longer passed to shareholders. Dividends out of profits that benefit from manufacturing relief are fully liable to income tax but carry a greatly reduced tax credit. The result has been a clear shifting of the tax burden from companies to individuals, as the following example shows:

Example 1 (using 1997/98 tax rates)

	Dividend out of Normally taxed profits	10% taxed profits
dividend	1,000.00	1,000.00
tax credit	265.82	55.56
taxable	1,265.82	1,055.56
tax at 48%	607.59	506.67
less: credit	(265.82)	(55.56)
net liability	341.77	451.11
tax rate	34.18%	45.11%

The lower rate of tax credit dramatically increases the effective tax liability of the individual investor. In contrast, dividends out of exempt profits are exempt from tax at shareholder level. Export sales relief and Shannon exemption expired on 5 April 1990. Any related profits remaining undistributed after 6 April 1994 are if subsequently distributed, subject to ACT at the normal rate and carry a full tax credit.

B. Advance corporation tax (ACT)

From April 1975 until February 1983, Ireland granted tax credits to recipients of dividends of taxpaying companies without reference to the amount of corporate tax collected from the paying company. Dividends of non-taxpaying companies (those availing of export sales relief, Shannon exemption, the patent income exemption, the stallion fee exemption, the greyhound stud fee exemption, the pre-1974 farming exemption or the woodlands exemption) understandably carried no tax credit, since they were also exempt in the hands of the shareholder.

The availability of these low-rate regimes reduced the urgency of the introduction of ACT. With many of the most profitable companies enjoying the benefits of export sales relief and, after 1980, manufacturing relief, the proportion of dividends carrying the $^{35}/_{65}$ tax credit was small, and the real cost to the exchequer of unfunded tax credits, though never published, was probably negligible. Also, the drafting difficulties associated with designing an ACT system capable of dealing simultaneously with two (and after 1 January 1981, three) levels of tax credit, and all combinations in between, were considerable.

The value of ACT to the exchequer has been greatly limited by the high proportion of companies that are not obliged to pay it. A company may claim that any of the following distributions may be paid without any liability to ACT:

(a) loan interest treated as a distribution paid by a 75 per cent subsidiary to its non-resident parent company;
(b) dividends paid by a 75 per cent subsidiary to its parent company resident in a country with which Ireland has a tax treaty;
(c) dividends paid by a consortium-owned company to a consortium member company which is resident in a country with which Ireland has a tax treaty;
(d) a premium arising on a company's share buy-back, which is regarded as a distribution where the recipient of this distribution is a parent company within (b) or a consortium member within (c).

A consortium-owned company is a company of which at least 75 per cent of the ordinary share capital is owned by five or fewer member companies, each of which owns at least 5 per cent of the ordinary share capital.

Similarly, ACT was not applicable to companies availing of export sales relief or Shannon exemption, both of which expired on 5 April 1990. Most companies with profits accumulated under those regimes ensured that they were distributed before 6 April 1994, since when they carry a full tax credit and are liable to ACT.

Under manufacturing relief, which continues until 31 December 2010, the $^{1}/_{18}$ tax credit referred to above is matched by the same rate of ACT.[10]

Therefore, ACT has been relevant mainly to Irish-owned companies that neither manufacture nor export. Tax credits and ACT have consequently been the concern of a relatively small number of corporate taxpayers. For those that are Irish quoted companies, usually owned by Irish and UK-based individual and institutional investors, tax credits are of great importance, and ACT is the price paid for maximizing them. A review of tax credits on dividends paid in 1996 by the top 25 Irish quoted companies suggests that most of them have managed their distributions to ensure that they came as far as possible from standard rate profits. This tax credit management function is complicated by the possibility that a company paying a dividend may have up to three different profit pools, taxed at the standard rate, the 10 per cent rate or the zero rate applicable to export profits or other exempt profits. There are complex rules to compute the composite tax credit accompanying dividends out of these mixed profit pools. Dividends received by the distributing company may also carry such a composite tax credit. If these are distributed

8. The consolidation of the Taxes Acts removed references to the farming exemption. Sec. 140 Taxes Consolidation Act 1997 provides for a "nil" tax credit in respect of dividends out of profits which by virtue of Secs. 231 (stallion fees), 232 (woodlands) or 233 (patent royalties) were not charged to tax. Thus, it appears that if a company that carried on farming prior to the enactment of FA 1974 were now to distribute its retained exempt earnings, there is no longer any prohibition on a full tax credit.
9. Sec. 18 FA 1969, now Sec. 232 TCA 1997.
10. The same rate of tax credit applies to companies entitled to the 10 per cent rate of corporation tax until 31 December 2005 under the International Financial Services Centre and Shannon Zone legislation.

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onwards by it, the computation of the accompanying tax credit is even more complex.

A company may specify the year out of which profits are being distributed. This provides a high degree of control over the rate of tax credit accompanying its dividends.

III. THE NEW LEGISLATION

Section 51 of the Finance Act 1998 redefines "the standard credit rate" in the general definitions section of the Taxes Consolidation Act 1997 so that for the income tax year 1997/98 it is $^{21}/_{79}$ for distributions paid prior to 3 December 1997 and $^{11}/_{89}$ for distributions paid for the remainder of that year and for 1998/99. The existing tax credit of $^{1}/_{18}$ in respect of distributions out of profits taxed at the 10 per cent rate will remain unaffected by this change, as it is not driven by the "standard credit tax rate". Schedule 4 of the Finance Act contains the detailed amendments resulting from the reduction of the tax credits, and Schedule 5 deals with their elimination with effect from 6 April 1999. There is no express abolition of ACT, but the elimination of tax credits effectively leaves the relevant legislation ineffective for distributions after 5 April 1999.

A. Impact of abolition on companies paying dividends

The abolition of ACT will eliminate a payment obligation that would otherwise arise on the 28th day of the sixth month following the end of the accounting period in which a dividend is paid. In practice, since this is also the due date for the payment of estimated corporation tax on the profits of the same accounting period, and ACT can be offset against the corporation tax liability, its elimination will have no cash-flow effect for most taxpaying companies. In fact, the existence of the same payment deadline for ACT and mainstream corporation tax makes redundant the term "Advance" – it would be more appropriately named "Minimum Corporation Tax" after the tax payment and filing dates were re-set on the introduction of the self-assessment system in the Finance Act 1988.

In some circumstances, ACT can constitute a genuine acceleration of tax payments. For example, where dividends are paid in a year where there is insufficient corporation tax liability to absorb the ACT, it effectively constitutes a minimum tax. This can arise, for example, where:

- a large dividend is paid out of retained earnings;
- a dividend is paid in a year when tax losses arise;
- a company redeems shares at a premium; or
- a company distributes foreign-source dividends bearing a high level of credit for foreign tax.

The number of companies affected by the last of the above anomalies will increase temporarily with the increase in foreign tax credit made available by Section 60 of the Finance Act 1998, which provides unilateral credit for underlying tax not only at the level of the paying company, but where a treaty applies and certain minimum ownership percentages exist at all levels below it. However, the abolition of ACT will eliminate all the above difficulties after 6 April 1999.

B. Impact of abolition on various recipients of distributions

1. Corporate investors

Because dividends received from Irish resident companies are not liable to corporation tax, and the present proposals involve no change in this, the vast majority of corporate investors in Irish companies will not be directly affected. Their tax liability will remain unchanged. A loss-making recipient will lose the cash-flow boost available under Section 157(1) Taxes Consolidation Act 1997, under which it could claim payment of the tax credit attaching to dividends received by it.

2. Irish individual investors

These will suffer additional taxation of their Irish dividends as the level of tax credit is phased out. Since 1981, as illustrated in Example 1, they have suffered a higher effective rate of taxation on receiving dividends carrying the $^{1}/_{18}$ tax credit. The effect of a reduction in all tax credits to zero will reduce their after-tax income from dividends. This will eliminate their preference for dividends from fully taxed companies.

A dividend of 1,000 received from an Irish resident company would be taxed as follows:

Example 2

	Before 3 Dec. '97	3 Dec. '97-5 April '98	6 April '98-5 April '99	After 5 April '99
dividend	1,000.00	1,000.00	1,000.00	1,000.00
tax credit	265.82	123.60	123.60	–
taxable	1,265.82	1,123.60	1,123.60	1,000.00
tax at 48%	607.59	539.33		
tax at 46%			516.85	460.00
less: credit	(265.82)	(123.60)	(123.60)	–
net liability	341.77	415.73	393.26	460.00
tax rate	34.18%	41.57%	39.33%	46.00%

The effective rate of taxation will rise to the marginal rate of income tax after tax credits are abolished on 6 April 1999. In the meantime, dividends paid after 3 December 1997 will suffer an increase in the effective rate of taxation of over seven percentage points. This is temporarily alleviated after 5 April 1998 with a two-percentage point reduction in the top rate of income tax, but jumps to that top rate after 5 April 1999. The marginal rate of income tax may be further reduced by that time, although the government has made no formal statement about its long-term plans in this regard. With a 12.5 per cent universal rate of corporation tax already announced, to come into effect possibly from 2002, it may be difficult for the government to cut personal taxes any further.

The lack of a tax advantage for investing in Irish equities will focus the attention of individual investors on opportunities elsewhere. Their attention is likely to be concentrated on

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companies located in countries that have a tax treaty with Ireland. With most of Ireland's tax treaties limiting withholding tax on dividends to 15 per cent,[11] and a credit available for this, Irish resident individuals will look more keenly to foreign stock markets, while avoiding the incremental taxation often associated with cross-border portfolio investment. They may also follow the investment allocation strategy of Irish charities and pension funds described below.

3. Irish charities and pension funds

Irish charities and pension funds will also be severely affected by the abolition of tax credits. Being exempt from corporation tax, they have been entitled to a payment of the tax credit accompanying dividends received from Irish resident companies. Removal of tax credits will directly affect their level of investment income. As in the case of Irish resident individuals, the greater attractiveness of Irish equities for these investors will disappear after 6 April 1999. However, unlike individuals, they will not be free to exit completely from these investments. Under regulations issued by the Minister of Finance, pension funds are obliged to hold a percentage of their investment portfolios in Irish assets.[12] To the extent that they currently hold in excess of this minimum, they are likely to look more closely at investment opportunities in countries where the applicable tax treaty provides for payment to residents of the other country of all or part of the tax credit. Many of Ireland's tax treaties negotiated since 1976 contain provisions for the payment to residents of one state of part of the tax credit attaching to dividends paid by companies resident in the other. Faced with two equally attractive share investment opportunities in terms of risk/return, one domestic and one located in one of the above treaty countries, an Irish charity or pension fund is likely to opt for the latter.

4. Other Irish-based investors

Resident companies and branches of non-resident companies will suffer no additional taxation on Irish dividends as a result of the changes, being exempt from corporation tax on such distributions in accordance with Section 129 Taxes Consolidation Act 1997. Resident companies receiving such income will, however, enjoy greater simplicity in passing on Irish-source dividends to their shareholders, being no longer obliged to perform the complex tax credit computations required if they received dividends out of profits eligible for manufacturing relief.

5. UK-resident investors

The significance of Irish tax credits for UK-resident investors depends on whether they are so-called portfolio investors, owning less than a defined percentage of the capital of the company paying the dividends, or investors owning a higher percentage.

a. *Companies or individuals owning less than 10 per cent of the paying company*

The Ireland–United Kingdom tax treaty was the first of Ireland's tax treaties to contain provisions entitling recipients resident in either country to a payment from the source country of the excess of the tax credit attaching to distributions by a company resident in the other over the tax rate that the treaty allocates to the source country. Under the treaty, the source country may retain a maximum of 15 per cent of the aggregate of the dividend and tax credit. The qualifying resident may claim a credit for this against his/its home country tax liability in respect of the dividend, and claim a refund directly from the source country's tax authorities for the remainder. Elimination of the possibility of a refund will reduce the yield for UK-based portfolio investors in Irish companies. The comparative advantage available by switching to investment in UK equities has already been eliminated by the proposals in the United Kingdom to phase out the refund of tax credits over the same period.[13] It should be noted that the present Ireland–United Kingdom treaty is scheduled for full renegotiation in September 1998, at which time the dividend article is likely to be simplified to reflect the new tax credit regimes introduced in both countries.

b. *Companies owning 10 per cent or more of the paying company*

For these, the treaty does not permit a refund of part of the tax credit. Instead, the recipient is entitled to claim relief for underlying corporate tax. Since this approach to double taxation relief ignores dividend-specific tax credits, and looks instead at the underlying corporate tax liability of the paying company, UK companies entitled to avail of it will be unaffected by the abolition of Irish dividend tax credits.

6. Investors resident elsewhere

Following the lead set by the Ireland–United Kingdom treaty, the dividend article of many of Ireland's tax treaties (Australia, Austria, Denmark, Finland, Israel, Republic of Korea, Sweden, New Zealand, Spain, Switzerland and the United States) now contains wording along the following lines:

> A resident of (other country) who receives dividends from a company which is a resident of Ireland shall be entitled to the tax credit in respect thereof to which an individual resident in Ireland would have been entitled had he received those dividends, and to repayment of any excess of that tax credit over his liability to Irish tax.

This entitlement is conditional on the investor's percentage ownership of the paying company being less than 10 per cent (in the case of Australia, Finland, Israel, Republic of Korea, New Zealand, Sweden, the United Kingdom and the United States) or 25 per cent (Austria, Denmark and Switzerland).

11. For portfolio investors only. For direct corporate investors holding a specified minimum percentage of the paying company, the withholding rate is reduced to zero in Ireland's treaties with Denmark, Finland, France, Germany, Italy, Lithuania, the Netherlands, Norway, Poland, South Africa and Spain.
12. In 1995 and 1996, Irish pension funds held 24.5 per cent of their assets in the form of Irish equities.
13. For an outline of the UK changes see D. Hughes, "Recent Changes to the UK Tax Credit Regime, The Abolition of ACT, and Certain Related Matters" 52 *The Bulletin for Fiscal Documentation* 1 (1998), at 19.

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The reduction of an Irish individual's entitlement to a tax credit below the source country's treaty entitlement of 15 per cent eliminates any prospect of a refund of the excess Irish tax credit for portfolio investors resident in the above countries. It is likely that the Irish tax authorities will apply the reduced rate of tax under Section 153(1) TCA 1997 rather than the higher rate of 15% allowed to Ireland under the treaty. Accordingly, relief should be available in the residence state for this reduced tax credit.

Many countries do not grant unilateral relief for underlying corporate tax ("indirect credit") or they impose a minimum percentage shareholding requirement that a portfolio investor is unlikely to meet. When the tax credit is abolished on 6 April 1999, full taxation of Irish-source dividends at marginal income tax rates in the investor's country of residence will probably result, greatly reducing their attractiveness to investors in the above countries, who are likely to seek more tax-efficient investment opportunities elsewhere.

IV. OPPORTUNITIES PRESENTED BY THE ABOLITION OF ACT AND TAX CREDITS

A. Irish companies with foreign subsidiaries

A major frustration of Irish companies with international operations has been the tax inefficiency associated with dividends received from foreign subsidiaries and passed on to their shareholders by way of dividend. Ireland's implementation of the Parent-Subsidiary Directive involves full taxation of dividend income with a credit for any underlying corporate tax borne by the paying company. (This tax credit would have been available in any case for dividends received from companies resident in a treaty country.) Where the paying company paid a low rate of tax, the amount of this credit is insufficient to offset the corporation tax liability on that income. On passing these profits on to shareholders, the Irish company incurs a liability to ACT. In addition, where foreign-source income of this type is substantial in relation to Irish profits, this ACT liability can exceed the amount of corporation tax payable by the company, on its combined Irish and foreign-source profits resulting in an accumulation of unused ACT.

B. A new holding company location?

The abolition of ACT will reduce the tax inefficiency associated with repatriation and distribution of overseas profits of Irish groups. It also places Ireland ahead of the United Kingdom and many other jurisdictions as a tax-efficient location for international holding company activities. Together with a number of other factors, Ireland may be emerging almost by accident as a viable holding company jurisdiction.

The Irish Government has announced a corporation tax rate of 12.5 per cent for trading income of all companies after 2006. (Existing entitlements to the 10 per cent rate will be allowed run their course.) Non-trading income will be taxable at 25 per cent. If the related legislation is appropriately sensitive to the "trading character" of dividends received by a holding company, a favourable component of a holding company regime could be installed in an efficient and low-key manner. Other components, such as the new unilateral foreign tax credit and an expanding treaty network will also add to Ireland's eligibility as a holding company location, although the majority of Ireland's treaties permit relatively high (10 per cent or 15 per cent) source country taxation of dividends. Capital gains taxation, even with the rate reduced from 40 per cent to 20 per cent, also remains an inhibiting factor, but sensitive drafting of the legislation introducing the "12.5 per cent/25 per cent" regime that would regard investments of holding companies as assets eligible for roll-over relief would take care of this.

On a broader scale, with international financing activities already well established in the International Financial Services Centre and multi-country shared services being located in Ireland by many multinationals, there may be a benefit in combining all headquarters activities in a single location. On the individual tax front, Ireland's "remittance basis" of taxation for non-domiciled expatriates constitutes an additional cost saving. It provides highly effective protection against the high costs of moving headquarters personnel from other countries. Ireland's neutral status and lack of a colonial past provides an additional non-tax attraction.

C. Companies buying back their own shares

Following a company law amendment[14] effective from 1 July 1991, it became possible for Irish-incorporated companies to acquire their own shares. Tax legislation traditionally treated payments to shareholders (and other participators) in a wide range of circumstances as similar to dividends, under the all-encompassing term "distributions". Under these provisions, any amount paid "out of the capital" of a company is treated as a distribution, with a few exceptions (repayment or reduction of capital, repayment of an issue premium etc.). If these provisions had remained unchanged, amounts received by shareholders under the new concept of "share buy-back" would fall into this category. Part I Chapter VIII of the 1991 Finance Act[15] removed distribution treatment for certain share buy-backs and brought them within the scope of the Capital Gains Tax Act. In certain cases, the redemption or repurchase by a company of its own shares does not give rise to a distribution. Instead, the full amount received by the shareholder for his shares is dealt with under the capital gains tax rules. In other cases, the distribution rules apply so that the excess of the buy-back or redemption price over the amount originally subscribed for the shares is treated as a distribution, with a tax credit.

The capital gains tax treatment applies in all cases where the buy-back or redemption is made by a quoted company or by an unquoted company which is a member of a group in which a quoted company is also a member (Section 175 TCA 1997). The capital gains tax treatment also applies, if certain condi-

14. The enactment of Part XI (Secs. 206-234) of the Companies Act 1990.
15. Now Sec. 176 Taxes Consolidation Act 1997.

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tions are met, where the buy-back or redemption is made by a company which is either an unquoted trading company or an unquoted holding company of a trading group.

While the rate of capital gains tax was 40 per cent, this treatment was somewhat of a mixed blessing. For a corporate taxpayer, normally not liable to corporation tax on distributions from resident companies, it was decidedly disadvantageous. For exempt investors, such as the trustees of a pension fund, it is also less attractive. For individuals, capital gains treatment was slightly preferable to taxation as income, as the benefit of obtaining a tax credit did not compensate for the loss of a deduction for the indexed acquisition cost and the lower rate of tax (40 per cent) on capital gains than on income (now 46 per cent, but higher in the past). The reduction of the capital gains tax rate to 20 per cent in the 1998 Budget, combined with the phasing-out of tax credits, tips the scales decidedly in favour of share buy-backs for an individual investor. A corporate investor would prefer to receive a dividend both before and after the abolition of tax credits, while a pension fund no longer entitled to a payment of the tax credit will now be indifferent between dividends and capital gains.

V. CONCLUSION

The abolition of ACT and tax credits in Ireland is likely to have less dramatic effects than the less sweeping measure in the United Kingdom. So many distributions by Irish resident companies have been exempt from ACT, and so many others liable at the reduced $^{1}/_{18}$ rate, that the amount of tax involved will probably be small. The high proportion of foreign ownership and control of dividend-paying companies rendered tax credits irrelevant in a large number of cases. Only portfolio investors resident in one of the countries having a treaty with Ireland that recognizes the Irish imputation system are likely to be directly affected, and these probably account for far less investment in Ireland than foreign multinationals. The few Irish-based multinationals will welcome the removal of the tax inefficiency associated with repatriation of profits from high-tax jurisdictions.

Corporate tax managers will be relieved of a tedious and complex computation when dividends are declared. Tax-exempt investors, such as pension funds, will suffer reduced investment yields, with adverse implications for their ability to provide pension benefits. This will affect employers sponsoring defined benefit schemes, who will now be required to increase their contributions to these pension plans. It will reduce the pensions that can be paid to retired individuals under defined contribution pension plans.

A potentially interesting side effect of the abolition derives from its combination with two other innovations in the Irish tax environment – the unilateral multi-tier foreign tax credit for dividend income and the new corporate tax rate of 12.5 per cent. Their combined effect has, perhaps unintentionally, created improved conditions for international holding company or headquarters activities. Together with other tax and non-tax factors, these may result in increasing attention being paid to the possibility of locating international headquarters operations in Ireland.

Overall, the changes are of less importance in themselves than as part of a broader redefinition of the Irish tax environment, in which the long-standing favoured position of the corporate taxpayer is reinforced.

Ireland in International Tax Planning

by Charles Haccius

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The book has been written principally with those unfamiliar with the Irish tax system in mind; consequently, an introduction to Irish tax legislation is provided, along with an explanation of the effect of treaty relief. The discussion of treaties includes practical comparison with the OECD Model Convention and the effect on treaty relief of the Constitution of Ireland. Ireland's domestic legislation is outlined alongside the corresponding treaty provisions in the OECD Model Convention, and the interrelation between the two is discussed.

There follows a practical discussion of Ireland's tax breaks, most significant of which is manufacturing relief; the author provides a definition, and examines in depth how the relief is calculated, the advantages and disadvantages of an Irish resident subsidiary, as against a permanent establishment, and tax-efficient financing. Tax planning opportunities offered by Irish trusts are explored, as well as various tax breaks for specific business, individuals and locations, including writers and artists, air and sea transport, forestry, bloodstock, international executives, self-employed professionals and Shannon Airport and the International Financial Services Centre. The book also covers transfer pricing and anti-avoidance legislation in an Irish context.

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CENTRAL EUROPE

TAX COMPETITION HEATS UP IN CENTRAL EUROPE

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I. THE GROWING PROBLEM OF TAX COMPETITION

Although the phenomenon of tax competition has been remarked upon from time to time over the past twenty years or so in the general literature on international taxation, the topic really only hit the headlines with the publication of the Monti Memorandum, in May 1996,[1] which also coined the expression "fiscal degradation". That was soon followed by talk of tax "dumping", and fiscal "piracy" or "poaching". By mid-1997, tax competition had moved to the top of the European Union's agenda. At more or less the same time the issue was being discussed in the forum of the OECD. Initially the intention there had been to deal with the question of investment incentives in the context of the proposed Multilateral Agreement on Investment (MAI),[2] but it soon became apparent that the deadline for publishing the draft agreement would not be met if it were to deal at any length with tax issues, and a separate task force was set up to examine the specific problem of tax competition.

The problem of tax competition, as it is perceived in the European Union, is twofold. First, there is competition to attract *portfolio investment*, especially investment by individuals in interest-bearing accounts; by imposing little or no withholding tax on interest payments to non-residents, and by failing to provide information about such payments to the tax authorities of the country of destination, some countries stand accused of seeking to poach investment from abroad by offering an open invitation to tax evasion. Secondly, there is tax competition to attract *direct investment*, where a country offers generous tax incentives to foreign enterprises to locate in that country rather than elsewhere. It is this latter form of tax competition with which this paper is concerned.

Tax incentives for foreign direct investment have been around for a long time but, as is pointed out in a comprehensive recent UNCTAD study, such incentives have increased substantially in range and in scope since the 1980s and strong competition to attract foreign direct investment has developed in many parts of the world.[3] At the same time, the process of globalization and the integration of markets through the creation of free trade areas and customs unions has greatly increased the importance of taxation in investment decisions. The problem, of course, is not confined to the member countries of the European Union and the OECD. Tax competition has become an important issue within the ASEAN and MERCOSUR groups and, as this paper will seek to demonstrate, is fast becoming a problem in the countries of Central Europe. Tax incentives for investment, which seemed largely to have disappeared in most of the countries of that region by 1993-94,[4] have started to reappear and to assume a new and increased importance. The competition to attract foreign investment within the region has become intense.

This paper will focus on the three Central European countries that are already members of the OECD and that are expected to be in the next wave of entrants into the European Union – the Czech Republic, Hungary and Poland.

II. THE FIRST STAGES OF TRANSITION IN CENTRAL EUROPE: 1988-1992

The tax systems, as they applied to foreign investment, evolved in the three countries in a relatively similar fashion, despite the fact that those countries embarked upon economic reform from rather different positions. Hungary had introduced limited market-oriented reforms somewhat earlier than its neighbours and had, since the early 1980s, encouraged the formation of joint ventures with foreign participation, although less than 300 such ventures had been established by the end of 1988. Poland had begun to permit foreign investment even earlier, introducing legislation in 1976 to promote investment by expatriate Poles (the so-called "Polonia" firms); a Joint Venture Law of more general application was introduced in 1986. By contrast, the former Czechoslovakia had had one of the most rigid socialist systems and, until the "velvet revolution" in 1989, almost the entire economy was in the hands of state-owned enterprises and foreign investment was virtually non-existent.

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1. *Taxation in the European Community*, discussion document for the meeting of the ECOFIN Ministers, Verona, 12-13 April 1996.
2. In May 1995, the OECD Council committed the organisation to start negotiations on the establishment of a Multilateral Agreement on Investment, with a view to reaching agreement by May 1997. Among other topics, the agreement was intended to deal with some aspects of the taxation of foreign direct investment; see R. Couzin, "Taxation and the Multilateral Agreement on Investment", *Tax Notes International*, 24 April 1996 (96 TNI 122-14).
3. United Nations Conference on Trade and Development, *Incentives and Foreign Direct Investment* (New York, 1996, U.N.) (Doc. UNCTAD/DTC1/28).
4. See *Taxation and Foreign Direct Investment: the Experience of the Economies in Transition* (Paris, 1995; OECD) (hereafter "OECD, 1995").

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Nevertheless, despite these differences, tax reform in the three countries during the initial transition period proceeded along quite similar lines.[5] From the initial economic reforms in 1989 until the adoption of an entirely new tax code in 1992, the (then) Czecho-Slovak Federal Republic accorded preferential tax treatment to foreign investors. Domestic enterprises, most of them still state-owned, were taxed at rates as high as 65 per cent, whilst foreign-owned enterprises and joint ventures with substantial foreign participation were taxed at a rate of 40 per cent. Additionally, enterprises with foreign participation were entitled to apply for, and were usually granted, tax exemption during the first two years of operation. Similarly, Hungary treated foreign-invested firms more favourably than domestically-owned firms; until 1989, the latter paid tax at rates of 60 per cent or more, whereas joint ventures with foreign participation were subject to a different tax regime with substantially lower rates. The Foreign Investment Law of December 1988 made foreign-invested enterprises subject to the general tax system, but introduced a number of special exemptions and reliefs to avoid a large increase in the tax rate. In particular, larger enterprises with a capital in excess of HUF 50 million and a foreign participation of at least 30 per cent, were entitled to a reduction of 60 per cent in their corporate income tax liability during the first five years of operation, and a 40 per cent reduction for a further five years, provided at least one half of their sales revenue derived from manufacturing. As for Poland, the 1986 Joint Venture Law granted a two-year tax holiday to ventures with foreign participation; the 1988 Foreign Investment Law replaced this with tax holidays of three, and in some cases, six years, for enterprises with at least 20 per cent foreign participation and investments exceeding USD 500,000. Those tax concessions were repealed by the Foreign Investment Law of 1991, though existing enterprises continued to enjoy the benefit of incentives which they had been granted under the earlier law; however, the 1991 law introduced new tax concessions applicable to enterprises in which foreign investors had acquired shares before the end of 1993.

III. ACHIEVING A LEVEL PLAYING FIELD: 1992-1995

Special privileges for foreign investors could be justified so long as profits tax rates were well above the international norm and most domestically-owned enterprises remained under state control. However, as the domestic private sector grew, two trends in tax reform became apparent; special concessions for foreign investors were gradually phased out and corporate profits tax rates were reduced to more normal levels. Those reforms reflected the widely-held view that special tax incentives for foreign investment tend to be relatively ineffective (as well as being costly) and that serious, long-term, investors are much more concerned with the general corporate tax system and rates than with special temporary concessions. The reforms also clearly reflected the influence of bodies such as the International Monetary Fund and the OECD, which played a major part in advising the governments of the region on tax reform.

The new Czech tax code, which took effect from 1 January 1993, removed the previous discrimination in favour of foreign investors and eliminated almost all special tax incentives. The Czech government took the view that the strength of its currency, the prospects of economic growth, relatively low labour costs and a favourable geographical location were in themselves sufficient factors to encourage foreign investment, without the need for special tax incentives[6] – a position that was maintained until the departure of Prime Minister Vaclav Klaus at the end of 1997. A flat rate of corporate income tax, initially set at 45 per cent, applied to all enterprises; that rate has subsequently been progressively reduced, to 35 per cent in 1998 and, it is hoped, to 30 per cent by the year 2000. Some very limited incentives (which do not discriminate between foreign and domestic enterprises) were retained, in the form of accelerated depreciation for investment in certain types of assets and some special deductions for the expense of training or retraining certain categories of employees. Local authorities are empowered to provide assistance and support to investors in the form of providing infrastructure, and in some regions grants are available for the creation of new jobs. However, the central government has consistently resisted proposals and requests to grant special tax incentives for new investment, foreign or otherwise, and the Czech "playing field" has, until now, been considerably more level than most.

Hungary, too, introduced major tax reforms in 1993. Thereafter, the special privileges accorded to foreign investors were (at least in theory) eliminated. However, foreign-invested firms already in existence at the end of 1993 continued to enjoy tax holidays granted under the previous legislation. In place of the earlier tax relief, two new incentives were introduced as from 1 January 1994. The one provided for tax holidays, for up to ten years, to be granted on a case-by-case basis for investments of over HUF 500 million, if certain conditions were met;[7] the other took the form of an allowance where a large firm reinvested a substantial proportion of its profits. Those incentives were short-lived and disappeared with the introduction of a completely new corporate income tax system on 1 January 1995. The 1995 reforms reduced the corporate income tax rate from 36 per cent to 18 per cent, but introduced a supplementary tax, at 23 per cent, on distributed profits. One effect of this was to cut by half the effective rate on retained profits, thus rendering redundant

5. For more detailed studies, see OECD, 1995 (*supra*, note 4); G. Erdös, "Trends in the Taxation of Profits: Central and Eastern Europe", 33 *European Taxation* 6/7 (1993), at 214; M. Véghelyi, "An Overview of Trends in Tax Reforms in Selected Central European Countries", 51 *Bulletin for International Fiscal Documentation* 2 (1997), at 86.

6. See D. Roach, "Czech Republic: Fine Tuning of Tax Laws", 35 *European Taxation* 7 (1995), at 230.

7. In particular, the new investment had to increase export revenues or create new jobs. In addition, a further incentive was introduced for job creation in regions of high unemployment.

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the previous reinvestment incentive.[8] The 1995 system was also short-lived, being replaced at the end of 1996. The latest system retains the 18 per cent corporate income tax rate, but eliminates the supplementary tax and replaces it with what is effectively a withholding tax on dividends, at a rate of 20 per cent.[9]

Poland also introduced important new reforms in 1993. Foreign-invested firms established after 1993 now receive no special tax privileges. Since then, the only tax incentives that are generally available, to foreign and domestically-owned enterprises alike, are certain special capital investment allowances introduced in the Income Tax Law of 1993. These provided at 1 January 1997 for the following deductions:

(1) up to a maximum of 20 per cent of taxable income for the year, for investment in a new activity exceeding ECU 2 million;
(2) up to a maximum of 40 per cent of income if the taxpayer's revenue from exports exceeds (a) 50 per cent of its total revenue for the year, or (b) ECU 8 million; and
(3) up to a maximum of 50 per cent (and in some cases 75 per cent) of income for investment in (listed) regions of high unemployment.

In addition, full or partial exemption from corporate income tax may be granted for firms employing substantial numbers of handicapped persons. The rate of corporate income tax was fixed at 40 per cent in 1993, and was reduced to 38 per cent in 1997. The new government, elected in 1997, has announced that it intends to reduce the rate to 32 per cent.

IV. THE RETURN OF TAX INCENTIVES: 1996-1998

By 1994, as we have seen, the tax treatment of foreign investment was broadly similar in all three countries. Corporate tax rates had been reduced to the sort of levels that are found in most Western European countries; privileges for foreign investors had been largely eliminated, as it seemed had special tax incentives for investment generally. Since then, however, there appears to have been a gradual drift back towards a policy of granting special tax incentives for investment – and that tendency has been growing during the past two years. Although the new incentives do not discriminate between domestic and foreign investment it is fairly obvious that they are primarily designed to attract investment from abroad.

A. Hungary

The Hungarian corporate tax system is especially favourable to foreign investors. The nominal tax rate, of 18 per cent, is one of the lowest in the world and the effective rate may be further reduced by general incentives such as accelerated depreciation, etc. Furthermore, since the additional tax on distributed profits is structured as a withholding tax it is usually reduced to 5 per cent (or is eliminated entirely) by tax treaty.

Although general tax holidays were eliminated in the 1993 reforms, the Hungarian Government retained for a further two years an additional, discretionary, incentive for large investments. From 1 January 1996, a new normative incentive was introduced. From that date firms investing over HUF 1 billion may be granted a 50 per cent reduction in the basic corporate income tax (or even full exemption in some cases) for a five-year period (and sometimes longer).[10] Additional incentives may also be available for investment in "enterprise zones", to be designated by the government.[11]

The intention behind this latter provision was to promote investment in less-developed regions of the country. To date, foreign investment has been heavily concentrated in the western part of the country and near the capital, Budapest; the eastern regions of the country are substantially less developed and suffer from high unemployment. In 1995, a decision was taken to establish a special economic zone in Zahony, close to the frontiers with Slovakia and Ukraine. The Corporate Tax Law of December 1995 provided a legislative basis for granting tax advantages for investment in that, and other, special zones, permitting the granting of accelerated depreciation for investment in the zone, and for tax holidays (from the corporate income tax) for up to five years in appropriate cases.[12]

The creation of further special economic zones began to be discussed in earnest during 1996 as part of a general strategy to attract more investment to less-developed regions of Hungary. A new ten-year tax holiday applies from 1 January 1998 for investments of at least HUF 10 billion, or of HUF 3 billion if located in designated less-developed areas of the country.[13] These new incentives, apparently, will continue to be available until the year 2011. In addition, the proposal suggests that as many as eight new special economic zones may be created, in which investors will enjoy similar privileges.

B. Poland

As already noted, the Polish reforms of 1993 largely eliminated special tax incentives for investment. An exception was made, however, for investments in designated special

8. The "grandfathered" pre-1993 tax holidays were converted into a credit that could be set against the 18 per cent basic rate, and the 1994 incentives were similarly preserved for those firms that had qualified for them. The intention was to preserve the value of the former tax holidays, but not to give firms the benefit of both the rate reduction and the holiday; see D. Deak, "Investment Incentives", *Tax Notes International*, 8 July 1996 (96 TNI 131-8); M. Véghelyi, "Hungary: Moving toward A New Corporate Tax System", 35 *European Taxation* 4 (1995), at 117.
9. For analysis of the new system, see D. Deak and R. Krever, "Company and Shareholder Tax Reform in Hungary", *Tax Notes International*, 25 November 1996 (96 TNI 228-13).
10. Factors to be taken into account in determining the extent of the tax reduction include job creation, the improvement of technology and the promotion of exports.
11. Hungarian law also provides for the creation of duty-free zones for enterprises engaged in manufacture or processing for export; see A. Easson, "Duty Free Zones and Special Economic Zones in Central and Eastern Europe and the former Soviet Union", (1998) 16 *Tax Notes International*, at 445.
12. For further detail, see Easson, *supra* note 11.
13. G. Jelinek, "Parliament to Vote on new Tax Holidays", *Budapest Business Journal*, 8 September 1997, at 8.

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economic zones. The idea of establishing special economic zones in Poland seems first to have been discussed seriously in 1992. Those discussions led to the enactment of the Act on Special Economic Zones, on 20 October 1994. According to that Act, the aims of creating special economic zones are to develop economic activity, to create employment, and to promote new technology and exports. The Act provides that special economic zones may be created by means of a regulation of the Council of Ministers, which shall define the territory of the zone, appoint a zone administrator, specify the period for which the zone is established and the activities which may or may not be carried on in the zone.[14] The regulation may also provide for the exemption from income tax of income earned from activity within the zone for a period of up to one half of the period for which the zone is established, and that tax may be reduced by 50 per cent for the remainder of the period. Since in most cases special economic zones have been established for a 20-year period, this effectively means a complete tax holiday of ten years, with a further period of up to ten years during which income tax is reduced by half. Additionally, certain investments may be expensed immediately and accelerated depreciation of fixed assets is allowed. In order to qualify for these tax privileges certain conditions must be met; these refer to the amount of the investment, the number of employees, and the extent of activities within the zone. The reality, however, is that virtually all enterprises currently operating within the zones qualify under one or other criterion and enjoy the full tax exemption.

The first special economic zone was established in 1995 in Mielec, in the south-east part of the country, and the first investors obtained their licences in mid-1996, at about the same time as the second and third zones were being officially established – in Katowice (in southern Poland) and in Suwalki (in the north-east). The original intention seemed to have been to create 8-10 such zones by the end of 1997, and things appeared to be going according to plan when three further zones were established in May, 1997. Then, in September, the creation of nine additional zones was announced, followed by two more in November, bringing the total to 17. By this point, almost every region of Poland had been granted its own special economic zone, and investors are now able to locate in almost any part of the country and enjoy substantial tax concessions.

C. The Czech Republic

The Czech Republic had gone furthest in eliminating special tax concessions and the government was firmly opposed to the use of incentives as an instrument of investment policy. That situation now seems to be changing. The policy pursued for the past five years was very much associated with Prime Minister Klaus personally. The new government, which took office at the end of 1997, is thought to be more receptive to proposals for the adoption of tax incentives, which have been urged by officials of the Ministry of Industry and Trade. According to recent reports, the Ministry of Finance is now disposed to agree to the introduction of incentives, and these are expected to be approved by the government. Under the proposals, large investors (investing at least USD 10 million) will be eligible for tax holidays of up to five years, as well as exemption from customs duties on new equipment and machinery. Additionally, the creation of special economic zones has been proposed.[15] These developments reflect a concern that important investment opportunities have been lost, especially in the past two years, due to the Czech failure to match incentive packages being offered by other countries.[16]

V. INCENTIVES AND THE COMPETITION FOR INVESTMENT

Since the introduction of market reforms the Czech Republic, Hungary and Poland have been keen rivals in the competition to attract foreign investment. Each year the statistics on foreign investment are studied eagerly, with the attention normally given to football league tables, to see who is winning the race to attract most investment. At the end of 1997, Poland proudly announced that it had overtaken Hungary, the perennial leader, as the most favoured investment destination among the transition economies. Investments of USD 6.6 billion in 1997 had pushed Poland into first place overall, with total investments since 1989 of USD 20.6 billion. Hungary placed second, with USD 17.0 billion, and the Czech Republic fourth, just behind Russia, with a total of USD 8.2 billion. However, in terms of per capita investment Hungary retained the lead, with USD 1,666 per inhabitant, Slovenia ranked second (USD 950), the Czech Republic third (USD 796) and Poland fourth (USD 543).[17]

However, until quite recently this rivalry probably did not translate into competition to attract specific investment projects. Rather, the levels of investment were taken as an indication of how well, or how badly, each country was doing in transforming its economy. Most investment in the region took the form of joint ventures between foreign investors and domestic enterprises, and was associated in particular with the privatization process. The location of the domestic enterprises determined the destination of the investment, and tax incentives probably had little influence upon investment decisions.[18]

The situation, however, appears to be changing. For that, there may be a number of explanations. One factor that may account for the growing attention that is being paid to tax incentives is the fact that, in Central Europe, those incentives have recently become increasingly generous. So long as

14. Act on Special Economic Zones, 20 October 1994, Art. 4. See further, Easson, *supra* note 11.
15. See R.A. Greene, "Giving the Dog a Bone", *Prague Post*, 18 February 1998.
16. R. Frank, "Czechs join Rivalry in Eastern Europe to lure Foreign Firms with Incentives", *Wall Street Journal*, 22 September 1997, at A-18.
17. See "Foreign Investment: Poland leads Region", *Polish News Bulletin*, 2 February 1998.
18. D. Holland and J. Owens, "Taxation and Foreign Direct Investment: The Experience of the Economies in Transition", 50 *Bulletin for International Fiscal Documentation* 2 (1996), at 46. According to one study, only about 25 per cent of investors in the transition economies stated that the availability of tax incentives influenced their investment decisions; *Assessing Investment Opportunities in Economies in Transition* (Paris, 1994; OECD), at 50.

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incentives took the form of relatively short tax holidays, as they mostly did in the early days of transition, they had little attraction to serious long-term investors.[19] But recently-introduced tax incentives – notably those for investment in the Polish special economic zones – are so substantial that it no longer seems possible to argue that the general features of the tax system are more important than special incentives; no one expects the general tax system to remain unchanged for 20 years.

Perhaps of equal importance is the fact that the nature of foreign investment in Central Europe seems to be changing. As already noted, a large proportion of the initial foreign investment in the transition economies was related to the privatization of existing enterprises. But the more advanced transition economies are now competing to attract greenfield investment and, especially, export-oriented investment. Investment of that nature has a wider choice as to location and is also generally thought to be more influenced by tax considerations. Firms contemplating investment in the region now consider locations in a number of countries and, as other features of the investment environment have become relatively similar, tax incentives are starting to play a more important part in the decision. This tendency has been accelerated by the creation of customs unions such as the Central European Free Trade Association (CEFTA), of association agreements with the European Union providing for freer trade and, especially in the case of the three countries studied in this paper, of the prospect of full membership of the European Union in the (relatively) near future. When a single market exists, embracing a number of countries, all investment is potentially export-oriented; the entire market can be served from a single location. Large firms, especially those in the automotive and electronics sectors, now look at a number of alternative locations, within Europe and outside;[20] the choice of location has become a matter of crucial importance, and one in which tax considerations appear to be playing an increasingly important part.

The countries of Central Europe have, in the past two or three years, become acutely aware of this development. Indeed, it is possible that they have overestimated the importance of tax considerations on investment decisions and have acted too hastily in bowing to pressures to introduce new incentives. Each country has taken note of the tax incentives being offered by its neighbours. The creation of special economic zones in Poland, with their generous tax holidays, was probably a factor in Hungary's decision to establish further zones in its less-developed regions. Poland's actions may, in turn, have been taken in response to a perception that Hungary's comparative success in attracting foreign investment was at least in part due to its more generous tax incentives. And the recent developments in the Czech Republic are clearly prompted by fears that if it does not follow suit and introduce special incentives it will not be able to compete with its neighbours.

VI. TAX COMPETITION AND MEMBERSHIP OF THE EUROPEAN UNION

Tax competition is heating up in Central Europe. The Czech Republic, Hungary and Poland have each embarked upon a programme of granting increasingly generous tax exemptions in order to attract foreign investment to their countries. Other countries of the region – notably Bulgaria and Romania – are doing likewise. An obvious danger exists of an expensive – and probably self-defeating – "race to the bottom"; "fiscal degradation" has become a problem in Central Europe.

It is, of course, possible that the countries of the region will get together, coordinate their foreign investment policies, and limit the incentives that have been introduced or proposed. Such action could be taken within the framework of the CEFTA, though there is little indication that this is likely to occur. The prospect of OECD membership did, perhaps, impose certain restraints on the use of tax incentives in the three countries reviewed here, but now that they are all fully-fledged members that restraint seems to have been discarded.[21] Some constraints on the use of investment incentives are imposed by the rules of the World Trade Organisation (WTO), though those relate principally to the use of tax incentives as a form of export subsidy.[22]

By contrast, the rules of the European Union would seem to provide some protection against excessive tax competition among its potential members. Some of the existing or proposed incentives in the Czech Republic, Hungary and Poland appear to be contrary to existing EU rules and will presumably have to be eliminated when those countries become full members of the Union. For example, certain of the tax exemptions that apply in Hungary's duty-free zones may be contrary to Community customs law and to the VAT rules. The same is true of exemptions from import duties and VAT on imported machinery and components, such as have been granted in some cases in Poland[23] and, perhaps, of those that are currently being proposed in the Czech Republic.

Potentially of greater importance are the rules on state aids. The EC Treaty (Article 92) prohibits the granting of any state aid which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, insofar as trade between Member States is affected.

19. They tended mostly to attract short-term, footloose, investment that was unlikely to be of much benefit to the host country; see OECD, 1995, *supra* note 4.
20. The recent Czech experience in trying to attract investment from General Motors and from Intel is instructive; see Easson, *supra* note 11.
21. The OECD has expressed concern with the problem of tax competition and has established a working party to study the issue. It is unlikely, however, that its conclusions will differ greatly from the "code of conduct" recently adopted in the European Union; see *infra*.
22. Both Hungary and Poland have made certain tax exemptions conditional upon export performance, but those provisions have been of very limited importance. Poland removed one such provision in 1997.
23. Complaints were recently raised by the European Union regarding customs concessions granted by Poland for the import of components of Korean cars; see "Polish Tax Concession to Daewoo suspect to European Union", *Tax Notes International*, 13 February 1997 (97 TNI 30-16).

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The treaty goes on to provide that certain types of aid may be permitted by the Commission, in particular aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious unemployment. Community law has clearly established that special tax concessions may constitute "aid" for the purposes of Article 92. It is less clear precisely when a particular tax measure will fall within the scope of the state aid prohibition; that is a question that is currently being studied by the Commission.[24] Of the potential new members, Hungary would presumably seek to justify the incentives it grants for investment in its less-developed regions and Poland would likewise claim that the concessions granted to its special economic zones fall within the Article 92 exemption.[25] For the Czech Republic, where unemployment is relatively low and regional disparities are small, such arguments might be more difficult to sustain.

Even where tax incentives are not prohibited by Article 92, they may still fall within the recently agreed "Code of Conduct", under which harmful tax regimes are to be removed by the beginning of the year 2003. Here, for the most part, the Czech, Hungarian and Polish incentives do not appear to be especially offensive. They apply equally (in theory, at any rate) to both foreign and domestic investment, and are directed towards genuine economic activities.

In any event, it is clear that the tax systems of potential members will be subject to scrutiny to determine whether they are consistent with the EC Treaty and with the Code of Conduct, although some of the existing incentives will probably be allowed to remain in effect, at least temporarily. It is apparent that EU rules are already having an impact in those countries that are in the first rank of applicants for membership, even if the main impact seems to have been to produce an unseemly scramble to have a comprehensive set of tax incentives already in place by 1999.[26]

24. "Finance Council: Political Agreement on Taxation Package", *European Report*, No. 2273, 3 December 1997. The ECOFIN agreement requires the Commission to publish, by mid-1998, guidelines for applying state aid rules to corporate tax measures.
25. See "Poland seeks EU Nod on SEZs", *Tax Notes International*, 11 March 1998 (98 TNI 47-21). The argument has become more difficult to sustain with the creation of so many new zones in late-1997.
26. In Poland, for example, it seems to have been accepted that no new special economic zones may be created after 1999; see "EU Ministers: Closure of Poland's Economic Zones Considered", *PAP Polish Press Agency*, 4 December 1997.

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SWITZERLAND

NEW TAX INCENTIVES FOR CORPORATIONS

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This article presents the new rules governing relief available on income and capital gains derived from *qualifying participations* as well as on income derived from *service companies*.

I. INTRODUCTION

Most international tax advisers are aware of the more common tax incentives available to corporations in Switzerland. These include relief for qualifying dividend income, holding companies, domiciliary companies, international sales companies and service companies.[1] Recently, Switzerland has become more attractive with the introduction of more generous rules for relief on qualifying participations and a more generous approach to the taxation of service companies.

With regard to qualifying participations, relief was only available on dividend income received by a Swiss corporation which owned either at least 20 per cent of the capital of another company, or a participation the value of which exceeded CHF 2 million. Companies with qualifying dividend income could reduce their corporate income tax in proportion to the ratio between net earnings on such participations and total net profit.

As of 1 January 1998, relief will be extended to include capital gains earned by Swiss corporations. To qualify for relief on capital gains a Swiss company must hold at least 20 per cent of the capital in another company for more than one year before selling the shares. Losses incurred as a result of the sale of qualifying participations remain tax deductible.

As per the transitional rules, capital gains from the sale of qualifying participations acquired prior to 1 January 1997 will not benefit from tax relief unless the sale takes place on or after 1 January 2007. Nevertheless, if a Swiss company should sell such participations to a group company abroad, the gain will be deferred until sold to a third party. Where the third party sale takes place on or after 1 January 2007, tax relief will be available.

Service companies are able to take advantage of another form of relief. Indeed, the Swiss federal and Geneva cantonal tax authorities have recently issued circulars which reduce the net taxable income attributable to service companies. Until now, where a Swiss resident company provided services to other companies within the same multinational group, the profit assessable in Switzerland was generally deemed to be at least 10 per cent of total expenses incurred for the provision of the services. However, as per new administrative practice, the profit margin has been reduced to 5 per cent.

II. QUALIFYING PARTICIPATIONS

In Switzerland the classical system of taxation applies to corporate profits. This implies that a company is charged to tax on its profits and that its shareholders are taxed separately on the dividends paid out of these same profits. There are no rules to allow the shareholders a credit for the tax paid by the company.[2]

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

A. Legislation

The following articles are to be found in the Federal Direct Tax Law (DTL)[3] and are applicable for Swiss federal tax pur-

1. H.R. Hull, "Switzerland: Income Tax Incentives for Corporations", 50 *Bulletin for International Fiscal Documentation* 1 (1996), at 29.
2. Swiss resident shareholders may obtain relief for taxes paid by corporations in states which apply the tax credit mechanism if granted by a double tax convention. (This concerns distributions from entities resident in Great Britain, France and Ireland.)
3. Loi fédérale du 14 décembre 1990 sur l'impôt fédéral direct, R5 642.11 & Message concernant la réforme 1997 de l'imposition des sociétés du 26 mars 1997, FF 1997 II 1058 & loi fédérale sur réforme 1997 de l'imposition des sociétés du 10 octobre 1997, FF 1997 II 737, published on 21 October 1997; unofficial translations by author.

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poses. However, similar rules are also to be found in the Tax Harmonisation Law (THL)[4] which is used as a basis for cantonal and communal tax purposes. Since these rules are fairly general, they have been explained in more detail by the Federal Tax Administration.[5]

Article 69 DTL

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

Article 70 DTL

1. Net earnings on participations pursuant to Article 69 correspond to the earnings on these participations less the financing costs related thereto, and an amount of 5 per cent which covers administrative costs (unless it is proven that actual administrative costs are lower or higher than this percentage). Financing costs are defined as interest on loans and other costs which are economically equivalent thereto. Capital gains generated from participations and proceeds from the sale of priority subscription rights thereon are also considered as earnings on participations. The above is limited by Article 207a.

2. The following are not considered as earnings on participations:
- earnings which represent commercially justifiable expenditures for the paying joint-stock company or cooperative;
- revaluation gains from participations.

3. Earnings on participations shall only be taken into account in calculating the reduction when such earnings have not led to a depreciation of the corresponding participations which reduces taxable net profits (Article 58 ss).

4. Capital gains are only taken into account to calculate the reduction:
- when earnings from the sale are in excess of the cost of investment;
- when the participation which is sold represented at least 20 per cent of the share capital of another company and if the joint-stock company or cooperative held the participation for at least one year.

5. Transactions which result in an unjustified tax saving by a group shall lead to a correction of taxable income or a decrease in the reduction. A tax saving is considered to be unjustified when capital gains, capital losses or capital depreciation relative to participations pursuant to Articles 62, 69 and 70 are related.

Article 207a DTL

1. Capital gains generated from participations and proceeds from the sale of priority subscription rights thereon are not included in the calculation of net earnings pursuant to Article 70 paragraph 1, if the joint-stock company or cooperative held the participations in question before 1 January 1997 and generates the gains before 1 January 2007.

2. With regards to participations held before 1 January 1997, their fiscal value at the beginning of the financial year ended during the calendar year 1997 is considered to be the cost of investment (Article 62 paragraph 4, and 70, paragraph 4(a)).

3. If a joint-stock company or a cooperative transfers a participation which it held prior to 1 January 1997 to a foreign company in the same group and if the participation represents at least 20 per cent of the share capital of another company, the difference between the fiscal value and the market value of the participation is added to the net taxable income. In this situation, the participation is considered as having been acquired before 1 January 1997. Simultaneously, the joint-stock company or the cooperative can create a non-taxable reserve of the amount of the difference. This reserve shall be dissolved and taxed if the participation is sold to a third party outside the group or if the company whose participation rights have been transferred disposes of an important portion of its assets and liabilities or if it is liquidated. The joint-stock company or the cooperative shall attach to the tax return a list of participations for which a non-taxable reserve has been created pursuant to this article. The non-taxable reserve is dissolved without any tax implications on 31 December 2006.

B. Companies for which relief is available

Qualifying dividend relief is available to joint-stock companies and cooperatives. The former include Swiss corporations, limited liability companies, and corporations with unlimited partners.[6] It is also available to foreign companies of a similar nature if the foreign company maintains a permanent establishment in Switzerland and the dividends are directly linked to the Swiss operations.[7] All these entities may qualify for relief on dividend income regardless of the nature of their activities and regardless of the country in which the shareholders are resident.

C. Dividend income for which relief is available

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

Participations include shares or any other interests which grant the right to a dividend or similar income (e.g.: partici-

4. Loi fédérale du 14 décembre 1990 sur l'harmonisation des impôts directs des cantons et des communes, RS 642.14. Art. 28, para. 1 THL is similar to Art(s). 69 & 70 para. 1 (1) DTL.
5. Circulaire no 27, "Réduction d'impôt sur les rendements de participations des sociétés de capitaux et des coopératives (Art. 69 et 70 LIFD)", *Federal Tax Administration*, 29 December 1995.
6. Société anonyme, Société à responsabilité limitée, Société en commandite par actions.
7. Art. 49 para. 3 DTL, Art. 24 OECD Model tax convention on income and on capital (non-discrimination). Permanent establishments of foreign companies do not qualify for treaty relief on dividends received from abroad.

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pation certificates).[8] Participations do not include bonds and other loan certificates held by shareholders.[9] Participations must be held directly by the Swiss beneficiary at the time the dividends are due. They may not be held on a fiduciary basis nor be subject to usufruct.

Earnings generated from participations include ordinary dividend distributions as well as any other attribution of income to shareholders such as hidden dividend distributions, liquidation proceeds, bonus shares, etc. The term does not include income for which a deduction is granted to the distributing entity,[10] and revaluation gains.

Earnings on participations shall only be granted relief to the extent that a distribution of earnings does not lead to a subsequent tax deductible depreciation of the shares in the distributing company.[11] Indeed, it is not possible to obtain the relief for qualifying dividend income as well as a tax deduction resulting from the corresponding depreciation of the share.

D. Capital gains for which relief is available

To qualify for relief on capital gains, a Swiss company must make a profit on the sale of a participation which represents at least 20 per cent of the share capital of another company which it has held for at least one year and which does not result in an unjustified tax saving by a group. Losses incurred as a result of the sale of qualifying participations will remain tax deductible.

As a rule, this relief is applicable to all qualifying participations acquired after 1 January 1997 and only to those acquired previously if they are sold after 1 January 2007. International share transfers to group companies constitute an exception to this rule.

A capital gain is defined as the difference between the earnings from the sale of a participation and the cost of the investment. Hence, any tax deductible depreciation, or provision on the participation is not taken into consideration when calculating the amount of gains which can take advantage of the relief. In addition, revaluation gains from participations do not qualify.

With regards to participations held before 1 January 1997, their fiscal value (usually book value) at the beginning of the financial year ended during the calendar year 1997 is considered to be the cost of investment.

Transactions which lead to an unjustified tax saving by a group of companies shall result in a correction of taxable income or a decrease in the amount of relief available. Legislation considers that there is an unjustified tax saving when capital gains, capital losses or a capital depreciation are related.[12]

Although we can imagine numerous situations of abuse which are likely to be clarified by administrative practice and case law, this provision typically aims at situations where a group holding company transfers the assets and liabilities of one subsidiary to a new subsidiary prior to a third party sale. Under this scenario, and in the absence of abuse provisions, it would be possible to benefit from a tax deductible capital depreciation on the first subsidiary as well as a tax neutral capital gain on the sale of the new subsidiary. This is clearly not the intention of the new law.

International share transfers to group companies take advantage of special rules governing participations held prior to 1 January 1997. Indeed, where a Swiss company transfers at least 20 per cent of the share capital of such a participation to a group company abroad,[13] the capital gain shall not be taxable if, simultaneously, a reserve is created for the amount of the capital gain.

If the participation is still held by the group on 31 December 2006, the reserve can be dissolved without any tax implications. However, the reserve shall be dissolved and fully taxed if the participation is sold to a third party outside the group or if the company whose participation rights have been transferred disposes of a significant portion of its assets and liabilities or is liquidated.

E. Calculation of tax relief

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

$$\text{tax relief} = \text{corporate income tax} \times \frac{\text{net qualifying dividend income and/or capital gains}}{\text{total net profit}}$$

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

Total net profit
This is the net taxable profit which is used as a basis to determine the corporate income tax as per Swiss tax law. It includes qualifying dividend income and capital gains. There are special rules to take into account the situation were Swiss companies may also obtain relief for permanent establishments or real estate situated abroad.[14]

8. Bons de participations.
9. Except if the loan is economically considered as share-capital and the interest received is not allowed as a deductible expense in the hands of the distributing company (see Art(s). 65 & 75 DTL, Art(s). 24 para. 1 (c) & 29 para. 3 THL).
10. Due to payment of interest, royalties, commissions, management fees, R & D etc.
11. Art. 70, para. 3 DTL.
12. Art. 70, para. 5 DTL.
13. There is currently some discussion as to the definition of group company. Art. 663 e, para. 1 Swiss Code of Obligations refers to a company which, through voting rights or otherwise, unites one or more companies under a single management.
14. Circular No. 5 "Relation existant entre la réduction pour participations de l'article 59 AIFD et les réductions pour établissements stables et immeubles à l'étranger selon l'article 55 AIFD", *Federal Tax Administration*, 21 January 1985.

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Net qualifying dividend income and capital gains
The following formula must be applied to determine the amount of net qualifying dividend income and capital gains:
- gross qualifying divided income and capital gains;
- less financing costs;
- less administrative costs (5 per cent of gross qualifying dividend income);
- less other costs:

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

Gross qualifying capital gains is the difference between the price of sale of a participation and the cost of the investment.

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

Administrative costs incurred due to the management of participations may be difficult to determine. To avoid any time-consuming complications, a fixed 5 per cent deduction is allowed without justification. The deduction must not exceed the actual costs and does not apply to pure holding companies whose only income is qualifying dividend income and capital gains.[15]

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

III. SERVICE COMPANIES

Service companies generally provide technical, administrative or scientific assistance including research and promotional activities. When such services are provided to group companies, it is very difficult to determine the taxable income generated by the service company i.e. the extent of the contribution of the Swiss resident company to the total profits of the group. In order to limit the number of litigious cases, the Swiss Tax Administration commonly attributes to service companies a notional profit upon which tax is levied.[16]

This practice is not provided for in the legislation. It has, however, been officially confirmed by the Swiss Federal Tax Administration[17] as well as by the Swiss Supreme Court.[18]

A. Criteria to qualify for service company status

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

B. Taxation of service companies

Until recently, profit assessable in Switzerland has generally been 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. However, for the financial year ending during 1997 and thereafter, this margin has been reduced to 5 per cent of the total expenses incurred or one twelfth (8.33 per cent) of total local payroll costs.[19] Other income such as dividend, interest or licensing income must be added to the notional income.

The service company ruling merely indicates the method of calculating the taxable income. For cantonal and communal tax purposes, it may be combined with the rules applicable to domiciliary companies (as defined). The following relates to the situation in the canton of Geneva.[20]

(1) Services provided in Switzerland are subject to ordinary taxation, i.e. 5 per cent of expenses are taxed at ordinary rates;
(2) In situations where a group service company employs non-resident personnel to provide services abroad to non-resident affiliates, 80 per cent of the notional income is exempt. The remaining 20 per cent is subject to ordinary rates.
(3) Where Swiss resident personnel are employed to provide services abroad to non-resident affiliates, 50 per cent of the notional income is subject to the above mentioned preferential regime (i.e. 80 per cent exemption). The remaining 50 per cent is subject to ordinary rates.
(4) If Swiss resident employees work abroad for short periods of time, any notional income related to such activity is broken down between (1) and (3) in proportion to the number of days worked in Switzerland and abroad.

The Geneva Tax Administration has introduced a simplified method of calculating the corporate income taxes on Service companies which are primarily involved in rendering services abroad to group companies. Under this system, the company is assessed on 50 per cent of notional income at ordinary rates, and on 20 per cent of the remaining 50 per cent at ordinary rates.

Companies wishing to take advantage of these measures must request a prior ruling from the Geneva Cantonal Tax Administration.

15. If the net qualifying dividend income is artificially reduced by 5 per cent, a pure holding company whose only income is qualifying income, would not be totally exempt since the net qualifying income would be lower than the total net profit.
16. Conrad Stockar, *Aperçu des droits de timbre et de l'impôt anticipé*, 3ème édition, Lausanne 1994, at 103.
17. Circular No. 14, "Imposition des sociétés suisses qui exercent leur activité commerciale principalement à l'étranger", *Federal Tax Administration*, 29 June 1959 and the circular entitled "L'imposition des sociétés étrangères qui entretiennent en Suisse des établissements stables", *Federal Tax Administration*, 1 June, 1960.
18. Supreme Court decision of 25 January 1997, *Archives* 48, 207.
19. Circular entitled "Imposition de sociétés de services; marges bénéficiaires", *Federal Tax Administration*, 17 September 1997.
20. Information No. 7/97, "Imposition des sociétés dites de service à marges bénéficiaires", *Geneva Tax Administration*, 18 December 1997.

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AUSTRALIA

COMPANY AND TAX LAW ASPECTS OF CORPORATE TAKEOVERS

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I. INTRODUCTION

Investors contemplating the acquisition or takeover of an Australian company must consider a range of company law and taxation law issues relevant to changes in company control. The takeover must be structured so as to comply with company law and should be arranged in a manner that will not trigger undesirable tax consequences for the vendors, the target company, or the acquirer. If the prospective acquirer is a foreign individual or company, the possible application of foreign investment review legislation must also be considered. This article examines the company, foreign investment, and taxation laws relevant to takeovers in Australia.

The article is divided into three principal sections following this introduction. The second section examines the company law rules relevant to takeovers, the third section looks at foreign investment and other laws that set ownership levels if the acquirer is not Australian or that impose ownership restrictions for specific sectors of the economy, and the fourth section reviews the taxation implications of takeovers.

The discussion is based on the takeover of a company in the sense of ownership of shares in the company passing to new owners. It is possible to "take over" a company in another way, namely by acquiring the company's business assets (goodwill, inventory, depreciable equipment, etc.) and leaving the company's ownership intact, with the original shareholders owning a cash-rich entity. While there have been some instances of acquisitions of this sort, acquisitions by means of takeovers of companies owning business assets is more common. There are a number of reasons for this. Because there are no company law restrictions on sales of businesses owned by companies as opposed to sales of companies themselves, in theory a sale of business assets can be used to avoid company law restrictions on takeovers. However, this technique will not avoid the application of foreign investment restrictions, which apply equally to sales of businesses and sales of companies. More importantly, a sale of assets may lead to tax costs substantially higher than those arising upon a sale of shares.[1]

None of the three main bodies of law actually use the expression "takeover" of a company.[2] Rather, company law speaks in terms of the acquisition of interests in a company above set thresholds. Foreign investment review is concerned with the legal consequences of an acquisition of a substantial interest in a company or business. Taxation law is concerned with changes in "majority" ownership of a company. These concepts are defined differently in the various laws. In some cases, laws provide different definitions of the same concept for different purposes. The laws are both restrictive and prescriptive with respect to changes of control. For example, the foreign investment review legislation restricts the sale of interests in a company where control will pass to a foreign person unless certain conditions are met. The company law operates in a similarly restrictive fashion, prohibiting the acquisition of shares above certain thresholds unless conditions are met. The tax law, by way of contrast, has no restrictions on transfers of company interests but prescribes, subject to exceptions, negative tax consequences where majority ownership of a company has changed. These include the loss of rights to carry forward and utilize a range of prior year losses. Changes of control may also trigger deemed disposals of company assets and consequent deemed receipt of taxable gains following a change of control.

A host of other tax considerations are relevant to takeovers of Australian companies. If the acquirer is relying on debt to finance the acquisition, the deductibility of interest payments on the debt becomes an issue. Following a takeover, a range of tax considerations will determine whether capital injections should be made by way of additional equity or debt stakes in the company acquired. If the new owner is foreign-owned, thin capitalization measures may restrict the interest deductions available to the Australian subsidiary. From a target company's point of view, the deductibility of costs incurred to respond to or to defend against an unwanted takeover attempt will be a relevant consideration. The company's owners will be concerned with the potential tax consequences from the sale of their shares.

II. TAKEOVERS AND COMPANY LAW

Company law in Australia, including the law relating to takeovers and share acquisitions, falls within the constitutional powers of both the State and Commonwealth (i.e. fed-

1. In addition to income tax consequences from a sale of assets, there may be stamp duty imposts significantly higher than those imposed on a transfer of shares.
2. Although, as is noted below in section III, the Act relevant to levels of foreign ownership is titled the Foreign Acquisitions and Takeovers Act.

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eral government). As a result of an agreement between the States, Territories and the Commonwealth, the Commonwealth Corporations Law applies in all jurisdictions.[3] While a company "takeover" usually connotes a change in control of a company, the Corporations Law is not concerned with changes of control per se. Rather, the legislation is concerned with acquisitions above a relatively low ownership threshold, namely 20 per cent of voting shares, which may constitute de facto control of a widely held public company.

The Corporations Law is relevant to takeovers for two reasons. First, the Law attaches conditions to all acquisitions by a person holding an interest representing 20 per cent or more, but less than 90 per cent, of the company's voting shares. Similar conditions apply to any acquisition by a person with an interest representing less than 20 per cent of the company's voting shares if the acquisition will result in an ownership level of 20 per cent or more.[4] Second, the Law provides a procedure for persons owning 90 per cent or more of the voting shares in a company to acquire the remaining shares. This procedure may be important for both tax reasons – as explained below, there are many advantages to 100 per cent ownership in terms of inter-group transfers – and non-tax reasons such as the wish to avoid dealing with minority interests.[5]

The Corporations Law uses a somewhat convoluted construction to achieve its objectives with regards to regulated acquisitions. Rather than state directly the conditions that must be met where an acquisition falls within the regulated acquisition rules, it regulates the acquisitions indirectly, by prohibiting all acquisitions of voting shares within the regulated thresholds unless they fall within one of the exceptions contained in Chapter 6 of the Corporations Law.

There are 15 exceptions in the legislation.[6] The main exception is a formal takeover bid.[7] Two other important exceptions are acquisitions of not more than 3 per cent of the shares of a company in a six-month period (sometimes called a "creeping acquisition")[8] and an acquisition approved by independent shareholders.[9] A formal takeover bid may be off market[10] or on market (if the target is a company listed on the Australian Stock Exchange).[11] The offeror must give the target company and its shareholders a statement containing prescribed information.[12] The target company directors must respond with another statement indicating whether or not they recommend acceptance of the bid.[13] The legislation also contains detailed rules relating to the minimum price at which a bid can be made,[14] specific time period for statutory requirements to occur,[15] requirements for registration of documentation,[16] rules dealing with variation[17] and withdrawal of a bid,[18] and provisions dealing with mopping up minority interests after a successful bid.[19] The body that administers the Corporations Law, the Australian Securities Commission (the "ASC"), has a number of important discretions in relation to takeovers, including the power to exempt a person from compliance with the statutory requirements[20] and a power to modify the legislation as it applies to particular persons.[21]

The initial prohibition applies to an "acquisition" of "voting shares" that would cause a person's "entitlement" to voting shares after the acquisition to fall within the regulated acquisition thresholds. The rules raise several issues. What is an "acquisition" to which they apply, what are "voting shares" that are subject to regulation, and, apart from outright ownership, what might constitute an "entitlement" to shares?

A. What is an acquisition?

The restrictions that affect company takeovers apply to "acquisitions" of voting shares. The focus on acquisitions stands in contrast to the approach used in predecessor legislation, which prohibited *offers* or *invitations* in relation to shares which would take the offeror's holding to more than a prescribed percentage. This formulation meant that if an offeror could acquire shares without making an offer or an invitation, no breach of the legislation occurred.

The Corporations Law sets out two ways in which a person may *acquire* shares in a company.[22] The first is where the person acquires a relevant interest in those shares as a result of a transaction entered into by or on behalf of the person.[23] The second is where legal and equitable interests in shares are separated as would occur, for example, when the legal owner of shares declares that they are being held on trust for another person. Both the legal owner and beneficial owner will acquire interests in the shares in this case. Where a person acquires shares as a "bare trustee", that is, as an agent for or

3. For a discussion of the cooperative scheme which has been operative since 1 January 1991, see H. Ford, *Principles of Corporations Law* (8th ed.) (Sydney: Butterworths, 1997), para. 2.280-2.290.
4. Corporations Law Sec. 615(1).
5. Ford, *supra* note 3, at para 24.190 identifies the benefits as:
- eliminating conflicts of interest;
- reducing administrative and reporting costs;
- facilitating financial restructuring; and
- protecting the confidentiality of business plans and products.
6. Corporations Law Secs. 616-623.
7. Corporations Law Secs. 616 and 617.
8. Corporations Law Sec. 618.
9. Corporations Law Sec. 623.
10. Corporations Law Sec. 616 and Part 6.3.
11. Corporations Law Sec. 617 and Part 6.4.
12. Called a Part A Statement for an off market bid and a Part C Statement for an on market bid.
13. Called a Part B Statement for an off market bid and a Part D Statement for an on market bid.
14. These apply where the consideration is cash rather than shares or a mixture of cash and shares: Corporations Law Sec. 641.
15. For example, the bid must remain open for a minimum one month period and a maximum of six months: Corporations Law Sec. 638.
16. Corporations Law Sec. 644.
17. For example, by increasing the consideration: Corporations Law Secs. 655 and 665.
18. A bid may only be withdrawn with the consent of the ASC: Corporations Law Sec. 653.
19. Corporations Law Sec. 701.
20. Corporations Law Sec. 728.
21. Corporations Law Sec. 730. The ASC has used this power to modify the legislation in relation to foreign offerings which result in an acquisition of shares in an Australian corporation where the ASC is satisfied that the regulatory requirements in the relevant jurisdiction are comparable to the Corporations Law: ASC Policy Statement 71.
22. Corporations Law Sec. 51.
23. The concept of entering into a transaction is defined in Corporations Law Sec. 64 to include a reference to becoming a party to a relevant agreement in relation to the shares, and a reference to exercising an option to have shares allotted.

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nominee of another person, the legislation looks through the transaction and treats the acquisition as that of the person with the underlying interest only, disregarding the bare trustee's interest.[24]

B. What are voting shares?

The restrictions on acquisitions apply to acquisitions of voting shares. Voting shares are defined as shares that carry the right to vote other than a right to vote that is exercisable only in limited circumstances such as on a winding up.[25] Shares which carry the right to vote only in these limited circumstances will be regarded as non-voting shares. The restrictions are not concerned with other types of securities such as non-voting shares, convertible notes or renounceable options so that there are no restrictions on persons seeking to acquire these types of securities. However, the transaction required to convert a convertible note to a voting share or to exercise an option over a voting share would amount to an acquisition and thus be subject to the restrictions.

The compulsory acquisition provisions that enable the owner of 90 per cent or more of a company's shares to acquire by compulsion the remaining shares in a company also only refer to shares.[26] The provisions enable an offeror that has made a successful takeover offer and acquired 90 per cent or more of the shares in a class to require owners of outstanding shares in the class to transfer their shares to the offeror. Separate measures give remaining shareholders, holders of convertible notes and holders of renounceable options the right to require an offeror who has acquired at least 90 per cent of the voting shares in the company to acquire their securities as well. However, there are no provisions granting any compulsory acquisition rights to the offeror other than in respect of the shares of the same class acquired.[27]

C. What is an entitlement to voting shares?

The restrictions on acquisition of voting shares apply to persons who are "entitled" to a number of voting shares prior to the acquisition that meets or crosses specified thresholds. The most difficult aspect to determining whether or not the restrictions on acquisition of voting shares applies to a particular person is working out that person's entitlement to shares in a company both before and as a result of a proposed acquisition.

The reference to persons "entitled" to voting shares rather than, say, "owning" a certain number of shares or "holding" a certain number clearly indicates the intention of the legislation to include various sorts of indirect rights to voting shares when determining if a person seeking to acquire shares crosses the restriction threshold. The notion of entitlement to shares was chosen because this is more likely to reflect whether a person has "control" in relation to the shares, whereas a prohibition on acquiring and holding shares above a specified threshold could be easily avoided by the use of associates and nominees.

An expansive deeming measure sets out when a person will be treated as being "entitled" to voting shares. The measure envisages five broad types of entitlement:

- the first is where a person has a more-or-less direct interest, labelled a "relevant interest" in the legislation, in a company's voting shares;[28]
- the second is a deemed entitlement by a person where an "associate" of the person holds a relevant interest in a company's voting shares;[29]
- the third is where a person has entered into an agreement that enables the person to control directly or indirectly or to influence substantially the voting power attached to shares in which the other party to the agreement has a relevant interest;[30]
- the fourth is where a person has entered into an agreement such as an option that will enable the person to acquire shares in which the other party to the agreement has a relevant interest or that will enable the other party to the agreement to require the person to acquire the other party's shares;[31]
- the fifth is where a person has entered into an agreement that would require the other party to the agreement to dispose of shares in accordance with the person's directions.[32]

The broad deeming measure that expands the concept of entitlement to shares in turn builds upon two subsidiary definitions that of a "relevant interest" in a share (discussed below at II.C.1) and that of an "associate" of the person (discussed below at II.C.2).

1. What is a "relevant interest" in a share?

There are 16 different sections to be considered to identify whether a person has a "relevant interest" in a company,[33] but the basic rule is that if a person has the power to exercise the right to vote or the power to dispose of the share, that person will have a relevant interest in the share.[34] A person will be deemed to enjoy a relevant interest in shares if the person has entered into an agreement that, when performed, would leave the person with a relevant interest.[35] A number of cases have considered the nature of these two powers to vote or to dispose of a share.

The basic rule as to what constitutes an agreement that might yield a relevant interest was explained in *TVW Enterprises Ltd. v. Queensland Press Ltd.* (No 2).[36] This case concerned an exchange of correspondence in 1979 between two parties (Fairfax and Queensland Press) who each held 15 per cent of

24. Corporations Law Sec. 39.
25. Corporations Law Sec. 9.
26. Corporations Law Sec. 701.
27. Corporations Law Sec. 703.
28. Corporations Law Sec. 609(1)(a).
29. Corporations Law Sec. 609(1)(b).
30. Corporations Law Sec. 609(1)(c) and (2)(a).
31. Corporations Law Sec. 609(1)(c) and (2)(b).
32. Corporations Law Sec. 609(1)(c) and (2)(c).
33. Corporations Law Secs. 30-45.
34. Corporations Law Sec. 31.
35. Corporations Law Sec. 34.
36. (1983) 7 ACLR 821.

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the shares in a company (Herald and Weekly Times Ltd.). In the correspondence there was an agreement to execute a formal agreement if requested to do so. The formal agreement, when executed, would give pre-emptive rights (that is, a right to purchase the shares before or in preference to others) and also an agreement to vote the shares the same way.

In 1982, Fairfax sold some shares to Queensland Press giving Queensland Press 27 per cent of the shares in Herald and Weekly Times Ltd. Another shareholder in Herald and Weekly Times Ltd., TVW, argued that this acquisition in 1982 was in breach of the prohibition. Queensland Press argued that it had a relevant interest in the shares in 1979 and therefore there was no change in entitlement in 1982. Queensland Press argued that the exchange in correspondence created an enforceable agreement with respect to the shares held by Fairfax which gave Queensland Press the ability to exercise some control over the disposal of the shares and in relation to the voting rights attached to those shares.

TVW argued that the exchange of correspondence did not create an enforceable agreement, and that for a relevant interest to exist it was necessary to show that the power to exercise control over voting or disposal was absolute or, at least, gave substantial control. The Court held that by the exchange of correspondence the parties did have an enforceable agreement with respect to the shares and that Queensland Press had the ability, by requesting execution of the formal agreement, to exercise some true or actual measure of control over disposal and in relation to the voting rights and that this was all that was required.

Another case that discussed the nature of the powers that constitute a relevant interest was *North Sydney Brick and Tile Ltd. v. Darvall*,[37] which concerned a company whose articles contained a provision that prevented disposal of shares to a third party, without those shares first being offered to other shareholders (that is, the members had pre-emptive rights in relation to all the other shares in the company). Darvall was a member of the company and had made a takeover offer to the other shareholders. The company, which opposed Darvall's takeover bid, argued that the takeover documents did not comply with the restrictions placed on acquisitions taking a person over the restricted acquisition threshold.

Darvall argued that the effect of the pre-emptive provision was to give him power to exercise some control over the disposal of all the shares in the company and accordingly gave him a relevant interest in all the shares of the company. Therefore, he argued, his proposed acquisition would not change his entitlement and so there was no need to comply with the requirements for restricted transfers. The Court accepted this argument and said that the negative power to prevent another shareholder disposing of shares otherwise than in accordance with the articles may constitute a power to control.

The decision in *North Sydney Brick and Tile Ltd. v. Darvall* has not been as far-reaching as first thought and clearly depends on the form of the company's articles. In *Foodland Associated Ltd. v. Garina Pty. Ltd.*,[38] the articles of the company provided a restriction on disposal which said that the shares could be transferred to any other member, or to a purchaser of a member's business or to anyone approved by the directors. The court in *Foodland Associated* distinguished the holding in *North Sydney Brick and Tile Ltd.* on the basis that the company's articles in *Foodland* did not impose the same restriction on offering to non-members.

The provision that deems a person to enjoy a relevant interest in shares if the person has entered into an agreement that will result in the person acquiring a relevant interest clearly means that prior to settlement a purchaser will have a relevant interest in the shares subject to the agreement. Other agreements can also confer relevant interests. For example, if a person is contemplating making a takeover offer and enters into a pre-bid understanding with a shareholder as to whether the shareholder will accept the bid, the pre-bid understanding will give rise to a relevant interest being acquired by the prospective offeror. Conditional agreements may also give rise to relevant interests. In *Baden Pacific Ltd. v. Portreeve Ltd.*,[39] it was held that the condition in the agreement that independent shareholders approve the acquisition was not a condition precedent to formation of a binding contract but rather a condition precedent to performance and so did not prevent a binding contract coming into existence.[40]

The legislation also deals with identification of relevant interests where a company or series of companies is involved. The relevant sections are Section 32 and Section 33 of the Corporations Law.[41] Section 32 provides that if a person (either an individual or a company) in some way "controls" a body corporate, the person will be deemed to have the same power as the body corporate. This process of "looking through" the company to its controllers applies no matter how many companies are in the chain. That is, if A controls Co B, and B controls Co C and C has a relevant interest in Co D; A, B and C will all have the same relevant interest.

Section 33 provides that where a person (together with associates) has the power to vote in respect of not less than 20 per cent of voting shares in a company, the person will be deemed to have the same relevant interest in shares in which the company has a relevant interest. Unlike Section 32, Section 33 does not have an extended operation. That is, if A has more than 20 per cent of the voting shares in Co B, and B has more than 20 per cent of the voting shares in Co C and C has a relevant interest in shares in Co D; B and C will be deemed to have the same relevant interest, but A will not. This occurs because of the inclusion of the words "other than this section" in the opening words of Section 33.

An example of the operation of these provisions arose in *NCSC v. Brierley Investments Ltd.*[42] This case involved two

37. (1986) 10 ACLR 837.
38. (1989) 14 ACLR 739, see also *Zytan Nominees Pty. Ltd. v. Laverton Gold NL* (1988) 14 ACLR 524.
39. (1988) 14 ACLR 677.
40. The Court relied on the High Court decision in *Perri* v. *Coolangatta Investments Pty. Ltd.* (1982) 149 CLR 537. However, a different Court reached a contrary decision at about the same time: see *Magnacrete Ltd. v. Robert Douglas-Hill* (1988) 15 ACLR 325.
41. Another section that should be noted is Sec. 317, which provides that a body corporate can have a relevant interest in its own shares.
42. (1988) 14 ACLR 177.

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New Zealand companies: Brierley Investments Ltd. (NZ) ("BIL") and Rainbow Corporation (NZ) ("Rainbow"). Each of these companies had a relevant interest, through a chain of wholly owned companies, in Woolworths Ltd., an Australian company. BIL acquired a 30 per cent holding in Rainbow in New Zealand and Australian regulatory authorities claimed that as a result there had been a contravention of the prohibition. Traced through Section 32, Rainbow was deemed to be entitled to approximately 20 per cent of the shares in Woolworths, and BIL was deemed to be entitled to approximately 20 per cent. The transaction in New Zealand had the effect of linking the two holdings through Section 33, so that BIL's entitlement increased to nearly 40 per cent. BIL argued that the transaction only concerned New Zealand law, but the Court indicated that what it was considering was the power to control shares in an Australian company.

It should also be noted that a number of relevant interests are to be disregarded[43] such as the interest of a bare trustee[44] or the interest of a financier.[45]

2. Associates

It has been noted that a person will also be entitled to shares in which an associate has a relevant interest.[46] If the person is a company, the directors or the secretary of that company will be its associates.[47] Any company that is a related company will also be an associate.[48] A related company could be a holding company, a subsidiary or sub-subsidiary or a co-subsidiary.[49] The directors and secretary of the related company will also be associates.[50] Parties may also be associates if they have an agreement for the purposes of controlling or influencing the composition of the company's board or the conduct of affairs of the company.[51] In each of these cases, the association means that the first person is entitled to all the shares in which the associate has a relevant interest.[52]

A person may also be entitled to shares as a result of an agreement.[53] Where a person enters into an agreement with another person and the agreement relates to the exercise of voting power attached to shares in which the other person has a relevant interest, or which relates to the acquisition or disposal of shares in which the other person has a relevant interest, the first-mentioned person will be entitled to those shares. Unlike the provisions dealing with association arising by virtue of a relationship, the entitlement only relates to the shares which are the subject of the agreement.

Despite the broad nature of the notion of an "associate", parties will not be associates merely because one gives advice of a professional or business nature to the other, the parties are in the relationship of dealer and client, one of the persons has made a takeover offer under the Corporations Law or because one has appointed the other an unpaid proxy.[54]

III. TAKEOVERS AND LAWS RESTRICTING FOREIGN OWNERSHIP

As well as the Corporations Law, there are a number of other laws that may be relevant if an offer is being made to acquire shares in an Australian corporation. Some of these laws relate to the nature of the bidder (i.e. as a "foreign person"), some to the nature of the target, if the target corporation operates in a regulated industry, such as the media or banking, and some to whether the acquisition may be "anti-competitive".

A. Foreign bidders

If the bidder is a "foreign person", the Foreign Acquisitions and Takeovers Act 1975 (Cth) may apply. This Act imposes a number of restrictions whenever a "foreign person" wishes to acquire a "substantial shareholding" in an Australian corporation (or having a substantial shareholding, wishes to acquire more shares), or wishes to acquire assets that would result in a foreign person controlling an Australian business.[55]

A "foreign person"[56] is defined as a natural person not ordinarily resident in Australia[57], a corporation in which foreign interests constitute a controlling interest,[58] or the trustee of a trust in favour of foreign beneficiaries.[59] There are also provisions which permit tracing of indirect interests through chains of companies and trusts.[60]

43. Corporations Law Secs. 38-42.
44. Corporations Law Sec. 39.
45. Corporations Law Sec. 38.
46. Corporations Law Sec. 609(1)(b).
47. Corporations Law Sec. 11(a).
48. Corporations Law Sec. 11(b).
49. Corporations Law Sec. 50.
50. Corporations Law Sec. 11(c).
51. Corporations Law Sec. 12(1)(e).
52. There is an exception for an approved nominee body corporate: Corporations Law Sec. 609(1)(b) and (3).
53. Corporations Law Sec. 609(2).
54. Corporations Law Sec. 16.
55. Restrictions may also apply to the acquisition of interests in Australian land. Where there is an acquisition of shares in a corporation which owns a significant amount of land (i.e. more than 50 per cent of total assets) the shares are treated as interests in land: Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 26a.
56. Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 5(1).
57. "Ordinarily resident" is defined in Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 5A as a person who has been in Australia for at least 200 days in the preceding 12 months and whose presence is not subject to any time constraint imposed by law, such as a limitation imposed on a prohibited person under the *Migration Act 1958* (Cth).
58. That is, a corporation in which a person being either a natural person not ordinarily resident in Australia, or a foreign corporation holds an aggregate controlling interest, defined in the Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 9 as an interest that together with the interests of associates, amounts to not less than 15 per cent of the voting power or issued shares in the corporation or, where there are two or more such persons, if the aggregate interest of these persons, including interests of their associates, amounts to more than 40 per cent of the voting power or issued shares in the corporation.
59. That is, a trustee of a trust in which a natural person not ordinarily resident in Australia or a foreign corporation holds a "substantial interest", defined in Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 9A as a holding that together with the holdings of associates amounts to an interest in not less than 15 per cent of the corpus or income of the trust or the trustee of a trust in which two or more persons, each of whom is either a person not ordinarily resident in Australia or a foreign corporation, hold an "aggregate substantial interest" in the trust, defined in Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 9A as a holding that, together with the holdings of associates, amounts to an interest being not less than 40 per cent of the corpus or income of the trust.
60. Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 12C.

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A foreign person intent on acquiring a substantial shareholding in an Australian corporation must notify the Federal Treasurer[61] (in practice, the Foreign Investment Review Board (FIRB)[62]) before acquiring the interest, or if they already hold such an interest, before acquiring more shares.[63] For these purposes, a substantial shareholding exists where a person, together with associates, holds not less than 15 per cent of the voting power or issued shares in a company.[64] It would appear that acquisitions of interests such as options or convertible notes that are not shares are not regulated. Once notification has been given, the proposed acquisition is considered by FIRB, upon whose advice the Treasurer will decide whether or not to object to the bid if it is considered to be "contrary to the public interest".[65]

Although the Act does not require prior notification in the case of an acquisition of assets of a business (as opposed to acquisitions in a company owning the assets), the Treasurer may make orders in respect of an acquisition of assets that would result in a foreign person controlling an Australian business.[66]

There are some exceptions to the pre-notification rule in relation to share acquisitions. First, a foreign person may enter into an agreement to acquire shares without notification if the agreement is made conditional on approval under the Act.[67] Secondly, no notification is needed for the acquisition of shares pursuant to an issue of new shares made pro rata to all shareholders.[68] Finally, the Act does not apply to an acquisition of shares in a corporation which has total assets not exceeding AUD 5 million.[69]

Although notification is still required, since 1992, automatic approval is given to an acquisition of shares in a corporation which has total assets of less than AUD 50 million in certain sectors, including agriculture, forestry, fishing, oil and gas, mining (excluding uranium) manufacturing, non-bank financial intermediaries, insurance, stockbroking and tourism.

If the Treasurer wishes to prevent an acquisition or permit it only subject to conditions, he must make that decision within 30 days of notification[70] and must notify the applicant within ten days of the decision being made.[71] Alternatively, the Treasurer may inform the applicant that he has no objection to the proposal.

B. Acquisitions in regulated industries

1. Broadcasting

An acquisition of shares in a corporation which holds or controls a commercial television broadcasting licence or a commercial radio broadcasting licence will be subject to the restrictions in the Broadcasting Services Act 1992 (Cth). The overriding policy of these provisions is to encourage diversity of control, and ensure that Australians have effective control of the more influential broadcasting services.[72] There are three types of restrictions. First, there is a requirement for a person obtaining control of a licensed corporation to notify the Australian Broadcasting Authority.[73] This is purely a notification requirement and will not have any further consequences unless one of the other rules (concerning cross-media or foreign ownership) is breached. An interest of 15 per cent in a company (including the interests of associates[74]) will be regarded as control. A person will also be regarded as having control if that person has actual control of programming or the composition of the board.[75]

Secondly, the Act prohibits a person from being in a position to control multiple licences or from having cross-media interests.[76] For example, a person must not be in a position to control a commercial television broadcasting licence whose combined licence area populations exceeds 75 per cent of the population of Australia,[77] or control a commercial television broadcasting licence and a newspaper that is associated with the licence area of the licence.[78] A breach of the prohibitions constitutes an offence.[79] The articles of a licensee are also required to contain provisions prohibiting a person from holding shares in breach of the prohibition and enabling divestiture in the case of breach.[80]

61. Failure to notify is a punishable offence under Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 26(2).
62. The FIRB does not have any statutory foundation. It is a body established to act in an advisory capacity to the Treasurer.
63. Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 26. An acquisition of shares in an overseas corporation may also be relevant, for example where the corporation is a holding company of an Australian corporation with assets in excess of AUD 20 million. In such a case, the Treasurer may make orders concerning the acquisition: Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 13.
64. Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 26(6).
65. Guidelines are issued by Treasury to assist investors with their applications. Earlier, these were published in a booklet entitled *Australia's Foreign Investment Policy – A Guide for Investors* (Dept of Treasury, 1992). This has now been replaced by faxed sheets entitled *A Summary of the Government's Foreign Investment Guidelines* which are available on the Treasury's website: http://www.treasury.gov.au. The sorts of factors that may be significant to a bid include job security for employees, improved technological efficiency, local research and development, greater export opportunities, planned Australian participation, improved employee relations prospects and any other competitive advantages that may accrue.
66. Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 19. The Treasurer can also make orders concerning agreements about board representation or alterations of a corporation's constituent documents where either change would result in a foreign person controlling an Australian business: Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 20. These provisions do not apply if total assets are less than AUD 5 million (or AUD 3 million if more than 50 per cent of total assets are rural land): Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 13a.
67. Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 26(3).
68. Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 26(4).
69. Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 13a. If more than 50 per cent of the corporation's assets comprise rural land, the threshold is AUD 3 million.
70. Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 25(2), although the period can be extended up to 120 days: Sec. 22. Where an acquisition has already occurred, the Treasurer may order divestment: Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 18.
71. Foreign Acquisitions and Takeovers Act 1975 (Cth) Sec. 25(1b). This outcome is assumed to be the case if advice to the contrary is not received within the requisite time limits.
72. Broadcasting Services Act 1992 (Cth) Sec. 3.
73. Broadcasting Services Act 1992 (Cth) Secs. 63 and 64.
74. Defined in a similar way to the definition in the Corporations Law.
75. Broadcasting Services Act 1992 (Cth) Schedule 1.
76. Broadcasting Services Act 1992 (Cth) Secs. 53, 54 and 60. There are now similar cross-media restrictions in relation to licences for cable TV (known as "pay TV" in Australia): Secs. 106-110.
77. Broadcasting Services Act 1992 (Cth) Sec. 53(1).
78. Broadcasting Services Act 1992 (Cth) Sec. 60(b).
79. Broadcasting Services Act 1992 (Cth) Secs. 66 and 69.
80. Broadcasting Services Act 1992 (Cth) Schedule 2. This may constitute a takeover defence.

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Thirdly, the Act prohibits a "foreign person" having control of a commercial broadcasting television licence or having an interest exceeding 15 per cent in a company with such a licence.[81] Furthermore, two or more foreign persons must not have interests in such a company that exceeds 20 per cent.[82] The Act also specifies that not more than 20 per cent of the directors of such companies may be foreign persons.[83] "Foreign persons" for these purposes means a natural person who is not an Australian citizen, a company (wherever incorporated) in which persons who are not Australian citizens hold interests exceeding 50 per cent (a foreign company), or a company in which a foreign company or persons who are not Australian citizens together hold interests exceeding 50 per cent.[84] There are no foreign ownership restrictions applying to commercial radio broadcasting licences.

2. Banks and other financial institutions

The Banks (Shareholding) Act 1972 (Cth) prohibits a person from acquiring an "interest" in more than 10 per cent of the total issued voting shares in an Australian bank.[85] However, an exemption may be granted permitting a person to hold up to 15 per cent of the shares in an Australian Bank if it appears to the Treasurer that this would not be against the national interest.[86] The legislation also contemplates the possibility of an exemption being obtained for a greater percentage but does not provide guidance as to when this would be appropriate.[87] The Act does not contain an exhaustive definition of "interest"[88] although the use of terms such as "controlling interest" and "associates" suggests it has a similar meaning to the term "entitlement" in the Corporations Law. Breach of the prohibition is a punishable offence[89] and it is also possible for the banking licence to be suspended.

The acquisition of shares in permanent building societies and credit unions is regulated by the Financial Institutions Code.[90] The maximum permissible entitlement to shares[91] allowed under the Code in a building society or credit union is 10 per cent,[92] although the rules of the building society or credit union may provide for a smaller maximum shareholding.[93] The definition of "entitlement" and related terms is modelled closely on the definitions in the Corporations Law. Shares in excess of the permissible maximum must be sold or forfeited.[94]

3. Insurance companies

The acquisition of interests in shares in Australian-registered insurance companies is regulated under the Insurance Acquisitions and Takeovers Act 1991 (Cth). A person must not acquire an interest in 15 per cent or more of the shares in such a company, or having such an interest, increase it, without the prior approval of the Treasurer.[95] The Act is not specifically directed at preventing foreign ownership of such companies, but rather aims to monitor who controls such companies and to ensure that such persons are not "unsuitable".[96] For the purposes of the Act, "interest" is defined to mean any legal or equitable interest in the shares.[97] Interests of associates are included and interests may be traced through interposed companies.[98] Breach of the prohibition is an offence[99] and the Treasurer may also order divestiture.[100]

C. Acquisitions that may be anti-competitive

The Trade Practices Act 1974 (Cth) prohibits an acquisition of shares (or assets) of a body corporate which would have the effect, or be likely to have the effect, of substantially lessening competition in a substantial market for goods or services in Australia,[101] unless authorization is obtained from the Australian Competition and Consumer Commission (ACCC).[102] The concept of "market" and when there will be a "substantial lessening of competition" are very complex and beyond the scope of this article and reference should be made to a specialist work.[103] It should, however, be noted that the Act may have an extra-territorial operation.[104] An acquisition effected outside Australia, including an acquisition by a foreigner (that is, a person or corporation not resident or incorporated in Australia or carrying on business in Australia)[105] may be subject to the Act.[106] Where there is an acquisition outside Australia of a controlling interest[107] in a body corporate, which results in the acquirer acquiring a controlling interest in a corporation in Australia, a declaration may be made by a Tribunal established under the Act[108] that there would be, or is likely to be a substantial lessening of competition in a market in Australia and that there would not result in such a public benefit that the acquisition should be

81. Broadcasting Services Act 1992 (Cth) Sec. 57.
82. Broadcasting Services Act 1992 (Cth) Sec. 58.
83. Broadcasting Services Act 1992 (Cth) Sec. 58(1).
84. Broadcasting Services Act 1992 (Cth) Sec. 6(1).
85. Banks (Shareholding) Act 1972 (Cth) Sec. 10(1).
86. Banks (Shareholding) Act 1972 (Cth) Sec. 10(2),(2a), (2d).
87. Banks (Shareholding) Act 1972 (Cth) Sec. 10(4), which states that approval may be given by the Governor General. See also the Banks (Shareholding) Regulations.
88. Banks (Shareholding) Act 1972 (Cth) Sec. 8.
89. Banks (Shareholding) Act 1972 (Cth) Sec. 10(13).
90. Building societies and credit unions are not regulated under the Corporations Law. The Code is uniform legislation enacted by each State and Territory in Australia to coordinate regulation and prudential supervision of these entities.
91. "Shares" are defined as permanent shares, redeemable preference shares and withdrawable shares: Financial Institutions Code Sec. 193.
92. Financial Institutions Code Sec. 193(1).
93. Financial Institutions Code Sec. 193(3).
94. Financial Institutions Code Sec. 194.
95. Insurance Acquisitions and Takeovers Act 1991 (Cth) Sec. 26.
96. Insurance Acquisitions and Takeovers Act 1991 (Cth) Sec. 5.
97. Insurance Acquisitions and Takeovers Act 1991 (Cth) Sec. 25.
98. Insurance Acquisitions and Takeovers Act 1991 (Cth) Sec. 15.
99. Insurance Acquisitions and Takeovers Act 1991 (Cth) Secs. 24 and 26.
100. Insurance Acquisitions and Takeovers Act 1991 (Cth) Sec. 30.
101. Trade Practices Act 1974 (Cth) Sec. 50.
102. Trade Practices Act 1974 (Cth) Sec. 90. The ACCC will sometimes provide an informal clearance of a proposal.
103. See, for example, Miller, Annotated Trade Practices Act (16th ed., Law Book Co. 1995).
104. By virtue of Trade Practices Act 1974 (Cth) Sec. 5, Sec. 50 can also apply to acquisitions effected overseas by a corporation incorporated in Australia or which carries on business in Australia.
105. Trade Practices Act 1974 (Cth) Sec. 5.
106. Trade Practices Act 1974 (Cth) Sec. 50a.
107. Defined in Trade Practices Act 1974 (Cth) Sec. 50A(8).
108. The Australian Competition Tribunal. This Tribunal exercises a number of quasi-judicial functions under the Trade Practices Act 1974 (Cth).

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disregarded.[109] Contravention of the prohibition[110] can result in significant penalties[111] and possible divestiture of the shares or assets[112] or a number of other orders.[113]

IV. TAKEOVERS AND INCOME TAX LAW

The tax implications of takeovers may be considered from the context of four types of taxpayers: offerors generally, foreign offerors, target companies, and vendor shareholders. The tax issues that confront these persons are examined below.

A. Overview of the income tax regime

1. The income tax base

Australia uses the same income tax legislation[114] for individuals and corporations and subject to only a few exceptions, which are detailed below, the same tax base applies to both incorporated and unincorporated taxpayers. Tax is imposed on "taxable income", which is calculated as gross income, or in the Australian terminology, "assessable" income, less deductions.[115]

The first Australian income tax Act contained no definition of income and it was left to the courts to determine what gains were subject to the inclusion provision. Having no familiarity with income tax concepts, the courts turned to other areas of law for guidance, in particular trust law which had developed the concepts of "income" gains and "capital" gains for the purpose of identifying which gains derived by a trust accrued to the benefit of each of the two categories of trust beneficiaries, namely life beneficiaries and remainder beneficiaries. The former were entitled to those gains characterized as income gains and the latter to those gains characterized as capital gains. Not surprisingly, the judicial concept of "income" for tax purposes coincided almost completely with the income concept in trust law.

Income according to judicial concepts is identified by a range of criteria including periodicity of the payments and, in the case of one-off transactions, the taxpayer's intention with respect to the acquisition of property the disposal of which generated a gain. If a taxpayer acquired property with the intention of resale at a profit, the gain was classified as an income gain; acquisitions for other purposes led to the realization of capital gains. Remarkably, the same tests applied to corporate taxpayers so it was possible for a company to derive tax-exempt capital gains.

The resulting tax base was narrow, inequitable, and inefficient. Seven decades of ad hoc reform that followed with arbitrary inclusion measures did little to address the shortcomings. A sweeping tax reform programme adopted in 1985 finally led to the inclusion in the income tax base of most "capital gains" that had previously escaped taxation. Importantly, the capital gains measures were not aimed solely at capital gains in the conventional sense of gains derived on the sale of assets other than inventory. Rather, through a series of complex and highly artificial deeming measures, the capital gains provisions were designed to catch most types of gain that had slipped outside the judicial concept of income and the ad hoc inclusion provisions.

A rewrite of the income tax legislation adopted in 1997 explicitly recognized the two arms of the income tax base, labelling income according to judicial concepts "ordinary income" and income included in the tax base through the specific inclusion measures or the broader capital gains regime as "statutory income". Some types of statutory income enjoy concessional treatment. This is particularly true of capital gains realized on the disposal of assets, which are calculated by reference to a fully indexed cost base. More importantly, a complete exemption was codified for assets acquired on or before the date on which tax reform was announced, 19 September 1985.

Ordinary and statutory income (including net capital gains) are netted with deductions to ascertain a taxpayer's taxable income. A special rule applies to capital losses. These are quarantined from the general calculation formula and are deductible only from capital gains (net capital gains after taking into account capital losses enter the general calculation formula). Capital losses in excess of capital gains may be carried forward indefinitely to be deducted from future years' capital gains (although, as explained below, there are some restrictions on the carry-forward of capital losses by companies).

Consolidated tax returns are not used in Australia and every company, including each company in a wholly owned group, is a separate taxpayer. While accounts cannot be directly combined in the sense of a consolidated accounts system, as is explained further below, many tax attributes can be transferred between group companies.

Dividends flowing from one company to another holding shares in the first company are included in the assessable income of the recipient company. To prevent cascading of tax when profits flow from one company to another, resident companies are entitled to an inter-corporate dividend tax rebate, which should offset completely the tax payable on the dividends received.[116]

An exception to the general rule applies in some cases to dividends received by private companies. As is explained below in section IV.A.2., Australia's imputation system attributes to dividends any tax paid (by the company making the dividend payment) on the profits from which the dividends are paid. Dividends are either franked (paid from profits that were fully

109. Trade Practices Act 1974 (Cth) Sec. 50a(1).
110. In Trade Practices Act 1974 (Cth) Secs. 50 or 50a.
111. The maximum pecuniary penalties are AUD 10 million for a body corporate and AUD 500,000 for an individual: Trade Practices Act 1974 (Cth) Sec. 76(1)(a), Sec. 76(1a) and (1b).
112. Trade Practices Act 1974 (Cth) Sec. 81(1).
113. See Trade Practices Act 1974 (Cth) Sec. 81.
114. Australia is in the process of redrafting its income tax legislation, progressively replacing provisions in the original law with measures in a new simplified "plain English" law. Legislative references below are to the original (1936) law and the new (1997) law, depending on whether the relevant provision has yet been redrafted.
115. Income Tax Assessment Act ("ITA") 1997 Sec. 4-15.
116. ITA 1936 Sec. 46.

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taxed at the nominal company tax rate of 36 per cent) or unfranked (paid from profits that were not taxed at the company level). With the adoption of imputation, there were many instances of individuals holding their share portfolio through interposed private companies. Franked dividends carrying imputation credits could be passed through the interposed company to the individuals, while unfranked dividends that would have been fully taxed without any imputation credits had they been derived directly could be received tax-free by the interposed company and reinvested through that company. To prevent this result, the inter-corporate dividend tax rebate was amended so it does not apply to unfranked dividends received by a private company.[117] The rebate will continue to apply if the private company is a group company to the company paying the dividend, meaning both companies are ultimately owned by the same persons.[118] In this case, there is no tax minimization from the transaction since the owners could have retained the unfranked profits in the first company free of taxation.

2. The imputation system

In 1987, Australia made a dramatic shift from a full classical system, in which fully taxed company profits were taxed again when distributed to shareholders, to a full imputation system, under which resident individual shareholders receive credit for all Australian income taxes paid by a company when taxed profits are distributed to shareholders. The imputation system operates by means of a "franking" account system. Company taxes are credited to a "franking account", which can then be debited to "frank" dividends and thus mark them as being paid from profits that bore the full rate of company taxation. In the hands of non-corporate shareholders, franked dividends are grossed up to the pre-company tax value and the gross-up figure is included in the shareholder's assessable income. The shareholder is then allowed a credit for the company tax that had been paid on the profits.

Debiting of a company's franking account and the gross-up and credit system at the shareholder level all presume a company's profits were taxed at the nominal company tax rate of 36 per cent. Where a company pays tax at a lower effective tax rate as a result of concessions such as accelerated depreciation or exemptions for foreign-source income, the franking account will not be sufficient to frank all distributable profits. If a company distributes profits after the franking account is exhausted, the dividends are treated as "unfranked" dividends, paid from profits that were not taxed at the company level. These are assessable to shareholders but not grossed-up for company tax paid on the profits and no credit is available to shareholders in respect of these dividends.

As noted earlier, inter-corporate dividends received by a resident company are effectively tax-free as a result of the inter-corporate dividend tax rebate. Where a franked dividend is paid to a shareholder that is a resident company, the franking account of the company paying the dividend is debited in the usual manner and the franking account of the recipient company increased by the same amount.

The inter-corporate dividend rebate does not apply to shareholders that are non-resident companies. These shareholders are assessed on distributions in the same manner as non-resident individuals. The tax treatment of non-resident shareholders depends on the status of the dividends paid. Fully franked dividends, paid from profits that have borne the full 36 per cent company tax, are fully exempt from further Australian tax when paid to a non-resident.[119] Unfranked dividends are subject to a flat-rate 30 per cent final withholding tax. This is normally reduced to 15 per cent in Australia's double tax agreements.

Non-residents will be better off receiving an unfranked dividend (and paying withholding tax) than receiving a franked dividend that has been subject to company tax at the rate of 36 per cent. This has led some companies to "stream" dividends, so that franked dividends are received by shareholders who benefit most. Concerned at the cost to the revenue from streaming arrangements, the government has announced new measures the purpose of which is to prevent streaming.[120] The new measures are strict and could potentially apply whenever shareholders in the same class are treated differently in relation to the payment of dividends. In the takeover situation, this could occur where only some shareholders accept the offer and receive a payment that includes a dividend with franking credits attached, i.e. here the same payment is not received by other shareholders.

B. Tax considerations for structuring the takeover

1. Reducing the vendors' capital gain

Tax considerations will play an important role in the process of financial planning for a takeover. An initial consideration is to reduce the tax costs for existing shareholders. A simple cash-for-shares offer to existing shareholders will involve a disposal of the shares and consequent capital gains tax consequences for the existing shareholders if they acquired their shares after 19 September 1985 (see section IV.A.1.). A similar result follows from a share-for-share bid, as Australia has no roll-over provisions that apply to share exchanges involving a swap for shares in one company for shares in a different company.

A starting point for tax planning to overcome the capital gains tax disincentive to accepting a takeover offer is with the target company's franking account. If the target company has a positive balance in the franking account, it must be holding fully taxed profits. To the extent the sale price corresponds to the value of retained fully taxed earnings, vendors will be double taxed on the profits, as they will pay capital gains tax on the sale of their shares even though the consideration received merely reflects retentions of already-taxed company profits. In many cases, therefore, it will make sense for the

117. ITA 1936 Sec. 46f(2).
118. ITA 1936 Sec. 46F(3).
119. ITA 1936 Sec. 128D exempts the dividends from the ordinary assessment regime and ITA 1936 Sec. 128B(3)(ga) exempts franked dividends from withholding tax.
120. The basic anti-streaming rule (proposed ITA 1936 Sec. 160AQCBA is contained in the Taxation Laws Amendment Bill (No. 7) 1997. That Bill also contains anti-avoidance measures aimed at franking credit trading (proposed Sec. 177EA).

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target company to distribute frankable profits as dividends immediately prior to the sale and in this manner reduce the capital gain on the disposal of the shares.

In some cases, a distribution of retained earnings will be desirable even if the target company does not have a positive balance in its franking account. For example, if the vendor shareholders are resident companies, retained earnings can be distributed tax-free by reason of the inter-corporate dividend tax rebate. If the vendor shareholders are non-resident but able to take advantage of a double-tax agreement, the dividends will be subject to a 15 per cent withholding tax, which may be less than the capital gains tax that the vendors would face in their home jurisdiction if the profits were retained in the target and reflected in a higher sale price for their shares.

An alternative tactic is for the bidding company to acquire an equity interest in the target company and for the target company to use the cash injected by the bidder to cancel the shares of the original shareholder or purchase them in an off-market transaction. To the extent to which the consideration received by the original shareholders in respect of the cancellation or buy-back exceeds a component representing a return of original "capital", it will be treated as a deemed dividend that can be franked by the company.[121]

A completely different approach is for the bidding company to insulate the shareholders of the target company from tax consequences by absorbing the tax costs of the transaction itself. This can be done by means of a reverse takeover where the bidder's shareholders exchange their shares in the bidding company for shares in the target company. There are no tax consequences to the target company or its existing shareholders from the issue of new shares by the target company. If the shareholders in the bidding company are residents of Australia, they may (depending on when they acquired shares in the bidding company) face a capital gains tax liability on the share exchange. If they are non-residents of Australia and the bidding company is not an Australian company, the tax consequences of the arrangement will depend on their home jurisdiction's laws.

Note that if the shareholders of the bidding company are non-residents but the bidding company is Australian, the foreign shareholders may be liable to Australian capital gains tax on their shares. Non-residents are subject to Australian capital gains tax on disposals of shares in private Australian companies *and in shares of an Australian public company*, where they hold a 10 per cent or greater interest in the public company.[122]

2. Spreading out the payment period

In many, if not most, cases, bidding companies will rely in part or in full on borrowed funds to finance a takeover bid. One way of reducing the costs of external borrowings is to contract for the purchase price to be paid by instalment payments over a period. The instalment payments may carry explicit interest charges or the financing costs can be converted to capital gains if the vendors agree to larger instalment payments with no explicit interest component in lieu of smaller payments with an interest charge. Formerly, this technique was used often in Australia because vendors could convert explicit (and assessable) interest receipts to an untaxed capital gain. While the Australian income tax legislation authorized the Commissioner of Taxation to carve out the implicit interest component in instalment sale payments,[123] revenue officials were almost never able to use the power as the courts refused to recognize implicit interest components.

Since 1985, vendors have switched tactics and now seek explicit interest components so they can defer tax on the interest payments until the interest is derived. If the financing charges are converted from interest to capital gains by means of incorporation into larger instalment payments, the capital gain is recognized – and taxed – up-front, at the time of sale, not on a pro rata basis when each instalment payment is made.[124]

An alternative approach is for the bidding company to convert instalment payments into dividend payments. This can be done by offering vendors a share-for-share exchange with the bidding company providing specially tailored shares in exchange for shares in the target company. For example, the shares provided by the bidding company could be redeemable preference shares carrying rights to fixed, cumulative dividends. The redemption price and dividend levels could be varied to suit the vendors' interests, as could the ratio of franked to unfranked dividends paid to holders of the new shares in the bidder.

3. Ensuring deductions for the acquirer's interest expenses

As mentioned earlier, company takeovers are commonly financed in part or in whole using borrowed funds. If the acquirer will be subject to Australian tax, an important consideration is to ensure that the taxpayer will be able to deduct interest payable on borrowings used to fund the takeover bid.

The prerequisite condition to deductibility of interest expense is that it be incurred in gaining or producing assessable income.[125] Where a company borrows to fund a takeover, the interest payments will normally satisfy this condition, since anticipated dividends from the target will constitute assessable income to the acquirer, if the takeover is successful.[126]

The only potential pitfall faced by an acquirer in this situation arises from a special ordering rule applying to interest outgoings which requires taxpayers to subtract interest incurred to derive dividends from the dividends before it is subtracted from other income when calculating taxable income.[127] In

121. The definition of "dividend" in Sec. 6(1) of the ITA 1936 combined with Sec. 44(1) of that Act will treat consideration in excess of capital return as a dividend in the case of a share cancellation; Sec. 159GZZZP of the ITA 1936 will do the same in the case of an off-market share buy-back.
122. ITA 1936 Sec. 160T,
123. ITA 1936 Sec. 262.
124. ITA 1936 Sec. 160ZD(1)(a).
125. ITA 1997 Sec. 8-1(1)(a); another basis for deductibility not usually directly applicable to takeovers is that the expense be necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income – ITA 1997 Sec. 8-1(1)(b).
126. See Taxation Ruling IT 2606.
127. ITA 1936 Sec. 50(a).

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many cases, the effect of this rule will be to cause a taxpayer to "waste" the inter-corporate dividend tax rebate, since the rebate is only available to the extent the dividend is taxable to the recipient. If the interest expenses reduce the taxable dividends to zero, no rebate will be available.

To avoid wasting the inter-corporate dividend tax rebate in this way, acquirers are usually advised to structure their takeovers in a manner that separates interest expenses from dividend income. The most commonly used structure is a "dividend trap" arrangement under which one company in the acquirer group borrows from a third party and forwards the funds to another member of the group as equity and loan capital and this other company is used to acquire the shares of the target company. The actual acquirer company traps dividend income from the target, which usually leaves the company that borrowed from outside the group in a loss position. As is explained below in section IV.D.1., the loss can then be transferred to profitable companies in the group.

There are two potential drawbacks to the dividend trap structure. First, unless (or until) the acquirer group acquires 100 per cent of the shares in the target company, that company will not be a "group" company for Australian tax purposes. Until the target company is a full group company, losses from the interest expense cannot be transferred to the target company to offset the profits it realizes from its business operations. Secondly, dividends paid by the target company may be trapped in the company holding the target's shares if the owner of the target company is in turn owned by the company incurring the interest expense. The group may not be able to defer upwards distribution of profits from the target company until the loan has been paid off.

The preferable outcome for the group may be to offset the interest expense directly against the target company's business income. This could be done in two ways. First, the debt could be transferred down to the target company or the target company's income-generating assets could be transferred up to another group company. Both alternatives come with potential high transaction costs and some tax costs (realization of accrued gains on assets or taxable income gains from the debt transfer). Another approach could be to refinance the loan by having the target company borrow from a third party and transfer cash upwards by means of a dividend or cancellation of shares so the first borrower can repay the initial loan.

4. Recognizing the ancillary costs of a takeover

In addition to the actual costs of acquiring shares, a successful takeover bidder is likely to incur ancillary costs, particularly accounting and legal fees. These expenses will almost certainly be characterized as capital outlays for Australian tax purposes and no deduction will be available for the expenses for Australian tax purposes.[128] However, the expenses may be added to the cost base of the assets acquired and thus reduce any capital gain realized on subsequent disposal of the property.[129] The same result follows where the acquirer obtains the target's business rather than shares in the target. If, in the case of an acquisition of business assets rather than shares, the acquirer attempts to recharacterize the nature of the outgoings by tying them to other aspects of the transaction such as "lease payments" for the use of some of the target's assets, the courts will most likely uphold any attempt by the Commissioner to look through the transaction and treat the expenses as the cost of obtaining the underlying assets.[130]

Costs incurred by a target company in defending against a takeover will also be characterized as non-deductible capital expenses.[131] Unlike the case with capital expenditures incurred by the acquirer, however, the target is unlikely to ever be able to recognize its outgoings for tax purposes. Because no property is acquired by the target, there is no asset cost base to which the expenses can be added and there are no other cost base or amortization provisions in the income tax law that allow independent recognition of capital expenses of this sort. Formerly labelled "nothings", by many practitioners, non-recognizable capital expenses of this sort are now commonly referred to as "black holes" by tax advisers.

C. Tax implications for a target company from a change in control

A change of control of a target company can significantly affect its tax position. In particular, the target company may lose the right to use a range of losses suffered prior to the change and assets owned by the company may shift from tax-exempt to taxable status.

1. The carry-forward of previous years' losses

Australian tax rules provide for the indefinite carry-forward of three types of losses: ordinary business losses, capital losses, and unrecognized bad debts.[132] Carried-forward losses may be offset against ordinary business income and capital gains to reduce taxable income in future years.

The first, and most important category of carried-forward loss is the "ordinary" loss that results when allowable deductions for a year exceed gross or assessable income for the year. The indefinite carry-forward of ordinary losses[133] is subject to only one proviso – carried-forward losses may not be deducted by a company where there has been a change in the beneficial ownership of shares representing more than one-half of the right to vote, the right to receive dividends, or the right to receive distributions of capital from the company.[134] This exception is in turn subject to an exception – where the company carries on the same business after the change in ownership as it did prior to the change, it may utilize carried-forward losses notwithstanding a change in ownership.[135]

128. ITA 1997 Sec. 8-1(2)(a).
129. ITA 1936 Sec. 160ZB(1)(b), amplified in Sec. 160ZH(5)(a).
130. *Sun Newspapers Ltd. v. F.C.T.* (1938) 61 CLR 337 (Full High Court).
131. *F.C.T. v. The Swan Brewery Co. Ltd.* (1991) 22 ATR 295 (Full Federal Court); *AAT Case 7769* (1992) 23 ATR 1086 (Administrative Appeals Tribunal).
132. There are further subdivisions for two special types of losses, losses on film investments and losses suffered by a special type of concessionally taxed fund known as a "pooled development fund".
133. ITA 1997 Sec. 36-15.
134. ITA 1997 Sec. 165-12.
135. ITA 1997 Sec. 165-13.

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The continuity of ownership test measures ownership in the year a loss is suffered and the year in which the company seeks to use the loss to offset current income. It disregards interim years, so it is possible for a company to be sold to completely new owners and repurchased by the original owners and use losses that were denied to the interim owners.

The continuity of ownership test is supplemented by an anti-avoidance rule that looks behind arrangements that appear to satisfy the test if the apparent legal owners have entered into any sort of "arrangement" with respect to their shares, one of the purposes of which is to reduce the company's liability to pay income tax. Examples of arrangements that trigger the anti-avoidance provision include a case where a shareholder sold a minority interest in a loss company and granted the minority shareholder a proxy over the retained shareholding;[136] and a case in which shareholders entered into an arrangement to sell their shares but agreed to postpone legal transfer of the shares.[137]

Australia has few very widely held public companies – a relatively small number of shareholders effectively control most "public" companies listed on the stock exchange and a large number of shareholders have small holdings under 1 per cent of the shares issued. Nevertheless, applying the continuity of ownership test to public companies proved to be a difficult and often costly exercise. Accordingly, in 1997 a modified test was adopted for these companies. Rather than having to prove a continuity of ownership during the whole of the loss year and the income year, public companies only need demonstrate continuity of ownership at the beginning of each year, the end of each year and at a time of "abnormal" trading in shares in the company, if this occurred in either year.[138] At the same time, the legislation established a "notional shareholder" who is deemed to own all shareholdings of less than 1 per cent.[139] As a result, it is not necessary to include changes in ownership between very small shareholders when applying the continuity of ownership test.

The "same business" test has been the subject of litigation in a number of reported cases and reconciling the various judgments is somewhat difficult.[140] Read literally, it imposes a very strict test: the company must not have started to carry on a business it had not previously carried on or entered into a transaction of a kind that it had not previously entered into.[141] The courts have interpreted the first limb of the test (carrying on a business not carried on previously) narrowly. For example, in a leading case a car parts company was held not to be carrying on the same business when it operated under a different name, at different locations, with different directors and employees, with different inventory and equipment in conjunction with different car dealers, even though it was still selling car parts.[142]

Interpretation of the second limb of the test has been a little more generous. A venture capital company that provided capital and financial expertise to businesses, usually in exchange for shares in the company conducting the business, was held not to have entered into a different type of transaction when, following a change in ownership, it entered into a partnership arrangement in which it provided finance and expertise to a business.[143]

The continuity of ownership or continuity of business requirements for recognition by a company of losses suffered in previous years also applies to "current" year losses where there is an alteration of ownership during the income year.[144] Similar restrictions apply to bad debts held by the company and not yet written off as uncollectible.[145] For taxpayers other than financial institutions, a carried-forward bad debt is only deductible when written off as uncollectible if the amount was previously brought into account as income.[146] Taxpayers in the business of lending money can deduct any written off debts owing to them.[147] Finally, the continuity of ownership or business requirement also applies to carried-forward capital losses.[148]

The ordinary and capital loss current year and carry-forward recognition rules are subject to special anti-avoidance rules that are triggered when ordinary income and capital gains respectively have been "injected" into a company for the purpose of utilizing the relevant losses and a benefit from the tax savings subsequently accrues to persons other than the existing shareholders of the company or does not accrue to those shareholders in proportion to their shareholdings.[149] This would be the case, for example, if following an income injection a debt owing to the company were assigned to another person for much less than its face value[150] or if the arrangement resulted in the repayment of a debt owed to a principal shareholder with no similar benefits for other shareholders.[151]

2. The implications of change in "majority underlying control"

As was explained in section IV.A.1., the income tax base was broadened significantly in 1985 with the inclusion of capital gains in the income tax base. When capital gains were added to the income tax base, a generous exemption was provided for gains realized on assets acquired prior to 20 September 1985, the day after the government announced its intention to include capital gains in the income tax base.

136. *F.C.T. v. Brian Hatch Timber Co. (Sales) Pty. Ltd.* (1972) 128 C.L.R. 28 (Full High Court).
137. *K. Porter & Co. Pty. Ltd. v. F.C.T.* (1977) 52 A.L.J.R. 41 (Full High Court).
138. ITA 1997, Sec. 166-5.
139. ITA 1997, Sec. 166-230.
140. The Commissioner of Taxation's interpretation of the provision and the cases is found in the public ruling Taxation Ruling TR 95/31.
141. ITA 1997, Sec. 165-13.
142. *Avondale Motors (Parts) Pty. Ltd. v F.C.T.* (1971) 124 C.L.R. 97 (High Court).
143. *J. Hammond Investments Pty. Ltd. v F.C.T.* (1977) 77 A.T.C. 4311 (Supreme Court of New South Wales).
144. See ITA 1997 Subdivision 165-B.
145. ITA 1936 Sec. 63A and Sec. 63C.
146. ITA 1997 Sec. 25-35(1)(a).
147. ITA 1997 Sec. 25-35(1)(b).
148. ITA 1936 Sec. 160ZC(5), picking up the continuity tests from Subdivs. 165-A and 175-A of the ITA 1997. From the 1996-97 tax year, following the application of ITA 1936 Sec. 160ZC(1a), the relevant tests are found in ITA 1936, Part IIIA, Divisions 3A-3D.
149. The rules applicable to ordinary income are found in ITA 1997 Subdivisions 175-A and 175-B, while the rules applicable to capital gains are found in ITA 1936 Part IIIA, Division 3D.
150. Case 23 (1979) 23 CTBR (NS) 173.
151. Case 74 (1979) 23 CTBR (NS) 683.

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The exemption for assets acquired prior to 20 September 1985 opened a potential avenue for avoidance of the capital gains tax. After 19 September 1985, taxpayers could invest in companies that owned assets prior to 20 September 1985 and realize the gains on those assets tax-free so long as the gains were retained in the company.

This problem was attacked by a measure that deems a company to have sold all its pre-20 September 1985 property and reacquired the property at its market value when a majority of the underlying interests of the company as measured on 19 September 1985 changes hands.[152]

The reference in the deeming provision to a change in "majority underlying interests" requires a company to trace ownership through interposed entities to the underlying natural persons with interests in the company. In theory, the provision requires companies to monitor the share register continuously and invoke the deemed disposal/deemed reacquisition provision as soon as the relevant ownership change has occurred. The potential compliance cost burden of this process was recognized and in early 1997 the provision was amended to provide an easier test for public companies.[153] Public companies are now only required to test for changes in majority underlying interests once every five years,[154] unless there is "abnormal" trading in the company's shares in the interim. "Abnormal" trading is defined as:

- a transaction in which 5 per cent or more of the company's shares were traded in one transaction;[155]
- more than 20 per cent of the company's shares were traded over a 60 day period;[156] or
- the company knows or reasonably suspects trading in its shares was part of an acquisition of the company by another company.

The majority underlying interests is measured as an undissected whole. It is possible, therefore, for control of a company to change without triggering the deemed disposal provision. Consider, for example, a company with three owners as follows:

A 10 per cent
B 45 per cent
C 45 per cent

A and B together have a majority underlying interest in the company. If A were to acquire shares from B and C so the share register ended up with the following allocations:

A 80 per cent
B 10 per cent
C 10 per cent

the deeming provision would not be triggered, as the persons holding a majority of underlying interests prior to the share transfer, A and B, continue to own a majority of the underlying interests after the transfer, even though the relative weighting vis-à-vis each other has changed.

D. Consequences of a target company becoming a "group" company

Once 100 per cent of the shares in the target company have been acquired, the target becomes a "group" company with all other companies subject to the same ultimate corporate ownership.[157] Both ordinary business losses and capital losses may be transferred to group companies. Some, but not all, assets may be transferred between group companies without an immediate tax consequence.

1. Inter-corporate ordinary business loss and capital loss transfers

A loss company can transfer its loss to another company in the same group for the transferee company to offset against its taxable income.[158] The loss must be "surplus" in the sense that the transferor company does not have sufficient income to offset the transferred loss.[159] Current year or previous year losses can be transferred, but the loss must have been incurred after both the transferor and transferee companies became group companies.[160] It is therefore not possible to transfer losses to or from a target company when the losses date from the year the target becomes a group company or a previous year. The maximum loss that can be transferred is the amount that the transferee company can use.[161] That is, the transferred loss cannot exceed what would otherwise be the transferee's taxable income for the year – it is not possible for the transferee to end up with a loss as a result of the transfer.

A further condition on the transfer is that neither company would have been prevented from using the loss had it been a current or carried-forward loss of the company. This means that there must be no violation of the anti-avoidance condition imposed on recognition of current and carried-forward losses within a single company.

Parallel transfer rules apply to capital losses.[162]

For commercial accounting purposes, the transferee company may pay consideration to the loss company for the transferred loss. The payments, commonly referred to by tax practitioners as "subvention" payments, are excluded from the recipient company's assessable income[163] and are not deductible to the payer.[164]

2. Inter-corporate transfers of inventory

In some cases, corporate reorganizations following a takeover involve a transfer of inventory (or trading stock, as it is referred to in some Anglo-Saxon countries) between members of the corporate group. There are no roll-over provisions or concessions for transfers of inventory within a corporate group. This means the normal inventory rules apply

152. ITA 1936 Sec. 160ZZS.
153. ITA 1936 Sec. 160ZZS(1AA) exempts public companies from the normal test and they are instead subject to the test in Sec. 160ZZSA.
154. ITA 1936 Sec. 160ZZSA(1) and Sec. 160ZZRR (1) definition of "test time".
155. ITA 1936 Sec. 160zzsg.
156. ITA 1936 Sec. 160zzsi.
157. ITA 1997 Sec. 975-500.
158. ITA 1997 Sec. 170-5(1).
159. ITA 1997 Sec. 170-5(3).
160. ITA 1997 Sec. 170-30.
161. ITA 1997 Sec. 170-45(2).
162. ITA 1936 Sec. 160ZP.
163. ITA 1997 Sec. 170-25(1).
164. ITA 1997 Sec. 170-25(2).

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and a transfer outside the ordinary course of business will be treated as a deemed sale for full market value[165] so all unrealized profit on the inventory will be brought into account immediately.

A simple technique often used to avoid this result is for a company holding inventory to transfer the product, but not ownership of the product, to another group company with the new holder selling the product on a consignment basis for the first company. Tax authorities will normally accept the profit-split arrangement reached by the parties provided it prima facie reflects the sales efforts of the second company and the financial risk of the first one.

3. Inter-corporate capital asset roll-overs

Transfers of assets other than inventory between group companies may qualify for roll-over treatment. Where the transferor and transferee elect to have the roll-over apply, the transferor company is deemed to have disposed of the asset for cost[166] and the transferee company is deemed to have acquired it for the same amount.[167] Where the transfer at market value would result in recognition of a capital loss by the transferor company, the roll-over is compulsory.[168]

In the absence of any anti-avoidance measures, the roll-over provision could give rise to significant avoidance opportunities. For example, a parent company could arrange for a subsidiary to transfer all its assets to the parent and after the shares in the subsidiary have become worthless, sell the shares to recognize a large capital loss even though it has suffered no economic loss. Since the introduction of the capital gains tax a variety of rules have been tried in an attempt to combat schemes based on the roll-over. The current rule deems the transferee company to have disposed of the asset at market value and reacquired it for the same value if the transferee company ceases to be a group company[169] or is liquidated.[170] This rule has been supplemented by extensive anti-avoidance measures designed to catch any arrangement within a corporate group that results in recognition of a loss on equity investments or intra-group loans following an inter-corporate asset transfer.[171]

4. Inter-corporate transfers of depreciable property

Disposals of depreciable assets for more or less than their written-down book value will trigger a "balancing charge" for the taxpayer. The disposal of a depreciable asset also triggers the capital gains provisions, which apply to disposals of property other than trading stock.

If the property is sold for more than its cost, the excess depreciation from book value back to cost is recaptured under a balancing charge inclusion measure[172] and the value from cost (or indexed cost if the property has been held for a year or more) to proceeds of disposal is caught as a capital gain. If the property is sold for less than its cost, the difference will be recognized as a balancing charge deduction. There is no recognition of loss under the capital gains rules if the property is sold for less than its cost since the entire loss will have already been recognized under the combined depreciation and balancing charge measures.[173] An anti-avoidance provision deems the vendor of depreciable property to have received arm's length consideration for any disposal of the property for less than market value (to trigger a balancing charge deduction) to a related party.[174]

Australia's depreciation system provides accelerated, and sometimes very generously accelerated, depreciation schedules. Thus, in the absence of relief provisions, in most cases of inter-corporate transfers of depreciable assets, the transferors would face balancing charge income inclusions of the difference between the book value of assets and their market value. To avoid this result, a special roll-over regime has been implemented for depreciable property which the parties have elected to roll-over for capital gains tax purposes.[175] This roll-over transfers all depreciation tax attributes to the transferee. The new owner is thus treated as having made any elections with respect to the property that were made by the transferor (for example, whether to depreciate on an equal deduction or declining balance basis)[176] and as having taken as depreciation deductions any amounts previously deducted under the depreciation provisions by the transferor.[177] This preserves the tax position of the transferor for application when there is a disposal of the depreciable property outside the group or inside if no roll-over election is made in respect of a subsequent transfer.

E. Refinancing target companies after a takeover

Following a takeover, the acquirer company may wish to refinance the target by injecting new equity or debt into the target company. If the new owner is a non-resident of Australia, the refinancing may fall afoul of the "thin capitalization" rules in the income tax legislation.

The thin capitalization rules have been adopted to prevent foreign owners from exploiting the different rates of tax imposed on interest and dividends paid to non-residents. Franked dividends, while exempt from withholding tax, have borne a company tax of 36 per cent. Unfranked dividends are subject to a withholding tax of either 30 per cent (in the case of shareholders resident in jurisdictions with which Australia has no double tax agreement) or 15 per cent (in the case of shareholders resident in most jurisdictions with which Australia has double tax agreements). These rates compare with a single 10 per cent rate for withholding tax imposed on inter-

165. ITA 1997 Sec. 70-90.
166. For the purpose of calculating a capital gain upon eventual disposal outside the group, the cost base will be adjusted upwards for indexation where the asset has been held for a year or longer. For the purpose of calculating a capital loss in similar circumstances, the cost base will be reduced by any part of the cost for which deductions have previously been allowed.
167. ITA 1936 Sec. 160zzo(1).
168. ITA 1936 Sec. 160zzo(1aa).
169. ITA 1936 Sec. 160zzoa.
170. ITA 1936 Sec. 160zzob.
171. ITA 1936 Part IIIa, Division 19a.
172. ITA 1997 Sec. 42-190.
173. The cost base for capital loss purposes is reduced by these amounts under ITA 1936 Sec. 160zk(1).
174. ITA 1997 Sec. 41-65(2).
175. ITA 1936 Sec. 58(1)(a)(i).
176. ITA 1936 Sec. 58(4).
177. ITA 1936 Sec. 58(7).

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est paid to non-residents in treaty or non-treaty countries. In the absence of anti-avoidance measures, thin capitalization (excessive reliance on debt rather than equity investments in Australian subsidiaries) would offer a simple means of minimizing Australian tax exposure.

Thin capitalization measures to prevent tax minimization by means of excessive debt funding were first adopted in 1987 and significantly stiffened in 1997. Essentially, the measures deny resident companies deductions for interest expenses on debt to foreign controllers that exceeds the equity interest of foreign controllers in the company by more than two times (formerly three times, prior to 1997) in the case of companies other than financial institutions or six times in the case of financial institutions.[178] A foreign controller is defined as a person who, together with associates, has substantial control of the voting power in the resident company or is entitled to receive at least 15 per cent of any dividends declared by the company.[179] Control, foreign debt,[180] and foreign equity[181] are all measured in terms of direct owners *and associates*. "Associates" is very broadly defined,[182] and the regime is supplemented by deeming provisions aimed at catching indirect arrangements designed to convert what is essentially debt to equity.

V. SUMMARY

Takeovers of Australian companies, particularly by foreign investors (either acting directly or indirectly through interposed entities) must cross a number of hurdles. All takeovers must comply with the Corporations Law provisions dealing with takeover offers. And all takeovers must not be anti-competitive within the terms of the Trade Practices Act 1974. Takeovers in selected industry sectors – banks, other financial institutions, insurance companies, and the television media – must satisfy conditions set out in statutes governing ownership in those industries. And all takeovers by foreigners must be approved pursuant to the Foreign Acquisitions and Takeovers Act 1975.

Once any legal impediments to a takeover offer are addressed, planning for a tax-effective takeover becomes a priority. Initial issues to be considered revolve around the tax-position of vendors, since any tax saved by vendors will reflect favourably in the cost of acquisition to the acquirer. Furthermore, acquirers must also consider the likelihood that the costs of acquisition will not be recognized for Australian tax purposes.

At the same time that acquirers consider the tax aspects of the takeover process, they must also plan around the implications of a successful bid in terms of the target company and the group of which it becomes a member. In particular, care must be taken to ensure any tax losses carried forward by the target company will not be lost as a result of the change of ownership. Contemporaneously, looking forward consideration should be given to the possibility of transferring assets and tax attributes to and from the target after it becomes a group company.

178. ITA 1936 Secs. 158GZS and 159GZA, definition of "foreign equity product".
179. ITA 1936 Sec. 159GZE.
180. ITA 1936 Sec. 159gzf.
181. ITA 1936 Sec. 159gzg.
182. ITA 1936 Sec. 159gzc.

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REPUBLIC OF SINGAPORE

1998 BUDGET: A CAUTIOUS BUT PRAGMATIC BUDGET

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I. INTRODUCTION

The Minister of Finance, Dr Richard Hu, presented Singapore's 1998 Budget in parliament on 27 February 1998. The Budget Speech comprised three parts: a review of the economy; the financial year 1998 Budget; and revenue and tax changes.

The Minister reported that Singapore's economy grew by a robust 7.8 per cent in 1997 but that did not reflect the seriousness of the ongoing regional economic turmoil, which started in July 1997.

On the economic outlook for 1998, the Minister said that since the regional crisis was far from over, it was difficult to predict precisely its impact on Singapore's economy and businesses. He cautioned that the regional context was too volatile and fraught with uncertainties.

The Minister said the government was closely monitoring the impact of the regional crisis on Singapore's economy and adjustments would be made to keep the business environment competitive. In formulating its policies, the government's key objective was to maintain the framework for economic activity.

On fiscal policy, the Minister emphasized fiscal prudence in planning the government's Budget. The government would adopt a conservative fiscal stance, and target for a modest budget surplus, smaller than in recent years.

Before announcing the proposed tax changes, the Minister explained that as the tax rates remained competitive, no major tax changes would be made against a background of declining revenue collections and rising development expenditures. He added that as the economic outlook in the region in 1998 was volatile and unpredictable, the situation would be closely monitored. If a sudden downturn should take place, the government would not hesitate to respond with off-budget measures. Meanwhile, tax incentives would continue to be fine-tuned to promote activities with high growth potential and the Local Enterprise Financing Scheme would be enhanced to help local businesses to obtain working capital.

The tax changes announced are as follows:

II. TAX CHANGES FOR COMPANIES

A. Tax incentive to promote fund management

At present, income earned from managing non-resident funds is taxed at a concessionary tax rate of 10 per cent. Incremental income earned from managing non-resident funds of at least SGD 5 billion is taxed at 5 per cent. Those who manage at least SGD 10 billion of non-resident funds are totally exempt from tax.

To encourage more fund managers to expand their operations in Singapore, the threshold requirement to qualify for full tax exemption has been lowered. Fund managers which manage at least SGD 5 billion of non-resident funds will now enjoy the full tax exemption for fee income earned from managing non-resident funds for a period of five years.

For those which already manage SGD 5 billion of non-resident funds and have made strong commitments to further increase their level of fund management activities in Singapore, a longer exemption period of up to ten years may be granted.

Fund managers which manage less than SGD 5 billion of non-resident funds may qualify for tax exemption for up to five years if they increase their fund management activities in Singapore substantially.

The incentive scheme will take effect from year of assessment 1999.

B. Tax incentive to promote the bond market

To promote the development of an active bond market in Singapore, a package of tax incentives will be introduced:

- tax exemption on fee income earned by financial institutions in Singapore from arranging debt securities in Singapore, including the underwriting and distribution of such securities;
- 10 per cent concessionary tax rate on interest income earned by financial institutions and corporations in Singapore from debt securities arranged by financial institutions in Singapore;
- tax exemption on interest from debt securities arranged by financial institutions in Singapore and earned by non-residents who do not have any permanent establishments in Singapore; and
- 10 per cent concessionary tax rate on income earned by financial institutions in Singapore from trading in debt securities.

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The new tax treatment for fee and interest income will apply to debt securities issued within a period of five years commencing on 28 February 1998.

The incentive for income earned from trading in debt securities will be granted for a period of five years from 28 February 1998.

C. Taxation of unit trusts

Under the current tax incentive introduced in the 1995 Budget, trustees of unit trusts are required to withhold tax on income, except dividends, when distributed to all unit holders whether resident or non-resident. The existing incentive also granted a concession to resident individual unit holders who were taxed only on 10 per cent of the distributions made out of gains from the disposal of securities.

To make investments in unit trusts more attractive to resident individuals, the tax imposed on resident individual unit holders for 10 per cent of the distributions paid out of gains from the disposal of securities will be removed.

The withholding tax requirement on taxable distributions made to unit holders who are tax residents of Singapore will also be removed. Unit holders who are tax residents are, however, still liable to pay tax on the distributions.

The changes will take effect from 28 February 1998.

D. Tax exemption scheme for syndicated offshore credit and underwriting facilities

The tax exemption scheme for syndicated offshore credit and underwriting facilities, which is due to expire on 31 March 1998, has been extended for another five years.

To further develop the syndication market in Singapore, the scheme will be extended to credit and debt facilities which are syndicated by financial institutions in Singapore for Singapore borrowers, provided the funds raised are used outside Singapore.

The change will take effect from 1 April 1998.

E. Tax deduction for general provisions made by banks and merchant banks

Since 1991 banks and merchant banks have been allowed to claim tax deduction on general provisions of up to 25 per cent of qualifying profits or 0.5 per cent of qualifying loans and investments, whichever is lower, subject to their cumulative tax deductible general provisions not exceeding 3 per cent of qualifying loans and investments.

To encourage banks and merchant banks to further build up their general provisions and to give banks greater flexibility to make as much general provisions as possible to cushion against potential losses arising from the regional financial difficulties, the annual limits of 25 per cent of qualifying profits and 0.5 per cent of qualifying loans and investments will be temporarily suspended for a period of two years with effect from year of assessment 1998.

The overall limit of 3 per cent of qualifying loans and investment will remain unchanged.

F. Extension of tax holiday for SIMEX

The five-year tax holiday was first granted to the Singapore International Monetary Exchange Limited (SIMEX) in 1984. The tax holiday was extended in 1988 and again in 1993 for additional five-year periods to support the growth of SIMEX.

To meet the challenges of global competition and the emergence of other exchanges in the region, the tax holiday for SIMEX will be extended for another five years to 2003 to enable SIMEX to continue to improve on its facilities and strengthen its financial reserves.

G. Extension of venture capital incentives

Presently, venture capital funds enjoy tax exemption on the gains from disposal of investments, and on certain investment income for a maximum of ten years. Fund management companies which manage venture capital funds are awarded pioneer status for managing these funds. The current ten-year limit may be too restrictive for some investments which have maturity periods longer than ten years.

To encourage venture capital funds to take a longer-term view of their investments and to minimize premature divestment, the tax incentive enjoyed by venture capital funds will be extended, on a case-by-case basis, by up to a further five years beyond the current maximum of ten years. The extension will take the form of a concessionary tax rate of not more than 10 per cent. The fund management companies which manage these venture capital funds will also in tandem enjoy a concessionary tax rate under the Development and Expansion Incentive beyond the tenth year.

The change will take effect from 27 February 1998.

H. Transport and logistics

To encourage major transport and logistics operators to further expand their businesses in Singapore and use Singapore as a base for their operations, the following tax concessions will be introduced:

1. Tax exemption for income derived from uplift of freight

Currently, tax is levied on the uplift of cargoes from Singapore, except for Singapore-flagged vessels and vessels from countries with which Singapore has signed a tax treaty.

To further boost Singapore's development as an international cargo and shipping hub, non-resident shipowners and charterers will be exempt from tax on their freight uplift from Singapore. The benefit will also be extended to resident shipping companies and companies under the Approved International Shipping Enterprise Scheme.

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The exemption will take effect from year of assessment 1999.

2. Tax concession for international freight and logistics operators

To further enhance Singapore's hub status, a tax incentive to encourage international freight service providers to expand their activities in Singapore will be introduced. This incentive will be available to ship agencies, ship management companies and logistics providers. To qualify for the incentive, the company must have substantial operations and a good track record in the provision of freight and logistics services. Companies that qualify will be accorded a concessionary tax rate of not less than 10 per cent on their incremental income.

The incentive will be granted for a period of five years and will take effect from year of assessment 1999.

3. Tax exemption for income derived from writing offshore marine hull and liability insurance business

To allow insurance companies to tap the insurance potential of the shipping communities in the region and complement Singapore's development as a shipping hub, income derived by approved insurance companies from writing offshore marine hull and liability insurance business will be exempt from tax for a period of ten years.

The concession will take effect from year of assessment 1999.

I. Tax incentive for exhibition organizers

To provide further impetus to the development of the exhibition industry, approved exhibition organizers will be granted a concessionary tax rate of not less than 10 per cent on their incremental income.

The incentive will take effect from year of assessment 1999.

J. Approved cyber-trade scheme

In view of the expected growth of business transactions using the Internet within the next few years, Singapore has the potential to become an electronic commerce hub. To tap this growing market, a concessionary tax rate of 10 per cent on offshore trading income derived from transactions made over the Internet under the Approved Cyber Trader Scheme will be introduced for companies that qualify.

Approved companies will also enjoy an investment allowance of up to 50 per cent of the cost of their qualifying new fixed investments, and full or partial exemption of withholding tax on qualifying payments.

These incentives will be granted for a period of *five* years with effect from year of assessment 1999 and the scheme will be administered by the Trade Development Board.

K. Double tax deduction for employing talent from abroad

In view of the need for Singapore to tap the best talent worldwide to meet future competition, companies will be allowed to claim double tax deduction for approved relocation and recruitment expenses incurred in the hiring of talent from abroad. The double tax deduction will help to offset the extra costs which companies have to incur in employing such talent to supplement Singapore's local work force.

Further details of the scheme have yet to be announced.

L. One-year accelerated depreciation allowance for industrial noise and chemical hazards control

To encourage factories to implement effective measures to counter noise and chemical hazards, 100 per cent depreciation allowance will be allowed in the first year for expenditure on such measures provided that certain qualifying criteria relating to noise and chemical exposure levels are satisfied.

This incentive will apply to expenditure incurred with effect from 1 January 1998. The scheme will be administered by the Ministry of Labour.

III. TAX CHANGES FOR INDIVIDUALS

A. Income tax rebate

To provide a measure of relief to taxpayers, an across-the-board rebate of 5 per cent on individual income tax in year of assessment 1998 will be granted.

B. Rebates on HDB Service and Conservancy and rental charges

Currently about 70 per cent of individuals do not pay income tax and would not benefit from the income tax rebate. 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 half to two months depending on the type of HDB flat.

C. Rebates for revision in utilities rates

Rebates will be granted on the public utilities bills for Singaporeans living in one to four-room HDB flats. The rebates will range from SGD 50 to SGD 100 depending on the type of HDB flat in which they stay.

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 per month depending on the type of household.

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The monthly grant which started from July 1997 will continue until June 1999.

D. Pre-Medisave top-up scheme

Having paid the first three instalments under the Pre-Medisave top-up scheme in January 1996, January 1997 and January 1998, the government will pay the fourth instalment in January 1999 as scheduled. The top-up grant will be paid into the CPF Medisave accounts of eligible Singaporeans, who are 64 years or older on 1 April 1998. For this fourth 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.

E. Revision of CPF interest rates for special and retirement accounts and voluntary transfer of CPF savings from ordinary account to special account

From 1 July 1998, the interest rate premium for CPF special account and retirement account will be increased to 1.5 per cent above the ordinary account interest rate.

From 1 July 1998, CPF members will also be given the option of transferring their savings from the ordinary account to the special account (subject to a cap of SGD 40,000) to enjoy the higher interest rate.

The transfers from the ordinary account to the special account will not be reversible.

IV. OTHER TAX CHANGES

A. Property tax rebate

A 15 per cent rebate on property tax will be given for commercial and industrial properties for the year commencing July 1998.

B. Property tax exemption for land under development

The property tax exemption for land under development which was withdrawn will now be reinstated for a period of up to five years with immediate effect. The exemption will apply from the time construction begins to the time the Temporary Occupation Permit is granted.

C. Stamp duties

To further reduce costs and inconvenience to businesses and members of the public, stamp duty will be abolished on all instruments, except for those which relate to stocks and shares and immovable properties with effect from 28 February 1998.

(For details please refer to the Appendix.)

D. Duties on cigarettes

To discourage smoking particularly among the younger population, the excise duty on cigarettes will be raised from SGD 115 to SGD 130 per kilogram with effect from 27 February 1998.

E. Electronic road pricing and vehicle tax rationalization

The Electronic Road Pricing (ERP) system will be introduced on 1 April 1998. In conjunction with the introduction of the ERP, the vehicle tax structure will be rationalized and a package of road tax rebates will be granted with effect from 1 September 1998.

(Details were announced by the Minister for Communications on 4 March 1998.)

V. CONCLUSION

In conclusion, the Minister pointed out that due to the volatile regional environment, the policy measures in the Budget were based on the assessment of the present state of the Singapore economy.

He assured that the government would monitor the regional environment and economic conditions vigilantly and implement further measures promptly should there be drastic changes.

He cautioned that businesses and individuals must prepare themselves for a period of slower growth and uncertainty and be ready to respond to unanticipated developments.

However, the Minister was confident that if Singaporeans stay united in tackling the problems, they would strengthen Singapore's competitiveness, ride out the crisis and emerge stronger than before.

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APPENDIX

Stamp duty is abolished on the following instruments:

Description of instrument	Article in the First Schedule
assurance	4
bond, mortgage or other instrument executed by way of indemnity or of security for the due execution of an office	8
covenant	12
dissolution of partnership	15
insurance	22
instrument relating to formation of partnership	25
policy of insurance	27
reconveyance of mortgaged property, reassignment, release, discharge, surrender or renunciation	28
annuity*	2
bill of sale*	5
bond, covenant or instrument of any kind other than a marketable security or an indemnity bond*	6, 7, 21, 24
conveyance, assignment or transfer*	3, 10, 32
declaration of trust*	14
duplicate or counterpart*	11, 16
gift*	20
mortgage, agreement for a mortgage, equitable mortgage, further charge and debenture*	13, 17, 19, 24
release*	29
settlement*	30

* Except where it relates to stocks and shares or immovable property.

Instruments with stamp duty retained:

Description of instrument	Article in the First Schedule
bond, covenant or instrument for securing the payment for the hire of furniture, chattels, fittings or equipment in connection with the lease of immovable property and for the provision of services or facilities or to other matters or things in connection with such lease	6, 7, 21, 24 (duty same as a lease)
contract note	9
conveyance, assignment, transfer, bill of sale, annuity, release, agreement for sale	3, 5, 10, 29, 32
declaration of trust	14
duplicate or counterpart	11, 16
exchange	18
gift	20
lease or agreement for a lease	1, 23
mortgage, agreement for a mortgage, equitable mortgage, further charge, debenture	13, 17, 19, 24
partition	26
settlement	30
surrender of lease	31

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 54-56 of the January 1998 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

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Marks, J.
Maghreb quarterly report.
London, Middle East Economic Digest,
21 John Street, London WC1N 2BP, United Kingdom.
Middle East Economic Digest, Issue No. 26, September 1997, pp. 64.
The report provides regular, updated, in-depth assessments of key economic and political issues facing corporations doing business with and in the Maghreb countries Algeria, Libya, Mauritania, Morocco and Tunisia.
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ASIA & THE PACIFIC

ASEAN

Fiscal systems and practices in ASEAN. Trends,
impact and evaluation. Editor Mukul G. Asher.
Singapore, Institute of Southeast Asian Studies, Heng Mui Keng Terrace, Pasir Panjang, Singapore 119596. 1989, pp. 232.
ISBN: 981 3035 50 1.
The book focuses on the fiscal systems and practices since the mid-1960s in Indonesia, Malaysia, the Philippines, Singapore and Thailand. In addition to the country papers, an introductory chapter by Mukul G. Asher provides a comparative overview of ASEAN fiscal systems and practices, as well as compares the levels and structure of taxation in the ASEAN countries with those in the East Asian and industrialized countries.
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Pamphlet giving general information regarding Hong Kong with respect to profits tax, salaries tax, property tax and other miscellaneous levies.
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Singhania, Vinod K.; Singhania, K.
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New Delhi, Taxmann Publications Ltd. 1997, pp. 191. ISBN: 81 7194 158 3.
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Auckland, CCH New Zealand Limited. 1997, pp. 1294. ISBN: 0 86475 360 8.
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EUROPE

Austria

Haunold, P.
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Belgium

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97/2. (Bijgehouden t/m 31 augustus 1997).
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(B. 116.936)

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Cyprus

A guide to prospective applicants on the establishment of offshore trustee services companies ("OTCs"). 4th Edition.
Nicosia, Central Bank of Cyprus, 80 Kennedy Avenue, P.O. Box 5529, CY-1395 Nicosia. 1997.
Reference guide for those contemplating establishing an offshore trustee services company in Cyprus.
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Nicosia, Central Bank of Cyprus, 80 Kennedy Avenue, P.O. Box 5529, CY-1395 Nicosia. 1997.
Reference guide for those wishing to establish an offshore financial service company in Cyprus.
(B. 117.028)

A guide to prospective applicant banks on the establishment of offshore banking units/administered banking units/representative offices in Cyprus.
Nicosia, Central Bank of Cyprus, 80 Kennedy Avenue, P.O. Box 5529, CY-1395 Nicosia. 1997.
Policy statement and guidelines on the establishment and operation of offshore banking units, administered banking units, and representative offices in Cyprus.
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The principle of equal treatment in EC law. Editors Alan Dashwood and Siofra O'Leary.
London, Sweet & Maxwell. 1997, pp. 118.
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Wederzijdse bijstand op het gebied van directe belastingen.
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Reuber, H.G.
Die Besteuerung der Vereine. 2 Volumes.
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Taxation of clubs. Two-volume loose-leaf practitioners guide. After a short systematic introduction all tax aspects of clubs are set out under 200 keywords, structured in alphabetical order. The annex provides the relevant statutes, parts of the application decree to the General Tax Code (AO-Anwendungserlass), other decrees and sample texts relating to activities of a club.
(B. 116.833)

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Wiesbaden, Verlag Dr. Th. Gabler GmbH., Abraham Lincoln Str. 46, 65189 Wiesbaden, Germany.
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Fully revised and updated edition of a study book dealing with the 1997 individual, corporate and business income taxes.
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Neufang, B.; Henrich, W.
Rückumwandlung. Umwandlung einer GmbH in eine Einzelfirma oder Personengesellschaft.
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(B. 116.841)

Bals, B.
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DEM 47.80. ISBN: 3 08 317798 4.
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Taxation of investment income. Besides giving an introduction into the taxation of income from investment funds and new forms of investment income, the book provides an A-Z table of new financial products. The table defines the term and states the income tax and the withholding tax ("Zinsabschlag") treatment. With literature index.
(B. 116.843)

Schmidt-Troje, J.
Der Steuerrechtsschutz.
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Legal defence in tax matters. Guide on the administrative tax procedure and the procedure before tax courts. Requirements for appeals and actions are laid out, with practical examples and many references to the jurisprudence of the Federal Tax Court. Also covers costs, shows the 1997 organizational charts of the Tax Court Cologne and of the Federal Tax Court.
(B. 116.835)

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(B. 116.839)

Ireland

Saunders, G.
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Croydon, Tolley Publishing Company Ltd. 1997, pp. 424. GBP 36.95.
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(B. 116.933)

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Pensions: revenue law & practice. Edited by Jim Mooney.
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(B. 116.956)

Isle of Man

Solly, M.
Taxation of companies in the Isle of Man.
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The book contains a comprehensive explanation of the taxes in the Isle of Man as they apply to companies. It includes a description of the relevant government authorities and their functions, a summary of all the taxes imposed in the island, detailed description of VAT and the Manx income tax, detailed description of non-resident companies, exempt companies, exempt insurance companies, exempt managed banks, international companies and limited liability companies.
(B. 116.962)

Italy

Le leggi tributarie fondamentali.
2nd Edition. Editor Roberto Lippi.
Milan, Dott. A. Giuffrè Editore. 1997, pp. 1213. ITL 50,000. ISBN: 88 14 06483 0.
The fundamental tax laws. This is a collection of the main Italian tax laws. All the fundamental taxes are included.
(B. 116.729)

Hilpold, P.; Steinmar, W.; Zandanel, P.
Grundriss des italienischen Steuerrechts.
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Principles of Italian tax law. Analysis of the Italian Income Tax Code. Important international aspects are considered. The book does NOT deal with other taxes (e.g. VAT or inheritance and gift taxes).
(B. 116.895)

Capolupo, S.
La tassazione dei proventi illeciti.
Padova, CEDAM Casa Editrice Dott. Antonio Milani. 1996, pp. 625. ITL 75,000.
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The taxability of income from illegal activities. The book deals with juridical and practical problems connected with the taxability of income from illegal activities. It takes into consideration both direct and indirect taxes. The problem is examined also from an international point of view (international cooperation, simultaneous tax audits).
(B. 116.896)

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Imposte sui redditi e patrimoniali.
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Handbook on VAT. The book is a thorough and complete commentary on the VAT rules applicable in Italy. It covers both the substantive rules and those governing assessment, auditing and penalties. It contains a very complete set of both bibliographical and administrative (as well as jurisprudential) references, divided by topic.
(B. 116.752)

Liechtenstein

Das Liechtensteinische Steuergesetz.
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Vaduz, Bonafides Verlags Anstalt. 1997.
ISBN: 3 905193 01 9.
Second edition of a loose-leaf publication on the Liechtenstein tax law. Text collection with references to case law.
(B. 117.011)

Netherlands

Doing business in the Netherlands.
Rotterdam, Moret Ernst & Young. 1996, pp. 144.
An overview of the investment climate, taxation, forms of business organization and business and accounting practices in the Netherlands. The book reflects information current at 1 April 1996.
(B. 116.913)

Eijck, S.R.A. van.
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Alphen a.d. Rijn, Samsom H.D. Tjeenk Willink BV., Postbus 316, 2400 AH Alphen a.d. Rijn.
Compensium vastgoed. 1997, pp. 301.
NLG 75. ISBN: 90 6092 872 5.
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(B. 116.943)

Blokland, T.
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Deventer, Fed.
Serie Belastingadviseursdagen No. 42. 1997, pp. 87. ISBN: 90 6002 741 8.
The book contains contributions on this subject, which focuses on business profits, income from a substantial shareholding, especially gifts and inheritance, insurances, periodical payments and tax deferrals.
(B. 116.940)

Estate planning. Editors F. Sonneveldt and W.M. Kleijn.
Lelystad, Koninklijke Vermande B.V. 1997, pp. 224. ISBN: 90 5458 424 6.
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(B. 116.965)

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Wederzijdse bijstand op het gebied van directe belastingen.
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Alphen a.d. Rijn, Samsom Bedrijfsinformatie. 1997, pp. 485. ISBN: 90 14 05597 8.
The book contains a comprehensive overview of all important aspects of social security law at national and international level.
(B. 116.926)

Norway

Doing business in Norway.
Amsterdam, Price Waterhouse. 1997, pp. 212.
The book provides potential investors with a quick reference guide to investing in Norway. The material was assembled in May 1997 and covers information on foreign investment and trade opportunities, tax system, banking and finance, audit and accounting.
(B. 116.966)

Poland

Ryszars Mastalski.
Prawo podatkowe II.
Warsaw, Wydawnictwo C.H. Beck. 1996, pp. 278. ISBN: 83 7110 076 0.
Second part of a monograph describing details of the tax system and its place within the Polish legal landscape. Historical background and motivation are dealt with. Special attention is paid to the structure and characteristics of income taxes, turnover and capital taxes from the taxpayers' and tax administration's points of view.
(B. 117.014)

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Development of foreign tax systems in 1991-1995 and tax reform in Russia.
Moscow, Russian Academy of Sciences, Central Economical and Mathematical Institute, Mackinowsky Prospect 32, 117418, Moscow, Russia. 1996, pp. 50.
Comparative study of the effective tax rate and tendencies of its changing in Russia and in 22 countries showing that it is necessary to decrease the effective tax rate in Russia to stimulate economic activity and harmonize the tax system of Russia with other countries.
(B. 116.988)

OECD economic surveys: Russian Federation 1997-1998.
Paris, OECD Organisation for Economic Co-operation and Development. 1997, pp. 275.
This book analyses the progress of Russia's transition to a market economy. It reviews macroeconomic performance, polices and prospects and pays special attention to the commercial banking sector and issues relating to corporate governance. It includes a short discussion of tax reform.
(B. 117.019)

Spain

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Curso de derecho financiero y tributario.
8th Edition.
Madrid, Editorial Tecnos S.A. 1997, pp. 811.
ISBN: 84 309 3056 6.
The book deals with the whole Spanish tax system and in particular with the rules tax procedures.
(B. 116.885)

Sweden

Handledning för internationell beskattning.
2nd Edition.
Stockholm, Riksskatteverket. 1996, pp. 550.
ISBN: 91 38 12963 9.
Second edition of a handbook on (Swedish) international taxation. The guide is designed to be used by the tax authorities and researchers alike. It covers international aspects of: income and capital taxation of individuals and companies, withholding taxes, VAT, social security contributions, gift tax, as well as unilateral methods for the avoidance of double taxation, tax treaties and mutual administrative assistance in tax matters.
(B. 115.102)

Switzerland

Hinny, P.
Die steuerrechtliche Behandlung der Marke im Konzern (einschliesslich Steuerplanung).
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(B. 114.749)

Kläy, H.
Die Vinkulierung. Theorie und Praxis im neuen Aktienrecht.
Basel, Helbing & Lichtenhahn Verlag AG. 1997, pp. 625. ISBN: 3 7190 1592 0.
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(B. 116.954)

Amonn, K.
Beiträge zum SchKG, Banken- und Steuerrecht. Festschrift zum 80. Geburtstag.
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Anniversary publication in honour of the 80th birthday of Prof. Kurt Amonn (University of Bern). The book is a collection of his most important articles in the fields of tax law, bank law and bankruptcy law.
(B. 116.971)

Turkey

Doing business in Turkey.
New York, Ernst & Young International, Ltd. 1996, pp. 116.
A quick overview of the investment climate, taxation, forms of business organization and business and accounting practices in Turkey.
(B. 116.915)

United Kingdom

Nightingale, K.
Taxation. Theory and practice.
London, Pitman Publishing. 1997, pp. 650.
ISBN: 0 273 61426 6.
Comprehensive textbook providing coverage of both the theoretical and practical aspects of taxation in the United Kingdom. The book gives students a grounding in the economic theory of taxation. The practical aspects of assessing liability to income tax, capital gains tax, corporation tax and VAT are covered. It also includes highlights on tax planning opportunities, and an examination of the PAYE system and the administrative organization of the Inland Revenue.
(B. 116.948)

Smailes, D.; Golding, J.; Saunders, G.; Wareham, R.
Tolley's tax computations 1997/98.
Croydon, Tolley Publishing Company Ltd. 1997, pp. 695. ISBN: 1 86012 539 5.

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A manual of practical examples governing income tax, corporation tax, capital gains tax, inheritance tax and value added tax. This latest edition is fully updated to cover the provisions of both Finance Acts 1997.
(B. 117.007)

British master tax guide 1997-98.
Bicester, CCH Editions Limited. 1997, pp. 1395. ISBN: 0 86325 450 0.
The guide provides concise yet thorough guidance on a wide range of taxation issues, covering legislation and practice on income tax, corporation tax, capital gains tax, inheritance tax, value added tax and national insurance contributions. Incorporates all relevant provisions of the Finance Act 1997.
(B. 117.009)

Whillans's tax tables. 54th Edition.
London, Butterworths. 1997, pp. 101.
GBP 5.20. ISBN: 0 406 999 333.
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(B. 116.934)

Doing business in the United Kingdom.
New York, Ernst & Young International, Ltd. 1996, pp. 129.
The book gives a quick overview of the investment climate, taxation, forms of business organizations and business and accounting practices in the United Kingdom.
(B. 116.916)

Monitoring developments: Proposals for UK life policyholder tax changes.
Sudbury, Monitor Press Ltd., Church Field Road, Sudbury, Suffolk CO10 6YA, United Kingdom. 1997, pp. 22.
ISBN: 1 871241 49 9.
The booklet discusses the issues raised by the proposals, includes commentary and practical working examples. It is essential reading for all those involved with UK life policyholder plans, whether as a tax, funds, investment or pensions adviser.
(B. 116.736)

INTERNATIONAL

Ault, H.J.
Comparative income taxation: a structural analysis.
The Hague, Kluwer Law International. 1997, pp. 540. ISBN: 90 411 0601 4.
The book presents a comparative analysis of some of the structural and design issues which are involved in mature income tax systems. The countries selected for this study are: Australia, Canada, France, Germany, Japan, the Netherlands, Sweden, the United Kingdom and the United States, all have relatively mature and sophisticated tax systems. Individual country descriptions are followed by parts dealing with basic income taxation, taxation of business organizations and international taxation.
(B. 116.967)

The international guide to taxation of life assurance and mutual funds.
Sudbury, Monitor Press Ltd., Suffolk House, Church Field Road, Sudbury, Suffolk CO10 6YA, United Kingdom.
This loose-leaf publication contains the rules for the taxation of life insurance contracts and mutual funds in the EU countries, Nordic countries, Australia, Singapore, South Africa, Canada, the United States and Japan. Covered are the occasions in the life of a financial product when tax could be relevant. These include: income and gains arising both to the investor and the product provider, relevant anti-avoidance legislation (if any), changing the underlying investment, partial and full encashment of the investment, assignments and gifts, wealth tax assesments, and death of the investor (inheritance and succession duties). The work is updated to November 1997 and will be kept up-to-date by future supplements.
(B. 114.007)

Immigration manual.
Hong Kong, Baker & McKenzie, 14th Fl., Hutchison House, 10 Harcourt Road, Central, Hong Kong. 1997, pp. 226.
Manual designed to provide a general overview of the immigration laws and procedures of various countries. Immigration laws and procedures are constantly changing and are subject to new policies and developments. Unless otherwise indicated, the law is as stated on 1 October 1997.
(B. 116.975)

Developing countries

Rosengard, J.K.
Property tax reform in developing countries.
The Hague, Kluwer Law International. 1998, pp. 212. ISBN: 0 7923 8095 9.
Practical guidelines for the design and implementation of property tax reform in developing countries. The book reviews the underlying fundamentals of the property tax, analyses the experiences of Indonesia, Chile, Jamaica and the Philippines and concludes with detailed suggestions for future property tax reform initiatives.
(B. 58.392)

LATIN AMERICA

Venezuela

Doing business in Venezuela.
Amsterdam, Price Waterhouse. 1997, pp. 161.
The book provides potential investors with a quick reference guide to investing in Venezuela. The material is based on information available as at 31 December 1996.
(B. 19.004)

MIDDLE EAST

Kuwait

Doing business in Kuwait.
New York, Ernst & Young International, Ltd. 1997, pp. 80.
Guide providing potential investors with a quick reference guide to investing in Kuwait. The book reflects information current at 1 May 1997 and covers information on foreign investment and trade opportunities, structure of business entities, tax system, auditing and accounting.
(B. 58.390)

Qatar

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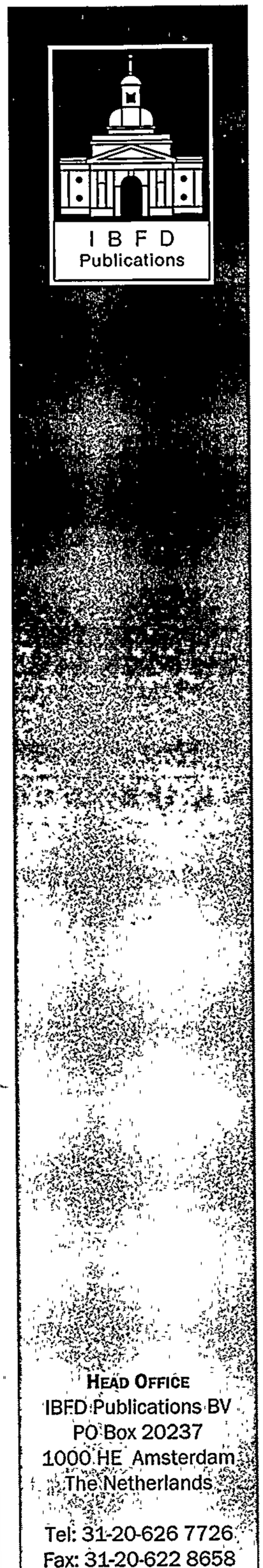

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SOUTH AFRICA

RECENT DEVELOPMENTS IN SOUTH AFRICAN TAX

Ray Eskinazi and Tracy Wylie*

Ray Eskinazi, an admitted attorney of the Supreme Court of South Africa, is a tax partner with Deloitte & Touche in Johannesburg, specializing in international tax. Ray obtained B.A. and LL.B. degrees from the University of Natal, Durban. He has also obtained post-graduate qualifications in both tax and company law from the University of the Witwatersrand, Johannesburg. He has spent time on secondment to the international tax offices of another big-six firm in both London and New York, where he gained considerable experience in international tax planning. Ray specializes in comparative foreign tax systems and the structuring of international holdings and advises numerous South African multinationals on the international tax implications of outbound investment and foreign transactions. Ray is the editor of *The South African Tax Review* and a member of the faculty of the Master's degree in Taxation at the Rand Afrikaans University, Johannesburg. **Tracy Wylie** is an admitted attorney of the Supreme Court of South Africa and a Senior Tax Consultant at Deloitte & Touche specialising in international tax. Tracy obtained B.A. and LL.B. degrees from Rhodes University in Grahamstown, and is at present working towards obtaining a Master's degree in Taxation at the Rand Afrikaans University.

I. INTRODUCTION

A number of changes were made to the South African Income Tax Act during the last year. This article discusses the changes relating to the worldwide taxation basis for investment income, South Africa's foreign tax credit rules, exchange control regulations and the new South Africa–US double taxation treaty.

II. TAXATION OF INCOME EARNED OUTSIDE SOUTH AFRICA

The Katz Commission, an advisory body in respect of taxation matters, was established in 1994 to evaluate various aspects of the South African tax structure. The Commission has issued a number of reports in this regard, most notably its fifth interim report issued in 1997, which focuses on the taxation of foreign investment income.

In its fifth interim report, the Commission distinguished between active income and passive income, recommending that active income (i.e. income derived from a business) be taxed on a source basis while passive income (i.e. income from investment activities) be taxed on a global basis. The Commission recommended that active income should only be taxed in South Africa to the extent the income is sourced in South Africa, and non-residents should only be taxed on active income in South Africa to the extent the income is attributable to a permanent establishment (PE) situated in South Africa. In the case of passive income, the Commission recommended that South African residents should be liable for South African tax on their worldwide passive income.

The 1997 Income Tax Act, which was promulgated on 4 July 1997, only implements some of the Commission's recommendations regarding the taxation of offshore investment income derived by South African residents. The proposals on active income are not included in the amendments, but the explanatory memorandum to the Act makes it clear that further amendments dealing with cross-border activities can be expected. The measures implemented in the 1997 Income Tax Act were prompted by the need for the tax system to take into account the fact that as from 1 July 1997, local resident individuals may legally hold certain offshore investments. The Minister of Finance in his Budget Speech on 11 March 1998 announced that the provisions of Sections 9C and 9D (see discussion below) are to be amended to address certain practical problems encountered in the application of the provisions.

A. Foreign investment income

Before the amendments discussed below, South African residents were only subject to South African income tax on foreign-source investment income in certain limited cases. The 1997 Income Tax Act (the Act) introduced, *inter alia*, two new sections, one of which essentially taxes South African residents on their worldwide investment income (Section 9C), and the other which provides for anti-avoidance measures when the income is not earned directly by a South African resident but is earned by offshore entities either controlled by South African residents or to which South African residents have made donations, settlements, or other dispositions (Section 9D).

The provisions relating to the secondary tax on companies (STC) and foreign tax credits have been amended to facilitate these changes. The new provisions came into effect on 1 July 1997 and apply to any investment income received or accrued on or after that date.

1. Foreign investment income earned directly by South African residents

Under Section 9C, "investment income" received by or accrued to a resident from any country outside South Africa is now deemed to be South African-source income, and

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hence subject to income tax in South Africa. A resident is a natural person ordinarily resident in South Africa, as well as any other person (e.g. a company, trust, etc.) which has its place of effective management in South Africa. Investment income is income in the form of an annuity (excluding pensions for past services), interest, rental income, royalty income or income of a similar nature. Thus, it excludes dividend income – foreign (as well as local-sourced) dividend income remains exempt from income tax in this country. The various types of income are specifically defined. Accordingly, any income falling outside these definitions is exempt unless it can be said to be "income of a similar nature".

Deductions or allowances that are available in the case of South African-source income are available in the case of the above types of foreign-source income. For example, if a taxpayer purchases property in Germany for the purpose of earning rental income, and raises a loan to purchase the property, the interest incurred on the loan may, for South African tax purposes, be set off against the rental income. The place where the loan was made is irrelevant.

It should be noted, however, that the following investment income is outside the scope of the new provisions:

- income derived by an immigrant for the three tax years ending February 1998, 1999 and 2000 where the income arises from assets acquired by the immigrant before he became ordinarily resident in South Africa for the first time; and
- income that arises from and is connected to the "business activities of a substantive business enterprise conducted (by a resident of South Africa) through a PE in any country other than South Africa, where such PE is suitably equipped for conducting the principal business of such substantive business enterprise."

For the purposes of the latter provision, the term PE has the same meaning as it has in the OECD model tax treaty, namely, a "fixed place of business through which the business of an enterprise" is carried on. As a result, a branch, office, factory, workshop, mine, place of management or long-term building site would be included within the definition.

2. Foreign investment income earned by non-residents

The provisions of Section 9C also apply to non-residents (both individuals and companies) that earn foreign investment income and income that is derived from activities carried on by non-residents through a PE situated in South Africa. Accordingly, if a US company has a PE in South Africa and as a result of its activities there, earns rental income from leasing plant and machinery to factories in Zimbabwe it would be subject to South African income tax on the rental income.

3. Investment income of foreign entities controlled by South African residents

As noted above, anti-avoidance measures have been introduced to prevent South African residents from using foreign companies to defer or avoid payment of tax. This could occur when taxable income (e.g. rental income) is earned by a foreign company and then remitted back to its South African shareholders by way of dividends. Since dividend income is usually exempt, the foreign rental income is in essence received tax-free in South Africa; alternatively, when investment income is "trapped" in a foreign entity by accumulating or capitalizing it in that entity, deferral may be achieved.

Section 9D of the Income Tax Act requires that a resident include in his tax return his proportionate share of investment income that is received by or accrues to an entity which is a "controlled foreign entity" in relation to the resident. The resident's proportionate share is based on his share of the participation rights in the entity. The apportioned amount is the resident's share of the entity's "income" (i.e. before expenses), not its taxable income. For these purposes:

- the terms "resident" and "investment income" have the same meaning as in Section 9C (see above);
- a "controlled foreign entity" is a foreign entity in which one or more South African residents, whether individually or jointly, and whether directly or indirectly, hold more than 50 per cent of the participation rights, or are entitled to exercise more than 50 per cent of the votes or control of such entity;
- a "foreign entity" is any person, other than a natural person, which has its place of effective management outside South Africa (thus it could include offshore companies or trusts);
- "participation rights" are any rights to share, directly or indirectly, in the capital or profits of, in the dividends declared by, or in any other distribution/allocation made by the entity in question.

Since the terminology refers to a participation "right", these provisions would presumably not apply when the local resident is a beneficiary of an offshore discretionary trust, with mere contingent rights to income. In such a case, the beneficiary would usually only be liable for tax on the income earned by the trust when it is distributed/allocated or if the beneficiary acquires a vested right to income (however, see below under section II.A.5).

The amount apportioned to a resident must be converted into rands at the spot rate applying on, at the latest, the last day of the resident's financial year. A resident who holds such a participation right at any time during the tax year must disclose the holding when submitting his annual tax return.

These provisions apply not only to individuals ordinarily resident in South Africa, but also to, for example, the investment income of a foreign subsidiary of a South African holding company. However, the provisions do not apply in the following cases:

- the foreign tax payable in any country on the apportioned amount would be more than 85 per cent of the South African tax payable by the resident on the income; or
- the income arises from and is effectively connected to a substantial business enterprise carried on through a PE in a foreign country (the PE must be suitably equipped to conduct a substantial business); or
- the income is attributable to an immigrant and arises from assets acquired by the foreign entity before the immigrant became ordinarily resident in South Africa for

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the first time. This exemption only applies to the February 1998, 1999 and 2000 tax years; or
- the income is taxed in a country that is deemed by the Minister of Finance as being a country whose tax on such income is similar to South Africa's (no such list has yet been published).

In determining the taxable income of a resident holding such participation rights, the resident may deduct from the apportioned investment income its proportionate share of the expenses incurred by the foreign entity in conducting its trade. Normal South African tax principles also would apply in determining the amount of the deductions, although the deductions are limited to the resident's share of the investment income, and any excess may be carried forward to the resident's next tax year. The excess is available for set-off against apportioned income in succeeding years provided the foreign entity continues to trade in the succeeding tax years.

4. Acquisition by a resident of a vested right to capital

In certain circumstances, when a resident acquires a vested right to participate in an amount of capital of a "controlled foreign entity" as defined above, that amount is taxable as income in the hands of the resident. This occurs where the capital is derived from investment income earned by the foreign entity in previous tax years during which the resident only had a contingent right to such income, and where the investment income of the foreign entity has not previously been subjected to South African tax under Section 9D. Again, this is an anti-avoidance provision aimed at situations where income is accumulated in an offshore discretionary trust and then after a number of years is distributed as capital. Some of the exemptions discussed above (see section II.A.3) also apply in this case. A resident who acquires such a right to capital is required to disclose this fact when submitting his annual tax return.

5. Foreign investment income from a donation, settlement or other disposition

Another anti-avoidance provision is contained in Section 9D(4) of the Act and is targeted at a situation when a resident donates assets to an offshore trust where the beneficiaries have no vested right to income. Without this provision, income generated by the assets could be accumulated free of South African tax in the trust. Section 9D(4) provides that where investment income is received by, or accrues to, a non-resident as a result of any donation, settlement or other disposition made by a resident, that income is taxed in the hands of the resident.

Section 9D(4) also applies when non-South-African-source investment income is received by, or accrues to, a resident as a result of a donation, settlement or other disposition made by another resident. The income arising in the hands of the first resident, which would have been taxable in the second resident's hands (under Sections 7(3), (4), (5), (6), or (7) of the Act) had it been South African-source income, is deemed to be the second resident's income and is taxed in the latter's hands. This provision is aimed at, for example, a case where a parent (who is a resident) establishes a trust having a foreign income stream, with his minor children as income beneficiaries with vested rights. Income that flows to the minor children as a result of a donation made by the parent to the trust is deemed to be the parent's and taxed in his hands.

If an asset is disposed of for less than its market value, the amount by which the market value exceeds the consideration received is deemed to be a donation. The concepts of "settlement" or "other disposition" would include an interest-free loan.

The application of Section 9D(4) is limited in that it only applies to so much of the investment income as is attributable to the donation, settlement or other disposition, and it does not apply to a donation, settlement or disposition to a foreign entity of a "public character," e.g. an established offshore charity or educational institution. Furthermore, the exemptions mentioned in section II.A.3 above also are applicable to situations where Section 9D(4) could apply.

B. Foreign income and STC

Previously, when a company (or close corporation) declared a dividend out of profits derived from sources both within and outside South Africa, that proportion of the dividend declared out of profits derived from foreign sources did not attract STC. An amendment pulls income deemed to be from a South African-source (under Section 9 or 9C) into the STC net. As a result, with effect from 1 July 1997, where a company earns foreign investment income (which is deemed income under Section 9C), and it subsequently declares a dividend out of such earnings, the dividend attracts STC. It should be noted that this amendment does not extend to foreign investment income of a foreign entity controlled by a South African company which is apportioned to the South African company for tax purposes (under Section 9D).

III. FOREIGN TAX CREDITS

The increase in outbound investment by South African individuals and corporate entities has necessitated a review of the mechanism(s) whereby South Africa grants a credit for foreign taxes paid against South African income tax payable. Although South Africa's tax treaties provide for relief from double taxation, two sections of the Income Tax Act (i.e. Sections 6bis and 6quat) provide unilateral relief. Section 6bis, which provided relief from double tax in the case of royalties, has been repealed and the provisions of Section 6quat have been extended. Section 6quat previously had a narrow application in that it only applied when the income subject to potential double taxation was from a "source" in a foreign country. Section 6quat now provides that relief is available as follows:
- to natural persons ordinarily resident in South Africa, or to persons (other than natural persons) whose place of effective management is in South Africa (in certain limited cases it is also available to non-residents);
- whenever income is earned by a resident "from any country other than" South Africa, the income is subject to

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tax in South Africa, and foreign taxes on the income are "proved to be payable, without any right of recovery, other than a right of recovery in terms of any entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment";
- where foreign investment income has been apportioned to a resident under Section 9D, and the controlled foreign entity has suffered foreign tax on the apportioned income;
- in the form of a credit for the foreign tax against South African taxes payable. The foreign tax paid which may be credited against the South African tax payable is limited to "an amount which bears to the total normal tax payable, the same ratio as the taxable income attributable to the income so included bears to the total taxable income";
- any amount of foreign tax in excess of the amount which may be set off against the local income tax may be set off against STC payable on dividends paid out of the after (income) tax foreign income.

Contrary to the recommendation of the Katz Commission, however, any excess of foreign tax paid (over the amount utilized as a credit against South African income tax) arising in one year may not be carried forward to subsequent tax years to be set off against South African income tax in those years.

IV. EXCHANGE CONTROL REGULATIONS

South Africa's 1997 Budget included a substantial relaxation of exchange controls which is expected to assist South Africa to return to the international business arena and to encourage investment both into and out of South Africa.

A. Offshore investments

Numerous quantitative limits applicable to current account transactions covered in various sections of the exchange control rulings have been abolished. The nature of the liability must be confirmed with the original documentary evidence. As far as foreign parent company share incentive/share option schemes are concerned, the value of shares which may be retained has been increased from ZAR 10,000 to ZAR 100,000, subject to the prior approval of the South African Reserve Bank.

B. Payment of fees

South African banks also may now approve applications by South African residents to pay for services that have already been rendered by non-residents. These are services that are not dealt with elsewhere in the exchange control rulings. Dealers must have documentary evidence of the amount involved and the fees payable must not be calculated on the basis of a percentage of turnover, income, sales or purchases, but on the basis of time and related costs.

C. Restriction on local borrowings

Where 75 per cent (from 1 March 1998, prior to that date, 50 per cent) or more of the shares or votes or entitlement to the income or capital of a South African company is controlled by non-residents, the South African company is an "affected person" for exchange control purposes. The definition of an affected person has been narrowed in recent years from a 25 per cent non-resident shareholding to the current 75 per cent. The effect of being an affected person for exchange control purposes is that the South African company's borrowing capacity in South Africa is restricted. The purpose of the restriction is to ensure adequate capitalization and prevent excessive gearing.

An affected person may borrow locally a percentage of its effective capital (essentially total permanent shareholders' funds and including South African shareholder loans to the extent these are matched or exceeded by foreign shareholder loans), determined by the following formula:

$$100\% + \frac{[\%\ \text{local shareholding} \times 100\%]}{\%\ \text{foreign shareholding}}$$

The amount which may be borrowed locally has been increased from 50 to 100 per cent in terms of the above formula. Local borrowings include any form of borrowing other than normal trade credit.

V. TAX TREATIES

A. General

The following double taxation treaties between South Africa and other countries have entered into force:

Country	Date of entry into force
Austria	6 February 1997
Canada	30 April 1997
Croatia	7 November 1997
Czech Republic	3 December 1997
India	28 November 1997
Ireland	5 December 1997
Japan	5 November 1997
Korea	7 January 1998
Lesotho	9 January 1997
Malta	12 November 1997
Mauritius	20 June 1997
Singapore	5 December 1997
United States	28 December 1997

B. South Africa–US double tax treaty

The new South Africa–US double tax treaty replaces the 1946 double tax treaty which was rescinded with effect from 1 July 1987. The new treaty generally follows the OECD model but also contains some unique provisions.

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1. Residents

The new treaty applies only to residents of both or either South Africa and the United States. Certain provisions (e.g. exchange of information) may affect non-residents. Subject to certain limitations, the United States may tax its citizens and former citizens or long-term residents where their loss of citizenship or resident status had as one of its principle purposes the avoidance of tax for a period of up to ten years after this loss of status.

2. Taxes covered

The treaty applies to US federal taxes, excluding social security taxes, and to federal excise taxes imposed on private foundations. In South Africa, it applies to normal income taxes and to the STC.

3. Permanent establishment

The definition of a PE includes a ship, drilling rig, installation or other structure used for the exploration or exploitation of natural resources if this activity lasts for more than 12 months. It also includes the provision of services, including consultancy services, if this lasts for a period or periods aggregating more than 183 days in any 12-month period in the tax year concerned.

4. Immovable property

Income derived from immovable property is generally taxable where the immovable property is situated.

5. Business profits

In general, the profits of an enterprise of one state may only be taxable in the other state if the enterprise operates through a PE in the other state to the extent the profits are attributable to the PE. When an enterprise operates through a PE in the other state, profits will be attributed to the PE as if it were an independent enterprise engaged in similar activities under similar circumstances.

The following expenses will be allowed as deductions for the purposes of determining taxable income:
- executive and general administrative expenses;
- research and development expenses;
- interest; and
- other expenses so incurred.

However, the PE may not deduct any of the following paid to its head office or any other related offices:
- royalties;
- fees or other similar payments in return for the use of patents or other rights;
- commissions or other charges for specific services;
- management; or
- interest on moneys lent to the PE.

Conversely, amounts charged by the PE to the head office falling within the non-deductible payments listed above, will not fall into the taxable income of the PE.

Profits and other income attributable to a PE will be taxable in the state in which the PE is situated, regardless of whether the PE has ceased to exist.

6. Dividends

Dividends paid by a resident of one state to a resident of the other state may be taxed in that other state. Dividends also may be taxed in the first state, but if the beneficial owner of the dividends is a resident of the other state, the withholding tax on the dividends is limited to 5 per cent if the beneficial owner is a company holding at least 10 per cent of the voting stock of the company paying the dividends, and 15 per cent in all other cases.

In the case of dividends paid by a US company which is a regulated investment company, the withholding tax is limited to 15 per cent. The withholding tax on dividends paid by a real estate investment trust (REIT) will be limited to 15 per cent only if the dividend is beneficially owned by an individual holding less than 10 per cent in the REIT; otherwise, the domestic rate of withholding tax will apply.

Dividends which accrue to a contracting state, any of its political subdivisions or local authorities, or any trust or pension fund of such entities which do not control the payer of the dividend, may not be subjected to any withholding tax.

Dividends paid by a resident of one state to a resident of the other state may only be taxed by the other state to the extent that they are attributable to a PE situated in the other state, even if they consist wholly or partly of profits or income arising in that other state.

A PE may be subject to an additional branch tax, which in the United States in addition to the corporate tax on profits, shall not exceed 5 per cent of the dividend equivalent; and in South Africa, shall not exceed the normal rate of corporate tax by more than 5 per cent.

7. Interest

Interest is exempt from any withholding tax and is taxable only in the state in which the recipient is resident. Interest is defined as income from debt claims of every kind, income from government securities and income from bonds or debentures including premiums or prizes attaching to such securities, bonds or debentures, and all other income that is subjected to the same tax treatment as income from money lent by the tax law of the state in which the income arises. Interest that is attributable to a PE or fixed base does not qualify for the exemption.

Where the interest exceeds an amount that would have been paid if the payer and the beneficial owner of the interest were not related parties, the treaty only applies to the amount that would have been paid. The excess remains taxable according to the laws of each state.

Contingent interest that is not portfolio interest under US law may not be taxed at a rate exceeding 15 per cent. Interest that is an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit is taxable by the United States in accordance with domestic tax law.

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8. Royalties

Royalties that are derived and beneficially owned by a resident of one of the states will only be taxable in that state. Any gain derived from the alienation of intellectual property which gives rise to a royalty will be considered to be a royalty, provided the gain is contingent on the productivity, use or disposition of the property. The provision will not apply if the beneficial owner of the royalties, resident in one state, carries on business in the state where the royalties arise through a PE, and the royalties are attributable to the PE.

Where the amount of the royalties paid exceeds that which would have been payable if the parties were not related, the provisions only apply to the amount which would have been paid. The excess will remain taxable under the laws of the applicable state.

9. Capital gains

Capital gains may be taxed in the state of source. However, gains from the alienation of ships, aircraft or containers operated in international traffic or movable property pertaining to the operation of ships, aircraft or containers will be taxable only in the state of residence.

10. Independent personal services

Income in respect of professional services or other independent services will be taxable only in the state of residence, unless the individual has a fixed base regularly available to him in the other state for the purpose of performing his activities. If he has a fixed base, the state of source may tax the income which relates to his fixed base.

When the individual stays in the other state for a period or periods exceeding 183 days in aggregate in any 12-month period commencing or ending in the financial year concerned, he will be deemed to have a fixed base regularly available to him, and his income derived from his activities in that state will be attributed to that fixed base.

11. Dependent personal services

Salaries, wages and other remuneration derived by a resident of one state in respect of employment will only be taxable in that state unless the employment is exercised in the other state, in which case, the remuneration derived from the other state may be taxed there.

Remuneration derived by a resident of one state in respect of employment exercised in the other state will be taxable only in the first state if the employee is present in the other state for a period or periods not exceeding in aggregate 183 days in any 12-month period beginning or ending in the financial year concerned, and the remuneration is paid by or on behalf of an employer who is not a resident of the other state, and the cost of the remuneration is not borne by a PE or a fixed base which the employer has in the other state.

12. Directors' fees

Directors' fees and other forms of similar remuneration are taxable in the state of source of the income.

13. Entertainers and sportsmen

Income received by an entertainer/sportsman resident in one state from activities exercised in the other state may be taxed in that other state provided his gross receipts, including expenses that may be reimbursed exceed USD 7,500 or its equivalent in South African rands for the taxable year concerned. When the income accrues to another person, that income may be taxed in the state in which the activities are exercised, unless it is established that neither the entertainer/sportsman nor any related person participates directly or indirectly in the profits of that other person in any manner.

14. Pensions and annuities

Pension distributions and other similar income are taxable in the source state under the following conditions. In the United States, the tax imposed may not exceed 15 per cent of the gross amount provided it is not subject to a penalty for early withdrawal; and in South Africa, the beneficial owner of the distribution must have been employed for a period or periods aggregating two years or more during the 10-year period prior to the date on which the pension first became due, and must have been employed in South Africa for a period or periods aggregating 10 years or more.

Social security and other public pensions are taxable only in the state of source.

Annuities may generally only be taxed in the source state unless they were purchased in the other state at a time when the owner of the annuities was a resident of that other state, in which case, they also may be taxed in that state.

Alimony that is paid by a resident of one state (and which is deductible in that state) to a resident of the other state will be taxable only in the first state. If the alimony is not deductible in the first state, it will be exempt in both states. Alimony is defined as "periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance or compulsory support".

Pension plan contributions paid by an individual to a pension plan that is established and recognized under the legislation of one state, where the individual performs personal services in the other state, are deductible as follows:

- contributions are deductible in the state where services are rendered. Benefits that accrue to the individual or payments made on his behalf by his employer during that period will not form part of the individual's taxable income and will be deductible by the employer;
- any income earned by the plan, but not distributed will not be taxable in that state until and only to the extent that a distribution is made;
- if the individual contributes distributions which he receives to a similar plan established in the other state within the time period and according to the requirements of the other state, the distributions will not be taxable in that other state.

In addition, the individual must have made contributions to the plan before arriving in the other state; and the pension plan must have been approved by the competent authority of

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the other state as generally corresponding to a pension plan recognized for tax purposes by that state.

The above benefits may not exceed the benefits that would be allowed by the other state to residents for their contributions to or benefits accrued under a pension plan recognized for tax purposes in that state.

The treaty deems a pension or similar remuneration to arise from sources within the state to the extent the pensionable services to which it relates are performed in that state.

15. Limitation on benefits

In the absence of a treaty, the United States imposes a withholding tax at the rate of 30 per cent on dividends, interest and royalties payable to a non-US resident. The South Africa–US treaty reduces this withholding tax to nil in the case of interest and royalties. The withholding tax on dividends is reduced to 5 or 15 per cent, the lower rate being applicable if at least 10 per cent of the US paying company is owned by the South African investor. The US reason for limiting the application of the benefits under the treaty is to prevent residents of third states from treaty shopping in order to make use of the treaty benefits. Since it is difficult to determine a taxpayer's intent, Article 22 (i.e., the limitation on benefits article) sets out objective tests in order to ascertain whether a taxpayer qualifies for benefits under the treaty. In general a taxpayer who is able to satisfy the requirements of the relevant test(s) contained in this Article is likely to have either a real business purpose for the structure it has adopted, or a sufficiently strong link to the other contracting state (e.g., resident individual).

To qualify for benefits under a tax treaty, it will normally be necessary for a South African investor to demonstrate South African residence in accordance with the definition of "resident" in the treaty. In addition to satisfying the definition of "resident", an investor who wishes to obtain benefits under the South Africa–US treaty also must meet the strict requirements of the limitation on benefits provision.

Certain residents have unrestricted access to treaty benefits, i.e.:

- an individual;
- a contracting state, political subdivision or local authority thereof;
- a legal person organized under the laws of a contracting state that is generally exempt from tax in that state under laws relating to charitable and other similar organizations;
- a legal person organized under the laws of a contracting state that is generally exempt from tax in that state, and is established and maintained in that state to provide pensions or other similar benefits pursuant to a plan, provided more than 50 per cent of the beneficiaries, members or participants are individuals resident in either contracting state.

All other persons are subject to the limitation on benefits provision.

a. *Companies*

In order to qualify for treaty benefits, a company must fulfil the following requirements.

A public company will qualify for treaty benefits if it qualifies as a South African resident, and all the shares in the class(es) of shares representing more than 50 per cent of the voting power and value of the company are regularly traded on a recognized stock exchange, or at least 50 per cent of each class of shares in the company is owned directly or indirectly by companies entitled to benefits under the above condition, provided that, in the case of indirect ownership, each intermediate owner is a person entitled to benefits under the above condition.

A recognized stock exchange means NASDAQ or an other national securities exchange registered under the US Securities Exchange Act of 1934, the Johannesburg Stock Exchange, or any other exchange agreed upon by the competent authorities.

The US tax authorities consider shares to be "regularly traded" if at least 10 per cent of the average number of shares outstanding during the year are traded during that year. Further, there must be trading of the shares on at least 60 days during the year.

There is no indication in the treaty that a taxpayer would be denied treaty benefits where it appears that such trade is or appears to be motivated chiefly to meet the rule.

Subsidiaries of public companies will qualify for treaty benefits if at least 50 per cent of each class of their shares is owned directly or indirectly by qualifying public companies, provided that in the case of indirect ownership, each intermediate owner is a person entitled to the benefits of the treaty.

A private company will qualify for benefits under the treaty if:

- on at least half the days of the taxable year, a person qualifying for benefits (described above) owns directly or indirectly at least 50 per cent of each class of shares or other beneficial interests in the company, provided that each intermediate owner in an indirect ownership chain is a person who is entitled to treaty benefits; and
- less than 50 per cent of the private company's gross income for the taxable year is paid or accrues directly or indirectly to persons who are not residents of either state, unless the payment is attributable to a PE situated in either state, where such payments are deductible for income tax purposes in the private company's state of residence.

A trust will qualify for treaty benefits if:

- on at least 274 days of the taxable year qualifying persons own directly or indirectly (through a chain of ownership in which each person is entitled to treaty benefits under this paragraph) at least 80 per cent of the aggregate beneficial interests in the trust; and
- less than 50 per cent of the trust's gross income for the taxable year is paid or accrues directly or indirectly to persons who are not residents of either state (unless the payment is attributable to a PE situated in either state) in.

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the form of payments that are deductible for income tax purposes in the trust's state of residence.

b. *Active trade or business qualification*

Where a resident of a contracting state does not otherwise qualify for treaty benefits it may qualify in respect of an item of income derived from the other state if it passes the active trade or business test. To qualify under this test:

- the imcome must be connected with or incidental to the trade or business; and
- the trade or business must be substantial in relation to the activity of the resident (and any other related parties) in the other state which is generating the income.

These qualifications must be met separately for every item of income derived from the other state. This means that a taxpayer may qualify in respect of one item of income but not another.

The US benefits under the treaty will not apply to any item of income in respect of which the combined South African and third jurisdiction tax is less than 50 per cent of the South African tax that would be imposed if the income were earned by the South African resident and were not attributable to the PE, where a South African resident derives income from the United States that is attributable to a PE in a third jurisdiction, and the South African resident is not subject to tax in South Africa on profits attributable to that PE. Interest or royalties to which this exclusion applies will be subject to a US tax at a rate of 15 per cent. However, this exclusion does not apply to the following:

- interest derived in connection with or incidental to the active conduct of a trade or business carried on by the PE, provided the business is not the making of or managing of investments where these activities are not banking or insurance activities carried on by a banker or an insurance company, respectively;
- royalties received for the use or the right to use intangible property produced or developed by the PE itself; and
- income derived by a South African enterprise if the United States taxes the profits of the enterprise under certain provisions of the US Internal Revenue Code.

16. Elimination of double taxation

The United States will grant US residents or citizens a credit against US tax in respect of the South African tax paid or accrued by or on behalf of a US resident or citizen; and South African income tax paid by or on behalf of a South African resident distributing company with respect to the profits out of which dividends are paid to a US company owning at least 10 per cent of the voting stock of the South African resident company. When a US citizen is a resident of South Africa, South Africa will allow as a credit the tax paid, if any, that the United States may impose under the treaty, other than taxes imposed solely by reason of citizenship, with respect to income that is exempt from US tax or subject to a reduced rate of US tax.

The United States will allow as a credit against US tax on the above items of income, the amount of South African tax paid after the above credit has been taken into account. This credit will not reduce the portion of US tax that is creditable against the South African tax.

The above items of income will be deemed to arise in South Africa to the extent necessary to avoid double taxation of such income.

US taxes paid by South African residents, other than taxes imposed by reason of citizenship, are deductible from South African taxes due. This deduction may not exceed an amount which bears the same ratio to the total South African tax payable as the income concerned bears to the total South African taxable income.

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SUB-SAHARAN AFRICA

CUSTOMS AND TRADE FACILITATION: CHALLENGES AND OPPORTUNITIES IN SUB-SAHARAN AFRICA*

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I. INTRODUCTION

Many countries in Sub-Saharan Africa (SSA) in the last decade have been undertaking structural adjustment programmes that have been leading to more open international trade environments.[2] At the same time, many of these countries are signatories to the new World Trade Organization (WTO) agreements,[3] and most are members of one or more regional integration agreement. These changes in the domestic, regional and international economic environment are being phased-in during the years leading up to the turn of the century. The 21st century will see Sub-Saharan African countries facing significant new challenges to their customs and trade facilitation systems. This paper aims to elucidate the changes in the economic environment, the adjustments already being undertaken in customs and trade practice, and the future challenges on the horizon and possible responses to these challenges. The spirit of the paper is that a challenge represents an opportunity for progressive improvement in government systems and operations rather than an excuse for closure or control of an economy.

The paper will outline some of the typical changes in the economic environment that have occurred in many African countries in the last decade. Kenya will be used as the basic reference case, but other examples will also be used. The effects of these economic transformations have already demanded changes in customs and trade practice. These will be outlined. Finally, the current and future challenges will be detailed and policy options will be discussed.

II. THE RECENT PAST

Many SSA countries have emerged from highly controlled economic environments that prevailed a decade ago. Aside from tariff protection, controls existed on the allocation of foreign exchange in conjunction with varying degrees of quantitative restrictions on imports through import licensing requirements. Restrictions were also placed on a range of exports. Controls were also common on capital outflows and profit repatriation, and on the types and financing of inward investment. In addition, a range of domestic consumer goods was subject to price controls. The combination of these effects resulted in domestic prices differing significantly from "world" or "border" prices, and the differences were not merely the result of import tariffs and other indirect taxes being passed onto consumers. Quantitative restrictions and price controls caused more complex patterns of domestic prices. With such controls and inward-oriented policies, trade facilitation in terms of improved trade finance or transportation facilities was of secondary importance to concerns about the distortional, rent-creating and delaying effects of the import licensing and foreign exchange allocation systems.

Customs procedures were also affected by this controlled environment. Cargo control and identification was assisted in one respect by the import licensing and foreign exchange allocation system. Valuation of imports tended to be more focused on domestic reference prices rather than on border c.i.f. prices arising out of international market forces. The Brussels Definition of Value (BDV) procedures permitted these practices. This reduced the need for customs administrations to maintain valuation databases reflecting "world" prices for different goods. It also reduced concerns about dumping or export subsidies – such threats to local industry were countered through quantitative restrictions and/or customs valuation procedures.

While well-designed and managed computerized information systems can contribute significantly to any trade or customs system, the controlled environments did not create pressing demands for sophisticated computer support for trade and customs administration. Privileged importers were rewarded for delays in importation through higher domestic prices.

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1. This paper has benefitted from the comments of N. Kirira and K.L. Muga of the Ministry of Finance, Kenya and participants at the Symposium on "Innovations in Trade Administration: Customs in the 21st Century". All responsibility for the views, errors and omissions in this paper, however, remains with the author.

2. This paper draws on the experience of the author working as a fiscal adviser over the past decade primarily in Kenya, but also in Lesotho, Malawi, South Africa and Zambia.

3. As of 25 October 1995, 31 out of 53 African countries were members of the World Trade Organization. See *Business Guide to the Uruguay Round* (1995), at 55.

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Volumes of international trade were also constrained; putting less pressure on port, transport and customs facilities. Manual systems prevailed and were manageable.

III. THE TRANSITIONAL PHASE

Over the past decade, most SSA countries have been undertaking more or less radical economic structural adjustment programmes. Generally, trade liberalization has been at the core of these programmes. This has meant the removal of price controls, and the elimination of quantitative restrictions on imports and foreign exchange allocations. In addition, import tariffs typically have been, or are being, reduced and rationalized. A shift to greater reliance on *ad valorem* tariffs in place of specific tariffs has also occurred. Inward-oriented policies have been replaced by more outward-oriented export promotion policies. Controls on exports, capital flows and inward investment are being relaxed. This has led to SSA economies being characterized as small open economies with prices being determined more effectively by world prices as they have opened up to trade and capital flows.[4]

This trade liberalization has been conducted in wider forums than the national economy. Regional integration agreements such as those under the Common Market for Eastern and Southern Africa (COMESA), formerly the Preferential Trade Area, the Southern Africa Development Community and, more recently, the revival of East African Cooperation have also been leading to the lowering of tariff and other barriers to trade between member countries of these trading blocs and also to plans for greater harmonization of tariff rates with respect to trade with countries outside of these regions. These agreements have also improved transit, transport and trade financing arrangements. The recent 1994 GATT and WTO agreements have also influenced this trade liberalization process, more particularly in the Southern African Customs Union (SACU), where South Africa's rejoining of the international community has required it to comply with the Uruguay Round of trade negotiations and start a radical lowering and restructuring of the SACU tariff schedule. By the early 1990s, the SACU import tariff schedule had become one of the most complex and protective in the world.[5]

This process of opening up trade and adopting more export-oriented policies has faced SSA economies with a number of challenges in trade and customs policy. The greater openness to trade has led to greater volumes of trade. For example, in Kenya trade and foreign exchange market liberalization was largely introduced during 1993. Comparing trade flows in the previous decade of 1983-1992 to 1993-1996, both exports and imports of goods had increased markedly by about 7 per cent of Gross Domestic Product (GDP), on average. This is similar to the experience of the rapidly growing countries of the East Asia and Pacific region. Comparing trade in 1994 to 1980, both imports and exports grew by about 9 per cent of GDP. SSA countries over this same period showed a decline in exports and a slight increase in imports.[6] The trade growth observed in Kenya and the East Asia and Pacific region represents the future experience of much of the rest of SSA as economic liberalization and growth take hold. This trade expansion in Kenya led to greater stress on air- and seaport facilities. Improved physical facilities and port management and related customs capacities have become imperatives as have improved road and rail systems to support the expanded trade.

The new open economic environment has placed new demands on customs operations. With the removal of quantitative restrictions and price controls, (i) the relevance of domestic prices as reference prices has declined as domestic prices are set by international market forces; (ii) cargo control assistance from the import licensing and foreign exchange allocation system has been lost, which puts more pressure on the cargo control systems for the ports, warehouses and transit systems; (iii) undervaluation, dumping and export-subsidization of imports have become more of a concern from the perspectives of revenue collection and import competition for the domestic private sector; and (iv) domestic industry demands have increased for more effective cargo control to prevent smuggling, and for more effective application of import tariffs as they form their only sources of import protection. This new environment clearly has faced customs administrations with both cargo control and valuation problems. Customs administrations which previously had relied to a large extent on domestic price references and which, at the same time, are located in information poor environments, faced an urgent need to get access to objective sources of international market prices as well as to improve their control capacities. What actions have customs administrations been taking in response to these challenges?

One set of strategies revolves around tariff structures. Lowering maximum tariff rates to discourage undervaluation or other customs frauds, and rationalizing the tariff rate structure with fewer duty rates to remove classification complexities and frauds have been used to complement strengthening customs administration. In addition, to protect against gross undervaluation of imports and dumping, minimum customs values can be set for sensitive import categories. Alternatively, the functional equivalent is to set alternative specific duty rates equal to the duty arising at the *ad valorem* rate on the minimum customs value. The higher of the *ad valorem* or alternative specific duty is then charged. These minimum duty techniques have been used.

General improvement in customs administration capacity forms the other element of the strategy to deal with the new challenges. Steps included: intensified use of computer systems; development of valuation databases; implementation of taxpayer identification number systems that allow movement towards more integrated control of all taxes; increased coordination with air- and seaport authorities to identify and control cargo entries; strengthening intelligence and investigation capacities, and so on. All these actions, however,

4. For a more detailed and less stylized description of the structural adjustments undertaken by SSA economies, see World Bank *Africa's Adjustment and Growth in the 1980s* (1989), *Adjustment in Africa* (1994) and *A Continent in Transition: Sub-Saharan Africa in the Mid-1990s* (November 1995).
5. For a comprehensive listing of regional trade agreements in SSA, see *International Trade Policies, The Uruguay Round and Beyond*, Volume II (1994).
6. *World Bank Development Report 1996*, Selected World Development Indicators, Tables 12, 15 and 16.

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require a number of years to develop, implement and raise customs administrations to more effective and efficient levels of performance. To fill the gap in the interim, therefore, a number of countries have converted pre-shipment inspection (PSI) contracts that previously focused on foreign exchange control to programmes that supported customs valuation and control. Some 24 SSA countries have PSI contracts to support customs.[7]

Pre-shipment inspection that aims to support customs has provided a number of important inputs during this transitional phase. Firstly, it fills the fundamental information gap concerning world or border prices of imports. Secondly, this flow of objective price information provides the raw material for assisting in building valuation databases for the future. Thirdly, the PSI information helps identify and control imports in an analogous fashion to import licensing. Fourthly, computerized PSI information systems support customs computerization. Customs functions are enhanced where all PSI information is transmitted to the domestic authorities in computerized formats. This provides for more rapid, secure and usable information which facilitates international trade flows; which supports the building of valuation databases, import identification and control systems, and management information systems; and which also helps build a computerized customs administration for the future.

The current policy environment and administrative responses to support trade facilitation and customs is a transitional phase. The policy directions already being taken and agreements already made will be facing many SSA countries with new challenges within the medium term that will demand policy, tax structure and administrative responses beyond those currently being implemented.

IV. NEW CHALLENGES

The economic environments facing many SSA countries that will demand further policy and administrative responses will include: (i) larger regional free trade or customs union arrangements along with generally lower and more harmonized external tariffs; (ii) compliance with 1994 GATT and WTO agreements by 2000; and (iii) economic growth in SSA will require, and will be accompanied by, expansion in both regional and external trade. This new economic environment will face countries with a number of challenges. Firstly, compliance with GATT transaction value rules raises demands on the valuation capacity of customs services and raises questions about the future role of PSI programmes. Secondly, exposure to dumping and compliance with 1994 GATT anti-dumping and countervailing procedures puts demands on the capacity of SSA customs administrations. At the same time, questions of the relevance and usefulness of these procedures to dumping situations in SSA countries are raised. This is important because SSA countries tend to have higher import duty rates on average than developed countries, which induces more undervaluation and "dumping" incentives to evade these high duties. Thirdly, new tax structure and administrative strategies need to be evaluated for all types of indirect taxes to cope with (i) the potential revenue losses of lowering both intra-regional and external duty rates; (ii) the changing role of export incentives for trade within and outside of duty-free regional trading blocs; and (iii) to contain export and transit fraud that can escalate in the context of increased and more open trade within duty-free regional trading blocs. Fourthly, to support and enhance the expanded trade flows that are required for expanded growth, the physical port and transport facilities, the financial instruments, and the information systems to control and facilitate trade (a "tradenet" system) will need significant development and strengthening. The first three categories of challenges are discussed in more detail below, while the need for improved information systems will be raised in the context of potential new or improved indirect tax structures and administrative strategies.

A. Valuation procedures

Trade liberalization and the prospect of adopting GATT as opposed to BDV valuation procedures by the year 2000 is posing the customs systems of many SSA countries with a significant challenge. As pointed out above, these countries are in the process of switching away from quantitative controls, domestic reference prices, specific duties, and manual systems to free trade, international or border prices, *ad valorem* duties, and computerized administrative systems. These countries are generally not well "plugged in" or integrated to the information systems of the developed countries so that ready access to price and other market information has not been integrated into their customs systems. Intelligence systems are rudimentary. Databases of detailed price information by country of origin, and product type and quality, are not well developed and maintained as routine customs procedures. To fill this information gap, a number of SSA countries have been paying a high price for information through pre-shipment inspection programmes. At a price of around one per cent of import values, PSI costs anywhere from two to six times the amount spent on customs administration, which typically falls in the range of three-quarters of one to two per cent of revenue collections. These figures assume that, on average, effective indirect duties and taxes will amount to some 20 per cent of import values.

The implications for an agenda of action by the SSA countries are therefore relatively self-evident. There is significant scope for the cost-effective transfer of information acquisition and maintenance from the PSI companies through investment in computer database systems, market information and other intelligence systems, and integrating this information into the regular customs examination and investigation procedures. The PSI companies are obviously well placed to assist in this development effort over the medium term.

Looking forward to the adoption of GATT valuation rules, what are the changes for customs valuation and the role of PSI in the SSA countries? Currently, for most imports there is probably no difference between customs values under

7. *Business Guide to the Uruguay Round* (1995), at 102.

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PSI/BDV procedures and those that would arise under GATT rules as the actual transaction values are used. PSI/BDV procedures, however, allow the SSA country to mandate that the PSI-determined value of the normal export price in the country of origin be used as the basis of the customs value – the PSI-determined value provides the minimum basis for customs valuation. This allows the SSA country to readily override any false documents undervaluing the import relative to the actual transaction price. (It is recognized that a by-product is that in some cases this may well overvalue the import relative to an actual arm's length transaction. This side effect has been viewed as acceptable relative to the benefits of avoiding large-scale and widespread undervaluation through false documentation, which undermines attempts to lower duty rates to gain greater economic efficiency and customs compliance.) Under GATT rules, however, the burden of the proof of any false declaration of an otherwise arm's length market transaction falls more heavily on the SSA customs administration. While the customs administration can challenge the "truth and accuracy" of importer values and the importer is obliged to substantiate the declared values, potentially costly and cumbersome quasi-legal procedures have to be followed to resolve a challenge. Ultimately, access to the exporters' books and records may be required to resolve a disputed invoice value. This means that two revenue risks are faced under the GATT valuation rules: one is the loss of the current occasional PSI overvaluation, and the other is the undetected, unchallenged or difficult to challenge under-declared transactions price. The latter has the larger potential for large-scale revenue losses.

This situation poses two questions. One, will SSA country customs services be adequately prepared to detect and challenge under-declared transactions values when they switch to GATT rules? The other, will there be a cost-effective role for PSI companies to assist in the detection and challenge of under-declared transaction values? It is evident from the cost figures for the current costs of PSI and customs administration, that there is considerable scope for strengthening customs capacity in valuation procedures such that they would be in a stronger position to detect and challenge undervaluations under GATT rules in the medium term. It is a matter of governments making the effort, possibly with donor assistance, to build up this customs capacity in the medium term. Clearly, current PSI contracts should have a stronger development bias as well. Doubts remain, however, about the ability of SSA customs services to cost-effectively challenge undervalued import invoices.

The transaction costs of mounting a challenge, including administering quasi-legal procedures and possibly gaining evidence from the exporting country and/or exporting business, will be high relative to the resources of SSA customs administrations. Most SSA countries are small, low income (below USD 1,000 per capita), developing countries. Concerns also arise about the delays caused by the required quasi-legal dispute resolution process and the ability to sustain the integrity of such a process.[8] In cases of small shipments, the transaction costs of the required dispute resolution process would be unacceptably high while, in the case of large high-duty shipments, the integrity of the process could be put under severe pressure. Most successful customs reforms in SSA countries have aimed to minimize or limit any discretion in the customs valuation and release procedures. The further requirement to release goods under bonds while disputes are being resolved is only credible where the bonds are enforceable. This also is not generally the case in SSA countries. It would probably be preferable in terms of lower customs costs and trade facilitation to allow developing countries to fall back on market values of the "identical" or "similar" goods from the exporting country where they are not satisfied with the importer's defense of a declared transaction value.[9] Such a system would deal with most cases in a less costly, simpler, non-discretionary, rapid, objective and reasonably fair manner.

Whether a cost-effective customs support role for PSI companies can be formulated under GATT rules is an open question. Such a formulation will likely require identifying more limited and targeted PSI roles in terms of countries of origin, sizes of shipments, and types of goods to increase the probability of significant customs revenue pay-offs from a PSI programme. Alternatively, this role could be a combination of: (1) random post-release inspection (with reference to exporter and country of origin prices) as a form of "quality control" on domestic customs; and (2) on-demand supply of market price information from the exporter and/or country of origin to back up domestic customs efforts to detect and challenge under-declared transaction prices. Another role could be the detection of actual or potential export subsidies to assist in the application of countervailing duties as discussed further below. If developing countries could more readily fall back on the market value of the same or similar exports under GATT valuation rules where importer-declared transactions were challenged by customs authorities, then at clearer, if more limited role would remain for PSI-type activities to supply market values in the country of export.

B. Anti-dumping and countervailing duty capacity

As international trade has become more liberalized, concerns about exposure of domestic import-competing businesses to dumping and export subsidies has increased. This concern is sometimes more intense in a small developing country where the manufacturing industrial base is weaker and more fragile. The nature of dumping experienced by the small economies of SSA, however, tends to be different from that of large economies. Predatory pricing-dumping to capture a market share is not typically found in SSA. Few exporting companies, outside of possibly brand-dominated markets such as beer and cigarettes, would be interested in undertaking any systematic under pricing to capture market share of the very

8. Under the 1994 GATT valuation procedures, the importer is meant to have the right to clear goods subject to provision of a security bond to facilitate trade while a valuation dispute is settled. The difficulty of enforcing customs bonds in many SSA countries throws doubt on the effectiveness of this requirement.

9. It is recognized that for specialized "non-commodity" goods the deducted value, computed value or fall-back methods in the hierarchy of valuation methods under the GATT valuation rules may have to be used to challenge a suspect transaction value, but these would be more the exception than the rule for the bulk of imports.

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small SSA country markets. On the other hand, poor consumers are more price-sensitive than brand- or quality-sensitive. Hence, SSA countries are target markets for off-loading excess inventory of "out-of-date" or "out-of-fashion" (but still functional) models at fire-sale prices that are clearly below their costs of production. Where there are no competing domestic industries, these low-priced goods are of obvious benefit to the poor consumer. But where the local industry cannot compete with such below-cost-of-production imports, then the importing country faces a trade-off between the benefit to the consumer and the cost to the domestic producer. Where the injury to the producer is dominant, the target of any anti-dumping action, however, is often elusive because the dumping is not systematic, but more random. For example, inventory-clearing sales of radios or television sets could be undertaken by different companies in different countries at any point in time. These inventories may even be cleared by dealers in countries other than the country of origin of the radio or TV. Hence, the dumped products and countries of origin can be changing continuously and the volumes from any one export country or supplier may well not meet the three per cent of imports *de minimis* rule, but collectively from all sources such imports may form a significant share. Detecting and determining dumping is always a time-sensitive exercise, and systematic predatory-pricing dumping gives a more well-defined and persistent target for detection and determination. By contrast, the more rapid-fire and unpredictable nature of inventory-clearing dumping does not provide the luxury of time to detect and analyse the import pricing. This makes the application of anti-dumping procedures and duties (even if provisional duties are used) costly, administratively difficult, and therefore improbable.

Export subsidies are also of concern to SSA countries. These may be subsidies on manufactured exports and may, for example, arise from income tax exemption for export-related income as offered by India, or explicit export subsidies such as those under the General Export Incentive Scheme (GEIS) in South Africa. Subsidies on agricultural exports, such as the export subsidies of grains and other foodstuffs by developed countries to deplete surpluses arising from domestic farmer price or income support programmes, have also raised serious concerns in SSA countries where the agricultural sector is still the backbone of most economies and the major source of livelihood to the majority of the population. Outside of emergency aid situations caused by drought, war, civil strife and the like, subsidized food imports can disrupt or hold up market-based agricultural development through depressing domestic crop prices – a case of short-term gain for long-term pain. If these export subsidies were stable over the longer term, they could be regarded as a predictable structural feature of the transfer-and-price system faced by SSA countries. They are not stable, however, as illustrated by the sudden retraction of grain subsidies in 1995 as a grain shortage emerged in the international markets which led to exaggerated and sudden increases in domestic grain prices as both subsidies disappeared and world prices increased. These subsidies suddenly reappeared in the latter part of 1996 as grain prices fell again with increased world production.

The difficulty and cost of determining the size of an export subsidy can vary. Where explicit export subsidies exist such as under the South African GEIS, or the grain export subsidies offered by the United States from time to time, the detection and determination is straightforward. It can be complex, however, where the subsidy is more indirect. For example, the value of an income tax exemption on exports can vary from industry to industry depending on their typical profit margins. It can also vary from company to company depending upon the exact tax rules of the country and the tax situation of the company. For example, a company may make large actual profits from exports, but be in an overall tax loss position and, hence, not be able to benefit from the exemption until all the tax losses have been absorbed. Other cases of indirect subsidies can arise through market pressures to compete with explicitly subsidized goods. For example, when the United States offered subsidies on wheat exports, the wheat marketing boards of other smaller wheat exporting countries may have been obliged to offer similar discounts to export surplus wheat. No explicit documentation would be available to substantiate such a "competitive" subsidy on any particular export sale.

When SSA countries complain about damage to domestic industry being caused by dumping or export subsidies, they are typically advised to adopt the legal and administrative measures contained in the 1994 GATT and WTO agreements. These measures have generally been drawn up by developed countries to deal with the trade and protection problems they face and are built on the administrative capacities they possess. This leaves the SSA country with two difficult problems. Firstly, outside of systematic export subsidies, the typical dumping situation differs from that more commonly faced by developed countries. The more random, one-off and rapid-fire nature of dumped goods entering SSA countries is not suited to the recommended systematic detection, determination, and anti-dumping duty remedy targeted at specific companies and/or countries of origin. Secondly, most SSA countries do not have the capacity to implement the determination and remedy procedures required under GATT and WTO agreements. The determination of dumping or export subsidies requires sophisticated outreach into exporting countries to determine the existence and extent of the subsidy or under-pricing of dumped goods. Most SSA countries are still working towards establishing modern effective and efficient customs services in their own countries. The resource demands of establishing the world-wide reach required to determine the extent of dumping and export subsidies in addition to the costs of domestic reforms would exceed the resources available to most SSA countries.

What are the potential solutions to this problem? Firstly, the WTO should undertake a review of its recommended anti-dumping and countervailing duty procedures to determine their relevance and cost-effectiveness in the small, low-income, developing countries adopting liberalized trade regimes. Secondly, there should be reconsideration of the use of crude, but cost-effective measures such as alternative specific duties set at low rates to protect against gross undervaluation in sensitive product groups. (The effective duty rate would have to be capped at or below the bound import duty

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rates for the commodity.) Such measures are automatic and independent of origin of the goods and, therefore, overcome the timing and capacity problems of regular anti-dumping procedures already outlined above. Thirdly, the valuation procedure for fall-back on the value of the identical or similar goods recommended to resolve valuation disputes would also minimize the anti-dumping determination problem. Determining whether an invoice is falsely undervalued below the actual transaction cost, or is the true transaction cost but is below the normal price in the export market, essentially faces the customs administration with a similar problem of acquiring information about the exporter's costs and the export market prices. Therefore, the export market price for the identical or similar goods approach effectively deals with both the valuation and the dumping problems. Fourthly, consideration needs to be given to the development of dumping-determination support services either through contracting out to private sector companies with such skills, or through some intergovernmental cooperation amongst developing countries to overcome the high costs involved in investigating and determining the existence of dumping or export subsidies. Changes in international agreements may be required to legitimize either approach, i.e. to grant investigative powers and/or to facilitate the cooperation of authorities in the exporting country so as to gather the necessary price and cost evidence.

Failure to take action to support small developing countries to handle valuation, anti-dumping and countervailing measures in a cost-effective manner is expected to undermine the political resolve of such countries to sustain trade liberalization and other economic reforms. It is, in fact, exactly those countries that are making the strongest efforts to liberalize their economies that need the support of cost-effective WTO agreements and procedures in order to sustain their trade liberalization programmes in the face of the inevitable domestic opposition demanding higher protection because of undervaluation, dumping or export subsidies.

C. New indirect tax structures and administrative strategies

Currently, two major areas of indirect tax evasion in SSA countries are export fraud and transit fraud. In both cases, the source of the problem arises from allowing tax-free movement of goods within a country. In the first case, domestically supplied goods declared for export may move undutied from the supplier to the port of export and, in the second case, imports declared for transit move undutied from the port of import to the port of export. False declarations and fraudulent documents can be used to divert "exports" and "transit goods" into the domestic market without the payment of duties and taxes. These problems are exacerbated in the case of goods subject to high duty and tax rates which increase the pay-offs from tax fraud. Excisable goods such as alcohol, tobacco and oil products are often subject to high tax rates and therefore are common targets for export and transit fraud.

Export fraud is achieved through falsely documented claims for "exports" or through "round tripping" – goods are actually exported, but then smuggled back into the country without paying duties and taxes when they are reimported. Transit fraud is essentially the same. Transit imports are diverted into the local market through various types of document falsification. These include failure to declare all goods in a transit shipment or gaining false certification that the goods have been exported. Transit fraud opportunities are high within SSA because of the large number of landlocked countries in SSA which have to rely to a large extent on overland transport with some seaports.[10] This high incidence of landlocked countries also opens up opportunities for export fraud especially where round tripping is used to reimport goods.

The establishment of duty-free regional trading zones exacerbates export and transit frauds. Export and transit fraud becomes simpler through intra-regional exports when import duties on intra-regional trade are removed, and border controls on intra-regional trade are relaxed to promote intra-regional trade. On the other hand, intra-regional cooperation can be strengthened to allow more effective controls on export and transit flows and/or new cooperative indirect tax structures, and administrative strategies can be used to deal with export and transit frauds. Such improvements in duty and tax administration are important to help offset the potential revenue losses of lowering both intra-regional and external duty rates as part of trade liberalization efforts. In addition, the creation of duty-free regional trading blocs requires changing the role of export incentives for trade within and outside of duty-free regional trading blocs. These issues are discussed below first for indirect consumption taxes, and then for import duties and export incentives.

1. Consumption taxes

In analysing alternative indirect consumption tax structures and administrative strategies, the combination of a broad-based VAT using the credit or invoice method in combination with a single-stage selective tax, such as the excise duty, is used to illustrate the operation of different tax structures and administrative strategies. Typically, to support exports and investment, these taxes are destination- or domestic consumption-based. That is, they fall on domestic production plus imports minus exports.

The typical tax structures to remove taxes from exports are zero-rating of exports under a VAT, and duty exemption under an excise duty. The main attraction of zero-rating and exemptions on exports is that the costs of the exporter are lowered making the exports more competitive in world markets. Even if it is required that bond security be posted on the potential tax revenues to discourage tax fraud through diversion of undutied goods into the domestic market, these approaches still rely heavily on the ability to confirm exports and to enforce or cancel bonds. Bonds are ineffective if false documentation can be obtained, "certifying" goods have been exported, or if arrangements can be made for documents to disappear from files. In the case of intra-regional trade, regional cooperation in revenue enforcement can be used to

10. Africa has 53 countries out of which 6 are island states. Excluding the 5 North African countries, Sub-Saharan Africa has 42 mainland countries. Landlocked countries form 14 or 30 per cent of the 42 SSA mainland countries.

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counter these frauds. For example, the importing country can inform the exporting country that the goods, in fact, had been entered through sharing of import documents (manually or, preferably, electronically). Bringing the importing country into the administrative system brings a third party into the control system that makes corruption and fraud an order of magnitude more difficult.

All alternative strategies essentially operate by disallowing tax- or duty-free movement of goods while effectively still ensuring the zero-rating of exports under a VAT or the exempting of excise duties upon export. The key to the increase in control is the avoidance of the problems of having untaxed goods move within the country. If duty and taxes can be charged at the point of supply and then be refunded in some manner following export, then the temptation to divert export goods into the domestic market is reduced. Tax authorities are then forced to actively participate in tax fraud through false refunds rather than merely passively permitting tax fraud where goods move untaxed. Obviously, any switch to a pay-first, refund-later approach results in higher financing costs for exporters, and should only be used if the revenue risk is otherwise high, or the improved revenue collections can allow offsetting lower tax rates that result in lower costs to the exporter and lower efficiency costs to the economy from tax revenue collection. Three alternative structures are discussed for avoiding the untaxed movement of goods, especially in intra-regional trade. The three methods require increasingly higher levels of regional integration and co-operation.

a. *Tax refund system*

Under a tax refund system for exports, all sales are subject to VAT or excise duty, as the case may be, irrespective of whether the sale is to a domestic person or an export. Zero-rating under a VAT is then achieved by allowing a refund or offset of the VAT against other tax owing, after export has been confirmed. Similarly, under the excise duty, the duty collected from a sale can be refunded or offset upon confirmation of the export. This method raises the problem in the case of a manufacturing-level excise duty where the manufacturer sells to a trader who then exports. In this case, the manufacturer can only recover the excise duty if the trader supplies the manufacturer with proof of the export. To maintain the export incentive, the manufacturer has to either sell at the net-of-duty price and finance the duty until proof of export is received, or sell at the gross-of-duty price and require the trader to finance the duty until it is refunded. In either case, the financing of the duty or VAT does raise the cost of the export. A major advantage, however, is that the system can be run unilaterally. It does not necessarily require the cooperation of the importing country, though clearly, confirmation of receipt of the goods by the importing country strengthens the controls under this refund system.

b. *Bilateral transfer system*

A bilateral transfer scheme involves an agreement between two countries whereby the exporting country credits the importing country for the VAT and/or excise already paid on an export. This means that VAT or excise duty is charged on the sale in the exporting country as on a regular domestic sale. When the goods are exported, the importing country claims a tax credit or transfer of funds based either on import documents, or evidence of tax-paid purchase by a domestic business from an exporting country business. The former customs-documented claim would be the normal procedure where the two countries would still maintain customs control between the two countries, while the latter would be used where a "borderless" customs union or economic union has been established. South Africa is working to establish a customs-certified bilateral transfer system with the other members of the Southern African Customs Union for VAT and sales tax on intra-SACU trade. The implementation of this system is aimed to control major export VAT fraud that has arisen through false zero-rated exports from South Africa to the other SACU member countries. Arrangements are already being established between Lesotho and South Africa.[11] A borderless system is being attempted within the European Union.

A credit-method VAT works most smoothly with a bilateral transfer system where all traders in both countries are registered for VAT. In such cases, the importer merely has to make an input tax claim for the VAT paid in the country of export from the importing country's tax authorities, which, in turn, claim a VAT transfer from the exporting country. A number of added features have to be considered in bilateral transfer systems, however, where differing tax rates apply and exempt importers are involved and the like. A general structure, however, can deal with all situations. The importing country gives a credit or refund for any VAT or excise duty paid in the exporting country against any VAT or excise duty that would otherwise be charged on the import. If the import country tax rates are lower, or if the importer is exempt, a refund is paid by the importing country to the importer. If the importing country tax rates are higher, then the excess tax or duty is collected upon importation. In all cases, the importing country claims a transfer of the taxes or duties paid in the exporting country.

Bilateral transfer systems offer a potential solution to reduce export fraud. They reduce the incidence of VAT- and duty-free potential exports moving through a country. They demand good information systems be established between cooperating countries. They are also only suitable where bilateral agreements can be established, as would likely be the case between regional trade partners within some type of regional integration area. The administrative burden could also be justified in cases of high-tax-rate goods, such as excisable goods, because of the potentially high gains from reducing export fraud. Bilateral transfer systems, however, cannot deal with exports to all other countries. To reduce export fraud on sales to these extra-regional countries, tax and export credit systems such as already discussed above

11. See Glenday, Graham (1994), "The Design of Bilateral Direct Transfer Schemes between Lesotho and the Republic of South Africa", Harvard Institute for International Development, Development Discussion Paper No. 487, Taxation Series No. 20, for an early discussion of the bilateral transfer scheme between South Africa and Lesotho.

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can be used to fill the gaps, especially for exports of goods normally otherwise subject to high VAT and/or excise duty rates.

c. *Joint pooled collection system*

Where a customs or economic union has been established, joint collection can be considered, especially where the same VAT and/or excise duty rates are charged across the region. Joint collection means that all taxes and duties from domestic sales and imports (from outside the region) are combined into one pool which is then shared out across countries in the region according to their share of regional consumption (domestic production plus imports minus exports). The sharing of the pool across countries requires measurement of both intra- and extra-regional trade in order to measure each country's consumption. Ideally, all VAT exempt, or zero-rated and duty exempt, consumption in a country should be excluded from determining its share of the revenue pool.[12] While this method deals very effectively with reducing fraud in intra-regional trade, it does not deal with trade with extra-regional countries. Here again, the tax and credit method for dealing with exports to extra-regional countries would need to be considered to fill the gaps.

2. Imports and transit trade

The basic transit control device commonly used relies on bond security on the tax and duty potentially payable on the goods if they were imported. This bond is cancelled upon confirmation of export of the transit goods. Transit fraud essentially is achieved by falsification of transit import and/or export documents. As with the control of domestically produced exports discussed above, the importing country can assist in certifying entry of goods. This cooperation is easier to achieve for intra-regional trade within some bloc of countries under a regional integration agreement. Regional cooperation can be used to strengthen transit control by having the neighbouring country informed of the importation of all transit goods. This strengthens the basis for cancelling the bond.

As with consumption taxes, import duties can be protected by reducing the opportunities for duty-free movement of goods. This can be achieved by requiring transit goods to move duty paid within a duty-free trade zone or between countries with cooperative trade agreements. Two possible structures include either a cooperative agreement being established to collect import duties for all countries within a region, but keeping separate accounts for each country, or a joint pooled import duty collection being undertaken under a customs or economic union arrangement.

A cooperative collection agreement would require collection of import duties by any member country on behalf of any other member of the region. Import duties would then be transferred to the country of destination once confirmation of receipt of the goods in transit has been received by the country of first importation which collects the duty. To improve revenue flows, partial prepayment of the duties could be made to the destination country upon collection when the goods are entered in transit, and final payment could be made once confirmation of transit importation is received from the destination country. If the goods are diverted into the domestic economy, then the duty is reallocated to the domestic country revenues with adjustments reflecting differing import duty rates between the countries. This approach would require an international tax treaty between countries within the region as well as cooperation between the tax administrations. This approach could be applied whether or not a common external tariff exists for the region.

Joint collection of import duties within a region normally requires a common external tariff across the member countries of a regional trading zone in order to avoid trade diversion and to facilitate sharing of the pooled revenues. This type of arrangement would be found in a customs or economic union. The revenues could be shared based on the shares of each member country of total imports from outside the region. To take into account different import duty rates, the pool could be divided by revenues coming from the different import duty rate bands. Duty-free and exempt imports could be excluded from any account of total imports. A further sophistication could be the recognition of imbalances in trade between countries within the region. Countries that are net importers in intra-regional trade should receive a higher share of the revenues in order to capture either the forgone revenues of not charging import duties on intra-regional imports, or equivalently to recognize the net rents of protection that are effectively transferred to the exporting businesses in the net exporting country. Under the SACU arrangements, for example, South Africa gives a higher share of the pooled import duty revenues to the BLNS countries (Botswana, Lesotho, Namibia and Swaziland) to reflect their net importer status with respect to South Africa.[13]

As an aside, it is of interest to note that the general strategy of avoiding the duty- and tax-free movement of exports and goods in transit, as presented above, should also contribute to containing another endemic customs problem that plagues SSA countries. This is the problem of the many uncontrolled borders within the SSA region arising from the high costs of maintaining adequate customs controls at low volume ports of entry and along the extensive unguarded boundaries between SSA countries. This situation sets up opportunities for informal uncontrolled cross-border trade. This may often be barter trade or, during earlier periods of price and other controls, trade motivated by over- or undervaluation of exchange rates, or control-generated shortages. Most imports from outside of the SSA region, however, tend to enter the region through some major air- or seaport. This external trade also forms more than 90 per cent of total recorded trade.[14] Hence, if all goods in transit were duty- and tax-paid; if most

12. If all goods are subject to the same VAT or excise duty rate, then total consumption of goods can be used to measure consumption shares. Where different tax and duty rates are charged across goods, either it can be assumed that the same average consumption bundle is consumed in each country sharing the pool, or separate pools can be established for each positive tax or duty rate. In the former case, goods subject to any discretionary exemption should be excluded from the consumption bundle.

13. Since 1969, the BLNS countries have received a share of the import duty pool that is 1.42 times larger than their share of imports from outside of SACU.

14. International Monetary Fund, *International Trade Policies* (1994), Appendix X.

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intra-regional trade was duty-free with the full implementation of the large free trade zones such as under COMESA; and if most domestic exports were moved across borders with consumption taxes paid, then uncontrolled cross-border trade would be reduced in fiscal significance. Where any sharing of a revenue pool is involved that includes intra-regional trade in the sharing formula, however, the failure to capture the value of cross-border trade may cause significant biases in revenue sharing.

3. Export promotion programme

Export-led growth has become a core component of many countries' economic adjustment policies. A key feature of such policies is to give export producers access to inputs at world prices to allow them to compete when they only receive world prices for their outputs. This is typically achieved through either a duty drawback programme (such as that offered by Malawi since the late 1980s) or a duty exemption programme (such as that offered by Kenya since the early 1990s) for the inputs used to produce exports. Without such programmes, export producers face *negative* effective protection. When duty-free trade regions are created, however, exports between countries within such a region enjoy the higher prices created by the protection arising from the tariffs on imports from external countries. Unless the export product has a duty-free external tariff, the product will likely benefit from *positive* effective protection for any sale *within* the region. Therefore, where such duty-free trade areas are fully implemented (whether as a preferential trade area, customs union or economic union), the duty drawback or exemption programmes need to be modified to restrict them to only support external exports. Maintaining them for protected intra-regional exports will result in effective subsidies for these exports rather than serving the function of neutralizing negative protection on exports. SSA countries within COMESA, and more especially those signatories of the Cross Border Initiative, are now rapidly approaching a state of free intra-regional trade. Accordingly, those countries with duty drawback or exemption programmes for exports should be bringing amendments within the next few years to restrict these to producers of external exports or duty-free products.

V. CONCLUDING REMARKS

Many SSA countries are and will be facing new economic environments. The features include more open and liberalized economies, wider regional trade arrangements deepening trade cooperation and duty-free trading areas, and obligations to fully comply by the year 2000 with the 1994 GATT and WTO agreements, particularly the GATT valuation procedures and the full anti-dumping and countervailing duty procedures. These countries are also experiencing significant problems with export and transit fraud, which are expected to escalate as intra-regional trade grows.

While SSA countries have been adapting their trade and customs systems to deal with higher volumes of trade and to control customs more effectively, it is expected that full compliance with the GATT transactions valuation and anti-dumping procedures will not be feasible or cost-effective in the SSA context. The costs of the required outreach to exporting countries to confirm transaction prices and dumping margins are beyond most SSA countries' resources. The quasi-legal procedures for resolving valuation disputes are likely to be costly and open to abuse. Cheaper, simpler, non-discretionary, yet objective and reasonably fair methods are required for SSA countries in order that they can sustain their economic liberalization programmes while dealing with the trade-offs arising from tariff reductions between revenue demands, domestic protection lobbies, and customs fraud often induced by high duty rates. While customs and trade systems are being developed and strengthened, and also supported by pre-shipment inspection programmes, it is not expected that they will have the administrative capacity and financial resources by the year 2000 to fully comply with 1994 GATT and WTO valuation and anti-dumping procedures which are aimed more at greater fairness in developed country trading than in supporting economic reform in developing countries.

It is suggested that WTO undertake a review of its recommended anti-dumping and countervailing duty procedures to determine their relevance and cost-effectiveness in the small developing countries adopting liberalized trade regimes. Firstly, consideration needs to be given to encouraging and designing the use of crude, but cost-effective measures such as alternative specific duties set at low rates (and effectively subjected to the bound rates) to protect against gross undervaluation in sensitive import categories. Such measures are better suited to the random, rapid-fire inventory-clearing type dumping faced by SSA countries. Secondly, disputes over the under-invoicing or dumping prices could be settled, where possible, by reference to the identical or similar goods prices in the export country market rather than by complex and costly legal procedures between the importer and customs service. Thirdly, the possibility of developing dumping-determination support services to operate on a fee-for-service basis, to lower the costs to developing countries of investigating and determining the existence of dumping or export subsidies, needs to be explored and developed.

To contain the common problems of export and transit fraud in SSA, new tax structures and administrative strategies are possible in the context of the regional free trade zones that are in the process of being established. Aside from strategies of intra-regional cooperation, such as making use of neighbouring countries' import documents to certify exports of domestically produced or transit goods, tax structures that reduce the incidence of duty- and tax-free movement of goods, and hence the possibility of export and transit fraud, are presented. These structures include refund or credit structures for taxes on exports; bilateral transfer schemes for collection of consumption taxes; cooperative import duty collection arrangements; and joint pooled collection arrangements for import duties and consumption taxes. While these schemes often require some increase in administrative effort, they are particularly important to control high-tax-rate goods such as excisable goods. At a minimum, one of these schemes should be applied selectively to excisable goods. The revenue gains can in part be used to lower duty and tax rates in order to reduce the non-compliance incentives.

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LATIN AMERICA

THE LATIN AMERICAN APPROACH TO THE CONCEPT OF PERMANENT ESTABLISHMENT IN TAX TREATIES WITH DEVELOPED COUNTRIES*

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I. INTRODUCTION

The primary effect of the Permanent Establishment (PE) concept is that it is a decisive condition determining the taxing jurisdiction of income from business activities.

By including the PE article in their tax treaties, countries with an income tax system based on the source principle agree not to tax business income from domestic sources derived by non-residents who lack a "fixed place of business therein".

This is why developing countries have historically made significant efforts in order to widen the PE definition so as to extend their tax jurisdiction on business profits. The works of the former League of Nations and later the United Nations are the most significant examples of these efforts; particularly, the Mexico Draft and the United Nations Model Convention (UN MC).

Taking into account that the UN MC was specially intended to serve the interests of developing countries one would expect that these countries are actually following the patterns set forth in the UN MC.

This paper aims at ascertaining the way that developing countries in Latin America have addressed the notion of PE and particularly the extent to which they are following the UN MC in this matter.

The Latin American approach to the PE concept has been analysed by examining the existing double tax treaties concluded by ten countries which, according to the material upon which this paper is based, are to date the only Latin American countries involved in such treaties. These countries are: Argentina, Bolivia, Brazil, Dominican Republic, Ecuador, Mexico, Peru, Uruguay and Venezuela. Only the treaties concluded up until December 1997 have been considered. Some of the examined treaties are not yet in force.

Only treaties with developed countries have been analysed. For such purpose, the developed character of the treaty partner is determined by reference to whether it is currently a member of the OECD. For technical purposes, Mexico is treated as a developing country regardless of its OECD membership.

II. OECD MC AND UN MC DEFINITIONS

A. Historical background

Real efforts to produce a model convention for the avoidance of double taxation date back to 1921. A Committee comprised of four prominent economists[1] was appointed by the Financial Committee of the League of Nations to conduct a study into this matter. A report was produced in 1923, which was followed by a deeper revision conducted by a panel of technical experts.[2] This work led to the drawing up in 1928 of the first model bilateral convention.

A further revision was undertaken by a Sub-Committee which met at the Hague in April 1940 and was continued by two regional tax conferences held in Mexico City in June 1940 and July 1943. This Sub-Committee, which due to the advent of the Second World War was mostly composed of representatives from Latin American countries, drafted the "Mexico Draft" of 1943. Not surprisingly, its provisions were shaped according to the interests of these countries. Under the Mexico Draft, business profits could be taxed by the source state regardless of the existence of a PE, provided that the relevant activities did not merely take the form of isolated or occasional transactions.[3] This solution shows the origins of the Latin American policy towards the PE definition.

However, the approach was later reversed in the "London Draft" of 1946, which reflected the position of the industrialized countries. Contrary to the Mexico Draft, the London Draft requires that an enterprise should have a PE in a country for it to become subject to the income tax law of that country.[4]

* This article is a short, revised and updated version of a long essay submitted by the author in 1995 as part of the Law Master Program (LL.M.) of the University of London.

1. Bruins (Rotterdam), Einaudi (Turin), Seligman (New York) and Stamp (London).
2. The panel was originally comprised of experts from seven European countries: Belgium, the former Czechoslovakia, France, Great Britain, Italy, the Netherlands and Switzerland.
3. Arts. IV(1) and IV(2) of the Mexico Draft.
4. Arts. IV(1) and IV(2) of the London Draft.

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From another perspective, efforts by the OEEC (hereinafter OECD) in this matter date back to the second post-war period. In view of the increasing economic interdependence and cooperation of the member countries of the OECD during that period, the need for a model convention for the avoidance of double taxation was addressed by the Fiscal Committee. This led to four interim reports being prepared between 1958 and 1961 and the submission in 1963 of the "Draft Double Taxation Convention on Income and Capital" (hereinafter: OECD MC). A further revision resulted in the publication in 1977 of a new model convention.

In 1980, the United Nations finally published its "Model Double Taxation Convention Between Developed and Developing Countries" (hereinafter: UN MC), which was intended to serve as a model treaty more suitable to the needs of developing countries. The UN MC reproduces a significant part of the 1977 OECD MC. Its content, however, differs from the OECD MC in several aspects. One difference is the treatment of business profits and the definition of PE. The OECD MC was finally published in its current format in 1992 and has been modified since on a yearly basis.

B. The difference of approaches

The historical background of each model convention explains the difference of approach that each takes towards the PE definition.

The PE definition is found in Article 5 of both model conventions and it may be divided in four parts: (1) a "basic rule" comprising the main features of the concept, i.e. "a fixed place of business through which the business of an enterprise is wholly or partly carried on"; (2) a list of examples that might be regarded as constituting a PE; (3) a list of exceptions or exclusions, i.e. certain activities or fixed places of business that do not constitute a PE; and (4) the typical PE fictions, i.e. the construction activities and the agent's activities (OECD MC and UN MC) and consultancy services and activities of insurance companies (UN MC only).

Article 7 of both model conventions contains the rules on business profits and allocates tax jurisdiction to the source state provided that the non-resident has a PE therein. In such a case, under the OECD MC, the profits of the non-resident may be taxed in the source state but only so much of them as is attributable to that PE. This rule is relaxed in the UN MC by including the restricted "force of attraction" principle according to which profits from direct sales and other business activities derived directly by the non-resident enterprise are also attributable to that PE. The principle is said to be a "restricted" one because the rule does not apply to all kinds of sales or activities effected by the non-resident, but only to those of the "same" or "similar" kind to those effected through the PE.

Although the structures of Articles 5 and 7 are very similar in both model conventions, the UN MC differs from the OECD MC in that it broadens the PE definition. This is achieved mainly by enlarging the scope of the typical PE fictions (construction and agent's activities), by inserting new fictions (consultancy services and insurance companies), by reducing the list of exceptions (excluding delivery activities and combined excepted activities) and by adopting the restricted force of attraction principle.

III. OVERVIEW OF THE HISTORY OF LATIN AMERICAN TAX TREATIES

A. Predominance of the territoriality principle

Most countries in Latin America have historically based their tax systems on the principle of territoriality. Although the situation has changed[5] in the last decade, a long tradition of domestic legislation based on this principle had a negative effect on the expansion of these countries' treaty networks.

Unfortunately, for a long time these countries viewed tax treaties as a threatening device that would prevent them in many cases from exercising the tax jurisdiction to which they were entitled under their domestic legislation. This partly explains why their activity in this field was virtually insignificant until the 1970s.

In addition, from a regional point of view, the territoriality principle was long considered to be the best method to avoid double taxation. This position is clearly reflected in Decision 40 of the former Andean Group (now Andean Community).[6] Decision 40 has two parts: a multilateral tax treaty to which all member countries are signatories (Annex 1), and a model tax convention to be used by member countries when concluding tax treaties with third countries (Annex 2).[7]

In general, both the multilateral tax treaty and the model convention allocate tax jurisdiction to the source state. This is the case with regards to business profits which are exclusively allocated to the source state regardless of the existence of a PE. Paradoxically, there is a definition of PE in the model convention. However, its purpose is merely to emphasize the source rules.[8]

The criteria adopted in Decision 40 has been strongly criticized during this decade by tax specialists of the Andean Community countries. Within the context of the XV Latin American Congress on Tax Law, held in Caracas in 1991, it was pointed out that "unless the source rules are the same in all countries concerned, the practical results may be incompatible with the territorial theory".[9] On these grounds, it was further stressed that the source principle had in practice proved only partially effective in eliminating double taxation within a regional context. The fact that source rules vary in each country and that even uniform rules are usually not pre-

5. The following eight Latin American countries currently have an income tax system based on worldwide income: Argentina, Brazil, Colombia, Chile, Ecuador, Honduras, Mexico and Peru.
6. Adopted by the Commission on 16 November 1971. It entered into force on 18 June 1980 and is effective as from 1 January 1981.
7. Member countries of the Andean community are currently Bolivia, Colombia, Ecuador, Peru and Venezuela.
8. Decision 40. Annex 2, Art. 7.
9. Parra Perez, Jaime, "Tax harmonization within the Andean Region" (Venezuelan contribution to the XV Latin American Congress on Tax Law, Caracas, Venezuela, 1991).

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cise enough, led to the conclusion that the territoriality principle only proved to be efficient in practice with regards to the taxation of income from immovable property.[10]

Although no changes have been formally introduced to the model convention contained in Decision 40, evidence shows that such model has had no influence at all in the tax treaties concluded by Andean Community countries with developed countries.

The preceding overview shows an interesting trend in Latin America marked by a less radical approach towards the application of the territoriality principle. Undoubtedly, this attitude has allowed Latin American countries to expand their tax treaty networks.

B. Comments on the existing treaty network

The experience of Latin American countries in negotiating double tax treaties with developed countries dates back to the 1960s.

The oldest treaty of this kind seems to have been the one between Argentina and Sweden in 1962. Three more treaties were concluded in that decade: Peru–Sweden (1966), Brazil–Norway (1967) and Brazil–Japan (1967).

The treaty network of Latin American countries notably increased in the 1970s when 16 treaties were concluded with developed countries, mostly by Brazil. The amount of treaties decreased during the 1980s but increased substantially during the 1990s. About fifty per cent of the existing treaties have been concluded in the latter decade.

Brazil seems to be the more experienced country in this field having signed treaties with 18 developed countries. Mexico is the second in the list with 16 treaties, followed by Argentina (15), Venezuela (11), Ecuador and Bolivia (5), Uruguay (3), and Costa Rica, Dominican Republic and Peru having signed only one treaty.

The influence of each model convention varies from one country to another. However, the major influence of the UN MC is found in the treaties signed by Mexico. Brazil and Argentina also follow the UN MC in some respects, although to a lesser degree.

At present Germany is the developed country which has signed the highest number of treaties with Latin American countries. It has concluded treaties with 8 countries. It is followed by Sweden and France (6), Italy and Spain (5), Canada, the Netherlands, Belgium, the United Kingdom and Norway (4), Denmark, Finland and Switzerland (3), and Austria, Hungary, Portugal, Japan, Korea, the Czech Republic and the United States (2). Other developed countries such as Luxembourg and Poland have concluded treaties with only one Latin American country (see Appendix).

IV. IMPACT OF THE UN MC DEFINITION

A. The basic rule

1. Model conventions

The wording of the basic rule is identical in both model conventions. One of the most important requirements of the basic rule is the condition that the place of business has to be a "fixed" one. The fixed character implies that a PE can only be deemed to exist if the place of business has a certain degree of permanence. On these grounds it has been held that the fixed character has both a *locational* and a temporal aspect.[11] This means that, on the one hand, there has to be a link between the place of business and a specific geographical point, and on the other hand, the place of business must have a certain degree of permanence, i.e. it can not be of a purely temporary nature.

A rigid interpretation of the requirements laid down in the basic rule, particularly the location test and the permanence test, automatically excludes source state taxation of profits derived from activities which are mobile and temporary by nature. For this reason it was originally necessary to expressly include provisions on mobile and temporary activities by creating fictions such as the one on construction activities.[12] There are, however, many other activities of this kind that would escape taxation at source in the absence of special provisions containing similar fictions (e.g. show business activities, fishing activities and exploratory activities performed through ships or vessels).

This explains why many countries, especially those with significant resources in the offshore area, have included special provisions (PE fictions) in their treaties expressly dealing with such activities in order to allow source state taxation.

2. Tax treaties

Apart from the typical PE fiction for construction activities included in both model conventions, few other fictions are added in the treaties examined regarding any other onshore or offshore business activity.

The treaties between Argentina and Spain, Denmark and the United States and Mexico and the United States[13] refer to exploration activities carried on through ships, and installation or drilling rigs used for the exploration and exploitation of natural resources. In addition, the treaties of Argentina with Denmark and the United States include fishing activities with a time limit of three months. The Argentina–United States treaty also refers to the activity of making oceanographic surveys through ships with a time limit of 90 days.[14]

A particular PE fiction is included in the treaties concluded by the Netherlands with Venezuela and Argentina. It is provided in the protocols to these treaties that

10. Id.
11. See Arvid Skaar, "Permanent establishment. Erosion of a tax treaty principle", *Series on International Taxation*, 13, Boston (1991), at 112.
12. See below IV.D.1.a.
13. Signed on 21-07-92, 12-12-95, 07-05-81 and 18-09-92, respectively.
14. See Arts. 5(3)(c) and 5(3) of these treaties.

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> exploration and exploitation rights of the seabed and its subsoil and their natural resources shall be regarded as immovable property situated in the contracting state, the seabed and the subsoil of which they are related to and that these rights shall be deemed to pertain to the property of a PE in that state. Furthermore, it is understood that the aforementioned rights include rights to interests in, or to the benefits of, assets to be produced by such exploration or exploitation.[15]

With these provisions, which correspond to Dutch treaty policy, source state taxation is secured by excluding such activities from the scope of Articles 5 and 7.

A similar but more comprehensive provision is found in Article 21 of the treaty between Mexico and Norway,[16] which specially deals with offshore activities. A PE fiction is established in such article for activities in connection with the exploration and exploitation of the seabed and subsoil and their natural resources with a time threshold of 30 days. The article contains an anti-avoidance provision according to which such activities cover the bare-boat leasing of drilling rigs or similar purpose equipment. The provision extends the taxing rights of the source state to capital gains derived from the alienation of rights, property and shares connected with the exploration and exploitation activities. Furthermore, the source state may extend its rights to tax the salaries, wages and similar remuneration in respect of an employment connected with such activities as long as the duties are performed in its offshore area. This rule applies unless the employer is a resident of the other state and the activities are carried on for a period not exceeding in the aggregate 30 days in any 12-month period.

Finally, a peculiar PE fiction for the activities of providing the services of athletes and artistes is found in the treaties between Brazil and Germany, and Brazil and Luxembourg.[17]

As a rule, such profits are governed by Article 17 of the main model conventions irrespective of the PE concept. According to the said article, primary taxation of income derived by such entertainers from their personal activities as such is attributed to the state of the place of performance.[18] This remains the case even when such income accrues not to the entertainer or athlete himself, but to another person.[19] Therefore, according to this provision this kind of income is not treated as business profits even if the activities were carried on through *artistes companies*. Consequently, the PE issue is not relevant in this respect. By contrast, in the above-mentioned treaties a different treatment is given to such activities. Such treaties depart from the main model conventions in that they all introduce a rule under which the activities exercised by the entertainers or athletes generate a fictitious PE in the state of performance.

B. The list of examples

1. Model conventions

The purpose of this list is to give some examples of "places of business" which would amount to a PE provided that the conditions of the basic rule are met.

Both model conventions are in conformity in listing the following examples of a PE: a place of management, a branch, an office, a factory, a workshop and mines, oil or gas wells and quarries and other places of extraction of natural resources.

With regards to the latter it must be noted that only "extraction" (i.e. not "exploration") activities are mentioned in both model conventions. This explains why many countries include special provisions or fictions covering exploration activities with relatively short time thresholds.

2. Tax treaties

Both model conventions are in conformity in listing the examples of a PE. *Nevertheless*, deviations from the common pattern can be found in some of the examined treaties.

The main deviation in this respect concerns the inclusion in such list of a fixed place of business maintained with the purpose of acquiring or purchasing goods or merchandise for the enterprise. Although a fixed place of business for such purpose forms part of the list of exceptions in both model conventions, some treaties include it in the positive list as an example of a PE. Consequently, in such treaties, they are not listed in the list of exceptions. This feature is found in some of the treaties concluded by Argentina.[20]

Another deviation is the inclusion of a farm or plantation or a farming installation. This is the case, for instance, in the treaties of Bolivia with both Germany and Sweden[21] and the one between Uruguay and Germany.[22]

This inclusion only makes sense if the relevant treaty classifies income from farming activities as business income rather than as income from immovable property, which would be governed by Article 6 of the model conventions.

Other treaties include industrial and assembly workshops being used for industrial production. Such provision is found in the treaties of Germany with Ecuador and Uruguay.[23]

It must be noted that in most treaties no mention is made of exploration activities within the context of the list of examples. The majority simply refer, as envisaged in the model conventions, to "other places of extraction of natural resources".

A common feature in many of the treaties examined is the inclusion of construction activities in the list of examples. This approach (based on the 1963 version of the OECD MC) is found in all the treaties signed by Brazil. Ecuador, Uruguay, Venezuela, Peru, Dominican Republic, Costa Rica, Bolivia and Argentina have also followed this pattern in some of their treaties.

15. See provisions IV and II respectively, of the protocols to these treaties.
16. Signed on 23-03-95.
17. See Art. 5(7) of these treaties.
18. OECD MC, UN MC, US MC, Art. 17(1).
19. Id., Art. 17(2).
20. See, for instance Arts. 5(2)(g) and 5(2)(f) of the treaties of Argentina with France and the United States, respectively.
21. See Arts. 5(2)(c) and 5(2)(f) of the Bolivian treaties with Germany and Sweden, respectively.
22. See Art. 5(2)(c).
23. Id.

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C. The list of exceptions

1. Model conventions

This list consists of several business activities which are treated as exceptions to the basic rule. However, such activities are only excepted if the fixed place of business is being maintained solely for the performance of activities of such nature. If other (not excepted activities) are performed, a PE will be deemed to exist, and thus taxable as regards both types of activities.

The list of exceptions varies in each model convention regarding two aspects: the issue of delivery activities and the treatment of the combination of excepted activities. While fixed places of business for the purpose of delivery and maintaining a stock of goods to be delivered are excluded in the OECD MC, the UN MC deletes such activities from the list of exceptions. In addition, the UN MC also removes from the list the provision on combination of excepted activities. Therefore, under UN MC based treaties a combination of excepted activities may constitute a PE.

2. Tax treaties

Several treaties follow the UN MC by omitting the provision on combination of excepted activities from the list of exceptions.[24]

Regarding the removal of delivery activities, only the treaties between Argentina and Spain, and Uruguay and Germany follow the UN MC.[25]

It follows from this that with respect to the list of exceptions, the majority of treaties are mostly influenced by the OECD MC, either in its first version (1963) or in the more recent ones. Some deviations from the model conventions can also be found.

One such deviation relates to the omission of purchasing offices in some treaties, which is consistent with their inclusion in the list of examples, as it was mentioned *supra*.

It must be noted, however, that some treaties in which purchasing offices are excepted as provided for in Article 5 (4)(d) of the model conventions, include a special provision regarding the purchase of certain specific kinds of products to which the exception does not apply. This is the case for instance in the treaties of Argentina with Sweden and Germany.[26]

Both treaties signed by Argentina refer to the purchase of agricultural products. The latter refers in addition to forestry, mining and farming. A similar provision is found in the treaties between Bolivia and Sweden, and Dominican Republic and Canada.[27] The former refers only to the purchase of mineral products whilst the latter also includes agricultural products and livestock.

A large number of treaties expressly include in the list of exceptions activities such as advertising, supply of information and scientific research. The inclusion of such activities in the list of exceptions corresponds to the first version of the OECD MC and is based on the view that such activities are by definition regarded as having an auxiliary or preparatory character.

However, such activities are no longer included in Article 5(4) of the OECD MC. The OECD MC commentaries refer to them as examples of fixed places of business in which the services performed are so remote from the actual realization of profits that it is difficult to allocate any profits to them.[28] It is stressed in the commentaries that such activities should be excluded *if* they have a preparatory or auxiliary character.[29] It follows from this that under the current version of the OECD MC, the auxiliary or preparatory character of such activities is not presupposed.

Therefore, the inclusion of such excepted activities in relatively recent treaties is not in line with their present treatment in the existing model conventions.[30]

Another interesting deviation from the current model conventions is the inclusion as a non-PE in some Mexican treaties of activities of preparation relating to the placement of loans.[31] Such "liaison activities" are thus regarded as auxiliary in those treaties on the basis that the mere preparation relating to the placement of loans does not constitute a core business activity but rather is only one phase of the lending process.

Finally, the treaty between Mexico and the United Kingdom includes in the list of exceptions "the maintenance in Mexico of a representative office of a bank where the activities of the representative office are limited by the laws of Mexico to activities which are of a preparatory or auxiliary nature".[32] Such provision corresponds to the approach of certain judicial and administrative practice which denies PE status to offices of foreign banks set up for the purpose of merely promoting services, analysing lending proposals, etc. However, under the treaty, the legal qualification of the activities performed by the representative office (i.e. the question of whether or not these activities have an auxiliary or preparatory character) is left to Mexican domestic law.

D. The typical PE fictions

These provisions refer to certain business activities that in the absence of express regulation could not be considered as a PE for they actually do not meet the requirements of the basic rule. Therefore, the common feature of such provisions is that they all form an extension of the PE concept. Two provisions

24. See for instance the treaties between Brazil and Norway, Mexico and the Netherlands, Dominican Republic and Canada, Peru and Sweden, Venezuela and Italy, Venezuela and Sweden, etc.
25. See Arts. 5(4) and 5(4)(b) of these treaties, respectively.
26. See Arts. II(1.vi) and Art. 5(7) of the Argentinian treaties with Sweden and Germany, respectively.
27. See Arts. 5(5) and V(7) of these treaties, respectively.
28. OECD MC, Commentaries to Art. 5, para. No. 22.
29. Id.
30. See for instance the treaties between Bolivia and Germany (1992), Mexico and Spain (1992), Mexico and Switzerland (1993), and Venezuela and France (1992).
31. See Arts. 5(4)(e) of the Mexican treaties with Belgium, Canada and Germany.
32. Art. 5(4)(f).

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of this kind are found in the OECD MC: construction activities and the activities of agents. The UN MC, in addition, also contains a fiction for consultancy services and insurance companies.

1. Construction activities and consultancy services

a. *Model conventions*

Under both model conventions construction works are regarded as a PE if they last for a minimum period of time (12 months under the OECD MC and 6 months under the UN MC). The OECD MC only refers to a building site or construction or installation project,[33] whereas the UN MC also mentions "assembly projects" and "supervisory activities in connection therewith".[34]

It follows from this that under the OECD MC, planning and supervision of the erection of a building are covered by the construction article only if they are carried out by the building contractor himself.[35] This issue is of some importance since it is usual (particularly in developing countries typically short of know-how) to find a case where the physical part of the construction is undertaken by a domestic enterprise under the management and supervision of a foreign contractor. Under the OECD MC, such activities could only amount to a PE if the foreign enterprise conducts the activity through his own fixed place of business. By contrast, under the UN MC the supervisory activities of such foreign contractor will constitute a PE since such activities are expressly mentioned in the article for construction activities.

Furthermore, the UN MC establishes PE taxation for intellectual activities without any connection to a construction project, provided that the activities last for a period of 6 months within any 12-month period.

This rule is contained in Article 5(3)(b) of the UN MC, which refers to the furnishing of services, including consultancy services through employees or other personnel of an enterprise.

b. *Tax treaties*

In the majority of the treaties the time threshold for construction activities is six months. This is the case in the majority of treaties signed by Argentina, Brazil and Mexico. Only a few treaties have a different time limit for construction works.[36]

An interesting trend is observed in the most recent treaties concluded by Argentina. This country is consistently including provisions on supervisory activities in connection with construction works and the furnishing of services through employees. In both cases the time threshold is six months.[37] A similar provision is found in the treaty between Venezuela and the Czech Republic.[38]

As to the scope of the construction clause, most of the treaties examined follow the pattern of the OECD MC, (i.e. such provisions cover only a building site or construction or installation project). The treaties signed by Mexico follow the UN MC, although only partially. In such treaties the provision on construction works refers not only to a building site or construction or installation project but also to supervisory activities in connection therewith, as provided for in Article 5(3)(a) of the UN MC. They do not extend to cover, however, the furnishing of services included in Article 5(3)(b) of the UN MC.

It can be concluded from the preceding discussion that the examined treaties are influenced both by the OECD MC and the UN MC as far as the construction clause is concerned. The former is mostly followed regarding the content of such clause, whereas the latter is followed regarding the time threshold of six months.

2. Activities of the agent

a. *Model conventions*

Both model conventions contain the fiction concerning the agent's activities. The rationale behind this provision is that the source state should not be deprived of its jurisdiction to tax business profits of a foreign enterprise that continuously performs business activities in that country only on the basis that such enterprise is carrying on business within its territory through an agent rather than through a fixed place of business.

However, under the OECD MC for this provision to apply two conditions must be met. Firstly, the agent must be "dependent". Regarding the dependence of the agent it is mentioned in the OECD commentaries that to avoid being dependent he must be independent from the enterprise both legally and economically. Both model conventions have a provision in the PE article which contains some examples of independent agents. The provision excludes PE taxation in those cases, provided that such persons are acting "in the ordinary course of their business".

The UN MC has, in addition, a deemed dependence rule by virtue of which an otherwise independent agent is not regarded as such if his activities are devoted wholly or almost wholly on behalf of the enterprise of the concern. This widens the scope of PE taxation by expressly including an economic criterion for the dependence test. Thus, PE taxation is allowed even when the persons listed in the provision are acting in the ordinary course of their business where it can be concluded that the agent is almost entirely working on behalf of one principal. The rationale behind this is that an agent who is working almost solely for one principal has lost his independent status from the economic point of view.

Secondly, the agent must have and habitually exercise an authority to conclude contracts in the name of the enterprise. This condition shows the inefficiency of the OECD MC's agency provision since a PE is denied regardless of the circumstance that the contracts are wholly negotiated by the

33. OECD MC, Art. 5(3).
34. UN MC, Art. 5(3).
35. OECD MC, Commentaries to Art. 5, para. No. 17.
36. See for instance Art. 5(2)(g) of the treaty between Argentina and Italy (nine months), Art. 5(3) of the treaty between Venezuela and Portugal (nine months) and Art. 5(3) of the treaty between Mexico and Italy (eight months).
37. See Arts. 5(3)(a) and 5(3)(b) of the Argentinian treaties with Finland, the United Kingdom and the Netherlands.
38. See Art. 5(3)(a) and 5(3)(b).

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agent, only being subject to the principal's final approval. Clearly, significant economic bonds are created between the enterprise and the source state when an agent of the former negotiates contracts on a regular basis, even if such contracts are subject to final approval by the enterprise.

The UN MC departs from the OECD MC in that it allows PE taxation to a larger extent by including a provision regarding an agent who maintains a stock of goods or merchandise to be delivered on behalf of the enterprise. Therefore, whereas under the OECD MC an agent must have an authority to conclude contracts in the name of the enterprise, the UN MC allows a PE to exist in the absence of such authority provided that the non-authorized agent maintains a stock of goods or merchandise in the source state from which he regularly delivers goods.

In brief, the UN MC allows PE taxation to a larger extent by including this provision and by denying independent status to those agents whose activities are devoted wholly or almost wholly on behalf of the enterprise.[39]

b. *Tax treaties*

Out of all the treaties examined only the one between Venezuela and the Czech Republic is completely in line with the UN MC in the sense that it allows a PE to exist even if the agent has no authority, provided that he maintains a stock of goods or merchandise from which he regularly delivers goods.[40]

The treaty between Mexico and the United States contains a provision on agents similar to that of the UN MC, but concerned with the processing of goods rather than with the maintenance of a stock of goods or merchandise for delivery. Under such provision an agency PE is deemed to exist, even if the agent has no authority, if he "habitually processes in the first mentioned state goods or merchandise maintained in that state by the enterprise, providing that such processing is carried on using assets furnished, directly or indirectly, by that enterprise or any other associated enterprise".[41] This provision aims at covering those cases where a foreign enterprise processes goods in another state on a sort of commission basis, for which purpose assets are provided by it or by a related company. States wishing to tax such activities include this sort of fiction since the assets concerned may not always amount to a PE under the basic rule.

With respect to the rule on independent agents all countries in Latin America, except Argentina and Mexico,[42] follow the OECD MC. Therefore, the deemed dependence rule set forth in Article 5(7) of the UN MC, which favours source state taxation by narrowing the concept of independent agent, is only found in a few treaties.

Argentina has followed the UN MC pattern in the treaties signed with Canada, Spain, Denmark, Finland, the United Kingdom and the Netherlands. In the last three mentioned treaties a condition is added to regard such agents as not independent, where the transactions between the agent and the enterprise are not made under arm's length conditions[43] or, that in their relations, conditions are made or imposed that differ from those generally agreed to by independent agents.[44]

Some of the treaties concluded by Mexico are identical to the UN MC regarding the rule on independent agents. In others, although there is not a deemed dependence rule as provided for in the UN MC, a special rule is, however, provided that serves to clarify the concept of "independence". Such provision, found for instance in the treaties with France, Switzerland, the United States, Norway and Finland stresses that an independent agent, to be regarded as such, must not be bound in his commercial and financial relations with the enterprise by agreed or imposed conditions which differ from those generally agreed to by independent agents.[45] The rule thus aims at addressing the problem pointed out by certain developing countries according to which certain arrangements can result in tax evasion where an agent who is in fact dependent presents himself as acting on an independent basis. The commercial practice in the field of independent representation is thus taken into account to determine the actual status of the agent.

Interestingly the treaty between Mexico and the United Kingdom contains both the deemed dependence rule of the UN MC and the above-mentioned provision.[46]

A peculiar deviation from the model conventions is found in the treaties of Ecuador with Germany and Spain. Both treaties provide that the rule on independent agents applies irrespective of the independent agent's fiscal responsibilities.[47] Such provision, which seems completely unnecessary, merely clarifies that, in regard to his activities for his own account, the independent agent is subject to the tax laws of the state concerned.

Evidence shows that with respect to the provision on the agent's activities, Latin American treaties with developed countries are significantly influenced by the OECD MC. However, a recent trend to include the deemed dependence rule of the UN MC is also observed.

3. Insurance companies

a. *Model conventions*

This fiction is only included in the UN MC as a response to the fact, pointed out by developing countries, that agencies of foreign insurance companies, doing large-scale business in one state, could not be taxed by such state because they neither met the conditions of the basic rule nor the conditions of the provision on agents. In order to obviate this problem, the UN MC includes a fiction under which insurance companies are deemed to have a PE in the source state if they collect pre-

39. UN MC, Art. 5(7).
40. Art. 5(5)(b).
41. Art. 5(5)(b) of the Mexico–United States treaty.
42. Another isolated exception is found in Art. 5(7) of the treaty between Venezuela and the Czech Republic.
43. Art. 5(6) of the Argentinian treaties with Finland and the United Kingdom.
44. Art. 5(6) of the Argentina–Netherlands treaty.
45. See Art. 5(7) of these treaties.
46. Art. 5(7).
47. Arts. 5(5) and 5(6), respectively.

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miums or insure risks therein through a person other than an agent of an independent status.

b. *Tax treaties*

Only four Latin American countries so far have included such provision in their treaties with developed countries: Argentina, Brazil, Mexico and Venezuela.

By contrast, whereas Mexico has included this provision in all its treaties and Brazil and Argentina in most of them, Venezuela has recently started to include it in some of its treaties (see for example, the treaties with Portugal, Norway and the Czech Republic).

An interesting deviation from the UN MC is found in several treaties recently concluded by Argentina in which activities of reinsurance are covered. In such cases, the taxing rights of the source state are limited to a certain percentage of the gross premiums.[48]

Another deviation consists of choosing the place where the risk is situated as the only connecting factor for insurance activities. This is the case, for instance, with the Mexican treaties concluded with France and the United States.[49] Both treaties depart from the UN MC in that they have clearly chosen one connecting factor: the place where the insured risk is situated (as opposed to the place where the premiums are collected). Another example of this approach is found in some treaties of Argentina. Such treaties can also be said to have only one connecting factor, which varies depending on whether the insured risks are related to properties or persons. In the former case the connecting factor is the place where the property is located. In the latter case it is the residence of the persons insured.[50]

From the preceding analysis it can be held that only a few countries include the provision on insurance companies in their treaties. However, there seems to be a tendency in favour of such inclusion. Another trend consists of replacing the place where the premiums are collected by the place where the risk is situated.

E. The limited force of attraction principle

1. Model conventions

Under the OECD MC, profits derived by a foreign enterprise otherwise than through an existing PE may not be taxed in the source state. In contrast, the UN MC allows an existing PE to attract income derived directly by the foreign enterprise provided that the relevant transactions are similar to those concluded through the PE. This is achieved in the UN MC by including clauses (b) and (c) to Article 7(1). This rule (known as the "limited force of attraction principle") emphasizes the economic allegiance of the foreign enterprise with the state where the PE is situated and provides for source state taxation of profits derived in such state from transactions of the same kind as those carried on through the PE (but not directly performed by it).

The fact that certain activities are performed within the source state otherwise than through the PE should not override the fact that strong economic bonds have been created by establishing a fixed place of business in that state. This principle however must be interpreted and applied very carefully. A distorted interpretation usually leads to situations where the source state attempts to tax profits derived abroad from activities or supplies that are neither similar to those effected through the PE, nor capable of being performed by it.

2. Tax treaties

At present only the treaties of Argentina with Canada and Spain are completely in line with the UN MC provision in this respect.[51]

The treaties of Venezuela with Portugal and the Czech Republic follow a similar approach. However, in such treaties the principle of force of attraction applies only in respect of sales. Other "business activities of the same or similar kind" are not mentioned.[52]

A peculiar practice is observed in the treaties of Mexico and certain other treaties of Argentina. Both countries have made several attempts to include such principle in some tax treaties with developed countries. These attempts have resulted in four sets of rules.

The first set provides that the state of the PE may tax profits from a direct transaction of the same or similar kind as those effected by the PE, subject to the condition that the PE has been involved in such transaction in any manner. This is the case, for instance, with the treaties Mexico has with Belgium and Germany[53] and the one between Argentina and the Netherlands.[54] A similar approach is found in the treaties of Mexico with the United Kingdom and Japan and the treaty between Argentina and the United Kingdom. Under these treaties profits from direct transactions can be attributed to the PE as long as such PE takes an active and substantial part in the negotiation and conclusion of contracts entered into by the enterprise.[55]

It seems however, that such provisions do not really envisage the principle of force of attraction. Rather, they merely seem to clarify which profits can be attributed to the PE as having been derived by it.

A second set of rules provides that profits from direct transactions of the same or similar kind as those effected through the PE, may be attributed to that PE, subject to the condition that advertising, marketing, storage, display or delivery of goods is carried on through such PE. This is the case with the

48. See, for instance Art. 7(4) of the Argentinian treaties with Finland, the United Kingdom and Denmark and Art. 7(5) of the Argentina–Netherlands treaty.
49. See Art. 5(6) of these treaties.
50. See for instance Art. 7(4) of the treaties of Argentina with Finland, the United Kingdom and Denmark.
51. See Art. 7 of such treaties signed on 29-04-93 and 21-07-92, respectively.
52. See Art. 7(1) of both treaties.
53. See Provision 1 of the protocol to the Mexico–Belgium treaty and Provision 1(a) of the protocol to the Mexico–Germany treaty.
54. See Art. 7(1).
55. See Art. 7(6) of the Mexico–United Kingdom treaty, Provision 3 of the protocol to the Mexico–Japan treaty, and Art. 7(5) of the Argentina–United Kingdom treaty, respectively.

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tax treaty between Mexico and Italy.[56] This rule again relates to profits derived from transactions which are somehow connected with the PE in any of the above-mentioned ways. Thus, it could be held again that no force of attraction is really adopted.

A third set of rules contains a presumption under which direct sales of the same or similar kind as those effected through the PE are deemed to be carried on through such PE "unless the enterprise proves that such sales have been so made for serious economic reasons". Such a provision is included in the treaties of Mexico with France,[57] Spain,[58] Switzerland,[59] the United States,[60] Norway,[61] Finland,[62] and Korea.[63]

This set of rules adopts the force of attraction principle by means of a presumption which, however, admits counter-evidence by the taxpayer. They thus contain a "*iuris tantum*" presumption which results in the attribution to the PE of profits derived from direct transactions unless evidence is furnished by the taxpayer that the transaction was so undertaken for economic reasons.

This seems to be a fair approach to the issue of the force of attraction principle since, on the one hand, unlike the OECD MC it does not completely reject such principle and, on the other hand, it is more flexible than the UN MC approach because it allows evidence of the reason why transactions of the same or similar kind as those effected through the PE are being carried on directly by the enterprise to be admitted.

A fourth set of rules is found in the treaties between Mexico and Sweden and between Argentina and Denmark. These treaties have a similar approach to the one mentioned in the third set of rules. They also contain a *iuris tantum* presumption which results in the attribution to the PE of profits from direct transactions. Counter-evidence by the taxpayer is admitted to demonstrate that such sales "could not have been undertaken by the PE in the ordinary course of its activities".[64] The burden of proof in this case is easier to cope with since it refers not to a subjective matter (the "seriousness" of the transaction) but to an objective fact, i.e. that the PE could not have undertaken such sales in the ordinary course of its activities.

Except for the mentioned treaties of Argentina, Mexico and Venezuela, no other Latin American country has succeeded in including the limited force of attraction principle in their tax treaties with developed countries.

Finally, it is worth noting that some treaties have a special rule (usually contained in the corresponding protocol) which aims at preventing the PE state from taxing the profits derived by the head office (or another establishment situated in a third state) under a contract under which some supplies are to be effected by the head office and other supplies by the PE. This so-called "turnkey" provision is the result of a justified fear of some developed countries. The standard provision of this kind particularly refers to contracts for the survey, supply, installation or construction of industrial, commercial or scientific equipment or premises and of public works. The rule clearly states that in such cases the profits of the PE shall not be determined on the basis of the total amount of the contract, but only on the basis of that part of the contract which is effectively carried out by the PE in the source state.

This rule is normally found in the treaties with the Netherlands.[65] Germany,[66] Switzerland,[67] and the United Kingdom[68] have also included the turnkey provision in certain of their treaties with Latin American countries.

V. CONCLUSION

For a long period of time, the tax systems of Latin American countries were mostly based on the territoriality principle. This trend has been reversed during the last decade favouring the expansion of these countries' treaty networks.

The UN MC was designed as a guide to be followed by developing countries when concluding tax treaties with developed countries. With regards to the taxation of business profits, the UN MC broadens the scope of the PE definition favouring source taxation by capital importing countries.

The influence of the UN MC in Latin America has considerably increased in the last few years. With regards to the concept of PE, the preceding analysis shows that the major influence of the UN MC is found in the treaties concluded by Mexico, Brazil and Argentina, which are the most experienced countries in this field, having the largest number of tax treaties with developed countries. These countries have achieved a high degree of sophistication in treaty negotiations and their experience is increasingly being followed by other countries in the region.

APPENDIX

ARGENTINA

Country	Date of conclusion	Entry into force
Austria	13-09-70	17-01-83
Belgium	12-06-96	not yet in force
Canada	29-04-93	30-12-94
Denmark	12-12-95	04-09-97
Finland	13-12-94	05-12-96
France	04-04-79	01-03-81
Germany	13-07-78	25-11-79
Italy	15-11-79	15-12-83
Norway	08-10-97	not yet in force

56. Provision 2 of the protocol to the Mexico–Italy treaty.
57. Provision 3 of the protocol to the Mexico–France treaty.
58. Provision 2 of the protocol to the Mexico–Spain treaty.
59. Provision 3(b) of the protocol to the Mexico–Switzerland treaty.
60. Art. 7(1) of the treaty.
61. Id.
62. Id.
63. Provision 2 of the protocol to the Mexico–Korea treaty.
64. Art. 7(1) of both treaties.
65. See Provisions III and IV(2) of the protocols to the treaties of Argentina and Mexico with the Netherlands, respectively.
66. See Provision 1 of the protocol to the Venezuela–Germany treaty.
67. See Provisions 3 (b) and 1 of the protocols to the treaties of Venezuela and Ecuador with Switzerland, respectively.
68. See Provision 2(b) of the exchange of notes of 3 November 94 to the Bolivia–United Kingdom treaty.

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Country	Date of conclusion	Entry into force
Spain	21-07-92	28-07-94
Sweden	31-05-95	05-06-97
Switzerland	23-04-97	not yet in force
Netherlands	27-12-96	12-02-98
United Kingdom	03-01-96	01-08-97
United States	07-05-81	not yet in force

BOLIVIA

Country	Date of conclusion	Entry into force
France	15-12-94	01-11-96
Germany	30-09-92	12-07-95
Spain	30-06-97	not yet in force
Sweden	14-01-94	04-10-95
United Kingdom	03-11-94	23-10-95

BRAZIL

Country	Date of conclusion	Entry into force
Austria	24-05-75	01-07-76
Belgium	23-06-72	13-07-73
Canada	04-06-84	23-12-85
Denmark	27-08-74	01-01-75
Finland	02-04-96	26-12-97
France	10-09-71	12-05-72
Germany	27-06-75	30-12-75
Hungary	20-07-86	13-07-90
Italy	03-10-78	24-04-81
Japan	24-01-67	31-12-67
Korea	07-03-89	21-11-91
Luxembourg	08-11-78	23-07-80
Netherlands	08-03-90	20-11-91
Norway	21-08-80	26-11-81
Portugal	22-04-71	10-09-71
Spain	14-11-74	03-12-75
Sweden	24-04-75	29-12-75
Czech Republic	26-08-86	14-11-90

COSTA RICA

Country	Date of conclusion	Entry into force
Germany	25-01-93	not yet in force

DOMINICAN REPUBLIC

Country	Date of conclusion	Entry into force
Canada	06-08-76	23-09-77

ECUADOR

Country	Date of conclusion	Entry into force
France	16-03-89	25-03-92
Germany	07-12-82	25-06-86
Italy	23-05-84	01-02-90
Spain	20-05-91	19-04-93
Switzerland	28-11-94	22-12-95

MEXICO

Country	Date of conclusion	Entry into force
Belgium	24-11-92	01-01-97
Canada	08-04-91	11-05-92
Denmark	11-06-97	22-12-97
Finland	12-02-97	not yet in force
France	07-11-91	31-12-92
Germany	23-02-93	30-12-93
Italy	08-07-91	12-03-95
Japan	09-04-96	06-11-96
Korea	06-10-94	12-02-95
Netherlands	27-09-93	13-10-94
Norway	23-03-95	23-01-96
Spain	24-07-92	06-10-94
Sweden	21-09-92	18-12-92
Switzerland	03-08-93	08-09-94
United Kingdom	02-06-94	15-12-94
United States	18-09-92	28-12-93

PERU

Country	Date of conclusion	Entry into force
Sweden	17-09-66	18-06-68

URUGUAY

Country	Date of conclusion	Entry into force
Germany	05-05-87	28-06-90
Hungary	25-10-88	not yet in force
Poland	02-08-91	not yet in force

VENEZUELA

Country	Date of conclusion	Entry into force
Belgium	22-04-93	not yet in force
Czech Republic	26-04-96	12-11-97
France	07-05-92	15-10-93
Germany	08-02-95	18-08-97
Italy	06-06-90	14-12-93
Netherlands	29-05-91	11-12-97
Norway	29-10-97	not yet in force
Portugal	23-04-96	09-01-98
Sweden	08-09-93	not yet in force
Switzerland	20-12-96	23-12-97
United Kingdom	11-03-96	01-01-97

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TREATY MONITOR

PROF. DR KLAUS VOGEL
IN COOPERATION WITH THE IBFD'S TAX TREATY UNIT

TREATY NEWS

Prof. Dr Klaus Vogel

I. NO TREATY "DODGING" BY EXTENDING DOMESTIC SOURCE RULES

At certain intervals US legislators and tax officials seem to be seized by a fit of fear that non-US corporations might not pay their fair share of US taxes (or is this just a pretext, as some people think, for squeezing more money out of foreigners who do not vote at US elections?). One of the most recent manifestations of this attitude is a campaign against conduits which, though it is basically justified without doubt, shows a tendency to be carried beyond reasonable limits. The Tax Court of the United States recently had a chance to remind the IRS of those limits drawn by reason and by the applicable tax treaty in its ruling on *SCI v. Commissioner*.

A Dutch corporation which was a member of a group the overall parent of which was a resident of Bermuda, had licensed from another member of that group, a resident of Bermuda too, the right to market certain software on a worldwide basis. It granted sublicences of the software to other enterprises, among them a subsidiary of its own which was organized under US law and, therefore, was a resident of the United States according to its domestic law. The Dutch corporation received royalties from that subsidiary and it paid specified percentages of the royalties, which it received from its various licensees, among them its subsidiary, to the licensor. The IRS argued that these payments (the ones made by the Dutch corporation to its Bermuda licensor!) were US source income to the extent that they were based on royalties received from the US subsidiary, and, therefore, were subject to withholding tax under Section 881(a) of the Internal Revenue Code. The Dutch corporation, of course, had withheld nothing. So the IRS held it to be liable for not withholding those taxes as well as for penalties for not filing certain US forms.

To make things quite clear: the IRS did not request tax for the payments made by the US subsidiary to its Dutch parent. These were royalties exempt from US taxation under Article IX of the United States–Netherlands tax treaty of 1948. Nor did the IRS contend that the Dutch corporation was a sham or that the royalties were not "received by" the Dutch corporation, but rather by the Bermuda licensor, like in the classical *Aiken* case. If this had been the IRS's position, the IRS would have had to request withholding from the US firm, not from its parent. But whereas *Aiken* involved a back-to-back loan with equal sums and conditions on both sides of the Honduran intermediary, the Dutch corporation in the present case was an active company and the rights received and granted by the corporation as well as the conditions negotiated were different.

For these reasons the only way the IRS saw to tax the royalties in question was to claim that the payment made from the Netherlands to the licensor in Bermuda was subject to US taxation. Said in such simple words it is evident how grotesque this contention is. It is an attempt to dodge the tax exemption under the United States–Netherlands treaty by grabbing the income so exempted at a later stage. Quite rightly the Tax Court refused to support this attempt; it stated that the domestic source rule does not follow former US source income through further stages of its being passed on. But there is still quite a lot of discussion in the United States by authors who try to defend the IRS's position, grotesque as it is.

II. APPLICATION OF A SUBJECT-TO-TAX RULE TO PERMANENT ESTABLISHMENT INCOME

A German insurance corporation had a permanent establishment in Canada which insured, among other things, life risks based in the United States. According to Canadian law the profits received from these insurance contracts were not taxable in Canada. Therefore, they were not included in the permanent establishment's income. The United States was prevented from taxing the profits by the United States–Germany tax treaty, for the company had no permanent establishment in the United States. Germany under its tax treaty with Canada in principle avoids double taxation by exempting Canadian income. The German *Bundesfinanzhof*, however, in a former ruling had interpreted a source rule of that treaty's provision on avoidance of double taxation as if it were a subject-to-tax rule. Therefore, the German tax administration contended that the profits in question had not been subject to tax in Canada and were consequently to be taxed by Germany.

Whether the source rule in question can indeed be understood as a subject-to-tax clause is controversial in Germany and has been questioned by the author of this comment. There are indications that the *Bundesfinanzhof* might be inclined to review and, possibly, to overrule its former statement. But in the present case the Court saw no necessity to discuss this. Even assuming that there is a subject-to-tax clause the question remains whether it refers to the permanent establishment

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income as such, requiring that it was taxed as computed under the rules of Canadian law, or whether the clause refers to all parts of that income which would be taxable in Germany if no treaty existed. The *Bundesfinanzhof* by its ruling of 27 August 1997, decided in favour of the first alternative. It concluded that, as the income of the permanent establishment as such had been taxed in Canada, it was totally exempt from taxation in Germany including those profits which Canada does not consider to be part of the permanent establishment income. Thus the corporation's life insurance business in the United States carried on by a Canadian permanent establishment had to bear no income taxation at all. To some this result may seem unsatisfactory, but they should consider that the philosophy underlying the exemption method is to permit the source state to decide whether certain items of income shall be taxable or whether they shall not.

III. HOW TO NEGOTIATE OR HOW NOT TO NEGOTIATE?

Contributed by: Dali Bouzoraa,
Principal Research Associate, IBFD

The France–Switzerland tax treaty of 9 September 1966 has already been amended by a protocol of 3 December 1969 and a Frontier Workers agreement of 11 April 1983. Nevertheless, various adjustments were deemed necessary which required the conclusion of an additional protocol to the treaty on 11 April 1983. The 1983 protocol contained important provisions such as extension of the scope of application to the French net-wealth tax, abolition of the withholding tax on interest, an anti-abuse provision as to residence, and, in particular, a requirement of administrative assistance towards the exemption of Swiss companies from the French 3 per cent tax on immovable property. However, the ratification of the protocol was rejected by the Swiss Parliament and new negotiation rounds, which opened in 1988 and again in 1990, proved fruitless.

In the meanwhile, the idea that Switzerland was a tax haven much used by French residents became entrenched with the French tax authorities, as evidenced by recent French case law. In the past few years, many important decisions by French courts, whether regarding the application of CFC legislation, the non-deduction of payments to tax haven residents, or the 3 per cent tax on immovable property of non-resident companies, involved Swiss companies.

Negotiations between both countries resumed in 1994 and resulted in the conclusion of a protocol on 22 July 1997. This protocol contains important provisions and, in particular, a remarkable elimination of double taxation clause which would allow France to apply its CFC legislation notwithstanding other treaty provisions.

CFC legislation

1. The origins of the problem

Pursuant to Article 209B of the French Tax Code, resident companies are assessed to tax on a pro rata portion of the income realized (and retained) by foreign subsidiaries or permanent establishments benefiting from a favourable tax regime. The compatibility of these CFC rules with double taxation treaties and EU law is much debated. With respect to the interaction of the rules with tax treaties, the debate centres on whether they are reconcilable with Article 7 of the OECD Model. Hitherto, two lower court decisions rendered with respect to the same France–Switzerland treaty reached conflicting conclusions.[1] The lower administrative court of Strasbourg found the rules in conflict with Article 7 of the treaty, while the corresponding court in Paris held a contrary reasoning, even if it did not directly refer to Article 7. The tax authorities appealed the decision of the court of Strasbourg. However, subsequent unconfirmed reports indicate that the taxpayer involved accepted a transactional solution whereby the CFC rules would be applied. An appeals court decision would, therefore, be excluded for the time being.

In recent years, the French tax authorities have chosen to preempt incompatibility fears by insisting on the inclusion, in (re)negotiated tax treaties, of a specific clause to the effect that nothing in the convention shall preclude France from applying its CFC legislation. Such clauses are found, for example, in the treaties concluded with Austria, Bolivia, Cameroon, Jamaica, Japan, Mexico, South Africa, Spain, Venezuela and the United States.

According to our information, the inclusion, in the France–Switzerland protocol, of a specific clause which would authorize France to apply its CFC legislation notwithstanding other treaty provisions was *not* raised in the negotiations leading to the conclusion of the protocol. Quite logically, therefore, the new protocol contains no such explicit clause.

2. The solution

France ordinarily prevents double taxation by application of the exemption method. This is valid under domestic law (the territoriality principle), and also under most of France's double tax treaties. However, French treaties concluded over the past few years generally depart from the exemption method in favour of the credit method. Under those treaties, business income is normally taxed with a credit for French tax (which translates in an exemption), while dividends, interest and royalties are taxed with an ordinary credit for the foreign withholding tax.

The France–Switzerland protocol follows this new pattern, with one subtle albeit very important variation. Pursuant to the elimination of the double taxation clause (Article 25(A) of the protocol), "income which may be taxed or is only taxed in Switzerland in conformity with the provisions of this Con-

1. P-J. Douvier and D. Bouzoraa, "Compatibility of CFC Rules with Tax Treaties: Lower Courts Reach Conflicting Conclusions", in 37 *European Taxation* 3 (1997), at 103 et seq.

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vention, and which constitutes taxable income of a French resident, is taken into account in computing French tax when such income is not exempt under French domestic law." In contrast to other recent French treaties, the article further provides an ordinary credit mechanism for business income.

This subtle change allows France to apply its CFC legislation without the need to incorporate a specific clause to that effect in the protocol. This interpretation is confirmed by the report of the French Senate on the protocol which states that the formulation is an implicit authorization for France to apply its CFC rules. In fact, the effects of this formulation are twofold.

a. *French resident with a permanent establishment in Switzerland*

Under most other tax treaties, income of foreign permanent establishments would be in effect exempt in France either because the treaty provides for the exemption method or for a credit equal to French tax. Under domestic law such income is generally exempt in France unless the CFC rules apply. The application of the CFC rules in such a case is clearly in conflict with Article 7 of the OECD Model. In conclusion, France would be able to tax such income only if the treaty contains a specific clause allowing it to apply its CFC legislation, or the French resident opted for, and obtained approval, for worldwide taxation (which, hitherto, has not occurred in practice).

The drafting of the France–Switzerland protocol would allow France to tax income derived through low-taxed Swiss permanent establishments even though the treaty contains no specific clause allowing France to apply its CFC legislation. This results from the combination of the words "when such income is not exempt under French domestic legislation" and the provision of an ordinary foreign tax credit for business income.

b. *French resident with a subsidiary in Switzerland*

The situation here is more intricate since Article 25A of the protocol refers to Article 7, which concerns business income of permanent establishments and, strictly speaking, not subsidiaries. Nevertheless, under French domestic law, income of foreign CFCs is treated as *deemed* income of the resident controlling parent. Therefore, *although some doubts still persist*, it would appear that the combination of the elimination of double taxation clause in the protocol and the drafting of the French CFC rules would allow France to tax retained income of Swiss low-tax subsidiaries. This would be so even if the treaty contains no specific clause allowing France to apply its CFC legislation.

3. Imaginative or counter-productive?

In (re)negotiating recent treaties, France openly insisted on the inclusion of a specific clause allowing it to apply its CFC rules notwithstanding other treaty provisions. In the case of the new protocol to the treaty with Switzerland, the inclusion of such a clause was, according to our information, not evoked in the negotiations. Instead, the French authorities drafted the elimination of double taxation clause at variance with other French treaties and in a way to implicitly authorize France to apply its CFC legislation. This leaves an impression of "subtle manoeuvring", which other people may call by different names.

Of course, the elimination of double taxation clause is traditionally one of the least negotiated clauses of a tax treaty. It is deemed to reflect one of those domestic rules around which treaties are built. As such, tax treaties would rarely provide for elimination of double taxation at variance with domestic law rules. Nevertheless, in the case of the France–Switzerland protocol, the drafting of the elimination of double taxation clause represents a subtle variation on a new French treaty policy. More importantly, this subtle variation probably reflects more a calculated move than a "happy accident".

To an extent, the solution sought by the French authorities is "imaginative". However, the ratification of a treaty is not the end of the story, but rather its beginning. The Vienna Convention notwithstanding, the correct application of a treaty needs two willing partners, which willingness is surely fostered by mutual confidence. Therefore, it could also prove to be counter-productive.

According to unconfirmed reports, this "Swiss strategy" reflects a new and firm position of the French tax authorities which would also apply to future negotiations. Two tax agreements initialled very recently with EU countries reportedly reflect this position. The tax authorities argue that the formulation is not solely intended for the application of Article 209 B (CFC) or Article 238 0I (transfer of assets to a foreign trust) of the French Tax Code, but also as a pre-emptive move should France ever abandon the territorial rule in favour of a worldwide system.

RECENT TREATIES

Countries	Date of conclusion
Albania–Macedonia	15 January 1998
Korea–Romania	23 January 1998
Nepal–Thailand	2 February 1998
China–Hong Kong	11 February 1998
Korea–Uzbekistan	11 February 1998
Macedonia–Sweden	17 February 1998
Denmark–Thailand	23 February 1998
Latvia–Moldova	25 February 1998
Netherlands–Romania	5 March 1998
Malaysia–Myanmar	9 March 1998
Mauritius–Oman	30 March 1998
Canada–Indonesia (protocol)	1 April 1998
Belgium–Kazakstan	16 April 1998
Chile–Mexico	17 April 1998

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Conference Diary

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

JUNE

Transcontinental Trusts Conference 1998, The Royal Lancaster Hotel, London, the United Kingdom, 29-30 June and 1 July 1998 (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: juliet.neckar@ibcuk.co.uk

The 1998 Corporate Tax Symposium, The Waldorf Meridien Hotel, Aldwych, London WC2, the United Kingdom, 29-30 June 1998 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

AUGUST

Summer Course on International Taxation in the EC, Münster, Germany, 2-7 August 1998 (English):

Institut für Steuerrecht Westfälishe Wilhelms-Universität, Universitätsstraße 14-16, D-48143 Münster, Germany, E-mail: scitax1998@uni-muenster.de

Summer Course on the Principles of International Taxation, Amsterdam, the Netherlands, 17-28 August 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

Accounting & Tax for Derivatives, London, the United Kingdom, 25-27 August 1998 (English):

Hilary McCann, Managing Director of Public Programmes, Euromoney Training, Nestor House, Playhouse Yard, London EC4V 5EX, the United Kingdom, Tel.: 44-171-779 8753, Fax: 44-171-779 8693, E-mail: euromoneyt@dial.pipex.com

SEPTEMBER

Tax Efficient Structures for Cross-Border Mergers & Acquisitions, the Lanmark Hotel, London, the United Kingdom, 16 September 1998 (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: sarah.wheatley@ibcuk.co.uk

Tax and Business Implications of the Currency Crisis in Asia, Amsterdam, the Netherlands, 21 September 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

Transfer Pricing '98, Café Royal, London, the United Kingdom, 21-22 September 1998 (English):

SMi Ltd., No.1, New Concordia Wharf, Mill Street, London SE1 2BB, the United Kingdom, Tel.: 44-171-252 2222, Fax: 41-171-252 2272.

Mergers & Acquisitions, Amsterdam, the Netherlands, 24-25 September 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

OCTOBER

52nd IFA Annual Congress, London, the United Kingdom, 4-9 October 1998 (simultaneous translations into French, English, German and Spanish):

52nd IFA Annual Congress, Concorde Services Ltd, 10 Wendell Road, London W12 9RT, the United Kingdom, Tel.: 44-181-743 3106, Fax: 44-181-743 1010, E-mail:ifa@concorde-uk.com

Application of Tax Treaties, Amsterdam, the Netherlands, 21-23 October 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

Transfer Pricing Audits, Amsterdam, the Netherlands, 30 October 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

NOVEMBER

Accounting & Tax for Derivatives, London, the United Kingdom, 3-6 November 1998 (English):

Hilary McCann, Managing Director of Public Programmes, Euromoney Training, Nestor House, Playhouse Yard, London EC4V 5EX, the United Kingdom, Tel.: 44-171-779 8753, Fax: 44-171-779 8693, E-mail: euromoneyt@dial.pipex.com

International Tax Aspects of VAT, Amsterdam, the Netherlands, 19-20 November 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

International Tax Planning Aspects of Doing Business with MERCOSUR, Amsterdam, the Netherlands, 27 November 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

DECEMBER

Double Taxation Relief: Practice, Theory and Planning, Amsterdam, the Netherlands, 10-11 December 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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THE IMPORTANCE OF BEING PERMANENT

Barry Larking*

Head of Library and Source Information, IBFD

Recognizing a permanent establishment is not always easy. Among the main contributors to the problem are varying conceptions of "place of business", uncertainty over the role of time and place, and the absence of guidance on how to measure permanence. This article details some of the particular problem areas and identifies where policy choices could usefully be made or guidance provided.

I. DEFINITIONAL ISSUES

A. Meaning of "place of business"

The term "place of business" refers to the localization of a business activity by reference to a physical space or object.[1] Possible examples include "a facility such as premises",[2] "a pitch in a market place",[3] machinery,[4] a pipe-line[5] and even a racehorse.[6] The business activity is not restricted to the place of business. It is sufficient that it is carried on "through" the place of business.[7] This is underlined by the OECD Commentaries, which indicate that the business may be conducted by employees "in the State in which the fixed place is situated".[8] This leaves open the precise function of the place of business in relation to the activities performed outside it in the state of source. It has been suggested that a place of business should be the focal point or headquarters of the foreign enterprise's business,[9] but in practice a weaker connection may suffice.[10] It is clear that the concept is broader than a single focal point or headquarters from the fact that an enterprise may maintain several permanent establishments in the same state. This is also implicit from the varying nature of the places of business listed in Article 5(2) of the OECD Model. It has even been argued that the more business activity which is conducted outside the place of business, the less significance is attached to the activity carried on in the place of business.[11] The standard exception for preparatory or auxiliary activities in Article 5(4) of the OECD Model does not entirely solve the problem as this deals primarily with the relationship between the place of business and the enterprise as a whole rather than the function of the place of business in relation to the source state activities. Guidance on the nature of this relationship would be welcome.

B. Meaning of "fixed"

The place of business must be "fixed".[12] This is generally understood as implying both physical permanence, or a "link between the place of business and a specific geographical point",[13] as well as temporal permanence, or a "certain degree of permanency, i.e. if [the place of business] is not of a purely temporary nature".[14] Broadly speaking, this means that the place of business should stay in the same place for a sufficient length of time. The questions what is the "same place" and what is "sufficient" are considered below.

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* The views expressed are those of the author and do not necessarily represent those of the IBFD.

1. The idea of localization is less apparent from the (equally authentic) French text of the OECD's permanent establishment definitions, which simply refers to "une installation [ ] d'affaires". The author is indebted to Professor Vogel for having pointed out this distinction and its possible significance for source state taxation of mobile business activities, discussed in more detail below.
2. OECD Model Tax Convention on Income and Capital (1997), Commentaries to Art. 5 (hereinafter: OECD Commentaries), para. 2.
3. OECD Commentaries, para 4. The idea of a space or area as such constituting a place of business appears to be rejected in *Klaus Vogel on Double Taxation Conventions*, third edition, Kluwer Law International, at marginal number 23 to Art. 5. Perhaps the better view is to treat the space or area together with any business assets in it as the place of business.
4. OECD Commentaries, para. 2.
5. German Federal Tax Court decision BStBl II 1997, 12. This decision is not undisputed: see, e.g. M. Lampe, "Broadening the Definition of a Permanent Establishment: The Pipeline Decision", 38 *European Taxation* 2 (1998), at 67.
6. See the discussion of the US "race-horse rulings" in J. Huston and L. Williams, *Permanent establishments: a planning primer*, Kluwer Law and Taxation Publishers, 1993, at 41 et seq. and the critical observations of Vogel, *supra* note 3, at marginal number 28a.
7. OECD Model Tax Convention on Income and Capital (1997) (hereinafter: OECD Model), Art. 5(1). Contrast the 1963 OECD Draft Convention (hereinafter: OECD Draft), which referred to business carried on "in" a place of business. More liberally, Vogel considers (*supra* note 3, at marginal number 30) that the business may be carried on "in or through or by" the place of business. See also Lampe, *supra* note 5, at 70.
8. OECD Commentaries, para. 2. See, also, Larter, cited by J. Nitikman, "The Meaning of 'Permanent Establishment' in the 1981 US Model Income Tax Treaty (Part 1)", *The International Tax Journal*, Vol 15:2, at 159, footnote 37.
9. Nitikman, *supra* note 8, at 164.
10. See, generally, A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle*, Kluwer Law and Taxation Publishers, 1991, at 327 et seq., and in particular the cases cited.
11. Vogel, *supra* note 3, at marginal number 23: "[T]he weight attaching to the 'use' criterion is all the lighter, the more the actual business activity is exercised outside the place of business".
12. OECD Model Art. 5(1).
13. OECD Commentaries, para. 5. Although such a link is arguably already implicit in the use of the word "place" in "place of business", the OECD Commentaries' emphasis on a physical side to "fixed" was perhaps necessary to make up for the absence of such a link in the OECD's French rendition of the expression (see *supra* note 1). This might have been avoided, had the OEEC, when it took over the League of Nations' work on double taxation, continued to use the latter's French terminology, "lieu[x] d'affaires", which exactly reflected the English "place of business" (compare, e.g. Art. V(1) to the Mexico (1943) and London (1946) draft income tax conventions with the permanent establishment article in the first (1958) OEEC report on the elimination of double taxation).
14. OECD Commentaries, para. 6. Although "fixed" is sometimes used to describe the physical, and "permanent" the temporal aspect, for clarity the terms "physical permanence" and "temporal permanence" are used here.

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II. THE ROLE OF TIME AND PLACE

A. Physical mobility and permanence

Mobility and physical permanence appear at first sight to be incompatible concepts. However, the two may be reconciled in a number of ways. In the first instance, mobility within a place of business is not restricted (if it were, most places of business would not be physically permanent). This is particularly relevant to places of business defined by reference to a physical space or area. The larger the area, the greater the scope for mobility. This should arguably remain the case where there are within such a place of business (e.g. a construction site) moving objects which themselves could constitute places of business (e.g. machinery). Similarly, since, as already explained, the business activity need not be confined to the place of business, mobility outside the place of business will also be consistent with physical permanence. Again, it seems not to matter that what is moving could itself constitute a place of business. Thus, the operation of trucks (arguably places of business)[15] within a state should lead to a permanent establishment if the activity is coordinated from a central depot. However, this situation is not entirely free from doubt since there are now several places of business through which the business is being conducted, of which only one is physically permanent. In such cases, a strong connection between the mobile part of the business and the fixed place of business will presumably be needed before a single, taxable permanent establishment can be defended.

Where the business activity moves to a new place of business, the issue is only one of timing (dealt with in B.1. below). Where the place of business itself moves, the initial problem, dealt with immediately below, is with physical permanence. The additional relevance of time for such places of business is discussed in B.2. below.

Most "traditional" places of business, such as buildings, are incapable of movement and are clearly physically permanent. However, it may be argued that a place of business which does not actually move, but which is *capable* of movement, should also be regarded as physically permanent. This would not seem to conflict with underlying policy objectives such as ease of tax administration and "nexus" justifying source state taxation. The following OECD statement offers some support for this view: "[T]his does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands".[16] While it has been suggested that this statement should be confined to the specific case of machinery and equipment, both practice as well as commentators suggest it may be of more general application.[17]

On the assumption that the mere capacity to move is not a bar to permanence, the question remains whether, and if so in what circumstances, a place of business *can* move while remaining physically permanent. Movement at the termination of the business should not retrospectively affect permanence. There are two reasons for this. From a practical point of view, it would otherwise be impossible in most cases for such objects to constitute places of business since they would normally be removed when the business terminated. This would mean that capacity to move was in effect a bar to permanence. From the technical standpoint, in the absence of continuing business activities, the object should no longer qualify as a place of business and mobility would therefore be irrelevant. It may also be argued that movement of a place of business in between assignments (or for repair, storage or maintenance) is not a bar to permanence. This could be supported under the technical argument made above that at such times no business is being carried on and therefore movement is not relevant. However, it may not always be clear that during these periods of movement business activities have ceased. While domestic law concepts might be useful in this regard, generally applicable guidelines might provide a more practical and consistent solution. Alternatively, if the place of business returns to the same location, it may be argued by analogy with the OECD's approach to business interruptions in general, that temporary interruptions caused by such interim movement can be ignored.[18] There is some, but not unqualified, support in practice for this view. Arguably it underlies a Canadian Tax Court case involving a US taxpayer who had attended an annual Canadian trade fair for two weeks at a time over a 15-year period, making use of a collapsible booth which was annually trailered into and out of Canada. The court held that the non-resident had a permanent establishment.[19] Support is also apparent from the German Minister of Finance's pronouncement in the context of German domestic law to the effect that mobile places of business which are temporarily stationary (such as mobile sales stands with different locations) may constitute a permanent establishment.[20] By way of contrast, it has been reported that in an unpublished English case a semi-submersible drilling rig was held not to have a distinct situs when moving between drilling sites and therefore did not constitute a permanent establishment.[21]

The traditional view is that a place of business which moves while carrying out business activities (such as a ship or a truck) would not be physically permanent.[22] However, a trend has been reported by Professor A. Skaar, called the "spatial delimitation approach", whereby activities performed at fixed temporary locations within a delimited area may con-

15. See Skaar, *supra* note 10, at 134.
16. OECD Commentaries, para 5.
17. Arguing that the OECD statement is an isolated example, see Huston and Williams, *supra* note 6, at 47 and, contra, Skaar, *supra* note 10, at 120. In support of the view that the capacity to move should not be a bar to permanence, see A. Storck, *Ausländische Betriebstätten im Ertrag- und Vermögensteuerrecht*, Alfred Metzner Verlag, 1980, at 134, and see also the case law referred to by Skaar, *supra* note 10, at 120, C. van Raad in *Cursus Belastingrecht: Internationaal belastingrecht*, Gouda Quint (loose-leaf: February 1996) at 2.5.1.B(a), and H. Schaumburg in *Internationales Steuerrecht*, Otto Schmidt, 1998, at marginal number 5.163. See also, Vogel, *supra* note 3, at marginal number 24, "The facility need not be an integral part of the plot of land on which it stands".
18. See OECD Commentaries, para. 11. The question what is temporary is dealt with in Part B below.
19. *Fowler v. M.N.R.* 90 DTC 1834. Vogel rejects the decision on the (arguable) grounds that there was no fixed relationship to the earth's surface (see *supra* note 3, at marginal number 28a).
20. *Anwendungserlass zur AO* (AEAO) BStBl 1987 I 664 at 665.
21. Cited by Skaar as "Borgny Dolphin" (see *supra* note 10, at 140-141). Arguably this case should be viewed in the context of the "spatial delimitation approach", where the time spent at one place on one assignment does not of itself qualify.
22. See e.g. Skaar, *supra* note 10, at 134.

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stitute a permanent establishment.[23] A more radical version would accept a permanent establishment even without fixed temporary locations, i.e. movement while carrying out business activities.[24] The OECD Commentaries have been invoked in support of this approach on the basis of their statement that a physical link is only required "in the normal way".[25] The approach is perhaps more compatible with the French version of the OECD Model, which refers to "une installation fixe d'affaires", since this omits the physical link implied by "place" in "fixed place of business". However, it is questionable how much weight should be accorded to this language difference in view of the reference to physical permanence in the OECD Commentaries (in both languages) as well as the use of the term "stable" in the French translation of permanent establishment, "établissement stable".[26]

Notwithstanding such possible technical objections, this difference in wording may explain the acceptance of the spatial delimitation approach in some francophone countries or countries (e.g. Norway) whose treaty language follows the French formulation, or (as in the case of Canada) whose treaty culture is heavily influenced by the French language.[27]

The spatial delimitation approach should be distinguished from the place of business mentioned above which consists of a space or area. In the latter case, the area is the place of business, whereas under the spatial delimitation approach (as it is understood), the place of business, typically an offshore installation, moves within the area, or the business moves between different places of business within the area.[28] The "mobile" construction site permanent establishment has been cited as an example of the spatial delimitation approach.[29] In fact, it is arguably an example of both approaches. The construction site as such constitutes a place of business (within which movement is possible) and, to the extent the site is relocated, this will generally be within a "spatially delimited area". The condition in the OECD's example of mobile equipment, that in order to be physically permanent it must remain on a particular site, is perhaps another example of the spatial delimitation approach.[30] Whether an area is characterized as one or the other will depend in part on the extent of the enterprise's "right of use",[31] or "power of disposition".[32] A consequence of the distinction is that the business activities are not restricted to the area where this constitutes a place of business but by definition are so restricted under the spatial delimitation approach.

A final argument for permitting movement is that physical permanence has a variable meaning which is relative to the nature of the business. If accepted, it would mean mobility while carrying on business activities might also be tolerated by the permanence concept. This possibility, together with the question of how to measure permanence, is discussed in more detail under Section III below.

B. Time and permanence

1. Immobile places of business

Permanence is the tool used to establish a connection between the taxpayer and a location on the earth's surface. The connection must be through a place of business. In the case of an immobile place of business (i.e. one which is incapable of movement), the link between the place of business and the earth's surface is automatically satisfied.[33] This is the normal function of the physical permanence requirement. Establishing a sufficient connection between the taxpayer and the place of business will therefore establish the necessary connection with the earth's surface. This is the normal function of the temporal permanence requirement.

The temporal link is variously described in terms of the taxpayer's use of the place of business[34] or in terms of the activities carried on through the place of business.[35] There is some uncertainty as to whether it is actual or intended duration which is relevant. Most commentators tend to support the intended duration view, either by way of interpretation of the OECD Commentaries or as a matter of principle.[36] A related view focuses on whether the place of business was designed to serve the taxpayer on a permanent basis.[37] In practice, however, actual duration seems to play a significant role in determining temporal permanence. Proponents of the "intention" approach have justified this on the grounds that actual duration may provide evidence of intention.[38] Nonetheless, actual duration appears often to be taken as the determining (and only) factor.[39]

In addition to the discussion surrounding intention or actual duration there is an even more fundamental question as between indefinitely lasting and limited duration use. In prac-

23. Id., at 151.
24. See, e.g. Van Raad, *supra* note 17, who suggests the possibility of a transport ship following a fixed route being permanent.
25. OECD Commentaries, para 5. See, also, Skaar, *supra* note 10, at 131.
26. See also *supra* note 13.
27. See, e.g. the cases referred to by Skaar (*supra* note 10, at 143-145).
28. The latter case is difficult to reconcile with the basic definition of permanent establishment (in French or English) which is expressed in terms of a *single* place of business/installation.
29. Skaar, *supra* note 10, at 128. In a later work (Commentary on Art. 5 of the OECD Model Treaty, in *The Taxation of Permanent Establishments* (ed. I. Burgers and R. Betten), IBFD Publications BV (loose-leaf: September 1997), at 2.3.2) the same author suggests such sites might satisfy the physical permanence test because of their mobile nature (see further Section III below).
30. OECD Commentaries, para. 5. See, also, text to *supra* note 16.
31. Skaar, *supra* note 10, at 155.
32. Vogel, *supra* note 3, at marginal number 25. This principle (and that referred to in *supra* note 31) is supported by the OECD Commentaries, para. 4, "A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal".
33. See Storck, *supra* note 17, at 134.
34. Skaar, *supra* note 10, at 209 et seq.
35. See, e.g. Vogel, *supra* note 3, at marginal number 28: "The term 'fixed' implies that a certain **length of time** is required for such business activities" (original emphasis).
36. OECD Commentaries, para. 6. See also Treasury Department Technical Explanation of the United States Model Income Tax Convention (1996), Art. 5, para. 2, "it must be foreseeable that the enterprise's use of [the place of business] will be more than temporary". See also e.g. Skaar, *supra* note 10, at 217, Storck, *supra* note 17, at 145 ("ansonsten wäre die Voraussetzung immer erst im nachhinein erfüllt") and Nitikman, *supra* note 8, at 167.
37. Vogel, *supra* note 3, at marginal number 28. It has been pointed out that "designed to serve the business", which is somewhat broader than "carrying on business through", is limited to the German domestic law concept (M. Günkel in *DBA-Kommentar*, Art. 5 OECD-MA, marginal number 47, Verlag Neue Wirtscafts-Briefe (loose-leaf: October 1977)).
38. See, e.g. Skaar, *supra* note 10, at 217-218.
39. See, e.g. Skaar, id. at 132.

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tice limited duration use appears to be generally accepted within the permanence concept. In one view this is limited to the case where planned use for an indefinite period is prematurely terminated (e.g. due to ill health).[40] Another view is that even where the activity is planned for a limited duration, this can still be permanent.[41]

Another aspect of time in relation to immobile places of business is the duration of interruptions to business operations. The OECD indicates that "temporary" interruptions should not cause a permanent establishment to cease to exist.[42] The question is, what is temporary and does the frequency of such interruptions matter? Similarly, if limited duration activities (whether planned or not) can in fact constitute permanent establishments, the question is, how long is long enough? Some writers have argued in favour of a single fixed period either as a matter of principle or in an attempt to rationalize case law.[43] However, in practice the periods vary from case to case. Often this is attributed to a "facts and circumstances" approach.[44] A more concrete way of expressing this is that temporal permanence (like physical permanence) is relative to the nature of the business. This is discussed in more detail in Section III below.

2. Mobile places of business

Establishing a temporal link between the taxpayer and a mobile place of business (i.e. one which is capable of movement) says nothing about the duration of the taxpayer's presence in relation to the earth.[45] For this, a link is needed between the place of business and the earth, equivalent to the physical permanence of immobile places of business described above. This could simply be a second temporal test based on the length of time the place of business remains in one place.[46] Alternatively a single temporal test, applicable to both mobile and immobile places of business, can be formulated based on the duration of the taxpayer's use of (or activities carried on through) a place of business situated in any one physically permanent place. The need for a single test may be illustrated by the example of two circus tours, one making use of existing (immobile) theatres and the other using traditional (movable) tents and caravans. Given their essential similarity, the question of temporal permanence should have the same answer in both cases. This can be ensured by applying a single test with one set of standards. If temporal permanence is relative for immobile places of business it will then also be so for mobile places of business.

If movement within a particular area is tolerated by the physical permanence concept, the above test could be reformulated such that temporal permanence is based on the duration of the taxpayer's use of (or activities carried on through) a place of business situated in any one physically permanent place or area. The OECD Commentaries arguably contemplate something in this line in the case of equipment where it is "enough that the equipment remains on a particular site".[47]

III. THE RELATIVITY OF PERMANENCE

As already mentioned, there is a view that the permanence requirement (in time or place) is a relative concept whose meaning may be determined by reference to the nature of the business. This section deals with the practical implications of this "relativity principle" as well as discussing what technical and practical support it may have. There are two ways of applying the principle. The first is an "all or nothing" approach under which the permanence requirement (temporal and/or physical) is simply disregarded if the nature of the business is non-permanent. The second is a more gradual approach in which varying degrees of permanence may be recognized for different businesses and the permanence of the actual business is measured against the applicable standards or relevant norms.

A. Permanence versus non-permanence

Under the "all-or-nothing" approach the business must be characterized as either permanent or non-permanent (or as "mobile" or "non-mobile"). This raises a number of difficulties of which the first is whether to compare the taxpayer's business with other businesses from the same industry or business sector (objective standard), or to take the business itself as the relevant standard (subjective standard).[48] The subjective approach arguably achieves maximum taxpayer equity, by ensuring, for example, that new non-industry standard technology or business practices will still lead to source state taxation even if they achieve substantial time savings or require significantly less capital intensive presence.[49] Whether this is desirable from the point of view of

40. OECD Commentaries, para. 6.
41. See e.g. *Canadian Interpretation Bulletin* IT-177R2, 4 May 1984, para. 3. See also Skaar, *supra* note 10, at 210, "Otherwise 'temporary' activities such as extraction of mineral resources could not be a PE"; Vogel, *supra* note 3, at marginal number 28, "A place of business may be 'fixed' for purposes of the necessary time requirement even if it is planned for fewer than 12 months" (original emphasis); and Schieber, in Debatin/Wassermeyer, *Doppelbesteuerung*, Beck (loose-leaf: November 1997), MA Art. 5, marginal number 96 "da es keine unendlichen Aktivitäten gibt".
42. OECD Commentaries, para. 11.
43. R. Williams, *Permanent Establishments in the United States, in Income Tax Treaties* (ed. Bischel), Practising Law Institute, 1978, 189 at 282; Vogel, *supra* note 3, at marginal number 28, "For more than 12 months, the time requirement is satisfied in any case"; Skaar suggests exceeding a period of 18 months will always lead to a permanent establishment (see *supra* note 10, at 566).
44. See, e.g. Vogel *supra* note 3, at marginal number 28:"Whether the place of business meets this test of permanence must be judged against the background of all the circumstances constituting each individual case".
45. Perhaps for this reason, Skaar suggests the temporal test is limited to use of immobile places of business (see *supra* note 10, at 209).
46. Temporal permanence is sometimes described as "compensating" for a lack of physical permanence, or simply as an alternative. See, e.g. the German Federal Tax Court: "Eine ["feste" Geschäftseinrichtung] liegt vor, wenn eine feste Verbindung zum Erdboden besteht bzw. die Geschäftseinrichtung oder Anlage sich für eine gewisse Dauer an einem bestimmten Ort befindet" (BStBl II 1997, 12 at 14). See, also, F. Garcia Pratts, *El Establecimiento Permanente*, Editorial Tecnos, 1996 at 114-118.
47. OECD Commentaries, para. 5.
48. Compare the discussion of "ordinary course of [] business" in the context of Art. 5(6) of the OECD Model in, e.g. Vogel, *supra* note 3, at marginal number 172.
49. But see the discussion in Section IV.A. below, in particular the text to *supra* note 78.

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commercial and technological development is another matter. A more fundamental objection to this approach is that it would result in the permanence requirement being effectively abolished. If, for example, a place of business only need remain stationary when necessary for that particular business, it could never be too mobile to satisfy the permanence principle! If such a central tenet of source state taxation is to be abolished it would seem proper that this be done openly and explicitly.[50] On this basis, preference should be given to the objective approach. On the other hand, identifying a permanent or non-permanent industry is far from straightforward. For example, even where non-permanence is a defining characteristic of the industry itself (e.g. shipping), it by no means follows that every place of business through which the business is carried on (e.g. offices, terminals etc.) will lack permanence.[51] The solution here is perhaps to take the activities being carried on and limit the comparison to the same activities as carried on in the relevant industry. How the industry is defined may also affect the outcome of the objective approach. For example, is a rail catering business a typical member of the (non-permanent) transport catering industry or an exceptional member of the (permanent) catering industry. The problem appears to be recognized by the OECD in their approach to construction activities: "The very nature of a construction or installation project *may be* such that the contractor's activity has to be relocated..." (italics added).[52] Thus, not all construction projects (and therefore not all construction businesses) by their "very nature" lack (physical) permanence. The OECD's approach therefore suggests some preference for a subjective approach, at least as regards construction activities. A comparison with the taxpayer's own business as carried on outside the source state would also provide a degree of objectivity but would generate similar characterization problems as the above. In addition, the justification for such an approach is weak, at least in terms of capital import neutrality and taxpayer equity. For example, an antiques dealer attending antiques fairs in the source state would be taxable there if her business activities outside the source state were of a similar nature but not if, for example, they were carried on through an antiques shop.

B. Degrees of permanence

The alternative to the "all-or-nothing" approach is to compare different degrees of permanence. The permanence of the actual business is then compared with objectively established norms, i.e. derived from other businesses in the same industry or business sector. Where the actual business is as permanent or even more permanent than such norms it would qualify for permanent establishment status. The question is then, how to measure permanence? One set of commentators have suggested the following test: "whether, in instances in which all enterprises similarly engaged move appreciable distances, the enterprise in question moves significantly more often or greater distances".[53] This test might be refined to take into account the circumstances in which movement took place, e.g. whether during or at the end of business activities, and the reference to time might be changed so as to focus on the duration of use of the place of business while in one location rather than on mere frequency of movement. Such a test could also take into account the tendency of such businesses to repeat business activities in the same location or area. This would make the permanence requirement more flexible in both the physical and temporal sense. For example, it would permit several periods to be cumulated in determining temporal permanence, and treat repetition at different places within the same space or area as satisfying the physical permanence requirement. Under such an approach, regular use of a pitch in a market place (but not necessarily the *same* pitch) or a different room in an office building could qualify as a fixed place of business.[54] Norms for "quantifying" permanence may therefore be established using a combination of distance, duration and frequency. In practice it is unlikely that a single standard would emerge and a range of values (similar to the arm's length range used in transfer pricing)[55] may be more appropriate.

C. Support for the relativity principle: theory and practice

A number of treaties provide that permanence varies according to the nature of the business in the context of specific industries. However, it might be questioned whether such explicit recognition actually weakens rather than strengthens the case for implying this principle in other cases.[56] The fixed period for construction activities found in most modern treaties is an example as regards temporal permanence.[57] Another example is offshore activities clauses, which provide for temporal permanence after a minimum period of activity and physical permanence simply if the activities take place in the offshore area.[58] Less industry specific but to the same effect are the fixed periods for services in general found in UN Model type treaties.[59] In this case the physical permanence requirement is effectively lifted, as it also is in a unique instance for mobile businesses in general: "Where the business of an enterprise ... is of a mobile nature the place where such business is being carried on ... shall be deemed to be a fixed place of business".[60] It is not clear in this case whether the mobility of the business is to be interpreted in a subjective or objective way. In any event it clearly adopts the "all-or-nothing" approach.

50. See, "Permanent Establishment Update", E. Walker, in *Canadian Current Tax*, December 1990, Vol. 3, No. 12, at P23.
51. Skaar, *supra* note 10, at 134.
52. OECD Commentaries, para. 20.
53. Huston and Williams, *supra* note 6, at 14.
54. Contrast the German case of a market vendor, cited by Skaar, *supra* note 10, at 126-127 in which the fact that the same pitch was regularly used appears to have been a relevant factor in finding a permanent establishment.
55. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (loose-leaf: 1998), at 1.45 et seq.
56. See, e.g. New Zealand Taxation Board of Review 3 NZTBR 49 (1965) at para. 30.
57. E.g. OECD Model Art. 5(3). The example would be more convincing if the text were formulated somewhat differently to make clear that a project exceeding 12 months *does* constitute a permanent establishment.
58. E.g. Nordic Convention Art. 21.
59. United Nations Model Double Taxation Convention between Developed and Developing Countries, 1980 (hereinafter: UN Model), Art. 5(3)(b).
60. Japan–New Zealand Tax Convention Art. II(m)(iii).

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The idea of permanence being relative to the nature of the business also finds support in the OECD Commentaries. One instance is again in the context of a specific industry, i.e. construction: "The very nature of a construction or installation project may be such that the contractor's activity has to be relocated...".[61] However, the principle is endorsed for short duration activities in general where the brevity is "because of the special nature of the activity".[62] There are no clear statements in support of the relativity principle for physical permanence, although the requirement of a link between the place of business and a specific geographical point "in the normal way" arguably offers some support.[63]

There is also evidence of the relativity principle being applied in practice by both tax administrations and courts. For example, the Canadian tax administration has been reported as taking into account the seasonal nature of a business in interpreting temporal permanence[64] and it has been suggested that the Spanish tax administration's approach would be consistent with a relaxation of the physical permanence requirement for businesses which are by nature mobile.[65] In an English case (in an admittedly very different context) it has been noted that "permanent" is "indeed a relative term, and is not synonymous with everlasting"[66] and in a Canadian case a permanent establishment was found for short annual visits to a trade fair using a mobile booth, on the grounds that "it was the very nature of the business itself that mandated [the lack of permanence]".[67] Whether the court applied a subjective or objective approach in this case is not entirely clear. Support for the principle from commentators is also not lacking.[68]

D. Variations on the relativity theme

Permanence may be relative in more ways than just by reference to the nature of the business. It has, for example, been suggested that temporal permanence may be relative to physical permanence in the sense that an excess of one will compensate for a shortfall of the other.[69]

A similar view is that permanence is relative to regularity, in other words, the more often repeated, the shorter the duration required for each stay or the less the importance attached to a specific location. This reasoning may be read into a number of court decisions and rulings.[70]

A very different version of the relative approach to temporal permanence is that the relevant standard is the time needed to earn income in any particular case. Although this approach has been explicitly rejected in one New Zealand case it is questionable why it is wrong when seen from the point of view of capital import neutrality and taxpayer equity.[71] A possible criticism, based on grounds of administrative efficiency, is discussed in more detail in Section IV below. It might also be argued that this approach simply shifts the problem from the sphere of Article 5 (permanent establishments) to Article 7 (profit allocation). However, not all practice goes against the idea of permanence being measured at least partly in financial terms. Canadian tax administration practice appears, for example, to support the idea by allowing the dollar value of machinery and equipment and its contribution to the generation of gross income to be taken into account in determining the existence of a domestic law permanent establishment.[72] The use of financial standards is also found in tax treaties with the UN inspired provision for installation or assembly projects whose value exceeds a certain proportion of the related components price.[73] Where this test is only applied in the case of short duration projects (as in the case of the UN Model version), monetary significance effectively compensates for lack of temporal permanence. A similar idea, this time in relation to physical permanence, is a financial threshold for service activities which lead to a permanent establishment without the need for a place of business.[74] Here, monetary significance would compensate for lack of physical permanence. The relative unpopularity of this latter approach is probably due to the difficulty of establishing a meaningful monetary threshold for corporate services:[75] USD 10,000 might be a large amount for a small company but not for a large multinational corporate services group. The position might be different if clear, measurable relationships could be identified between, say, income on the one hand and, on the other, production factors, such as payroll. Alternatively, a test based on relative source state-residence state income might offer a solution. This would be similar to the test described above applied by the Canadian tax administration to machinery and equipment cases.

Although the above tests are useful in the sense that they provide for a more flexible concept of permanence, a number may be criticized on the grounds that they only indicate a relationship between different factors but do not provide guidance for actually measuring it. Moreover, a number should arguably be regarded more as substitutes for the per-

61. OECD Commentaries, para. 20. See also text to *supra* note 52.
62. OECD Commentaries, para. 6.
63. OECD Commentaries, para. 5. See, in this context, Skaar, *supra* note 10, at 130-131.
64. Skaar, id. at 220.
65. F. Garcia Pratts, *supra* note 46, at 113. This view is based on a resolution of the TEAC of 28 November 1988.
66. Per du Parq L.J. in *Henriksen v Grafton Hotel Limited* (2 K.B. 184 at 196).
67. See *supra* note 19, at 1836.
68. See, e.g. Huston and Williams, *supra* note 6, at 14; Skaar, *supra* note 10, at 566; M. Reuvers, "De vaste inrichting als aanknopingspunt", in *Losbladig Fiscaal Weekblad* FED (loose-leaf) 26 May 1977 Dubb.B.: Alg., at 105; and Birk, in Hübschmann/Hepp/Spitaler, *Abgabeordnung Finanzgerichtsordnung*, Otto Schmidt Verlag (loose-leaf: December 1977) at marginal number 15. See also FG München EFG 1986 Nr. 5, 259 at 260.
69. See, e.g. Skaar, *supra* note 10, at 151, "the lack of a specific spot may be compensated to some extent by the duration of the taxpayer's presence in the country", or *id.* at 562, "a business activity of long duration does not have to be located at one specific point to the same extent as a short-term activity". This reasoning appears to underlie the "spatial delimitation approach" referred to above. See also Skaar's comments on Canadian tax administration practice, *id.* at 144; Reuvers, *supra* note 68, at 106; and *supra* note 46.
70. See, e.g. *Fowler v. M.N.R.* (*supra* note 19); Rev. Rul. 67-322, 1967-2 C.B. 469.
71. Taxation Board of Review 3 NZTBR 49 (1965) (cited by Skaar, *supra* note 10, at 132-133).
72. Interpretation Bulletin IT-177 R2 (see *supra* note 41). See also *Fowler v. MNR* (*supra* note 19), at 1836, where the fact that the source state (Canadian) income amounted to a significant proportion of the income of the business as a whole appears to have been a relevant factor.
73. UN Model Commentaries at 63. See also, e.g. India–Turkey tax treaty Art. 5(2)(j)(ii).
74. See, e.g. UN Model Art. 5(3)(b).
75. See UN Model Commentaries at 65.

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manence criterion rather than as aids to its interpretation. It should also be pointed out that the approaches based on the financial significance of the source state activity would be likely to conflict with the OECD's traditional standpoint concerning profitability as a criterion for source state taxation.[76]

IV. FUTURE POLICY CONSIDERATIONS

A. Should the permanence requirement be abolished?

Abolishing the permanence requirement would open the door (insofar as it is not already open) to taxation of mobile businesses. As already noted, there is a concern that this would impede both technological as well as commercial development. Whether it would also distort foreign direct investment is another matter. It has for example been argued that the permanent establishment concept ensures economic efficiency (i.e. minimum tax distortion of the investment decision) but only if the enterprise has more than a "transient" presence: there must be a "transfer of capital factors for a certain duration".[77] Abolishing the temporal permanence requirement could not therefore be justified in terms of such neutrality. It has been suggested that similar considerations may apply from the point of view of taxpayer and inter-nations equity.[78] On the other hand, abolition of physical permanence would not seem to be a problem under this view.

A compromise might be to adopt the "spatial delimitation approach" described above, subject to the practical difficulty of defining with any degree of certainty the relevant space or area. Failure to define this would reduce the permanent establishment principle to "source-state taxation with a 'duration test'".[79]

Abolishing the permanence requirement would also have revenue implications for high value business activities of short duration or which do not require significant physical source state presence: The UN Model reflects the latter concern with regard to services (no place of business requirement).[80] However, concerns expressed in the UN Commentaries as to the former were not taken up in the text of the UN Model (no threshold less than six months).[81]

On the other hand, taxation of short duration, or occasional business has been criticized on a number of grounds, including administrative practicality,[82] damage to international commerce[83] and international custom.[84] The administrative problems of taxing short-term business were also used to defend non-source state taxation of itinerant merchants in the 1963 OECD Draft.[85] The insignificant revenue loss (which was also an argument used in this discussion) was perhaps the more important factor given that there was no apparent practical difficulty envisaged in taxing itinerant *agents* under the corresponding provisions of the same Draft. An argument put forward as early as 1980 in favour of taxation of short-term activities was the de facto source state taxation of artistes etc. under OECD Model Article 17.[86] Having said that, problems in practice have been highlighted. For example, in a recent report into the South African tax system (where in theory one-day's business activity would be taxable) it was noted that "a whole regime of non-enforcement on short-duration income has come into existence; this undermines compliance enforcement generally".[87] It would seem that prerequisites for abolition should include adequate tax administration technology and infrastructure plus efficient international cooperation, especially in terms of information exchange. Across the board abolition does not therefore seem a practical likelihood. As for damage to international commerce, the standard permanent establishment article already has a well-developed set of provisions for dealing with this problem.[88] It can certainly not be the function of the permanence requirement of the permanent establishment definition to ensure preparatory or auxiliary activities escape source state taxation, nor does it seem defensible to argue that profitable short-term business is either auxiliary or preparatory in the sense of such provisions.[89] Of course, offering non-taxation of short-term business may in certain circumstances act as an incentive to attracting that kind of investment but that is not the same thing as the promotion of international trade in general.[90] Finally, while international custom might go against ad hoc removal of the permanence requirement, this does not mean it would be incapable of adapting to coordinated development on this front.

B. The case for and against fixed time periods

Assuming some level of temporal permanence is required, there is a basic choice between adopting a fixed period or periods and leaving the content open. In evaluating these alternatives, the different functions of fixed periods should be clear. One possibility is to apply a "minimum threshold" approach under which a relevant activity lasting less than the minimum can not constitute a permanent establishment. Another possibility is to adopt an "automatic qualification" period under which a relevant activity automatically constitutes a permanent establishment if it exceeds the stated time. These two approaches may of course be combined but need

76. See OECD Draft, Commentaries to Art. 5, para. 4. But see references to profits in OECD Commentaries, para. 23 and OECD Draft, Commentaries to Art. 5, para. 12.
77. See Vogel, "Worldwide vs. source taxation of income – A review and re-evaluation of arguments", Part II *Intertax* 1988/10, 310 at 315.
78. Id. in Part III, *Intertax* 1988/393 at 400. Contrast the suggestion made above (text to *supra* note 49) in the context of the subjective approach to measuring permanence.
79. Skaar, *supra* note 10, at 128.
80. UN Model Art. 5(3)(b).
81. UN Model Commentaries at 64.
82. See, e.g. UN Model Commentaries at 65.
83. See, e.g. UN Model Commentaries at 64.
84. See, e.g. Skaar, *supra* note 10, at 21.
85. OECD Draft, para. 6.
86. UN Model Commentaries at 64.
87. Fifth Interim ("Katz") Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa, at 5.2.1.
88. See, e.g. OECD Model Art. 5(4).
89. Contra, UN Model Commentaries at 64.
90. For another view, see, *Guidelines for tax treaties between developed and developing countries*, United Nations, 1974, at 16.

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not be.[91] The formulation adopted in the UN Model suggests such a combination.[92] Contrast this with the wording of the OECD Model which suggests only the "minimum threshold" approach.[93] The arguments for and against fixed periods will be affected by which of the above choices is made.

Adopting a single fixed period for all activities has the advantage of administrative simplicity and taxpayer certainty but it is inequitable in that it fails to address commercial and practical differences between businesses.[94]

Adopting different fixed periods addresses the latter point but the difficulty is then to identify "appropriate" periods for different industries. As demonstrated above in the context of the "relativity principle", this is far from straightforward.

Fixed periods have also been criticized on the grounds that they provide inadequate taxpayer certainty unless the period is computed separately for each project (or related projects).[95] Such concerns appear to overlook the fact that a series of unrelated projects is far greater evidence of a structural connection, or integration with the source state (such as to justify source state taxation) than is a single project or series of related projects.

Concerns have also been expressed that fixed periods open the door to tax avoidance. To some extent, these concerns may be met by "anti-splitting" clauses, e.g. to cumulate activities which form part of a single project but which have been split up between group companies.[96] The significance of these concerns depends to some extent on the choice between the "minimum threshold" and "automatic qualification" function.

Another problem with fixed periods is that no room is left for "marginal" cases, i.e. as soon as the relevant threshold is exceeded source state taxation ensues (unless the "minimum threshold" approach is used). As already indicated, in the case of norms derived from industry practice, a range of values is the more likely outcome. This should help prevent anomalies as between essentially similar taxpayers who would otherwise fall just on either side of the dividing line. Adopting ranges, or degrees of "permitted deviation" for fixed period provisions should achieve a similar result.

The benefit of leaving the content open, to be completed on the basis of industry related norms, is that it offers increased administrative flexibility without unduly compromising taxpayer certainty. It would also help ensure that standards keep pace with technological and commercial developments. The problem of establishing the industry norms, however, remains.

C. Suggested action points

A number of areas highlighted above could usefully be the subject of clarification, perhaps in a forthcoming revision of the OECD Model. Some suggestions are set out below.

- A clear position should be taken on the interaction between source state taxation and capital import and export neutrality. Only then can proposals for changes which would limit or extend source state taxation be put in their proper context.
- Too much emphasis is currently placed on the existence of a fixed place of business as opposed to the relationship between the function of the place of business and the activity carried on in the source state. This is particularly important given the potentially far-reaching consequences of having a place of business. In the absence of practical guidance on how to measure and evaluate this relationship, consideration might be given to the more radical step of rejecting the place of business concept and focusing the test simply on the source state activity.
- Certainty is needed that limited duration activities can constitute permanent establishments whether or not limited duration is intended. This would recognize existing practice as well as commercial reality.
- The function of time in relation to physical permanence needs clarifying, i.e. that the same temporal test applies to both a mobile place of business and a mobile business.
- Where fixed time periods are used, it should be made clear whether these indicate minimum thresholds (below which source state taxation is not permitted) or automatic qualification periods (above which source state taxation is always permitted).
- Where the content of permanence is left open (e.g. fixed periods are not used) it should be made clear whether the appropriate standard of reference should be the business sector or industry, i.e. an objective test, or the actual business, i.e. a subjective test. It is also important whether these tests should be applied on an "all-or-nothing" basis or whether they reflect differing degrees of permanence. In any event, a provision for measuring permitted deviation from fixed time periods or industry norms may help reduce anomalies.

91. Such a combination has been noted in practice by Skaar, *supra* note 10, at 566 where he notes a minimum threshold of 6 months and an automatic qualification period of 18 months.
92. UN Model Art. 5(3).
93. OECD Model Art. 5(3).
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CANADA

CANADA'S 1998 FEDERAL BUDGET – INTERNATIONAL PROVISIONS

Jack Bernstein

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I. INTRODUCTION

On 24 February 1998, the Minister of Finance presented the 1998 Federal Budget and accompanying Notices of Ways and Means Motions. There were several provisions respecting international taxation. The stated objective was to harmonize Canada's domestic tax rules with the rules in Canada's tax treaties and to ensure that the treaties are applied appropriately. Canada currently has over 60 income tax treaties with other countries. The objective of the tax treaties is to ensure that double taxation is avoided. Canadian residents who earn income in another country may be subject to tax both in Canada and in the other country. The tax treaty may establish how the income is to be taxed. For example, the tax treaty may limit the rate of withholding tax imposed by the other country and may ensure that Canada provides a foreign tax credit for the foreign tax. In other instances, the treaty may provide another country with the exclusive right to tax the particular income.

II. TREATY-EXEMPT INCOME

A non-resident of Canada is subject to tax in Canada on employment income earned in Canada, income from carrying on business in Canada and income from the disposition of property known as taxable Canadian property. These amounts are referred to as the non-resident's *taxable income earned in Canada for the year*. This phrase does not take into account the effect of tax treaties. As a result, the non-resident's income that is not subject to tax in Canada may fall within this definition. A non-resident may be able to apply losses to reduce its Canadian tax liability, even though the income or gain or loss from a property or business itself would have been exempt under a tax treaty.

A specific provision is included in the Budget to deal with treaty-exempt income. A non-resident's taxable income earned in Canada will be computed without reference to income, gains or losses from business and property where those amounts are exempt from tax under Part I of the Income Tax Act because of a treaty. This change will apply for the 1998 and subsequent taxation years.

The Budget also proposes that income, gains and losses from a treaty-protected business and property will not be taken into account in calculating losses for other years that can be applied to reduce the taxpayer's taxable income earned in Canada for the 1998 and subsequent taxation years. In the past, taxpayers have excluded such income based on income tax treaties. The concern is that the non-resident may have attempted to claim a loss in order to reduce his Canadian tax liability even though any income or gain from the loss property or business would not be taxable in Canada by virtue of a treaty. A non-resident will not be entitled to carry forward or carry back a capital loss or a non-capital loss to the extent that the loss relates to a treaty-protected business or treaty-protected property.

Assume that an individual who ceases to be resident in Canada is subject to Canadian departure tax with respect to both taxable Canadian Property and non-taxable Canadian Property. The departure tax is paid and in the following year, while a non-resident, the individual disposes of the assets and realizes a capital loss. The capital loss relating to the non-taxable Canadian property would not be available to be carried back to offset the capital gain in Canada arising as a result of the departure tax. The capital loss arising with respect to the taxable Canadian property may be carried back. Although Canada's tax treaties would normally protect a resident of the other country from paying tax on a capital gain realized in Canada with respect to assets, other than real estate or shares in a real estate company, the treaties do not extend that same protection to a former Canadian resident within the first three years of departing Canada. As a result, the Budget proposal will not prevent that capital loss from being carried back.

III. FOREIGN TAX CREDITS

A resident of Canada is subject to Canadian tax on worldwide income. The income is reported on a Canadian tax return and a foreign tax credit is available to the extent that tax has been paid in a foreign jurisdiction. The foreign tax credit enables the Canadian resident to deduct the foreign tax against the Canadian tax to the extent that the foreign tax is not in excess of the Canadian tax that would have been payable on the income. In other words, provided the Canadian tax rate is higher than the tax in the foreign jurisdiction, a full credit should be available. Mismatching may occur where the income is required to be recognized at an earlier date in Canada than it is in the foreign jurisdiction. Revenue Canada is concerned that the foreign tax credit formula applies too

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broadly, taking into account the effect of Canada's income tax treaties.

Apparently, a Canadian resident may have earned income from a source in a foreign country that is exempt from tax in that country by virtue of a tax treaty and have been entitled to claim a tax credit even though no foreign tax was payable with respect to that income. This problem may have arisen because the foreign tax credit calculation takes into consideration the proportion of the taxpayer's Canadian tax otherwise payable that the income in the foreign country bears to the taxpayer's total income. Although not taxable on the exempt income, it would have been taken into account in the formula. The Budget proposes to limit the foreign tax credit such that the treaty-protected foreign income will be excluded from foreign income in determining the ratio of the income from that country to total income. Treaty-protected foreign income will continue to enter into the formula only if it is subject to an income or profits tax to which the treaty does not apply (such as state tax). This applies for calculating foreign tax credits for 1998 and subsequent taxation years.

While a Canadian resident must continue to report worldwide income, any business income, property income, capital gains and employment income that is exempt from tax in any other country will be excluded in computing the taxpayer's income from a country other than Canada for purposes of computing the foreign tax credit. Income will be considered to be tax-exempt where the income or gain is not taxable in the other country by virtue of a treaty or domestic law.

IV. DUAL-RESIDENT INDIVIDUALS

It is not unusual for an individual to be deemed to be resident in more than one country. For example, a person who is resident in Canada but does not sever his or her ties, will continue to be regarded as a Canadian resident for income tax purposes notwithstanding the fact that the person has spent a sufficient length of time in another jurisdiction so as to be deemed to be resident in that country. Generally, where the individual is otherwise a dual resident of Canada and a treaty country the tie-breaker clause in the treaty will deem the person to be resident of one country only for purpose of the items dealt with in the treaty. If the person were regarded as a continuing Canadian resident, Canada would require that person to report his or her worldwide income and to claim a deduction under paragraph 110(1)(f) for the income taxable only in the other country by virtue of the income tax treaty.

An individual who continued to be a resident of Canada but was deemed to be resident in the other jurisdiction would technically not be subject to Canada's departure tax which only applies if Canadian residency is terminated and is not dependent upon the characterization of the person as a resident in another jurisdiction. This may have created a limited planning opportunity for individuals who did not wish to be subject to Canada's departure tax and were content with continuing to file Canadian tax returns and reporting their global income.

It may have been possible for a person who was a resident of Canada and of another country to cherry-pick which items should be taxable under the Income Tax Act and which items should be subject to tax under a treaty. For example, if the person was deemed to be a resident in another country, he or she may have chosen to either be subject to the rate of Canadian withholding tax which applies under the treaty to income payable to a resident of the other jurisdiction or alternatively to report the income on a Canadian tax return and to claim the deductions available to a Canadian resident in respect of that source of income.

The Budget commentary states that Canada's income tax system does not specifically take into account the tie-breaker rules. Under the tie-breaker rules, an individual would generally be deemed to be resident in the jurisdiction in which he maintains a permanent home. If he or she maintains a permanent home in both jurisdictions then regard will be had to the jurisdiction in which the individual maintains closer personal and economic connections (the centre of vital interest). If both of those tests are neutral, then regard will be had to where the individual has an habitual abode. If the individual has an habitual abode in both jurisdictions, then regard will be had to the person's citizenship. If the person is a dual citizen, then the competent authorities will attempt to resolve the issue.

Revenue Canada was concerned that an individual could argue that the individual was both a resident of Canada under domestic tax rules (and therefore not subject to Canadian non-resident tax) and resident in the treaty country under the treaty (and therefore not subject to taxation as a resident of Canada).

In order to ensure that the treaty and the domestic rules cannot be set off in a contradictory manner, the Budget proposes to treat as a non-resident any individual who would otherwise be resident in Canada but has become entitled under a tax treaty, as a resident of another country, to an exemption from or reduction in Canadian income tax. This change applies to individuals who became entitled to treaty benefits after 24 February 1998. There is a comparable rule in existence which applies to corporations.

V. TREATY-BASED EXEMPTION: INFORMATION RETURN

A company or a corporate partnership that carries on business in Canada in a taxation year will be required to file an information return for the year if the corporation claims that it is, under an agreement between Canada and the corporation's country of residence, exempt from tax under Part I of the Income Tax Act on any part of the income for the year attributable to the business.

If a non-resident resides in a treaty jurisdiction and carries on business in Canada but does not maintain a permanent establishment in Canada, the income tax treaty generally would protect such income from Canadian tax. The business profits provision of the relevant treaty would permit Canada to only tax business profits attributable to a permanent establish-

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ment. As there is no filing currently required to claim the treaty exemption, it is difficult for Revenue Canada to audit these transactions. Revenue Canada will not know that a non-resident has relied on a tax treaty to claim an exemption from the Canadian income tax. A non-resident corporation will be required to file the information return in order to claim a treaty exemption. This will apply to taxation years that begin after 1998.

VI. INCOME TAX CONVENTIONS INTERPRETATION ACT

In order to ensure that Canada's tax treaties are applied consistently and in conformity with the intentions of Canada and its treaty partners, the Income Tax Conventions Interpretation Act sets out a number of interpretive rules and definitions. Canada wishes to ensure that amounts paid to a non-resident of Canada out of an RRSP, RRIF and other retirement income arrangements be given the favourable treatment afforded pensions. In some cases, income tax treaties are silent as to the definition of pensions. In other cases, pension is defined to be a payment relating to past services (i.e. an RRSP, and RRIP may technically not qualify). Some tax treaties treat pensions and annuities differently. An RRSP may fall into the definition of an annuity. Clarifying changes are being introduced to apply to amounts paid after 1996 and will provide that:

(a) pension payments are not annuities for the purposes of tax treaties;
(b) where a treaty does not define "pension", the term nonetheless includes payments under registered pension plans, RRSPs, registered retirement income funds and other retirement arrangements; and
(c) where the treaty does define "pension" the term extends to include as well periodic payments under the above arrangements.

The Income Tax Conventions Interpretation Act will also confirm that where a taxpayer disposes of any "taxable Canadian property" (a defined term which includes Canadian real estate, shares of Canadian private companies and certain other assets) for the purpose of applying a treaty, any income, losses or capital gains are considered to arise in Canada. This clarification applies to dispositions after 23 February 1998. Apparently, individuals who resided in countries having a tax treaty with Canada but not having a capital gains exemption (e.g. Japan) were able to argue that Canada should not have the right to tax the capital gain on the basis that the capital gain did not arise in Canada notwithstanding the fact that the treaty was signed. This amendment will clarify that point.

VII. DEEMED RESIDENTS

A resident of Canada must pay Canadian tax on global income and a non-resident of Canada is taxable in Canada only on Canadian-source income. Section 250(1) of the Income Tax Act deems certain persons to have been resident in Canada throughout the taxation year notwithstanding the fact that the person was not living in Canada. This would include members of the Canadian Forces, ambassadors, ministers, high-commissioners and other civil servants, employees of the International Development Assistance Program, and any member of the Overseas Canadian Forces school staff. In addition, the Income Tax Act would deem the spouse of such a person who is living with that person or a dependent child to also be deemed to be resident in Canada. The Budget proposes to eliminate this special rule for spouses. A new rule is proposed which would deem as resident, an individual who, by virtue of his or her relationship to a Canadian resident, is exempted from tax in another country under a tax treaty or international agreement. In other words, if a spouse is subject to tax in another jurisdiction (i.e. does not benefit from a treaty exemption), the spouse will be taxable only in the other jurisdiction and not be deemed to be resident in Canada.

Canada's tax treaties often contain provisions which compliment Section 250(1) and deem such individuals to be resident only in Canada. These changes would apply to individuals who would, but for the current rule cease to be residents of Canada after 23 February 1998. Individuals who but, for the current rule, would have ceased to be resident prior to 24 February 1998 will be permitted to elect that these changes also apply to them after 23 February 1998. If they make this election, they will be treated as having ceased to be resident in Canada on 24 February 1998.

The following example was provided in the Budget materials as to the application of this provision. Louise, a government employee, is posted to a Canadian embassy outside of Canada. Her spouse and dependent child move with her. They all cease to be factually resident in Canada but are all deemed to have remained resident in Canada by virtue of Section 250(1). Under the new rule, Louise will still be treated as a Canadian resident as well as the dependent child. The husband will be treated as a Canadian resident only if, because of his relationship with his spouse, a tax treaty or international agreement prevents the other country from taxing him.

VIII. CANADIAN TAX ON FORMER RESIDENT'S FOREIGN EMPLOYMENT INCOME

A non-resident of Canada is taxable on Canadian-source income. Employment income is considered to be sourced in Canada only if the services are rendered in Canada. The jurisdiction of the employer is not relevant to this determination. A non-resident who physically works in Canada will pay Canadian tax (assuming no tax treaty applies) whether or not the employer is resident in Canada. A non-resident who works outside of Canada will not be subject to Canadian tax even if the employer is a Canadian resident.

There is an exception for a former resident of Canada who continues to be taxable by Canada on income paid to him in respect of his employment abroad, unless the income is subject to tax in the country of residence. This special rule was originally enacted to ensure that an individual who is tem-

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porarily absent from Canada (e.g. teachers on sabbatical leave) could not escape taxation on their salaries paid to them by Canadian employers by ceasing to be resident in Canada. Changes in Canadian tax treaties have eliminated this problem by removing the limits on another country's right to tax such a person. It is therefore proposed that the rule taxing a former Canadian resident on foreign employment income be repealed. A new rule is proposed to enable Canada to tax the foreign employment income of an expatriate only if the other country has agreed to refrain from doing so in a tax treaty or other international agreement. These changes will apply to the 1998 and subsequent taxation years.

IX. IMMIGRATING CORPORATIONS

A corporation which becomes a resident of Canada is entitled to increase the tax cost of certain of its assets up to the fair market value of the assets at the time that the company became resident. This could apply where a corporation formed outside of Canada is continued as a Canadian corporation or alternatively where the central management and control of a corporation formed outside of Canada is moved to Canada. Such a corporation would also be deemed to realize a year-end immediately before becoming a resident. The deemed disposition and reacquisition would not apply to property that would be taxable Canadian property, inventory used in the business or eligible capital property in respect of the business carried on by the taxpayer in Canada at the time of disposition. There is an adjustment (increase) to the corporation's paid-up capital designed to reflect the new net tax cost of the property.

The current rules are designed to defer, but not eliminate, the taxation in Canada of the immigrating corporation's accrued gains on Canadian property, of its surplus from Canadian business operations, and of the surplus of Canadian corporations of which it is a shareholder. However, the sale of the immigrating corporation's shares, before it becomes resident, to a corporation resident in Canada can frustrate this objective.

Assume that a non-resident individual owns the shares of a non-resident corporation whose only property is stock of a Canadian subsidiary. The individual sells the shares of the foreign company to a new Canadian corporation for shares of the new Canadian company that have a cost and paid-up capital equal to the fair market value of the foreign company's shares. Such a sale would generally not be taxable in Canada as it involves a sale by a non-resident of shares of a non-resident company. After the sale, the foreign company becomes resident in Canada, with no effect on the tax cost of its shares in the Canadian company as the shares would be taxable Canadian property. However, the surplus of the Canadian company could potentially be remitted through the corporate chain as non-taxable dividends, and distributed to the non-resident shareholder as a tax-free return of capital. Alternatively, the shares of the Canadian corporate purchaser may be sold to an arm's length purchaser, with the non-resident individual having avoided the application of Canadian capital gains tax as a result of the increase in the tax cost of the shares of the foreign company created on the prior sale to a new Canadian company. Although the general anti-avoidance rule may apply to such a case, Revenue Canada wants to more specifically address the opportunity for this plan. The Budget therefore proposes that corporations that become resident in Canada after 23 February 1998, be treated as having disposed of their property including Canadian property, at its fair market value at the time of immigration. Where the immigrating corporation owns the shares of a corporation resident in Canada (other than a share on which any gain of the immigrating corporation is taxable in Canada), a dividend equal to the amount by which the share value exceeds its paid-up capital will be deemed to have been paid to the immigrating corporation before it became Canadian resident; withholding tax will arise on the deemed dividend. Section 128.1(2) of the Income Tax Act will be modified to establish that the total paid-up capital of the immigrating corporation, upon it becoming resident in Canada, be increased to reflect the fair market value of its net assets.

A corporation's immigration will be treated in the same manner as the sale of its shares for fair market value to a non-arm's length company. The immigrating corporation will be able to claim an investment allowance under Part XIV of the Income Tax Act for its last taxation year in which it was non-resident and, as a result, will be held to account for any branch tax arising in the year or deferred in respect of previous years.

X. SURPLUS STRIPPING

Section 212.1 of the Income Tax Act is an anti-avoidance rule designed to prevent a non-resident shareholder of a Canadian corporation from withdrawing taxable surplus from the corporation in the form of tax-free proceeds of disposition on the sale of the corporation's shares to another Canadian corporation with which the non-resident does not deal at arm's length. In *RMM Canadian Enterprises Inc. And Equilease Corporation v. The Queen* 97 DTC 420 (TCC), a non-resident corporation unsuccessfully attempted to circumvent Section 212.1 by selling shares of a Canadian corporation to another Canadian corporation owned by its employees. The objective was to access the capital gains exemption provided under the Canada–US treaty. The court after concluding that the parties factually did not deal at arm's length so as to cause the deemed dividend to arise, under Section 212.1, commented on the fact that the general anti-avoidance rule could apply and that the income tax convention is not to be construed so as to prohibit the application of a domestic-abuse tax law.

The Budget proposes three changes applying to dispositions after 23 February 1998 in order to ensure that the avoidance rule in Section 212.1 be applied correctly.

First, the rule currently applies only to dispositions of shares of Canadian corporations to Canadian corporations. The rule will now be extended to apply to transfers of shares of a corporation resident in Canada to any other corporation resident in Canada. This change reflects the fact that the concern with

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the potential application of tax under Part XIII of the Act exists equally with respect to all resident corporations, whether or not they are Canadian corporations. A corporation may be deemed to be resident in Canada by virtue of its management and control being exercised in Canada.

The rule will be amended to apply explicitly to partnerships of which a non-resident person (or non-resident-owned investment corporation (a special type of corporation under the Income Tax Act)) is a majority interest partner.

Further, the rule will not apply where the transferred shares are taxable Canadian property on which Canada's right to tax the gains is not limited by tax treaty. This would be the case where the underlying assets of the Canadian private company is Canadian real estate. Where Canada retains the right to tax a transaction as a share disposition, no tax avoidance exists unless the recharacterization of the proceeds as taxable surplus may be viewed as unnecessary and inappropriate.

XI. FOREIGN TAX CREDIT LIMITS

A Canadian resident may not be entitled to claim a tax credit with respect to taxes paid in another jurisdiction as a result of the taxpayer being tax-exempt from Canadian tax (e.g. a pension fund, RRSP or other deferred income plan) or not currently being taxable because of the ability to claim current losses or loss carry- forwards or loss carry-backs or other tax preferences. A non-resident may pay foreign tax for which a credit is not available in the non-resident's country of residence.

A person who is subject to a foreign withholding tax on particular income, but is unable to obtain a foreign tax credit, can sometimes effectively transfer that income to another person who is able to use the tax as a credit against Canadian tax on income from other sources in that foreign country. Revenue Canada does not approve of trading tax credits if the amount of the foreign tax credit is excessive relative to the pre-tax profit generated by the transaction.

The Budget proposes to address this concern by introducing a rule applicable to short-term securities acquisitions which will apply when the more general rule does not apply to deny a foreign tax credit. The objective is to restrict the amount of foreign withholding tax in respect of dividends and interest on a foreign security that is creditable under the foreign tax credit by reference to the gross profit realized compared to the tax paid by the company on the underlying security. The general rule will deny the credit where the profit from a property, net of foreign tax, is not material relative to the amount of foreign tax. These rules will apply to property acquired after 23 February 1998.

A. Short-term acquisitions

The application of withholding tax to dividend and interest payments on foreign shares and debts can create opportunities to trade in foreign tax credits by means of trading in the securities themselves. A taxpayer may purchase a foreign share or bond from its owner before the payment of a dividend or interest. The after- tax value of the income payment is greater to the purchaser than to the owner because the purchaser is able to claim a credit for the foreign tax. The purchase price reflects the value of the underlying security plus the value of the declared dividend or the accrued interest (net of any foreign withholding tax payable). The purchaser receives a dividend or interest, out of which foreign tax has been withheld, and then he sells the shares at their market value net of that payment either to the holder (possibly at a pre-agreed price) or in the market.

The time period between the purchase and sale may be short. If the security is resold to the original owner at a pre-agreed price, that party effectively retains its economic interest in the security while it is in the hands of the purchaser. The purchase price may be set so that some of the benefit of the foreign tax credit is transferred to the original holder as compensation for entering into the arrangement. Where a taxpayer disposes of a share or debt, not held as capital property, within one year of its acquisition, the Budget proposes that the amount of foreign withholding tax eligible to be recognized for foreign tax purposes will be limited to 40 per cent or 30 per cent (depending on whether the foreign tax constitutes business or non-business income tax) of the taxpayer's gross profit from the share or debt. Withholding tax for this purpose includes any tax levied on the gross amount of the income paid. Gross profit from the security will include both the income payment and any gain or loss on resale. This rule will ensure that the foreign tax credit provisions continue to prevent double taxation of the net income earned from the share or debt, while limiting the tax benefits that can shelter other related income.

B. Interest rate swap

It is possible to trade in foreign tax credits through an interest rate swap. The Budget proposes a more general rule that will apply where a taxpayer has acquired a property and it is reasonable to expect that the profit from the property, and from other transactions entered into as part of the arrangement in which the property was acquired, will not be material in relation to the amount of foreign income tax paid on income from the property that would otherwise be eligible for the foreign tax credit. This rule will apply more broadly to income and profits taxes and not only to withholding taxes.

Profit will be calculated by deducting the expected direct costs of acquiring, holding and disposing of the property and any foreign tax expected to be payable on income from the property. Direct costs of acquisition would include, for example, financing costs incurred for the purpose of acquiring the property. Where the profit is not material in relation to the foreign tax, that tax would not be eligible to be recognized for purposes of calculating the taxpayer's foreign tax credit. Instead a deduction from income will be allowed, but only to the extent of the taxpayer's income in respect of the property.

The following examples were contained in the Budget commentary.

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Example

Holder has a bond of a foreign corporation with an underlying value of CAD 100, on which a regular CAD 5 interest payment is about to be paid. The interest is subject to a 15 per cent withholding tax in the source country, so that Holder would receive CAD 4.25 net after CAD 0.75 in foreign tax had been withheld. Holder is not able to use an FTC.

Buyer purchases the foreign bond just prior to the interest payment date for CAD 104.50, and receives the CAD 5 interest payment on which CAD 0.75 has been withheld. A few months later, Buyer sells the bond either back to the Holder or on the market, for CAD 101, the appreciation reflecting the interest accrued during the holding period. This transaction at face value is moderately profitable to Buyer:

	(CAD)
proceeds	101.00
interest	5.00
less: acquisition	(104.50)
total income	1.50
less: foreign tax withheld	(0.75)
economic profit (loss) before Canadian tax	0.75

Under existing rules, however, Buyer would be entitled to include the full CAD 0.75 of foreign tax in its pool of foreign business or non-business income tax eligible for the FTC in respect of that particular country. Assuming that Buyer faces a 30 per cent Canadian federal tax rate, CAD 0.45 of the FTC would be needed to offset the tax payable on the CAD 1.50 of taxable income from the transaction. This would leave Buyer with an FTC balance of CAD 0.30, which could be used to offset tax on income from other sources in that country. The availability of the FTC significantly enhances Buyer's return from the transaction:

	(CAD)
economic profit (loss) before Canadian tax	0.75
unused foreign tax credit balance	0.30
profit after Canadian tax	1.05

The proposed rule would limit the amount of foreign taxes eligible for credit to 30 per cent (assuming income is not connected with a foreign business) of Buyer's gross profit from the share (CAD 1.50): CAD 0.45. Therefore, while the FTC would eliminate the Canadian tax payable in respect of the transaction, no excess credit would be available to offset tax on income from other sources.

Example

Assume a tax-exempt investor (Investor) wishes to borrow funds at short-term interest rates (say, 7 per cent) in order to purchase a CAD 1,000 long-term foreign bond which pays interest at 8 per cent. Investor is not able to use the credit for 15 per cent non-resident withholding tax payable in the country of source on the bond interest. (Even though the return after withholding tax is only 6.8 per cent, which is lower than the 7 per cent cost of funds, Investor anticipates that the bond will appreciate due to interest rate movements.)

If the foreign interest payments are channelled through Taxpayer who is able to use FTC, both parties can effectively obtain some benefit from the foreign tax credit. Taxpayer borrows funds at the short-term rate and buys the bond. At the same time, it enters into an interest rate "swap" agreement with Investor: Investor agrees that it will reimburse Taxpayer for the 7 per cent interest expense on the short-term loan, while Taxpayer agrees to pay over to Investor the net interest payments received on the bond, which Investor would otherwise have received directly (6.8 per cent), plus an additional 0.3 per cent to make the arrangement attractive to Investor. The arrangement could be set up to operate over a period of several years.

Before Canadian tax, the transaction would create a loss for Taxpayer:

	(CAD)
interest income on bond	80.00
income (loss) on swap agreement (CAD 70 from Investor minus CAD 71 to Investor)	(1.00)
interest expense on short-term loan	(70.00)
taxable income	9.00
less: foreign tax withheld	(12.00)
economic profit (loss) before Canadian tax	(3.00)

Taxpayer, however, would be entitled under existing rules to add the CAD 12.00 of withholding tax to its pool of potentially creditable foreign tax. Assuming that Taxpayer faces a 40 per cent Canadian tax rate, CAD 3.60 of the FTC would be needed to offset the tax payable on CAD 9.00 of taxable income from the transaction. This leaves an FTC balance of CAD 8.40 which could be used to offset taxes on income from other sources in the foreign country. The availability of the FTC makes an otherwise unprofitable transaction attractive for Taxpayer:

	(CAD)
economic profit (loss) before Canadian tax	(3.00)
unused FTC balance	8.40
profit (loss) after Canadian tax	5.40

In this case, the second proposed rule would apply since, after foreign taxes, the anticipated profit to Taxpayer from the bond and the related swap agreement – in fact, a CAD 3.00 loss – is not material in relation to the foreign tax of CAD 12.00 otherwise creditable. The rule would deny the FTC. Instead, Taxpayer would be entitled to deduct the CAD 12.00 in foreign tax from its CAD 9.00 in income in respect of the property, to the extent of that income. Taxpayer's income for Canadian tax purposes from the transaction therefore could be reduced to zero, but no credit would be available to shelter other income.

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XII. NON-RESIDENTS' EXEMPTION CERTIFICATES

Interest income paid to a non-resident of Canada is normally subject to Canadian withholding tax. There are income tax treaties and Part XIII contains exceptions where no withholding tax is required. A foreign pension plan may apply for an exemption from the withholding tax. Provided that the pension is tax exempted in the other country, the Minister of National Revenue may grant a certificate of exemption for interest payments received from arm's-length persons in Canada. Currently, there is no requirement that the foreign pension fund be active. It merely must have been established or incorporated for the purpose of providing benefits under a pension or superannuation fund. The Budget proposes that the foreign pension fund must now demonstrate not only that it was established or incorporated to provide benefits under pension, retirement or superannuation funds but it must continue to do so as its principal activity. This requirement will apply to all certificates of exemption issued after 23 February 1998.

XIII. AMOUNTS OWING BY NON-RESIDENTS

Section 17(1) of the Income Tax Act computes a return of interest on loans made by a corporation resident in Canada to a non-resident person, other than a subsidiary controlled corporation where the money was used in the corporation's business for the purpose of gaining or producing income. The imputed return is based on the prescribed rate of interest and is calculated only on loans which were outstanding for one year or longer and made at less than a reasonable rate of interest.

The Budget proposes to extend the computed interest under Section 17(1) to apply to all amounts owing to corporations resident in Canada, trusts with such corporate beneficiaries and partnerships with such corporate partners where interest is not paid at a reasonable rate. The amendments also ensure that the rule in Section 17(1) of the Act applies where amounts are owing either directly or indirectly by a non-resident. The section does not apply where tax has been paid on the loan under Part XIII of the Act or where the loan is made to a subsidiary which uses it in its business for the purpose of gaining or producing income. The latter exception would be modified to refer to "amount owing" rather than to "loans". The exception for a subsidiary controlled corporation will only apply where the amount owing arose in the course of the carrying on of an active business by the subsidiary controlled corporation. This will apply to taxation years in fiscal periods beginning after 23 February 1998.

It should be noted that it is not possible to avoid this restriction by having a Canadian corporation invest in shares of a corporation outside of Canada which in turn will loan funds to another non-resident corporation. Revenue Canada has attempted to challenge these transactions on the basis of the general anti-avoidance rule.

XIV. MERGERS OF FOREIGN CORPORATIONS

The Income Tax Act provides for a tax-deferred roll-over in respect of the disposition of shares of a taxable Canadian corporation where it amalgamates with one or more other taxable Canadian corporations and those shareholders receive in exchange for their shares of the predecessor corporation either:

(a) shares of the new corporation formed as a result of the amalgamation (a vertical or horizontal amalgamation); or
(b) shares of the taxable Canadian corporation that controls the new corporation formed as a result of the amalgamation (triangular amalgamation).

The Income Tax Act provides for a similar tax-deferred roll-over in respect of the vertical or horizontal merger of a foreign corporation with one or more other foreign corporations provided that all of the corporations are resident in the same foreign jurisdiction. We recently brought to the attention of the Department of Finance that the roll-over did not apply to a triangular foreign merger of such foreign corporations. In case of a triangular foreign merger, the shareholders or the predecessors receive shares of the foreign corporation that controls the new corporation formed under merger, rather than shares of a new corporation.

The Budget proposes to correct this problem by enabling the shareholders of the foreign corporation to benefit from a tax-deferred roll-over in respect of the disposition of shares of the foreign corporation where the foreign corporation has been the subject of a triangular foreign merger. The proposal will apply to a disposition of shares as a result of a triangular foreign merger that occurs after 24 February 1998. As well, where a taxpayer re-elects, the proposal will apply to any other disposition during the taxation year of the taxpayer for which the normal reassessment period has not expired before 1999.

XV. VISITORS' REBATE PROGRAMME

The Budget proposes a number of measures designed to simplify the goods and services tax and harmonized sales tax. Sponsors and non-registered organizers of foreign conventions (where at least 75 per cent of the participants are non-residents) are permitted to claim rebates of the GST and HST paid on eligible expenses, such as the rental of meeting rooms, short-term accommodation and certain other purchases of goods and services used in the course of the convention. Currently, food, beverages and catering services are excluded. The Budget proposes to expand the rebate to include 50 per cent of the tax paid in respect of food, beverages and catering services relating to the convention. The intention is to increase the competitiveness of Canadian convention facilities marketed to non-resident non-registrant businesses.

Non-resident individuals and businesses are entitled to a rebate of the GST or HST paid on accommodation in a hotel, motel or similar establishment for a period of less than one month. Currently, short-term accommodation status is avail-

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able for camp sites only if the camp site is part of a tour package that also includes food in the services guide. Rules are to be changed so as to allow the claimant to be able to choose in the case of separate supply of a camp site between claiming the actual amount of tax paid and CAD 1 per night. Similarly, the formula for calculating the rebate for tour packages based on a flat amount per night will be amended.

A non-resident may claim a rebate of GST or HST in person when the party in Canada had certain land-based crossings at duty-free shops operating under contract with Revenue Canada, provided the rebate amount does not exceed CAD 500. Alternatively, the non-resident may mail an application form to Revenue Canada, in which case the rebate is subsequently mailed to the foreign visitor at his or her home address. Private sector operators have also set up businesses at international airports to provide instant cash rebates. Currently, non-resident individuals may file only one rebate application each calendar quarter and non-resident businesses can file only one rebate claim each month. The Budget proposes to eliminate these filing restrictions. The proposal applies to rebate applications received after 24 February 1998.

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INTERNATIONAL

TAXATION WITHIN A CONTEXT OF ECONOMIC GLOBALIZATION*

Jeffrey Owens, OECD

I. INTRODUCTION

Today's world is a small place. Technical progress, improved communications and vastly expanded trade and investment flows have led to a growing globalization of economic activity. For better and for worse, nations are increasingly linked. The move towards democracy in the former socialist countries, the recent financial crisis in the "Asian Tigers", and global warming all make us aware that we live in an increasingly integrated and interdependent world.

Policy makers in both large and small countries are accepting that the international dimension of economic policy has become increasingly important. Globalization opens up new opportunities for national economies, but with it this process of integration also brings risks. Small and not-so-small countries can find their economic choices being severely constrained by decisions which are taken outside of their borders. However, even in large countries like the United States or Brazil, the international dimension of domestic policies cannot be ignored.

Whilst the integration of economic policies has advanced, nations continue to guard their political sovereignty. It is understandable that the newly emerging democracies in Eastern Europe and the former Soviet Union feel the need to reassert their sovereignty. However, even many of the old, well-established democracies are concerned about losing the right to shape their own economic destiny. This situation is slowly evolving both in Europe and the Americas but overall, the mechanisms for international coordination of economic policies remain weak. Nowhere is this more evident than in the tax area.

This article addresses only one small part of this broad theme, namely, how should governments respond to the increasing integration of national economies and what measures are available to coordinate national tax policies to deal with this process. Is harmonization a realistic option? This issue has to be addressed not from the perspective of just OECD countries or even just Latin American countries, but from a broader global perspective since many of the problems can only be resolved on a global rather than a regional level.

II. THE TAX IMPLICATIONS OF GREATER INTERDEPENDENCY

Despite the moves toward closer international integration, national policies and national frontiers will continue to have political and economic significance. What is clear, however, is that the increased interdependency of national economies creates a lower tolerance for diverging national policies and a need for greater international coordination. The potential conflict between increased transnational economic activity and the desire for national policy flexibility has created international tension in a number of areas of economic policy making. This has certainly been the case in the tax area.

Until relatively recently, economic policies fitted conveniently into self-contained boxes. Certain of these "boxes" were clearly labelled international: trade policies, for example.

Other "boxes" were clearly labelled domestic: social policies, industrial policy, tax policy. For each box, there was a specific conceptual framework, a terminology and, usually, a separate government department. Policy makers had well-defined ideas of what was national policy and what was international policy. Little attention was paid to the effects of domestic policies on other countries and the constraints imposed on national policies by international considerations were not well understood.

Globalization has broken down these barriers between the different boxes. Domestic policies in countries such as Japan, Brazil and the United States are now seen as having an impact on what happens in other countries. This has been evident in the impact of the Asian financial crisis on the Latin American region and on Russia. The greater interdependency between countries has severely limited the freedom of domestic policy makers to determine their own economic policies irrespective of what is happening outside of their frontiers (witness the effect of the decision by certain OECD countries not to implement withholding tax on interest payments to non-residents on Latin American countries).

Taxation is but one area where the effects of this breaking down of barriers are being felt. To take one example, the borderline between trade and tax policy is breaking down. Already many trade negotiators agree that promoting free trade will require at one point looking carefully at the trade effects of direct tax policies. Tax experts would agree that tax systems can contain hidden subsidies and barriers to trade in goods, services and capital, an issue which is arising both in the OECD discussions on the Multilateral Agreement on Investment (hereinafter: MAI) and in the WTO. It is unclear at present whether this breaking down of the barriers between the tax and trade boxes will lead to institutional changes at

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the international level or whether the problem will be dealt with by using the existing institutions, or simply just be ignored.

At a more specific level, it is clear that greater interdependency will have profound implications for tax systems. Four stand out:

- The base for taxes on income and wealth will become more geographically mobile and therefore more sensitive to tax differentials. This, in turn, will lead to a greater danger of tax competition between countries, with each country trying to attract a larger share of the global tax base.
- Highly skilled professionals (the growth generators of knowledge based economies) will become more sensitive to tax differentials.
- It will become more difficult to determine and to collect taxes on activities which take place outside of a country's tax jurisdiction, particularly transactions which take place over the Internet. This is not just a question of the volume of cross-border transactions increasing, but of their changing nature, what some have called the move to "virtual" commerce.
- The ways in which tax administrations carry out their "business" will change. New technologies open up new ways of assessing and of collecting taxes and for cooperation between tax authorities in different countries.

The next section of this paper identifies three areas where these pressures are already evident and then examines whether tax harmonization is a realistic response to pressures on tax systems resulting from economic integration.

A. Tax, trade and investment – confirming (and severing) the connections

While the relationship between trade and tax has been more or less continually researched and evaluated, the relationship between trade/investment and tax *agreements* and the ways in which trade/investment can be used to promote harmonization, have not. The similarities between trade and investment agreements and tax treaties are many. Both are intended to facilitate and encourage trade between countries on the assumption that global welfare is thereby enhanced. They both contain rules requiring certain kinds of advantages and prohibiting certain forms of discrimination against the treaty partner. They also contain rules and mechanisms for the resolution of disputes. In theory, this commonality of goal should not be a problem. In practice, however, the differences between the two types of agreements mean that the instruments and mechanisms for achieving the goal are different, being shaped by the different environments within which tax and non-tax international agreements operate. Coordinating trade and investment agreements with tax conventions and domestic tax provisions will continue to prove a difficult problem, and some still question the need for such coordination.

The problem arises from a recognition that many individual obligations and entitlements under trade and investment agreements could have potential application to tax matters in ways that were not thoroughly investigated when the agreements were prepared. A consensus appears to be developing that obligations which might be appropriately imposed under a trade or investment agreement are not necessarily suitable in a tax context, although no similar consensus has yet emerged about what these differences will mean in practical terms – where to strike the appropriate balance between the goal of preventing trade discrimination while permitting flexibility and the pursuit of national goals in the conduct of tax policy.

The problem of the potential interaction between tax and trade agreements was always implicit in the General Agreement on Tariffs and Trade (GATT). The General Agreement on Trade in Services (hereinafter: GATS) has made the issue starker. The twin issues of the unintended application of trade agreements, and their coordination with existing tax obligations, have been recognized in the more recent treaties – the GATS, the Maastricht Treaty and NAFTA – and have received more attention. The treatment of direct taxes in these agreements recognizes that the extensive tax treaty network – today there are more than 1,500 treaties – provides a multilateral framework to avoid and resolve trade- and investment-related tax disputes, with the vast majority of these treaties being based upon the OECD Model Convention.

Many issues arise – the extent to which tax incentives for enterprises or activities may be categorized as subsidies, the circumstances in which taxes may be viewed as confiscatory, the overlapping dispute settlement processes, and so on – but this paper will consider briefly the problem of giving a defined role to two obligations in trade treaties: the obligation of national treatment and the meaning of most-favoured-nation (hereinafter: MFN) treatment. Both of these are issues which would be central to any Free Trade Agreement in the Americas.

A broad conception of the obligation in trade treaties to afford "national treatment" would seem to require, in the context of direct taxes, eliminating many commonly-accepted distinctions between resident and non-resident taxpayers currently manifest in a multitude of tax rules in a variety of contexts – access to personal allowances and provisions for dependants, tax concessions for social programmes, the collection of tax by withholding, the applicable tax rates, taxation on a gross or net basis, access to benefits under the imputation system, the ability to transfer tax losses, taxation of branch profits, thin capitalization, payments to associated enterprises, access to certain tax incentives through deductions and credits, and so on.

These rules express governments' choices about their social and economic objectives and implement policies in which distinctions between residents and non-residents are valid tax policy objectives. The appropriateness of a qualified notion of national treatment was recognized in Article 73 of the Maastricht Treaty, which allows Member States of the EC to apply different treatment based on residence of the taxpayer and the source of income. The GATS permits the continuation of differences which are directed, for example, toward

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the effective imposition or collection of taxes. In the NAFTA agreement, a more general exclusion of direct taxes from the scope of the national treatment provisions was agreed, relying instead exclusively upon the existing scrutiny of alleged tax discrimination through the tax treaties of the signatory countries. These three variants show a consensus on the need to uphold the supremacy of tax treaties in resolving tax-related issues.

The MFN provisions of a trade or investment agreement are an important benefit to the signatories ensuring the preservation and expansion of the benefits of the agreement to the parties – bilateral treaties become in effect ambulatory multilateral agreements and are negotiated on this basis. Tax treaties, on the other hand, are more obviously the outcome of direct bargaining and individual compromises reached in the particular circumstances of the contracting parties and based upon the specific characteristics, not just of their tax systems, but more importantly, of the interactions between the two countries' tax systems.

Applying the MFN obligation in trade or investment treaties to direct taxes would turn the existing individually-negotiated compromises into a universal right to be extended to other countries without cost. Future tax treaty negotiations would have to change altogether and might, on the most pessimistic prognosis, become a multitude of Uruguay round negotiations, instead of a series of flexible and responsive exchanges. Recognizing these problems, the GATS allows measures inconsistent with a pure MFN treatment to exist where they result from a tax treaty. The NAFTA agreement also gave primacy to the provisions of the tax treaties of the contracting countries, denying the obligation to replicate for the benefit of all contracting countries the benefits and advantages for which individual countries negotiated under the parties' bilateral tax treaties.

For the future, the focus of attention is already moving from trade agreements to investment agreements. At its meeting in May 1995, the Council of the OECD initiated a negotiation on the MAI, to facilitate transnational investment flows. It is envisaged as an ambitious multilateral instrument, designed to induce further liberalization in investment and will expand into new areas at present untouched by existing trade and investment agreements. The MAI will be self-standing and open to non-member countries. From its outset, the Council recognized that the new instrument would have to take into account existing practices in tax treaties and the likely commitments of potential signatories. How this should be done is the subject of separate work being undertaken at the OECD.

The challenges for tax and trade reformers are both to coordinate the aims of these agreements with the existing network of bilateral and multilateral tax treaties, and to develop guidelines for drawing up future trade and investment agreements that will clarify the meaning of certain obligations and minimize, as far as possible, the scope for unintended consequences arising from the obligations undertaken. This is a challenge which will face the CIAT member countries as they move towards closer economic integration.

B. Tax competition

One difficulty facing tax reformers today is that they have to operate in a global business environment. This environment constrains the range of policy options open to reformers and impels domestic responses to tax measures occurring elsewhere in the world. Nowhere is this constraint more evident than in distinguishing between harmful and acceptable "tax competition". The potential consequences of a "rush to the bottom" are well appreciated by tax reformers – even large countries are not immune and the tax systems of small countries with open economies may be in serious jeopardy.

Harmful tax competition must be distinguished from acceptable forms of competition. There is nothing wrong with the process through which comparable tax systems impose a discipline on a country's tax system so that, for instance, countries are encouraged to innovate in their tax policies. Harmful tax competition, however, is better seen as the counterpart of what is sometimes referred to, in the trade area, as "unfair trade practices" as it involves measures that are globally damaging if their use becomes widespread.

Harmful tax competition is fast becoming a serious international tax problem in Europe, the Americas and the Asia-Pacific region. While "tax competition" may be a convenient label, the precise range of problems and the proper focus for remedial actions is still unresolved. It is, perhaps, easiest to identify three detrimental aspects of the topic which combine in such a way as to create the problem that requires managing:

- One aspect is the avoidance and evasion opportunities created by the spread of tax havens and preferential tax regimes. That is, the domestic tax regime of one country can undermine the ability of another country to collect taxes that it is attempting to sustain. This outcome can occur because, for example, the tax and regulatory environment of the country permits participants in the regime to be immune from outside scrutiny, because the benefits of the regime are not publicly stated, or because access to the regime is entirely discretionary.
- A second aspect of the problem is the international *spillover effects* of domestic regimes – hampering an individual country's ability to impose taxes on certain kinds of activities because of a tax regime in another country. This is especially evident in regimes which target particular activities, such as savings or financial activities, which are highly mobile. The spillover effects constrain the ability of other countries to sustain taxes which are desirable from a tax policy perspective and which, under current international practices, are allocated to its effective jurisdiction. This problem is more than a simple curtailment of national sovereignty. Instead, countries are left with a choice of taxing instruments which are less desirable because they are less efficient, less progressive or more expensive to administer and comply with.
- Finally, from a global perspective, preferential tax regimes may induce the misallocation of resources. The logic of eliminating the tax-induced discouragement of trade and investment through tariff reform and of reduc-

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ing the extent of the encouragement of trade in certain industrial sectors through subsidies, a logic that is so universally accepted in the context of trade agreements, applies also in the context of direct taxes.

The combination of deteriorating administrative feasibility and negative spillover effects are the two main ways in which the problem is manifest. But these effects do not fully express the extent of the damage which such regimes may cause, both to the country implementing the regime and the other countries affected by it. This form of inducement is most dangerous where the country offering the concessional regime imposes a substantial limitation on the tax base of the other country without suffering any real cost from doing so because the domestic market has been effectively protected from the adverse consequences of the concessional regime. These regimes are particularly unfair most obviously to the governments and citizens of other countries who are constrained to employ and to endure less suitable taxing instruments. In May 1998 the OECD issued a report which discusses these issues (see "Harmful Tax Competition", OECD 1998).

C. Information technology and the Internet

The rapid development of sophisticated information technologies will promise both great benefits and real dangers to tax administrators and tax reformers.

For tax administrators the benefits of information technology are well understood and are rapidly being implemented. Quicker and more accurate routine data processing can assist in faster tax-return processing, more comprehensive return verification, broader information matching, improved selection for audit, more thorough audits, more accurate tracking and reconciling of instalments and pre-payments, more accurate computation of arrears, interest and penalties, faster identification of potential arrears, better internal budgeting, more exact estimates of government cash flows, and so on. Standardized information formats are also facilitating the routine exchange of information between treaty partners under Article 26 of the OECD Model Treaty and other bilateral and multilateral legal instruments. The use of information technology in this context not only assists in better performance of these tasks, it also allows scarce human resources to be diverted into areas of administration where more individual judgement and creativity is required.

But this technology equally presents new problems for tax administrators as it changes the traditional methods of conducting business. The technology has the potential to develop into an alternative method for conducting many aspects of modern business, and some commentators speak of a parallel mechanism for selling goods and delivering services – "electronic commerce" – with its own payments system "cyber-payments" that intersects with traditional banking and payments systems only occasionally. If that occurs, several conceptual and administrative problems will become apparent.

The problems for tax administrators begin with the inadequacy of the traditional means of allocating revenue to jurisdictions. The international consensus that has developed to reconcile profit taxes at national borders allocates income to jurisdictions through generally recognized source rules, an approach which is supported by the extensive network of tax treaties. The idea behind the existing source rules is that business income can be allocated meaningfully to a country when there is substantial presence in that country, i.e. where the taxpayer has a "permanent establishment" in that country. However, it is precisely this rationale that is challenged by the new information technology – a team of architects or software writers or lawyers might be able to work just as easily from offices in Tokyo, Palo Alto and Singapore as they do from offices No. 128, No. 129 and No. 130. An enterprise may therefore be able to conduct substantial business in a country without ever having to establish a "permanent establishment" there, thus denying the country any taxing rights under tax treaties. Another aspect of the international consensus allocates full (i.e. worldwide) taxing rights on the basis of the notion of residence. For corporations, that may mean in some countries and under some treaties the place of effective management of the corporation, another concept which becomes more indeterminate with this technology.

Similar problems arise in applying the traditional concepts which underline VAT systems (e.g. place of supply) to these new activities.

The Internet, in particular, is creating a global "information superhighway" which will revolutionize business more quickly than previous technical advances. As technological change weakens the links between economic activity and a particular location, traditional tax concepts, such as "residence" and "source" become difficult to apply. Communications now allow distant groups of people to collaborate in new ways, for example, global securities dealing and scientific projects. Allocating the profits and losses of these activities to different countries is a problem for tax authorities. The Internet also allows entrepreneurs to extend the services they can offer abroad without the need to set up a physical presence in that country. As the Internet becomes more commercialized, a parallel banking and payment system becomes a distinct possibility. The existing information systems need to be adapted to allow tax authorities to identify when and where taxable activities are carried out, to allow access to record-keeping and to set reporting requirements. (The tax administrations' adaptation must also take into account the need for confidentiality.)

The challenge of electronic commerce becomes more important when the traditional payment methods are rendered redundant. An alternative payments system which is less accessible to tax administrators, whether because it is less regulated or because it is located in some exotic location, presents new types of audit difficulties. And non-cash transactions challenge the notion of withholding tax levies at source as the principal means of collecting tax on transactions with non-residents.

These trends will force tax administrators to examine how traditional concepts work in this new integrated environment

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and to work closely with financial banking and other regulators to ensure that tax policy interests are taken into account when formulating the regulatory framework within which the Internet and electronic commerce will operate. This will increase the incentive for tax authorities to address the problems collectively.

D. Options open to governments

Identifying problems is always far easier than putting forward solutions. Whilst there is no shortage of proposals, ranging from full harmonization to a global tax base and multilateral tax treaties, the difficulty arises that few of these solutions succeed in reconciling the five criteria that governments will use to evaluate any proposals: they must not imply a substantial revenue loss; they must not constrain unduly fiscal sovereignty; they must not open up new avenues for tax evasion and avoidance; they must not impair a country's competitive position; the transitional costs of change must not be too high. It is these criteria rather than the question of improving the worldwide efficiency of the allocation of capital, that will determine the acceptability of any proposals.

If unilateral actions are ignored, there are three choices open to deal with problems that arise from greater economic integration under the present tax arrangements:

- to enter into a process of formal harmonization of tax systems;
- to allow competitive forces to determine the design of each country's tax system;
- to undertake greater coordination between the tax policies followed by countries.

Formal harmonization would require a standardization of the tax system that would go beyond consumption taxes to cover taxes on income and capital. I believe that this is not presently a realistic option, neither at the global level nor in any of the existing regional groupings. Even the EU Member States have not been prepared to give up a substantial part of their sovereignty in tax matters. Harmonization would go against the principle of fiscal sovereignty and to be effective it would require harmonization not just of the corporate income tax but of all other taxes on income and capital. As business taxation is used to implement social and economic policies, it is very unlikely that governments would accept constraints on their use of these policy instruments. Within the European Union, the extension of tax harmonization from VAT and excises to include business taxation (and the associated dividend and interest income) would mean that on average less than a third of tax revenues would remain under the control of national governments. This degree of harmonization would imply some harmonization on the expenditure side of the budget because of the likely constraints imposed on the ability of individual countries to raise different amounts of revenue. One has only to compare the revenues and expenditures of Denmark and Greece to see how difficult such a task would be.

The European Union has had some success in harmonizing VAT systems but even in this area very large differences continue to exist in the rates of VAT and in the definition of the tax base (e.g. in the treatment of financial services). Recent moves to establish an EU Code of Good Conduct and EU Directives on intra-firm transactions are, however, hesitant steps towards a weak form of harmonizations in the area of direct taxes.

There is little to suggest that direct tax harmonization will be more successful in the Americas. The Brazilian tax system is very different from that of Mexico. The tax structure and level in Chile differs significantly from that in Argentina. Within the NAFTA, direct taxes have been effectively "carved out" of the agreement and there are little signs of convergence or of a will to align the tax systems of the three countries. It is also significant that the Americas encompasses a number of very large federal countries which have wide differences in their tax systems within a single country. Canada, for example, has not been notably successful in "harmonizing" its tax system in what is effectively an integrated economy.

To conclude, formal harmonization of tax systems fails to recognize the political realities of fiscally sovereign states and would require putting in place multilateral institutions which would supplant national governments and which would be responsible for "policing" the system. Similarly, as noted earlier in this paper, any attempt to use trade or investment agreements to move towards harmonization would encounter difficulties.

Under the *competitive option* governments would be free to compete for mobile resources by lowering their taxes and developing attractive tax regimes. One can argue as to whether lower taxes are desirable, in their own right, but this should be a choice for governments, rather than an action which is forced upon them by policies determined in other countries (although some economists argue that since the political process has a bias towards high taxes and high expenditure levels, tax competition may be an effective means of limiting the size of government; in practice, however, the more likely outcome is increased fiscal deficit).

Nevertheless, the option of allowing competitive forces to encourage countries to align their tax system – what some people have referred to as market-based convergence would be consistent with the current emphasis on the benefits of free markets. But the conditions required for competition to produce an optimum allocation of resources are unlikely to be met in the international tax area.

The reliance on competition to encourage a convergence of corporate tax regimes also encounters the danger that the effective tax rates on highly mobile capital (financial and real) would be substantially reduced. Since such capital is likely to be concentrated in the hands of a relatively few wealthy individuals, it is unlikely that society would be prepared to accept the distributional consequences of such a policy.

More generally, small open economies would probably find it unacceptable that their tax policies are determined by what happens in, for example, the United States.

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Even if the competitive option is chosen, we should not expect that this would lead to a complete convergence of tax systems because MNEs are sufficiently sophisticated to make a link between tax levels and expenditure levels, and the market is concerned with effective tax rates and not the ways in which these rates are achieved. Thus those who favour harmonization of tax systems should not look to the market to achieve this. In practice, competition may even lead to less tax base harmonization as countries introduce specific tax regimes to attract particular types of activities.

This leaves the option of *coordination* or "peaceful coexistence". Here the objective is to have tax systems which are responsive to market forces, which can reflect the specific situation found in each country and the increased integration of national economies and which at the same time do not interact in ways which adversely affect the international allocation of resources. Coordination can play a useful role in preventing large countries taking unilateral actions which impose costs on other countries, particularly on small, open economies. Only by coordination can a certain degree of national autonomy be maintained in tax policy. Put in this way it is difficult to disagree that this is the most desirable of the three options. The question is can this be achieved and if so, how?

Greater coordination of tax policies in integrated economic markets will require identifying specific problems and designing solutions addressed towards these problems. A non-exhaustive list of issues is set out below.

(a) *Strengthening the role of tax treaties*. Tax treaties provide a well-tried approach to practical coordination of tax systems. The operation of the existing treaty network can be improved by:

- Encouraging a greater uniformity in the application of treaties by, for example, getting greater agreement amongst countries on the interpretation of treaties and by strengthening the legal status of commentaries on tax treaties.
- Examining ways in which treaties can be adapted to a changing commercial and technological tax environment.
- Examining whether certain articles in tax treaties could be put on a multilateral, rather than bilateral, basis.
- Developing "case studies" which would illustrate how treaties are applied by different countries in specific circumstances.
- Examining ways to improve the operation of mutual agreement procedures and the role of arbitration.

At the same time, OECD and non-OECD countries should encourage those countries which have a limited network of treaties to intensify their negotiation of such agreements.

The OECD is prepared to play an active role in this process and has already extended its dialogue on tax treaties to more than 50 non-member countries, of which 17 have already set out their views on the OECD Model Tax Convention.

(b) *Extending and strengthening the international consensus on transfer pricing*. In 1995, the OECD issued extensively revised transfer pricing guidelines, confirming the arm's length principle and identifying the four methods by which that principle should be applied. The OECD recognizes that the success of these Guidelines in providing a "coordinated" approach to the taxation of MNEs will depend upon:

- an effective monitoring of the application of the existing Guidelines (In January 1998 the Committee on Fiscal Affairs issued a note on monitoring procedures.);
- an on-going extension of the Guidelines to different sections (e.g. banking and insurance) and adaptation to new technologies (e.g. to electronic commerce);
- the associating of non-member countries to the Guidelines. The CFA recognizes that if conflicts between both taxpayers and the tax administrations and between national tax authorities are to be minimized, there is a need for a globally accepted set of rules. This explains why the Committee welcomes the joint OECD-CIAT and OECD-UN initiatives in this area.

(c) *Intensifying international cooperations between tax authorities*. Organizations such as CIAT, CREDAF, CATA, IOTA, SGATAR, PATA, EU, G4, G6, G7 and the OECD already provide extensive opportunities for tax policy makers and administrations to engage in a dialogue. Nevertheless, in confronting many of the issues that are raised by economic integration tax authorities will need to look at new ways of intensifying and formalizing this cooperation. Possible options include:

- Exchange of information: countries should explore further the opportunities to adopt a multilateral approach to the exchange of information, building upon the experience of the European Union, the Nordic countries and the OECD's Multilateral Convention on Administrative Assistance. At the same time, the legal constraints and practical constraints on exchange of information should be critically re-examined. In some countries, bank secrecy, for example, continues to limit severely the access of tax authorities to banking information. Governments also need to examine how new technologies and a wider use of taxpayer identification numbers can make exchange of information more timely and "user-friendly".
- Extending the use of joint audits, simultaneous examination and advance pricing agreements. All of these are an effective way of minimizing conflicts in the area of cross-border activities.

(d) *Intensifying cooperation to counter harmful tax competition*. Sections II.C. and II.D. of this note and the paper prepared by Mr Forget explain why harmful tax competition is an emerging global problem. Counteracting the spread of tax havens and competitive bidding between countries for geographically mobile activities requires:

- Agreements on which low tax jurisdictions should be considered as tax havens and on the actions to be taken to make them less attractive as places where residents of other countries can avoid or evade taxes.
- Agreement on what constitutes acceptable and unacceptable tax regimes designed to attract financial and service activities and on the actions to be taken to discourage the spread of unacceptable regimes. The recently issued

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OECD report on harmful tax competition represents a significant step forward in this respect.

(e) *Developing a wide international consensus on how to deal with the tax policy and administrative issues that come from new communication technologies, the Internet and the development of electronic commerce.* Again, this is an issue dealt with in another session, but these developments will put pressure on existing, international tax arrangements and will, I believe, require an intensification of cooperation by developing an international consensus on:

- how tax treaties should apply to electronic commerce and on the application of the arm's length principle;
- how to adapt VAT systems to both on-line and off-line activities;
- the need to minimize customs formalities for goods ordered on-line but delivered in a traditional way;
- the implications for the ways in which tax administrations do their business.

The OECD is working on each of these areas and would welcome input from CIAT countries.

The challenge that policy makers face in this new interdependent environment, is to design tax policies that will improve the allocation of capital, reinforce market-oriented behaviour and lead to higher levying standards for all. An international framework exists to achieve this coordination, but the existing institutions should be given a wider mandate to develop some of the instruments referred to above and to monitor their implementation. It remains unclear, however, as to whether national governments are prepared to see this framework strengthened so that national policies are determined within a multilateral framework. Only with such coordination can small and not-so-small economies gain the benefits of a global market system while maintaining a high degree of economic sovereignty.

To develop procedures for a coexistence of divergent tax systems is the challenge that faces tax policy makers in the 21st century. If they fail to respond to the challenge, they may find that a "little tax competition" is far more constraining than a "small amount of coordination".

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HONG KONG

HONG KONG: AN OFFSHORE FINANCIAL CENTRE IN THE FAR EAST – ITS PRESENT AND FUTURE

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I. INTRODUCTION

Unlike other offshore financial centre (hereinafter: OFC) jurisdictions, Hong Kong, situated at the centre of Asia, is itself an international trade, industrial and financial centre. Hong Kong's economy rests squarely on a base of industry, commerce, shipping and port activity. It is also a major tourist centre. Being an OFC (officially it is just a low-tax area) is a sideline.[1]

This strong commercial framework has made Hong Kong more valuable as an OFC.[2] Because Hong Kong is one of the world's major trading and manufacturing centres and a service centre for the region, the location of an office or subsidiaries in Hong Kong can often be justified to foreign revenue authorities on commercial grounds, particularly when an enterprise is operating into China.[3]

II. ATTRIBUTES OF HONG KONG AS AN OFC

A. Its simple and straightforward tax system and the low rates of tax

Hong Kong is an OFC mainly because its tax system (like that of Panama) has a territorial base: only income arising in or derived from Hong Kong is taxed; foreign-source income, whether remitted to Hong Kong or otherwise, is not taxed except when it is deemed to have a Hong Kong source.[4] The extent of exposure to Hong Kong tax is not governed by residence status.

The current direct tax system in Hong Kong consists of salaries tax, profits tax and property tax, with the charge to tax on a schedular basis, i.e., a separate charge in respect of each type of income.[5]

Hong Kong does not tax dividends,[6] capital gains[7] or interest paid by financial institutions.[8] There is no withholding tax on dividends, interest, royalties or salaries.[9]

There are no customs duties except specific excise taxes on a narrow range of goods.[10] Stamp duty is payable on, *inter alia*, a variety of documents relating to assignments of immovable property, property leases and stock and share transfers.[11] There is no gift tax in Hong Kong. Estate duty is payable, but only on assets located in Hong Kong where the value of the estate exceeds HKD 6.5 million (the rates of tax vary between 6 per cent and 18 per cent).[12]

There is no social security contribution imposed on either employers or employees.[13]

1. The Hong Kong Government has never actively sought OFC status and successive Financial Secretaries have explained that any advantages of Hong Kong for international tax planning arise simply from the special circumstances of its tax system and the skills of its inhabitants. See, Barry Spitz, *Tax Havens Encyclopedia*, Butterworth & Co. (Publishers) Ltd. 1987, Hong Kong at 4.
2. In this context most developed countries and even certain of the less developed countries have introduced legislation preventing their residents from transferring, with a view to avoiding tax, their wealth or profits out of their jurisdiction. See, *Tolley's Tax Havens*, first edition, London, 1990, at 4-5. For detailed discussions about the specific anti-tax haven legislation in particular countries, see: Marshall Langer, "Treaty shopping", *The OFC Report 1994/95*, at 10-17; Richard J. Hay, "New Canadian rules for corporate redomiciliation", *The OFC Report 1994/95*, at 20-21.
3. *Grundy's Tax Havens: A World Survey*, sixth edition, Sweet & Maxwell, 1993, at 123. The seventh edition under the new title of *Offshore Business Centres: A World Survey*, Sweet & Maxwell 1997, does not contain this discussion. So here we still refer to the sixth edition.
4. Price Waterhouse, Doing business in Hong Kong, 1995, at 139-140. And also David Flux, revised by David G. Smith, *Hong Kong Taxation: Law and Practice*, 1996-97 edition, the Chinese University Press, Hong Kong, 1996, at 7; *Tolley's Tax Havens*, London, 1991, at 240; Milton Grundy, *Offshore Business Centres: A World Survey*, seventh edition, Sweet & Maxwell 1997, at 67.
5. *Tolley's Tax Havens*, London, 1991, at 240-245.
Note, however, there are exceptions so that an individual may, in appropriate circumstances, elect for Personal Assessment which has the effect of bringing all of his sources of income into a single assessment for which he must make a separate total income return. In the case of companies there is an effective merging of most heads of taxation into a single assessment. For a detailed discussion, see Chapter 6 of David Flux's *Hong Kong Taxation: Law and Practice* (1996-97 edition), at 367-390.
6. Sec. 26 (a), Inland Revenue Ordinance (hereinafter: IRO), which exempts dividends received from Hong Kong companies from profits tax.
7. See David Flux, *supra* note 5, at 7; Coopers & Lybrand, *1994 International Tax Summaries*, at H-1.
8. Until 1 April 1989, there was an interest tax in Hong Kong in addition to property tax, salaries tax and profit tax. With effect from 1 April 1989 interest tax was abolished, leaving just three separate taxes.
9. *Tolley's Tax Havens*, London, 1990, at 244.
10. Hong Kong is a free port and imposes no general tariffs on imported goods. However, alcoholic liquors, tobacco, methyl alcohol, and some hydrocarbon oils are subject to tax whether they are imported into or manufactured in Hong Kong for local use. See: Price Waterhouse, *Doing Business in Hong Kong*, 1995, at 185-186.
11. *Tolley's Tax Havens*, London, 1990, at 246. Stamp duty is imposed in Hong Kong under the Stamp Duty Ordinance (Cap. 117, 1981 Laws of Hong Kong). It is a significant revenue raiser. The tax was introduced originally by Ordinance No. 12 of 1866. The current ordinance dates from 1981.
12. Id., at 245.
13. Id.

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With the exception of a first registration tax on automobiles, there are at present no sales or purchase taxes.[14]

Hong Kong enjoys world renown as a low-tax jurisdiction. Corporations are taxed at the rate of 16 per cent,[15] while individuals and partnerships comprised of individuals are taxed at the rate of 15 per cent. Corporate partners are taxed at the rate of 16 per cent.[16] Taking into account the deductions and other adjustments available to taxpayers,[17] these rates are quite tolerable.

B. Good commercial and corporate law

Generally, the law of Hong Kong follows that of England. The common law of England and the rules of equity are in force in Hong Kong so far as they are applicable to the circumstances of Hong Kong or its inhabitants.[18] The English origin of the law of Hong Kong makes it understandable to the business world.

Hong Kong's company law is based on the British Companies Act 1929.[19] All forms of business entities are open to foreign investors, which include: public and private companies limited by shares; unlimited companies; companies limited by guarantee; sole proprietorships; partnerships; and joint ventures. Of these, private companies and branches of foreign companies are commonly used by foreign investors, as are partnerships and joint ventures.[20]

Company formation is simple and inexpensive. Hong Kong Government permission is not required for non-residents to set up a branch or subsidiary in Hong Kong. It normally takes approximately two months to incorporate a Hong Kong company. However, if a company is required immediately, it is possible to acquire an "off-the-shelf" company. Many accountancy firms and solicitors maintain a stock of so-called "shelf" companies which are available for immediate use.

A Hong Kong company must have at least two shareholders and two directors; these need not be resident in Hong Kong. However, the company secretary must be Hong Kong resident. Corporations can be directors/shareholders. Meetings of directors and shareholders may be held outside Hong Kong.

All Hong Kong companies must file an annual return with the Registrar of Companies. Public companies must also file a copy of their audited accounts with the Registrar. The accounts of private companies need not be filed.

There are no requirements regarding the minimum amount of share capital. However, as mentioned above a minimum of two shareholders is required. Hong Kong companies can, therefore, be set up with a paid-up share capital of as little as HKD 2. Shares of no par value may not be issued. Private companies are not permitted to issue bearer shares; these may only be issued by public companies.

There are no restrictions on repatriation of profits or initial capital or on the transfer of ownership.

Licences are required for banks and are granted sparingly to branches or subsidiaries of foreign banks.[21]

C. Good communication[22]

Hong Kong enjoys excellent communications with the rest of the world, the Kai Tak international airport is a major South-East Asian airport and a new Hong Kong airport is currently under construction.[23] The availability of the latest telecommunication technology,[24] and the use of English as an official language further enhances Hong Kong's accessibility.[25]

D. No exchange restrictions on foreigners

The Hong Kong dollar is legal tender in Hong Kong, and is now officially pegged to the US dollar at the rate of USD 1 = HKD 7.80.[26]

There are no exchange controls in Hong Kong.[27]

E. Advanced business infrastructure

The legal and accountancy professions are well developed and first-class. The biggest international law and accounting firms are represented in Hong Kong.[28]

14. Id.
15. This new rate was introduced in Hong Kong's new budget, see "Hong Kong: $13bn tax cut unveiled", by John Ridding in Hong Kong, FT, Thursday 19 February 1998.
16. See, Coopers & Lybrand, *supra* note 7.
17. See, *Tolley's Tax Havens*, London, 1990, at 243. For a detailed discussion about the depreciation allowance, see, David Flux, *supra* note 5, at 313-365.
18. Price Waterhouse, *supra* note 10, at 7.
19. Edouard Chambost, *Using Tax Havens Successfully*, Institute for International Research, 1978, at 92.
20. *Tolley's Tax Havens*, London, 1990, at 234.
21. See Price Waterhouse, *supra* note 10, at 76-91; and *Tolley's Tax Havens*, London, 1990, at 234-239.
22. See *Tolley's Tax Havens*, London, 1990, at 232.
23. In September 1991 the Prime Ministers of the United Kingdom and the People's Republic of China signed the Memorandum of Understanding Concerning the Construction of the New Airport in Hong Kong and Related Questions.
24. See, Price Waterhouse, *supra* note 10, at 20.
25. English will continue to be one of Hong Kong's official languages after 1 July 1997. See, Art. 9 of the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (hereinafter: the Basic Law), which reads as follows: "In addition to the Chinese language, English may also be used as an official language by the executive authorities, legislature and judiciary of the Hong Kong Special Administration Region."
26. *Tolley's Tax Havens*, London, 1991, at 232. There are arguments about whether the Hong Kong dollar should continue to be pegged to the US dollar, see, "The Currency's Champion – Mr Yam Has Little Time for Critics of the US Dollar Peg", *Financial Times*, 16 June 1997, V. Mr Joseph Yam is the head of Hong Kong's monetary authority. The stability of the currency, however, will remain one of the main objects of Hong Kong's monetary policies. In accordance with Art. 111 of the Basic Law, the authority to issue Hong Kong currency will be vested in the Government of the Hong Kong Special Administrative Region (hereinafter: SAR). The issue of Hong Kong currency must be backed by a 100 per cent reserve fund. Designated banks may be authorized to issue or continue to issue Hong Kong currency under statutory authority, after the government is satisfied that the issue of currency will be soundly based and the arrangements for such issue are consistent with the object of maintaining the stability of the currency.
27. *Tolley's Tax Havens*, London, 1991, at 234, 246.
28. See: Edouard Chambost, *Using Tax Havens Successfully*, Institute for International Research 1978, at 91.

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F. Confidentiality of transactions

As a general rule it has long been the policy of the Hong Kong Government not to enter into double taxation agreements, or other agreements to exchange information on tax affairs. The IRO specifically forbids disclosure of information relating to a taxpayer's affairs.[29] Since 1989, however, a few limited agreements have been negotiated. Now Hong Kong has double taxation agreements with the United States, South Korea, New Zealand, Canada, Germany and the United Kingdom. However, these only concern double taxation of shipping or airline profits.[30] In addition to these agreements, ad hoc administrative arrangements have existed for some time to deal with double taxation problems affecting Hong Kong based employees who are required to work in mainland China from time to time. Recently, a Memorandum of Understanding between mainland China and the Hong Kong SAR based on the standard OECD model double taxation agreement was announced. This might have some negative influence on the confidentiality of transactions in Hong Kong.[31]

G. Strong links with mainland China[32]

Hong Kong is located on the south-east coast of mainland China, adjoining the Province of Guangdong. This geographical proximity leads to strong economic and financial links between Hong Kong and mainland China. Since the adoption of "open door" policies by the People's Republic of China in late 1978, Hong Kong's economic relations with mainland China have undergone rapid growth and development. The two are now each other's major trading partners. Hong Kong has been one of Guangdong Province's largest foreign investors. Companies registered in Hong Kong account for approximately 70 per cent of total foreign investment in the province. Moreover, Hong Kong is a major fund-raising centre for the People's Republic of China (even though in some cases Hong Kong is not the direct source of funds, it serves as a window through which the People's Republic of China can gain access to external borrowings).

The prospects for further development of economic and financial links between Hong Kong and mainland China continue to be good, given the firm foundation that has been established over the years as well as the broadened "open door" policies and accelerated economic reforms in the People's Republic of China. The People's Republic of China has also invested heavily in Hong Kong.

Hong Kong is the ideal base from which to do business in mainland China.

III. THE USES OF HONG KONG AS AN OFC

Hong Kong is strongly recommended as an OFC for companies by many tax lawyers.[33] Almost all types of OFC entities can be used in Hong Kong (see below).

A. Holding companies

There is no special legislation regarding holding companies. The tax advantage of setting up a holding company in Hong Kong is obvious, i.e., dividends, whether intercompany dividends, stock dividends or dividends in kind and whether from Hong Kong or elsewhere, are not (except in very unusual circumstances) taxable.[34]

B. Investment companies

Because dividends are not taxed and Hong Kong interest is taxed only if it is received by a corporation carrying on business in Hong Kong,[35] many investment companies may avoid being liable to profits tax.[36]

C. International financial subsidiaries, offshore banks and trust companies

Hong Kong is a major offshore banking, trust and investment management centre.[37] Under its territorially-based tax system, if all the operations giving rise to interest income or to profits from the sale, redemption or presentment of a certificate of deposit or bill of exchange are performed overseas, the mere booking of the offshore income in Hong Kong by a financial institution will not make it taxable.[38]

Although in all general respects the ascertainment of the assessable profits of financial institutions is the same as for other types of business, there is an important provision, which deems interest income arising to certain financial insti-

29. *Tolley's Tax Havens*, London, 1991, at 234.
30. See, "Hong Kong: Air transportation agreements", *FT World Tax Report*, Volume XXV, April 1998, at 199.
31. "Hong Kong: Double tax arrangement with mainland China", *FT World Tax Report*, Volume XXV, April 1998, at 77. Hong Kong will implement the Memorandum from 1 April 1998 and mainland China from 1 July 1998.
32. See, Price Waterhouse, *supra* note 10, at 6-7, 36-37.
33. See, for example, Edouard Chambost, *supra* note 19, at 85-92. One reason that Hong Kong is not recommended as a tax haven for individuals might be its expensive housing. Hong Kong has now the second highest land prices in the world, only after Singapore; see, Price Waterhouse, *supra* note 10, at 12.
34. See, Price Waterhouse, *supra* note 10, at 143.
35. The Hong Kong tax authorities interpret "carrying on business" very widely. For example, a company dealing in Hong Kong securities can be held to carry on business in Hong Kong and therefore be subject to profits tax.
36. See, Price Waterhouse, *supra* note 10, at 154.
37. Id., at 71.
38. Id., at 42. Hong Kong's IRO was amended in 1978 to deal with source issues for financial institutions. Basically, loan interest will not be taxable if the loan involved is documented, negotiated, and approved by an associate of the financial institution outside Hong Kong. Loan interest becomes 50 per cent taxable if either the initiation or the funding of the loan is in or from Hong Kong. These provisions operate in a way that is designed to maintain Hong Kong's status as a low-tax jurisdiction for financial institutions. See, Ernst & Young, *Taxation in Hong Kong 1992/1993* (4th ed.), Longman (Far East), Hong Kong, 1992, at 212; and also, Willoughby, Peter, G., *Hong Kong Revenue Law: Volume 2*, paragraph 1.05.

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tutions[39] in defined circumstances to be subject to profits tax notwithstanding that under the source rules applicable to interest the source is not in Hong Kong. In accordance with Section 15(1)(i) of the IRO of Hong Kong, notwithstanding that credit may have been provided outside Hong Kong, interest income arising to a financial institution through or from the carrying on of its business in Hong Kong is deemed to have a Hong Kong source.[40]

It follows that the major attraction of Hong Kong to international financial institutions might not be Hong Kong's tax system, but its status as an important international financial centre. Foreign banks in Hong Kong tend to be the premier banks in their countries of incorporation. In addition, many major international merchant banks and investment banks operate in Hong Kong. The financial markets, particularly in foreign exchange and gold, form an integral part of the corresponding global markets. Moreover, Hong Kong serves as an important centre for the intermediation of international flows of savings and investment, particularly through the syndication of loans and international fund management. International investors play a significant and increasing role in Hong Kong, and Hong Kong's investment overseas is also believed to be considerable.[41]

D. Reinvoicing companies

Hong Kong's high level of commercial activity lends credibility to the activities of reinvoicing companies which have been attracted to Hong Kong as a result.[42] Companies (many of them owned through trusts in order to avoid taxes and also to achieve a greater degree of confidentiality for the ultimate beneficiaries) are set up in Hong Kong to buy goods and services from some third country for resale at a substantial profit to a company owned by the person or persons responsible for creating the structure. In accordance with the Departmental Interpretation and Practice Note No. 21 on the topic of the locality of profits,[43] in the case of commodity trading profits, these will not be taxable if both the contract for purchase and sale are effected outside Hong Kong. If an overseas company sets up a branch in Hong Kong to act simply as a purchasing or buying office for dispatching goods overseas, no profits tax liability normally arises.[44]

E. Shipping companies[45]

As one of the world's greatest harbours, Hong Kong has a large shipping register. Shipping companies are liable to tax only on Hong Kong source profits; therefore liability to profits tax depends on whether the shipowner is carrying on a business in Hong Kong. This is determined by reference to whether or not the shipping company is incorporated in Hong Kong, and whether the business is managed or controlled locally.[46]

What should be pointed out here is that although there are separate provisions for the ascertainment of the assessable profits of so-called resident shipowners and non-resident shipowners,[47] these provisions are virtually the same in that in both cases the assessable profit is based on a proportion of worldwide profit. In fact, there is very little difference in the calculation, the only difference being in relation to charter hire income. Under the provisions applying to resident shipowners, charter hire income is only excluded if it is derived through a permanent establishment outside Hong Kong and under the provisions applying to other shipowners, it is only included if it is concluded through a permanent establishment in Hong Kong.[48]

F. Patent/copyright holding companies

Hong Kong has no special legislation for patent/copyright holding companies.[49] Its territorially-based tax system and special provisions concerning the taxation of royalties, however, make Hong Kong an attractive place to locate patent/copyright holding companies.

Under its territorially-based tax system, royalties that have their sources outside of Hong Kong are not subject to Hong Kong taxation. Although royalties for the following are deemed to be receipts of a business carried on in Hong Kong, only 10 per cent of such gross royalties are liable to profits tax (unless the royalties are received from an associate in certain circumstances):

- exhibition or use in Hong Kong of cinematographic or television film or tape, any sound recording, or any advertising material connected with such film, tape or recording;
- use of a right to use in Hong Kong copyrighted material or a patent, design, trademark, or other property of a similar nature or the imparting of or undertaking to impart know-how connected with the use in Hong Kong of such property.[50]

G. Trusts

Hong Kong is a common law jurisdiction and common law precedents regarding trusts are followed. Trusts do not need

39. Here financial institution means:
(1) a bank licensed under the Banking Ordinance;
(2) a company registered or licensed as a Deposit-Taking Company under the Banking Ordinance;
(3) an associated company of (1) or (2) which would be liable to be registered or licensed under the Banking Ordinance but for the fact that it only takes deposits from licensed banks or registered or licensed deposit-taking companies.
See, Sec. 2(1) of the IRO.
40. See, David Flux, *supra* note 5, at 279-280.
41. See, Price Waterhouse, *supra* note 10, at 22-23.
42. *Tolley's Tax Havens*, London 1990, at 9.
43. Departmental Practice Note No. 21 was issued in November 1992 by the then Commissioner of Inland Revenue, Anthony Au-Yeung. The note is not law but rather the view of the Inland Revenue Department as to how the law presently operates.
44. Richard Cullen, "Hong Kong Revenue Law – The Present, 1997, and Beyond", 7 *TNI* 1109 (1 November 1993), at 1126.
45. The discussion under this subtitle applies to aircraft companies also. See, Price Waterhouse, *supra* note 10, at 154-155.
46. *Tolley's Tax Havens*, London 1990, at 246.
47. Sec. 23 B of the IRO applies to resident shipowners while Sec. 23 C applies to shipowners who are not covered by Sec. 23 B.
48. For a detailed discussion, see David Flux, *supra* note 5, at 197-202.
49. See, Price Waterhouse, *supra* note 10, at 155.
50. Id., at 143.

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to be registered.[51] Trusts are not specially taxable as such in Hong Kong, but if a trustee receives income of a taxable nature, the trustee will be taxable as a "person other than an individual", although there is doubt as to whether a trustee can be personally assessed upon income or profits which he receives merely in a fiduciary capacity. The trustee, however, can set losses incurred in a trade carried on by himself for the benefit of the trust against profits from that trade carried on by that trust.[52]

H. Hong Kong as a base for doing business in mainland China

As mentioned before, Hong Kong has strong links to mainland China, especially to Guangdong Province. This has made Hong Kong an ideal place to provide supporting services for corporations wishing to do business in mainland China. Many investors tend to set up stepping stone companies in Hong Kong before they begin their business in mainland China.

A notable phenomenon in recent years is the use of Hong Kong by enterprises from mainland China. One typical use for tax purposes is that some mainland enterprises set up subsidiaries in Hong Kong and than reinvest in the mainland via their subsidiaries in Hong Kong, so as to enjoy the preferential tax treatments vested by the Central Government or local governments of the People's Republic of China in Hong Kong investors.

IV. THE FUTURE OF HONG KONG AS AN OFC

In accordance with the Joint Declaration,[53] since 1 July 1997 the People's Republic of China has resumed the exercise of sovereignty over Hong Kong. This has raised many concerns about the future of Hong Kong as an OFC, for instance the political stability of Hong Kong, possible changes to its tax system, the possibility of exchange controls[54] and the influence of China's double tax conventions on the confidentiality of transactions in Hong Kong.[55]

A. The political stability of Hong Kong

The political stability of Hong Kong has been doubly-ensured by the Joint Declaration and the Basic Law.[56] Under the framework of the Joint Declaration and the Basic Law, Hong Kong is now a SAR of the People's Republic of China, exercising a high degree of autonomy and enjoying executive, legislative and independent judicial power, including that of final adjudication.[57] In accordance with the principle of "one country, two systems", the socialist system and policies will not be practised in Hong Kong SAR, and the current capitalist system and way of life will remain unchanged for 50 years.[58] The laws currently in force in Hong Kong, including the common law, rules of equity, ordinances, subordinated legislation and customary laws, will be maintained, except for any that contravene the Basic Law, and subject to any amendment by the legislature of the Hong Kong SAR,[59] while national laws of the People's Republic of China will not be applied in the Hong Kong SAR except for those listed in Annex III to the Basic Law.[60]

In addition, the Joint Declaration and the Basic Law guarantee that private property, ownership of enterprises, right of inheritance, and foreign investment will be protected by law.[61] Thus, although the political developments in China will have a significant bearing on the long-term outlook of Hong Kong, it is extremely unlikely that basic political change will take place in Hong Kong in the foreseeable future.

B. The tax system of Hong Kong SAR

The low-tax policy has been the policies of successive government administrations as regards taxation of income in Hong Kong. The following terms of reference given to the Third Inland Revenue Ordinance Review Committee in 1976 speak for themselves and the sentiments have been reiterated in various government speeches up to the present time:

> Having regard to the economic circumstances of Hong Kong which dictate
> (a) a comparatively low level of direct taxation;
> (b) that the system at given tax rates should be as productive of revenue as possible; and
> (c) that the relevant legislation should be simple and inexpensive to administer.
>
> To consider the present system of taxation of profits and other forms of income contained in the Inland Revenue Ordinance...[62]

In the light of the Joint Declaration and the Basic Law, Hong Kong should remain a "low tax" jurisdiction[63] and the SAR Government must balance income and expenditure;[64] the SAR has its independent finance, and the Central Government of the People's Republic of China will not levy taxes on

51. *Tolley's Tax havens*, London, 1990, at 239.
52. Id., at 240. And also, David Flux, *supra* note 5, at 132-134.
53. See: International Agreement – Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong, British *White Paper* (26 Sept 1984). V26 *Harvard International Law Journal*, at 249-263, Winter '85.
54. See, *The OFC Report 1994/95*, at 136 and Milton Grundy, *Offshore Business Centres: A World Survey*, seventh edition, Sweet & Maxwell 1997, at 67-69.
55. See, *Grundy's Tax Havens: A World Survey*, *supra* note 3, at 122.
56. The Basic Law was adopted at the Third Session of the Seventh National People's Congress on 4 April 1990 and came into effect as of 1 July 1997.
57. Art. 2 of the Basic Law.
58. Preamble and Art. 5 of the Basic Law.
59. Art. 8 of the Basic Law.
60. Art. 18 of the Basic Law. The laws listed in Annex III are: Resolution on the Capital, Calendar, National Anthem and National Flag of the People's Republic of China, Resolution on the National Day of the People's Republic of China; Order on the National Emblem of the People's Republic of China Proclaimed by the Central People's Government; Declaration of the Government of the People's Republic of China on the Territorial Sea; Nationality Law of the People's Republic of China; Regulations of the People's Republic of China concerning Diplomatic Privileges and Immunities.
61. Art. 105 of the Basic Law.
62. See, David Flux, *supra* note 5, at 2.
63. Art. 108 of the Basic Law. The basic law thus lends a final, important, reinforcing influence to the complex of factors driving Hong Kong's low-tax structure.
64. Art. 107 of the Basic Law.

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the SAR.[65] Furthermore, the Hong Kong SAR is required to maintain the status of a free port and shall not impose any tariff unless otherwise prescribed by law.[66] Thus, Hong Kong is unlikely to change its tax system as a SAR of the People's Republic of China.[67]

However, because the Hong Kong Government is facing a steadily rising level of long-term government expenditure,[68] there is a chance that the tax base may be widened to accommodate a tax on income of any kind arising in, or derived from Hong Kong or that tax may be imposed on dividends paid by companies centrally controlled and managed in Hong Kong.[69] Nevertheless, the OFC activities of Hong Kong are of significant economic importance, and it seems likely that the government will protect these activities.[70] Furthermore, because land remains an important component in the Hong Kong Government's revenue regime,[71] the need for a greater reliance on direct or indirect taxes is reduced. Hong Kong's HKD 100 billion tax cuts in her first post-colonial budget may serve to provide comfort on this point.[72]

C. No exchange control will be practised in Hong Kong SAR

The Hong Kong Dollar will continue to circulate as the legal tender in Hong Kong SAR[73] and remain freely convertible. The imposition of exchange controls is clearly ruled out by the Basic Law. Article 112 of the Basic Law reads as follows:

> No foreign exchange control policies shall be applied in the Hong Kong Special Administrative Region. The Hong Kong dollar shall be freely convertible. Markets for foreign exchange, gold, securities, futures and the like shall continue. The Government of Hong Kong shall safeguard the free flow of capital within, into and out of the Region.

The fact that the Hong Kong Government kept the Hong Kong dollar freely convertible even during this year's serious financial crisis emphasises the Hong Kong Government's ability and willingness to keep this promise.

D. The influence of China's double tax conventions on the confidentiality of transactions in Hong Kong

As mentioned above, the lack of double tax treaties is a component in Hong Kong's tax attractiveness for many. The People's Republic of China, however, has entered into double tax agreements with more than 40 countries, all of which provide for exchange of information between revenue authorities.[74] Under Article 153[75] of the Basic Law, there seems to be a possibility that the double tax agreements which the People's Republic of China is party to can apply to Hong Kong. Taking into consideration Hong Kong's independent tax system and independent finances, however, the possibility of applying the People's Republic of China's double tax agreements to Hong Kong is really very remote.[76]

V. CONCLUSION

To conclude, under the Joint Declaration and the Basic Law, Hong Kong, as a SAR of the People's Republic of China, should be able to continue its OFC status and retain its status as an international financial centre[77]and shipping centre.[78] Moreover, the political and economic ties between Hong Kong and mainland China have become stronger since the People's Republic of China resumed the exercise of sovereignty over Hong Kong on 1 July 1997. This will certainly enhance Hong Kong's role as a base for conducting business operations in or with China.

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65. Art. 106 of the Basic Law.
66. Art. 114 of the Basic Law.
67. There is a consensus among commentators on this issue. One of the commentators writes that "despite the immense political changes under way, future revenue law changes may be few in number and minor in degree." See, Richard Cullen, *supra* note 44, at 1110.
68. As Hong Kong's legislative council becomes more representative, there is increasing pressure on the government to augment expenditure, particularly on social projects. The projected expenditure on the airport is estimated to send the government's finances into deficit for several years. Id., at 136.
69. *The OFC Report 1994/95*, edited by Milton Grundy, Campden Publishing Limited 1994, at 136.
70. *Grundy's Tax Havens: A world Survey*, *supra* note 3, at 122. The words of Mr Tung Chee-hua, the first Chief Executive of Hong Kong SAR that "in so far as managing economics is concerned, we follow the line, by and large, of non-intervention, ... more support for manufacturing is possible, but not if it requires higher taxes" are reassuring. See, *Financial Times*, 16 July 1997, II.
71. A principal differentiating factor between Hong Kong and many other developed jurisdictions is the reliance the government continues to place on the collection of revenue from land transactions. In the late 1970s, land transaction revenues accounted for over one third of all government revenue in Hong Kong. See, Richard Cullen, *supra* note 44, at 1120.
72. "Hong Kong: $13bn tax cut unveiled", see *supra* note 15.
73. Art. 111 of the Basic Law.
74. For a complete collection of the double tax agreements which China has entered into, see: *Taxes and Investment in Asia and the Pacific* (loose-leaf; IBFD Publications BV).
75. It reads as follows:
The application to the Hong Kong Special Administration Region of international agreements to which the People's Republic of China is or becomes a party shall be decided by the Central People's Government, in accordance with the circumstances and needs of the region, and after seeking the view of the government of the region.
76. See, further, Ahern, Williams, "Tax Treaties for Hong Kong? – The 1997 Issues", 1 *Asia Pacific Law Review* at 95 (1992), and Richard Cullen, *supra* note 44, at 1133-1134. Richard Cullen, after examining the People's Republic of China–Australia treaty, concludes that the agreement defines the People's Republic of China, for the purpose of this treaty, to be the part of the People's Republic of China subject to Chinese income tax law. Since Hong Kong SAR has its separate tax system, logically, the double tax treaties of the People's Republic of China shall not apply to Hong Kong. The author has surveyed the most recent tax treaties that the People's Republic of China has entered into: one is the China–Uzbekistan (income) tax treaty concluded on 3 July 1996, the other is the China–Armenia (income and capital) tax treaty concluded on 5 May 1996, and reaches the same conclusion as that of Richard Cullen.
77. Under Art. 109 of the Basic Law, the Government of Hong Kong SAR shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre.
78. Under the Basic Law, the Hong Kong SAR shall maintain Hong Kong's previous systems of shipping management and shipping regulation, including the system for regulating conditions of seamen (Art. 124). Private shipping businesses, shipping-related businesses and private container terminals in the Hong Kong SAR may continue to operate freely after 1 July 1997 (Art. 128).

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INTERNATIONAL

TAX AMNESTIES: AN INTERNATIONAL REVIEW

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I. INTRODUCTION

Tax evasion remains an international social problem. In the United States, the difference between the taxes voluntarily paid and the taxes that would be collected if taxpayers accurately reported and paid is known as the "tax gap". The 1993 gross income tax gap in the United States was estimated at USD 170 billion (Guttman 1994). Tax administrations have predominantly responded to tax evasion with the enactment of legal sanctions on taxpayers, and also on the tax advisers who act for them. The efficiency of legal sanctions is called into question by (1) the continuing problem of tax evasion, and (2) the administrative enforcement and economic resources required to maintain a viable audit deterrent (Freiberg 1990; Alm 1991).

Another policy response being encountered more frequently, both at a national level, and in the case of the United States, at the state level, is the operation of a "one-time" tax amnesty. In 1998, the US Joint Committee on Taxation (hereinafter: JCT 1998), released a report on a possible federal tax amnesty. The report estimates that a federal tax amnesty would result in a net revenue loss over ten years of USD 8 billion, primarily because overall tax compliance in the long run is expected to decrease as a result of any amnesty.

Despite the growing popularity of tax amnesties, there is a scarcity of literature detailing the benefits and costs of implementing a tax amnesty programme. This article contributes to existing literature by outlining the claimed advantages and disadvantages of tax amnesties and the prior academic research on tax amnesties. The fourth section reviews the experiences and results of a number of amnesties conducted by various countries and US states and outlines the decision parameters that need to be addressed by any tax agency considering an amnesty programme.

II. ADVANTAGES AND DISADVANTAGES OF TAX AMNESTIES

A. Advantages

There are a number of perceived advantages and disadvantages in operating a tax amnesty. In terms of the advantages, tax amnesties allow taxpayers to comply in respect of past breaches of tax laws and allow tax evaders who have "dropped out of the system" because they had failed to file a tax return one year, or had found the returns too complex, to come back into the tax system with an honest disclosure of their prior year tax affairs. This also applies to those who omitted an item of income one year and were "forced" to repeat this on an annual basis.

A second benefit to tax agencies is the collection of outstanding taxes. In some countries, no official figures are released on the estimated level of uncollected taxes, but fraud detection and tax recovery procedures occupy a good deal of administrative resources and the one-off source of additional tax revenue created is often seen as an advantage of tax amnesties.

A third advantage suggested by Leonard and Zeckhauser (1987) is that tax amnesties may increase future voluntary compliance as taxpayers who have evaded tax in the past (for whatever reason), may be ready to turn over a new leaf and become compliant taxpayers in the future. A consequent advantage may be the improvement of tax agency records, as when past evaders are brought into the tax system (i.e. future enforcement procedures are facilitated). It is assumed that delinquents will be less likely to evade in a similar manner again.

A final advantage of tax amnesties is that they allow for a transition period prior to a strengthened enforcement regime. Tax evaders who are detected after the amnesty only have themselves to blame if they face more severe penalties as a result of not accepting the amnesty offer.

B. Disadvantages

There are a number of obvious disadvantages with tax amnesties. An immediate disadvantage is that honest taxpayers may be upset by them. If the bulk of taxpayers already voluntarily comply with the tax laws, then these taxpayers may take offence at a "soft option" being given to tax evaders. The issue is one of equity and may even have polit-

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ical overtones. The very nature of amnesties means an evaluation of taxpayer sentiment, and existing compliance levels should be made before an amnesty is introduced. It would be an unfortunate effect if the level of compliance was lower *ex-post* than *ex-ante* the amnesty. It is important to realize that amnesties are neither a reward nor a forgiveness for past non-compliance even given some reduction in dead-weight costs.

A second disadvantage is that tax amnesties can undermine guilt arising from tax evasion. This disadvantage can be minimized or even reversed by combining the amnesty with a strengthening of enforcement procedures and penalties. This can of course be initiated by policing procedures and/or in terms of harsher penalties provided through legislation. Although at first glance, the combination of increased enforcement and the offering of amnesty may seem mutually exclusive, they both seek to encourage future compliance. This is known as the "carrot and stick" approach and is accepted as a key indicator for the success of an amnesty.

A third disadvantage is that taxpayers may expect amnesties to be offered again in the future, possibly resulting in a reduction in compliance. A contrary viewpoint is that amnesties can be re-offered in the future without harming compliance as the underlying taxpayer base is of a dynamic nature. Naturally a reasonable period of time should elapse, as full amnesties offered at very short intervals would damage the integrity of a tax system and compliance levels.

Finally, an amnesty may not be economically viable. Lerman (1986) defines "net amnesty revenue" as the gross tax liability on amnesty returns but reduced by the following items:

- any taxes collected previously, e.g. through a withholding system;
- amounts known to the tax agency which could be collected without an amnesty;
- penalties which are forgiven on amounts that would otherwise have been collected;
- actual administration costs of the amnesty including the processing of amnesty returns;
- the opportunity costs of transferring enforcement personnel to administration of the amnesty.

Offsetting these reductions is an upward adjustment to amnesty revenue to reflect reductions in audit and collection costs as a result of better compliance or conceivably the diversion of audit effort to other revenue enhancement activities. Although the concept of net amnesty revenue is simple, the actual calculation of the final figure could be quite complex.

III. PRIOR RESEARCH ON TAX AMNESTIES

A. Tax amnesties within a public economics framework

The public economics literature contains a substantial stream of research which has modeled a taxpayer's rational decision to comply or evade with the tax laws (e.g. Allingham and Sandmo 1972; Beck and Jung 1989). Under this approach, a taxpayer chooses a level of compliance by weighing the trade-off between compliance and evasion and choosing the level of compliance that will result in the highest expected level of net benefits. This choice will depend on the various factors that affect the benefits and costs of tax evasion relative to complying with the tax laws. Factors that will influence the decision include the probability of the evasion being detected through audit procedures, the back taxes and civil and criminal penalties that will be imposed if evasion is detected, the taxpayer's ethics or morality, damage to the reputation of the taxpayer if the evasion is detected, the taxpayer's degree of "risk aversion", and the perceived benefits derived from a successful evasion of taxes.

From the negative side, the audit probabilities and the penalties imposed are the main determinants of the expected costs of tax evasion. If these expected costs were to increase, e.g. increased penalties, increased likelihood of detection due to increased audit rates, this should decrease the amount of evasion undertaken. In practice, other factors are correlated with tax compliance. For example, there is an active research stream on alternative approaches to tax enforcement involving the use of conscience appeals (Mason and Mason 1992), informal sanctions and stigmatization (Violette 1989; Porcano and Price 1993), etc. In the context of an amnesty, the more guilt that an evader might feel after evading taxes, the less tax will be evaded.

Malik and Schwab (1991) show that the declaration of an amnesty with no increase in enforcement efforts should have no effect on the behaviour of taxpayers. This is because no one would come forward to take advantage of the amnesty as a rational evader would note that the costs and benefits of evasion have not changed, so the evader's choice regarding compliance remains the same. If, however, the penalties for evasion are also increased, or the tax agency increases the probability of detection, the rational evader will re-evaluate past choices and may choose to take advantage of the amnesty since the expected costs of previous evasion have been increased. Alm and Beck (1990) also note that theoretical analyses of tax amnesties give mixed results as offsetting compliance effects occur in the analysis of the amount of past evasion to report in an amnesty and in the amount of current income to report to the tax authorities. They suggest that the total revenue impact of tax amnesties is "substantially clouded".

Stella (1991) also points out that the success of an amnesty cannot be measured by the amount of revenue collected during the amnesty. What is of crucial importance is the compliance effects in the long run and any amnesty offer, no matter how designed, could potentially have an impact on future levels of compliance. If taxpayers realize that existing tax law enforcement is weak, rational evaders may change their perception as to how much tax they might successfully evade. Contrary to the result intended, an amnesty which successfully increases tax revenues in the short term might signal to rational taxpayers that tax law enforcement is weak, and could induce these taxpayers to commence tax evading, or to increase existing levels of non-compliance.

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Alm (1991) notes that economic models of tax evasion do not represent the behaviour of all taxpayers, and the real world certainly would produce some taxpayers who would take advantage of an amnesty even without changes in the relevant enforcement parameters. For example, a tax evader might experience more guilt from tax evasion than expected and wish to reverse the earlier decision to evade taxes. However, a possible constraint on a taxpayer's willingness to take part in an amnesty is that to do so labels oneself a tax evader and may thus increase the probability of future tax returns being audited. Some amnesty promotional material states that participating in an amnesty will not alter one's chances of being audited; although whether these messages are believed is another issue.

A recent US report (JCT 1998) states that the likely effect on future non-compliance from a current amnesty can be mitigated. The incentive for future tax evasion stemming from a current amnesty will depend critically on the design of the amnesty. An amnesty that forgives only criminal penalties, and requires that all back taxes, interest, and civil penalties be paid, is unlikely to have a substantial effect on future compliance. It is because of this potentially dynamic effect that amnesties are usually advertised as one-time-only events, in conjunction with a switch to a tougher enforcement regime. However, the government's credibility in declaring the amnesty a one-time-only event may be suspect and there is ample evidence of the repetition of "one-time" amnesties (e.g. various Latin American countries and US states).

B. Empirical tax amnesty research

The lack of readily available databases from national tax amnesties has meant that most empirical research has been on data obtained from US state tax amnesties. Fisher, Goddeeris and Young (1989) used a sample of participants in the 1986 Michigan tax amnesty and classified the participants into three main groups; being those who filed amended tax returns, new filers already believed to be in the tax system database, and new filers believed to be outside the tax system database. They focused their analysis on the third group, as these participants might more closely represent "hard-core evaders" – although the numbers involved were relatively small. They concluded that amnesties may not be a particularly effective way to identify tax evaders and turn them into tax compliers.

Alm and Beck (1991) use the results of 28 state tax amnesties to test a model of an individual's response to an amnesty. Using structural features of the amnesty as the variables in their model, they find that individuals respond systematically and predictably in their behaviour to changes in incentives introduced by an amnesty. They suggest a productive amnesty will allow past evaders to participate, reduce interest payments on back taxes, increase penalties after the amnesty, and provide for increased enforcement after the amnesty. Note that the last factor would require increased government expenditure.

Alm, McKee and Beck (1990) overcome the limitations caused by scarce data and use an experimental economics methodology. Using university students in a laboratory setting, they replicated the basic structure of a voluntary tax setting as exists in the United States – with each subject receiving an initial endowment and income for each round (in tokens) and the individual being asked to declare some or all of this income. Declared income was taxed at 30 per cent and subjects paid no taxes on non-declared income, although they could be audited and subjected to penalty taxes on non-declared income. When an amnesty was introduced, the researchers found that overall levels of compliance fell after the amnesty. This decline in compliance was mainly due to the changed behaviour of those with moderate compliance levels. Subjects who either fully complied or fully evaded were largely unaffected by the introduction of an amnesty. This type of research gives indicators as to how real taxpayers may respond to an amnesty, but of course, a limitation of this type of research is that the behaviour of subjects in a laboratory may not exactly mirror the behaviour of amnesty participants in a real-life amnesty.

IV. TAX AMNESTIES AT THE NATIONAL AND STATE LEVEL

A. National tax amnesties

Tax amnesties were held in ancient Rome and many countries have held general amnesties and/or amnesties covering only certain taxes. National amnesty programmes have taken place in Western Europe (Belgium, France, Ireland and Italy), Latin America (Argentina, Bolivia, Brazil, Costa Rica, Honduras, Panama, Peru and Uruguay), Asia (India, Indonesia, Malaysia, Pakistan, Philippines and Sri Lanka) and the Pacific (Australia, New Zealand). In several cases (e.g. in certain Latin American countries) there have been repeated amnesty programmes – sometimes at an interval as short as every two years.

Some foreign amnesties have not only abated penalties but also interest and even liabilities for tax. In the 1996 Venezuelan amnesty, tax liabilities of participating taxpayers were reduced by 75 per cent and, in the 1974 Panamanian amnesty, by 80 per cent. Many amnesties have allowed taxpayers with accounts receivable or in civil tax litigation to participate and the 1995 Argentine amnesty even allowed participation of taxpayers involved in criminal tax proceedings (JCT 1998).

France: In 1982, France offered both a general tax amnesty and a special programme to encourage repatriation of untaxed assets from abroad. The general amnesty applied to all income and value added taxes, and offered an abatement of both interest and penalties for participating taxpayers. Collections were relatively small compared to US state amnesties, amounting to about USD 19 million from 2,786 taxpayers. Under the repatriation programme, French residents who brought back capital from abroad that represented undeclared income or that was illegally exported were taxed at a flat rate of 25 per cent (regardless of the original rate owed, which was in most cases higher). The repatriation programme had 276 participants, from whom a total of about USD 22 million was collected. In 1986, France undertook a

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second special amnesty for assets held abroad with a tax rate of 10 per cent on the assets repatriated (JCT 1998).

Ireland: Ireland has operated a total of five amnesty programmes in six years, with general amnesties in 1988 and 1993, both of which received considerable publicity. The 1988 general amnesty resulted in collections of more than USD 700 million. The first amnesty offered a waiver of all penalties and interest and was publicized as an opportunity to pay tax liabilities before increased penalties, interest and enforcement measures were adopted as part of an overall tax reform. Although the 1988 amnesty was publicized as a one-time opportunity, a second general amnesty was held in 1993. The Irish Government, facing a budget deficit, announced a special amnesty for repatriation of undeclared income from abroad. In addition to waiver of all interest and penalties and promises of confidentiality, the repatriated funds were subject to a special low rate of 15 per cent, in contrast to normal Irish tax rates which rose above 50 per cent. The amnesty was criticized by the parliamentary opposition and trade unions as a concession to wealthy taxpayers. The Irish Government responded by adopting a general tax amnesty. The general amnesty offered abatement of both interest and penalties, although no liabilities were reduced. Collections for the 1993 amnesty were reported to be significantly lower than for the 1988 amnesty (JCT 1998).

New Zealand: The provisions of the 1988 New Zealand tax amnesty were:

- Late payment penalty was still charged. The reason for this was that the taxpayer had the use of the tax for the time it was withheld. If this penalty had not been charged, amnesty participants would effectively be paying a lower tax (adjusted for the time value of money) than taxpayers who did pay on time – the result being adverse public opinion and a loss of public confidence in the tax system.
- Penal tax (which was then up to a maximum of 300 per cent of tax evaded) was waived. The precise amount levied is dependent on the seriousness of the offence. The commissioner publicly indicated that the post-amnesty rate to be charged would be "substantially increased". No prosecution action was taken and there was no publication of the applicant's name.
- A full disclosure was required.

The penalties for tax offences had been considerably strengthened in 1986 two years prior to the amnesty. For example, on a first conviction of filing a false income tax return, a taxpayer previously faced a maximum fine of USD 2,000. The maximum fine for this offence was increased to USD 15,000. This may be the reason why the amnesty was not a precursor to increased penalty provisions, although the internal penal tax benchmark was lifted.

The amnesty promotional material included two rather interesting comments. The first was that taxpayers would not be singled out for investigation just because they signed an amnesty form and that the chance that they would be investigated in the future would not be affected either way. Naturally, the information provided in the amnesty form would have been examined to ensure there was sufficient detail to enable an amended assessment to be made. The second comment was that the amnesty applied to taxpayers who had been involved in a tax minimization or tax avoidance scheme. The difference between evasion and avoidance is well known and typically tax avoiders would not incur penal tax or prosecution action in any case. It is hard to see that the amnesty held much attraction for this group of taxpayers.

The amnesty response saw 16,083 applicants lodge 24,685 amnesty returns which resulted in total tax assessed of USD 26.6 million and USD 3 million in refunds, with most returns relating to income tax. In respect of the large disclosures, interest and dividend income were very prevalent, then to a lesser extent disclosures from writers, artists, musicians, and sports people having overseas income (Hasseldine 1989, 1995).

B. State tax amnesties

Since 1982, 43 general tax amnesty programmes have been conducted by 35 US states and the District of Columbia. The revenues raised range from USD 200,000 for the 1983 North Dakota amnesty up to USD 401 million for New York's first amnesty in 1985-86. Table 1 summarizes the key features of these 43 general amnesty programmes.

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Table 1: US state tax amnesty programmes and revenues

State and year		Taxes covered	Accts Rec.	Rev. in USD m (% of tax rev.)	Instalments
Alabama	1984	all	no	3.2 (0.1)	no
Arizona	1982-83	all	no	6.0 (0.2)	yes
Arkansas	1987	all	no	1.7 (0.09)	yes
California	1984-85	ind. income	yes	154.0 (1.7)	yes
		sales	no	43.0 (0.5)	yes
Colorado	1985	all	no	6.4 (0.3)	yes
Connecticut	1990	all	yes	54.0 (1.1)	yes
	1995	all	yes	46.2 (0.6)	yes
Florida	1988	all	no	8.4 (0.09)	no
Georgia	1992	all	yes	51.3 (0.7)	no
Idaho	1983	ind. income	no	0.3 (0.02)	no
Illinois	1984	all	yes	160.5 (2.2)	no
Iowa	1986	all	yes	35.1 (1.6)	n/a
Kansas	1984	all	no	0.6 (0.04)	no
Kentucky	1988	all	no	61.1 (1.9)	no
Louisiana	1985	all	no	1.2 (0.04)	yes
	1987	all	no	0.3 (0.008)	yes
Maine	1990	all	yes	29.0 (1.8)	yes
Maryland	1987	all	yes	34.6 (0.7)	no
Massachusetts	1983	all	yes	86.5 (1.7)	yes
Michigan	1986	all	yes	109.8 (1.3)	no
Minnesota	1984	all	yes	12.1 (0.3)	no
Mississippi	1986	all	no	1.0 (0.06)	no
Missouri	1983	all	no	0.9 (0.02)	no
New Jersey	1987	all	yes	186.5 (2.2)	yes
	1996	all	yes	359.0 (2.6)	no
New Mexico	1985	all	no	13.6 (1.0)	yes
New York	1985-86	all	yes	401.3 (2.1)	yes
	1996-97	all	yes	277.5 (0.9)	yes
North Carolina	1989	all	yes	37.6 (0.5)	no
North Dakota	1983	all	no	0.2 (0.02)	yes
Oklahoma	1984	income, sales	yes	13.9 (0.9)	no
Pennsylvania	1995-96	all	yes	93.0 (0.6)	no
Rhode Island	1986-87	all	no	0.7 (0.08)	yes
	1996	all	yes	7.9 (0.6)	yes
South Carolina	1985	all	yes	7.1 (0.3)	yes
Texas	1984	sales	no	0.5 (0.006)	no
Vermont	1990	all	yes	1.0 (0.2)	no
Virginia	1990	all	yes	32.2 (0.5)	no
West Virginia	1986	all	yes	15.9 (0.9)	yes
Wisconsin	1985	all	yes	27.3 (0.5)	yes
Washington DC	1987	all	yes	24.3 (n/a)	yes
	1995	all	yes	19.5 (n/a)	yes

Source: The Federation of Tax Administrators (http://*www.taxadmin.org/fta/rate/amnesty.html*)

Key:
Accts Rec. = amnesty includes accounts receivable by the tax agency
Rev. = amnesty revenues in millions of US dollars
Instalments = amnesty permits taxes to be paid off by instalment arrangements
n/a = not available

As Table 1 indicates, a majority of programmes have allowed taxpayers already owing taxes to participate, although 19 amnesties did not allow those with amounts owing to participate. As a percentage of state tax revenues, the amnesty revenues range from a low of 0.008 per cent for Louisiana's 1987 amnesty to over 2 per cent of state revenues (for Illinois, New Jersey, and New York's first amnesty). For those states offering second amnesties collections as a percentage of state tax revenues tended to decline from the first amnesty to the second amnesty – indicating that voluntary compliance levels suffer with repeated amnesty offerings. Most programmes have included all taxes or at least individual and corporate taxes and about two thirds of the states have taken steps to alter the expected pay-offs to evading tax by either strengthening their penalty regime and/or allocating greater funding for enforcement activities (Alm and Beck 1991). The media campaigns have sometimes reflected the changes in

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post-amnesty enforcement efforts. Consider the following slogans for example:
"Get to us before we get to you" – California
"Pay now or pay later" – Louisiana
"Amnesty - an offer you shouldn't refuse" – Minnesota
"Don't say we didn't warn you" – Colorado
"We have got your number, have you got ours?" – New Mexico

C. A US federal tax amnesty?

There has been some controversy in the United States as to whether or not to offer a federal tax amnesty. There was, for example, an extensive Congressional hearing in July 1990 (Committee on Government Operations 1991), and more recently, in January 1998, the Joint Committee on Taxation (JCT 1998) released a report estimating the net revenue loss if a federal tax amnesty were to be held. If an amnesty were open to individual taxpayers and granted participants a waiver of penalties, 50 per cent interest reduction, and included accounts receivable taxpayers, amnesty collections would total about USD 4.2 billion. The additional revenues would, however, be more than offset by decreases in tax collections over the years 1999-2007 resulting in a net revenue loss of USD 8 billion. If the amnesty was offered on similar terms to non-filers only (i.e. excluding those taxpayers who already owe taxes and have filed a federal return), the net revenue loss over the same period would be limited to USD 200 million.

In estimating that a federal tax amnesty in the United States would result in a net revenue loss, JCT 1998 relied on the following assumptions:

1. The IRS would be given a lead time of approximately six to nine months between the date of enactment and the commencement of amnesty.
2. The determination of the exact starting and ending dates of the amnesty must be done carefully to provide the optimal scheduling of the amnesty. For example, an amnesty that overlapped the 15 April filing date could seriously overburden the administrative systems of the IRS and lead to serious difficulties with or the failure of the filing season or of the amnesty (or of both).
3. The amnesty would be approximately 90 days in length.
4. Participants would be permitted to pay through instalment agreements.
5. The amnesty would apply to all open tax years (except as noted in item 6).
6. Amnesty would not be available with respect to liabilities incurred in the year in which amnesty is announced nor in the year of the amnesty.
7. Amnesty would not be available to individuals currently under criminal investigation.
8. Participants in the amnesty generally would not be subject to criminal penalties.
9. An amnesty would require widespread publicity.
10. The amnesty would explicitly state that no future amnesty would be offered.

As JCT 1998 notes, there are several aspects of national and US state tax amnesties that limit their comparability with a possible US federal tax amnesty. For example, in many countries, a larger portion of the national economy escapes the tax system than probably occurs in the United States and few countries have reached the US federal level of development of enforcement mechanisms, especially with regard to use of computer technology and requirements of withholding and information reporting.

D. Decision parameters for offering a tax amnesty

Overall, amnesties may have certain short-term benefits but a number of potential long-term costs in terms of revenue, compliance and respect for the tax system in general. The resultant balance after these inherent trade-offs have been taken into account should be the major influence on the decision whether or not to offer a tax amnesty.

If a decision is taken to offer a tax amnesty, a number of design issues need to be taken into account. These include issues relating to coverage, length, any media campaign, personnel, etc. After the amnesty, assessments of the success of the amnesty in terms of revenue, voluntary compliance levels and public attitudes towards taxpaying should be made. A summary of the decision parameters relevant to operating a tax amnesty appears in Table 2.

Table 2: Amnesty decision parameters for tax agencies

A. *Prior to the decision to offer a tax amnesty*

1. Assess level of voluntary compliance.
2. Assess taxpayer attitudes to paying taxes and to tax amnesties.
3. Assess severity of current penalty provisions. Is any strengthening required? What is the current policy on voluntary disclosures? How well known is this policy? Is any change desirable?
4. Assess adequacy of audit coverage. Do citizens perceive that they could be caught (and punished) for evading tax? Can greater funding be allocated to enforcement activities?
5. Examine the results of previous tax amnesties, in particular those conducted in similar jurisdictions.
6. Assess the amount of revenue expected under a tax amnesty.
7. Is legislative authorization necessary for an amnesty to take place?
8. Is there a better alternative to a tax amnesty to encourage compliance, for example, the non-filer programme of the US IRS?

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B. *The design and administration of a tax amnesty*

1. What taxes (or offences) are to be included?
2. Who will the amnesty apply to? Most likely, non-filers can participate, but what about known delinquents? Are there any other eligibility issues needing consideration?
3. Over what time period will the amnesty run? Will any extension be required?
4. Which officers will be responsible for staffing the amnesty?
5. What sort of media campaign will be run to encourage amnesty participation? Should assurances be given that this is a "once-only" amnesty?
6. Other operational aspects of the amnesty – e.g. form design, toll-free numbers, liaison with tax practitioners, will instalment arrangements be permitted, etc.?

C. *After a tax amnesty has finished*

1. Compute gross and net amnesty revenue.
2. Construct a database of amnesty participants. Examine the characteristics of amnesty participants and isolate common trends and features. Use this information in future enforcement activities.
3. Assess level of voluntary compliance and taxpayer sentiment.
4. Make appropriate media releases.
5. Compare results to those of previous amnesties.

V. CONCLUSIONS

One easily reached conclusion is that the effects of amnesties on future compliance are difficult to predict. Despite this, the experience of prior amnesties and academic research suggests that there are a number of factors that may be associated with successful amnesties, e.g. increased post-amnesty enforcement efforts, a successful media campaign, and issues relating to timing. Amnesties may be a useful way of collecting past taxes owed to tax agencies, but do not appear to be very successful in bringing evaders into the tax system for the first time. It is also true that comparisons of amnesties are fraught with difficulty. Comparisons between countries are difficult because of the different taxpaying cultures and environments. For instance, one key aspect is how problematic are existing evasion levels, and can the problem be tackled in any other way?

As an alternative to a full tax amnesty, there are often elements of current law that have characteristics very similar to an amnesty. These can be referred to as "standing amnesties". This may be provided in legislation or in the practice of a tax agency. JCT 1998 notes that the tax administrations of Germany, the Netherlands, Sweden, Norway and Denmark, have in recent years had "standing" offers of amnesty, under which the national tax administration has committed to use its authority to abate all or a portion of penalties. In the United States itself, a non-filer initiative by the IRS provided that taxpayers would not be penalized for not filing returns if they could establish that their failure to file was the result of reasonable cause. Such a non-filer initiative is closely akin to the practice of several tax agencies in respect of voluntary disclosures whereby penalties are often reduced and criminal charges not laid, as long as the disclosure is made prior to any audit investigation of the taxpayer. In these cases some of the advantages of an amnesty can be obtained e.g. the use of a media campaign etc. without it being "labelled" as an amnesty and incurring the consequential negative impact on taxpayer sentiment that an amnesty might cause.

To conclude, tax amnesties are not a panacea, but they should be considered as an optional tool that can be used in association with changes to penalty provisions and policing procedures. Overriding consideration must be given by a tax agency to taxpayers' current attitudes and levels of voluntary compliance.

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Conference Diary

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

AUGUST

Summer Course on International Taxation in the EC, Münster, Germany, 2-7 August 1998 (English):

Institut für Steuerrecht Westfälishe Wilhelms-Universität, Universitätsstraße 14-16, D-48143 Münster, Germany,
E-mail: scitax1998@uni-muenster.de

Summer Course on the Principles of International Taxation, Amsterdam, the Netherlands, 17-28 August 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

Accounting & Tax for Derivatives, London, the United Kingdom, 25-27 August 1998 (English):

Hilary McCann, Managing Director of Public Programmes, Euromoney Training, Nestor House, Playhouse Yard, London EC4V 5EX, the United Kingdom, Tel.: 44-171-779 8753, Fax: 44-171-779 8693,
E-mail: euromoneyt@dial.pipex.com

SEPTEMBER

Tax Efficient Structures for Cross-Border Mergers & Acquisitions, the Lanmark Hotel, London, the United Kingdom, 16 September 1998 (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: sarah.wheatley@ibcuk.co.uk

Tax and Business Implications of the Currency Crisis in Asia, Amsterdam, the Netherlands, 21 September 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

Transfer Pricing '98, Café Royal, London, the United Kingdom, 21-22 September 1998 (English):

SMi Ltd., No.1, New Concordia Wharf, Mill Street, London SE1 2BB, the United Kingdom, Tel.: 44-171-252 2222, Fax: 41-171-252 2272.

Mergers & Acquisitions, Amsterdam, the Netherlands, 24-25 September 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

OCTOBER

52nd IFA Annual Congress, London, the United Kingdom, 4-9 October 1998 (simultaneous translations into French, English, German and Spanish):

52nd IFA Annual Congress, Concorde Services Ltd, 10 Wendell Road, London W12 9RT, the United Kingdom, Tel.: 44-181-743 3106, Fax: 44-181-743 1010,
E-mail: ifa@concorde-uk.com

Application of Tax Treaties, Amsterdam, the Netherlands, 21-23 October 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

Transfer Pricing Audits, Amsterdam, the Netherlands, 30 October 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

NOVEMBER

Accounting & Tax for Derivatives, London, the United Kingdom, 3-6 November 1998 (English):

Hilary McCann, Managing Director of Public Programmes, Euromoney Training, Nestor House, Playhouse Yard, London EC4V 5EX, the United Kingdom, Tel.: 44-171-779 8753, Fax: 44-171-779 8693,
E-mail: euromoneyt@dial.pipex.com

International Tax Aspects of VAT, Amsterdam, the Netherlands, 19-20 November 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

International Tax Planning Aspects of Doing Business with MERCOSUR, Amsterdam, the Netherlands, 27 November 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

DECEMBER

Double Taxation Relief: Practice, Theory and Planning, Amsterdam, the Netherlands, 10-11 December 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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ITALY

CROSS-BORDER CORPORATE REORGANIZATIONS: AN UPDATE ON THE ITALIAN PERSPECTIVE

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I. INTRODUCTION

This paper deals with the restructuring transactions regulated by EC Directive 90/434, i.e. mergers, demergers (divisions), transfers of assets (spin-offs) and exchange of shares as implemented in the Italian tax system by Legislative Decree 544/1992. A comparison between the tax treatment of domestic and cross-border reorganizations is also provided. Finally this paper focuses on the new tax treatment set forth by Legislative Decree 358/1997.[1] Within the context of company reorganizations,[2] this latter Decree mainly focuses on transfers of assets and the exchange of shares.

II. BACKGROUND

A. International[3]

In the competition between multinational companies the optimization of structural efficiency is a key factor. The objective of profit maximization requires a strategy which is globally integrated, aimed at the achievement of an optimal structure, reflecting the constraints imposed by tax variables and financial cash flows.[4] Within an international context, EC tax provisions are bound to heavily affect the structures implemented by multinational groups with European activities. An important role is played, by Merger Directive 90/434,[5] which has a facilitating role with regard to the reorganization of European multinationals.[6]

B. Italian

Since 1990 Italian multinationals have found an ever-increasing need for strategic tax planning. Four topics have played a determining role in the reorganization of Italian companies:

- EC directives (especially the Parent-Subsidiary[7] and the Merger Directive);
- tax treaties (particularly, the tax treaties concluded with France, Germany and the United Kingdom);[8]
- anti-avoidance legislation in Italian law (Article 10 of Law 408/1990);[9]
- the abolition of the monetary restrictions and the introduction of free movement of capital within the European Union.

III. LAWS IMPLEMENTING EC DIRECTIVE 90/434 IN ITALY

A. Law 142/1992

Article 34 of Law 142/1992 empowered the Italian Government to issue, by 3 March 1993, a decree regulating the tax regime of mergers, demergers, transfers of assets and exchanges of shares between joint stock companies residing

1. Legislative Decree 358/1997 has been issued in accordance with Art. 3, subsection 161 of Law 662/1996. Art. 3, (161) of Law 662/1996 authorized the government to issue one or more legislative decrees with the object of amending the regulations on income taxes applicable to processes concerning the reorganization of economic activity.
2. According to Art. 3(161)(b) of Law 662/1996.
3. See Valente, "Le operazioni di riorganizzazione societaria tra imprese italiane", in *Pianificazione Fiscale Finanziaria*, Milano, 1997.
4. See Valente, "Regime tributario delle operazioni di riorganizzazione societaria: spunti comparatistici e proposte di coordinamento", in *Aspetti fiscali delle operazioni internazionali*, Milano, 1995, at 333 et seq.
5. Council Directive 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, *OJ 1990 L.* 225, 20 August 1990.
6. See De Hosson, "Restructuring the businesses of multinational groups operating in Europe", *Intertax*, 3/1996, at 80; Tomsett, "Strategies for mergers and acquisitions in Europe", *Tax Planning International Review*, 9/1995, at 3; Van Thiel-Rattra-Meer, "Corporate Income Taxation and the Internal Market Without Frontiers: Adoption of the Merger and Parent-Subsidiary Directives", 30 *European Taxation* 11 (1990), at 326; Sass, "The New EC Tax Directives on Mergers and Parent/Subsidiaries", *Tax Planning International Review*, March 1991, at 6; Larking, "The Merger Directive: will it work?", 30 *European Taxation* 12 (1990), at 366; Chown, "The Mergers Directive – some broader issues", *The Direct Investment Tax Initiatives of the European Community*, Deventer, 1990, at 1.
7. Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, *OJ 1990 L.* 225, 20 August 1990.
8. Such treaties provide for the partial or entire refund, subject to certain conditions, of the dividend tax credit and/or the equalization tax to shareholders resident in the contracting state other than the residence state of the distributing company. See Valente, "Dynamics of Cross-Border Flows of Multinationals: The Italian Tax Implications", 51 *Bulletin for Fiscal Documentation* 11 (1997), at 510.
9. According to such a law, the Italian tax authorities may disallow the tax benefits arising from reorganizations of Italian companies where the reorganization is devoid of valid business reasons and is carried out solely in order to obtain an unlawful tax saving. See Valente, "Development of Anti-Avoidance Rules with respect to Corporate Reorganizations", 38 *European Taxation* 1 (1998), at 32.

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in different EU Member States, in compliance with the provisions of EC Directive 90/434. According to the guidelines set forth by Article 34(1)(a), Directive 90/434 is applicable to *SpAs* (stock companies), *Sapas* (partnerships limited by shares), *Srls* (limited liability companies), and to other entities subject to *IRPEG* (corporate income tax) mainly carrying out a business activity.

As far as the definition of mergers, demergers, transfers of assets and exchanges of shares are concerned, Law 142/1992 makes reference to EC Directive 90/434.

Article 34(1) (a) to (f) sets forth the following principles for mergers, demergers and transfers of assets:

- the "*tax neutrality*" rule characterizes the above mentioned transactions carried out by persons listed in letter a), with reference to assets and liabilities connected with a permanent establishment in Italy;
- the carry-over of the same tax values originally assigned to assets and liabilities of the company making the contribution; in addition, as far as mergers are concerned, Article 34(1)(c) provides that exchange profits or losses, if recorded in the balance sheet, are not relevant for tax purposes;
- the maintenance of the tax regime applied (before the transaction) to reserves temporarily not subject to taxation, provided that such reserves are recorded in the permanent establishment's balance sheet;
- the carry-forward of losses of the merged or demerged company, up to an amount corresponding to the difference between assets and liabilities effectively connected with the permanent establishment in Italy;
- the tax neutrality of the assignment of the shares of the beneficiary company to the shareholders of the contributing company in exchange for the shares previously owned by those shareholders, provided that such shares are not given a tax value exceeding their previous value, and that any possible currency adjustment is subject to taxation.

If the merger, transfer of assets or demerger also involves assets of the contributing company pertaining to a permanent establishment abroad, the state of the contributing company has the right to tax the capital gains deriving from the transfer of the permanent establishment; in the meantime the contributing company will be granted a tax credit for taxes which would have been due abroad in the absence of the directive provisions.

B. Legislative Decree 544/1992

Legislative Decree 544/1992 has implemented the provisions contained in Article 34 of Law 142/1992. Such Decree, which has been in force since January 1993, regulates the following transactions:

- mergers;
- demergers;
- transfers of assets;
- exchanges and contributions of shares.

The above mentioned transactions must be carried out between *SpAs*, *SapAs*, *Srls*, cooperatives and mutual insurance companies, governmental and private entities whose exclusive or main purpose is the carrying out of business activities, resident in Italy, and entities resident in other Member States provided that such entities:

- are not regarded as resident in a non-EU country, based on a tax treaty with that country;
- are included in the categories listed in table A of Decree 544/1992;
- are subject, without exclusions, to one of the taxes listed in table B of Decree 544/1992.

IV. MERGER

A. Tax regime of EU and domestic mergers

Legislative Decree 544/1992 does not contain a definition of merger; Law 142/1992 simply refers to the definition contained in EC Directive 90/434. Decree 544/1992 regulates both *direct mergers* (whereby one or more companies are absorbed into another company) and *consolidated mergers* (whereby the merged companies are consolidated into a new entity). In order to fall under the provisions of the above mentioned Decree, mergers must meet the following conditions:

- they must be carried out by the above listed entities, on the above mentioned conditions; and
- any possible currency adjustment cannot exceed 10 per cent of the nominal value of the shares received in exchange.

The tax regime provides for the exemption from taxation of capital gains, deriving from mergers even if recorded in the financial statements of the company resulting from the merger when:

- such capital gains relate to assets of the merged company;
- the assets are effectively connected to a permanent establishment in Italy or another EU country; and
- the assets are recorded in the balance sheet of the merged company relating to the tax period in which the transaction is carried out.

Even after execution of the transaction, the assets maintain the same tax value they had in the merged company. Any difference from the values recorded in the balance sheet must be indicated in a special document called *prospetto di riconciliazione* (reconciliation statement). If the merged company has a permanent establishment in another state, Italy will tax the capital gains as if realized at arm's length; however, the Italian company is granted a tax credit for taxes which, in the absence of Directive 434, would have been borne in the state of the permanent establishment; provided that the fiscal rights and duties of the Italian resident merged company are taken over by the merging company not residing in Italy.[10]

10. See Valente-Serbini, "Il conferimento di stabile organizzazione nell'ambito delle riorganizzazioni societarie", *Il Fisco*, 24/1997, at 6760.

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The law provides for the tax neutrality of merger profits and losses, either originating from an exchange or a cancellation of shares; consequently, the contribution of a merger loss to the assets recorded in the balance sheet of the merging company is tax neutral. The same principle is stated for mergers between Italian companies (i.e. domestic mergers) by Article 123(2) of the Italian Income Tax Act (ITA). However, as far as domestic mergers are concerned, following the changes introduced by Article 27 of Law 724/1994, it is no longer possible to revalue the tax basis of assets acquired through the merger. In addition the law provides that capital gains and losses relating to the shares given in exchange are tax neutral, provided that the new shares have the same value as the previous ones. Any possible currency adjustment is regarded as taxable income for the recipient.

As regards the reserves temporarily tax deferred recorded in the last approved balance sheet of the Italian merged company, such reserves must be kept in the balance sheet of the permanent establishment in Italy. If not so kept, the relevant reserves are taxed. A similar provision is stated for domestic mergers.

The law provides that any assets not imputed to the permanent establishment in Italy are considered as realized at arm's length; this provision applies also where assets, previously imputed to the permanent establishment in Italy, are subsequently removed therefrom.

As far as the loss carry-forward is concerned, Article 123(5) ITA provides that losses of both, the merged (*absorbed*) and the merging (*absorbing*) companies, can be offset against the income of the merging company only up to an amount not exceeding the relevant net equity. Furthermore, the amount of revenues and expenses for personnel (including social security contributions) shown in the profit and loss account of the company with losses to be carried forward in the year preceding the merger must exceed 40 per cent of the average value of the same items in the two prior years.

The permanent establishment is allowed to utilize the loss carry-forward of the merged company, within the limits of Article 123(5) ITA, in proportion to the difference between the value of assets and liabilities effectively connected with the permanent establishment and within the limits of the said difference.

Article 6 of Legislative Decree 358/1997 supplies clarification on the treatment of merger tax losses. The following are recognized for tax purposes:

- losses (from cancellation and from share exchanges) should the substitute tax be paid[11] (as per Article 1);
- losses from cancellation, if and insofar as the companies which entered them on the balance sheet show that they arise from surplus values previously subjected to taxation.

B. Tax regime of non-EU international mergers

Mergers between an Italian company and a non-EU company, although not expressly regulated by Italian law, are acknowledged by Italian commercial doctrine.[12] Therefore, in the absence of a special regime, this kind of operation is governed by the same tax rules applicable to domestic mergers.[13] However, where an Italian company is absorbed by a non-EU company, the Italian Tax Authorities might requalify the merger as a company liquidation.[14]

V. DEMERGER

A. Tax regime of EU demergers

As in the case of the merger, Decree 544/1992 does not define demergers. Law 142/1992 refers to the definition provided in the directive. Article 1(b) of the law provides that demergers must involve all the assets (partial demergers are not allowed) of an entity satisfying the requirements established by Article 1. Article 1 provides that within the context of an international demerger, assets and liabilities of the demerged company are transferred to one or more entities, already existing or newly incorporated and, at least one of the beneficiaries, has to be resident in a Member State other than that of the demerged company. The tax neutrality of a demerger is subject to three conditions: a) the shareholders of the demerged company must receive shares in proportion to the shares previously owned in the demerged company; b) the purpose of the demerger must be the transfer of a going concern and c) any currency adjustment given to the shareholders of the demerged company must not exceed 10 per cent of the nominal value of the participation received.

The tax regime introduced by Decree 544/1992 provides for the tax neutrality of capital gains and losses imputed to the assets of the Italian beneficiary company, provided that these relate to assets of the demerged company and such assets are effectively connected with a permanent establishment in Italy and are recorded in the balance sheet of the Italian company in the same tax period in which the transaction is carried out. Therefore, the assets transferred to the beneficiary company maintain the same tax value that they had in the demerged company, provided that any difference between those values and the values recorded in the balance sheet is disclosed in a special document called *prospetto di riconciliazione* (reconciliation statement). Shares received in exchange must maintain the carry-over tax basis. A currency adjustment is subject to taxation. Capital gains and losses on shares given in exchange are tax neutral.

Tax deferred reserves must be reconstructed in the financial statements of the Italian company; if not reconstructed, they are taxed.

11. See below.
12. In this respect, see Simonetto, "Delle società", *Commentario del codice civile*, Scialoja-Branca, 1976, at 211; Santagata, *La fusione fra società*, Napoli, 1964, at 4.
13. Accordingly, see Marino, "Profili fiscali delle riorganizzazioni di imprese con elementi di ultraterritorialità," *Dir. Prat. Trib.*, Nov.-Dec. 1993, at 2110; Valente, "Regime tributario delle operazioni transfrontaliere di riorganizzazione societaria", *Pianificazione Fiscale Finanziaria*, Milano, 1996.
14. Id.

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As regards losses carried forward, the same rules mentioned above for mergers apply.[15]

Assets not imputed to the permanent establishment are considered transferred at arm's length value; the same rule applies if the assets, once imputed to the permanent establishment in Italy, are subsequently removed therefrom.

B. Tax regime of domestic demergers

As far as domestic demergers are concerned, Italian tax legislation provides for the tax neutrality of such transactions, on the condition that, once transferred to the beneficiaries, the assets of the demerged company maintain their original value. Demerger losses or gains are tax neutral. However, following the changes introduced by Law 724/1994, the demerger loss can no longer be utilized to revalue the assets transferred. Funds temporarily exempt from taxation have to be reconstructed in the beneficiary companies in an amount corresponding to the portion of the demerged company's net equity transferred to each beneficiary. In conclusion, the beneficiaries can utilize the losses of the demerged company up to an amount corresponding to the percentage of the demerged company's net equity received.

C. Tax regime of non-EU demergers

Italian tax legislation does not provide a special regime for international demergers, that is, for transactions carried out with non-EU countries. Therefore, reference has to be made to the rules mentioned above for EU mergers.

VI. TRANSFER OF ASSETS

A. Tax regime of an EU transfer of assets

Decree 544/1992 provides for the tax regime applicable to a transfer of assets (spin-offs) carried out between Italian entities (i.e., *SpAs*, *SapAs*, *Srls*, cooperatives and mutual insurance companies, governmental and private entities whose exclusive or main purpose is the carrying out of business activities) and entities resident in other EU Member States. The transfer of assets relates to the transfer of business concerns and is carried out between entities residing in different Member States.

According to the above mentioned Decree, a transfer of assets is tax neutral, in the sense that the difference between the value of the shares received in exchange and the tax value of the assets transferred is not taxable, until realized or distributed to shareholders. Such a difference must be apportioned to a special reserve, which remains tax-exempt until distributed. If the assets transferred to a non-resident company are not imputed to a permanent establishment in Italy of the latter, the tax neutrality is lost.

The rights and duties of the non-resident contributing entity must be taken over by the Italian beneficiary.

As in the case of mergers and demergers, reserves temporarily exempt from taxation, recorded in the last approved balance sheet of the Italian resident beneficiary, must be transferred to the balance sheet of the permanent establishment in Italy. Should these reserves not be reconstituted, taxation would result.

Furthermore, the Italian contributing company's assets, if not imputed to a permanent establishment in Italy, would be viewed as transferred at arm's length value and the relevant capital gain would be taxed. The same tax treatment applies to assets imputed to the permanent establishment and subsequently transferred.

As regards the contribution of a permanent establishment in a Member State made by an entity which is resident in another State to a company resident in a third Member State, based on Article 10 of the directive, the State of the contributing company waives its right to levy any tax on the transfer of the permanent establishment located in another Member State. In fact, this is an exception to the general rule which requires that the assets, once transferred, remain effectively connected to the permanent establishment located in the State of the contributing company. However, losses of the permanent establishment can be reconstituted in the balance sheet of the contributing company and may, in the future, be deducted from the company's taxable income. The purpose of this provision is to prevent any loss that the State of the contributing company might incur as a consequence of the transfer of assets. Therefore, the State where the permanent establishment is located is not allowed to levy any tax on the proceeds of the transfer of the permanent establishment to the beneficiary. The same rule is applicable to the State of the beneficiary. Article 2(6) of Decree 544/1992 states that in the case of a transfer of assets involving the contribution, made by a resident entity, of a permanent establishment located in another Member State, the permanent establishment would be regarded as transferred at arm's length and would be subject to taxation with deduction of the tax that would have been levied by the other State in absence of the EC provision. In addition, the shares received by the contributing entity will have the same tax value as that of the transferred assets.

B. Tax regime of the domestic transfer of assets

As far as the domestic transfer of assets is concerned, for tax purposes this transaction is regarded as a transfer of goods; consequently, capital gains arising from the asset transfer (calculated as the difference between the arm's length value and the book value of the assets transferred),[16] may be taxed, at the taxpayer's option, entirely in the year when realized or in five equal instalments in the same year and in the subsequent four (based on Article 54 of ITA).[17] The beneficiary company will have to increase its share capital and to issue new shares in favour of the contributing company, which will record the participation in the beneficiary at an amount fixed

15. Reference is made to the above paragraph regarding mergers.
16. Based on Art. 9 of ITA.
17. See Valente, "La disciplina del conferimento nazionale", *La Tribuna Dottori Commercialisti*, 1/1997, at 18.

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by an expert valuation. Depreciation of the assets received by the beneficiary will be calculated on the arm's length value of the same.

Based on Legislative Decree 358/1997, it is possible to elect not to apply the above regime to transfers of going business concerns and qualified participations owned for at least three years executed between resident companies and instead apply either:

- a harmonized regime characterized by the possibility to perform the transfer of assets according to tax neutrality; or
- a substitute taxation regime (i.e., capital gains resulting from the transfers of assets are taxed at the reduced rate of 27 per cent).[18]

C. Tax regime of non-EU international transfers of assets

Italian tax law does not expressly regulate the transfer of assets where one of the entities involved is a resident in a non-EU country.[19] As noted above for mergers and demergers, tax rules provided for the domestic transfer of assets should be applicable. In that case, however, the provisions contained in Legislative Decree 358/1997 do not apply since they refer only to the case in which the transfer of assets occurs between resident companies. As a consequence, the transfer of assets between an Italian and a non-EU company is treated as a taxable transaction.

VII. EXCHANGE OF SHARES

A. Tax regime applying to an intra-EU exchange of shares

This applies where an entity acquires or increases a participation in an entity resident in another EU Member State, through an exchange of shares, by contributing to the latter its own shares or quotas in exchange for those received from the foreign entity.

The exchange of shares is tax neutral. From a tax viewpoint, no taxable capital gain arises from the transfer of the shares, provided that the shares received in exchange maintain the same tax value as the transferred ones (Article 2(5) of Decree 544/1992). Any capital gain arising from a subsequent transfer of the new shares would be taxed.

To benefit from the tax neutrality regime, the exchange of shares must comply with the following requirements:

- the purpose must be the acquisition of a *controlling participation*[20] in a company satisfying the requirements provided for by the above mentioned Decree;
- the share exchange must be realized through the contribution of shares or quotas in exchange for those received;
- any currency adjustment must not exceed 10 per cent of the nominal value of the shares received; and
- one of the persons involved in the transaction must be a resident of Italy, or the shares exchanged must relate to a permanent establishment in Italy of an entity satisfying the conditions listed in the Decree.

The Ministry of Finance, in Resolution 55/E of 17 April 1996[21] has expounded on how the provisions of Decree 544/1992 ought to be applied where an exchange of shares is carried out by entities residing in different EU Member States. The case submitted to the attention of the Ministry referred to a share exchange transaction between an Italian company and a Dutch company, by which the Italian company was to transfer to the Dutch company its entire participation in an Italian company in exchange for shares of the Dutch company.

By the above mentioned resolution, the Ministry of Finance has clarified the principle of "*tax neutrality*" concerning the exchange of shares between companies resident in different EU Member States, giving an extensive interpretation of Article 2(5) of Decree 544/1992.[22] The contribution does not create taxable capital gains for the transferring company, provided that the shares or quotas received in exchange maintain the same value as the transferred shares or quotas. In the case under examination, the Ministry was of the opinion that the share exchange was to be considered tax neutral, subject to the condition that the transfer was carried out at book value. No taxable capital gains or deductible losses would derive from the transfer, if the shares of the Dutch company were recorded in the Italian company's balance sheet at the same value as the transferred shares.

In conclusion, the tax neutrality of the exchange of shares depends upon the following conditions:

- both, the transferring as well as the receiving company must:
  - be resident in an EU Member State;
  - have one of the legal forms provided for in table A of Decree 544/1992;
  - be subject, without any exemption, to one of the taxes listed in table B of the above mentioned Decree;
- the transferor and the transferee must be resident for tax purposes in different EU Member States;
- following the transfer, the transferee must obtain the control[23] (majority of votes in the ordinary shareholders' meeting) of the transferred company;
- the company which receives the contribution must give in exchange only its own shares (excepting a currency adjustment not exceeding 10 per cent of the nominal value of the exchanged shares);

18. See Valente-Serbini, "Conferimento di attivo: riflessioni a margine della legge collegata alla manovra 1997", *Bollettino Tributario*, 13/1997, at 1002.
19. See Valente, "Riorganizzazioni societarie – Riflessioni de iure condendo in ambito transnazionale", *Il Fisco*, 27/1997, at 7703.
20. According to Art. 2359 of the Italian Civil Code (ICC).
21. See Valente-Serbini, "Regime tributario dello scambio di azioni transfrontaliero: risoluzione ministeriale 17 aprile 1996 n. 55/E", *Il Fisco*, 12/1997, at 3171.
22. Which states that exchanges of shares "do not give rise to taxable capital gains or losses on the shares contributed, the tax value of which is taken over by the shares or quotas received in exchange, provided that the tax value is allocated in proportion to the values given to those shares when the share exchange ratio was fixed".
23. According to Art. 2359(1)(1) of the ICC.

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– the transferor or the company which receives the contribution must be resident in Italy.

In addition, the Ministry has pointed out that it will maintain the right to make all the checks that may be deemed necessary to ascertain that a transaction was not carried out merely for tax-avoidance purposes. In practical terms, the tax rules applicable to the exchange of shares are the following:

– Article 37(3) of Presidential Decree 600/1973;[24]
– Article 10 of Law 408/1990.[25], According to the Central Tax Inspectorate (*SECIT*), Article 10 would also be applicable to intra-EU share exchanges, although not implemented by Decree 544/1992;
– Article 37-*bis* of Presidential Decree 600/1973[26], which provides for the cancellation by the tax authorities of transactions, which may be interconnected, where these are devoid of valid economic reasons and aimed at avoiding fiscal obligations or prohibitions in order to obtain tax savings which would otherwise not be due.[27]

B. Tax regime applying to the domestic exchange of shares

The exchange of shares among Italian residents can be achieved through a share contribution, or by means of a mutual assignment of shares.

The share contribution may be carried out[28] by the person holding the shares (company or individual) contributing them to a company which,

– if already existent, increases its capital and issues new shares in favour of the assignor or, later attributes to him the same shares already in his possession;
– if newly incorporated, uses the contribution in order to constitute its initial capital attributing the interest to the founding member.

The share contribution is treated as a sale of shares for tax purposes (see Article 9, last paragraph, of ITA which establishes that "*for income tax purposes, provisions pertaining to sales against payment are valid also (...) for contributions*"). The tax regime applicable to the operation, however, is not unitary but differs according to the nature of the subject executing the allocation.

Where this has been accomplished by a company or by an individual carrying out a business activity, the contribution will be subject to the rules and regulations governing business income (i.e. *contribution on behalf of the company or entrepreneur*) whereas, where the person is a non-entrepreneurial individual, the system will follow those rules governing other income.

Where the operation falls within the context of business income,[29] the assignor may realize proceeds and capital gains (Article 53(1)(c) and 54 of ITA) or, on the contrary, capital losses or decreases according to how the shares are recorded in the financial statements. In particular, the assignor realizes a capital gain/capital loss where the interest contributed has been recorded in the financial statements as a financial fixed asset (Article 53(2-*bis*) of ITA), whereas a profit or loss results whenever these have been included in the working capital.

In the case of the transfer of a financial fixed asset any possible future capital gain/loss is determined by reference to the difference between the consideration, i.e. the value attributed to the interest received, and the fiscal cost of the interest assigned. The value of the shares received whether Italian or foreign must be determined according to the procedures set out in Articles 9(2) and 9(4) of ITA. Capital gains may be taxed in the relevant fiscal year or at the taxpayer's option be spread evenly over a period of up to five years on condition that the shares have been recorded as a financial fixed asset in the last three years (Article 54(4) of ITA). Where, on the contrary, the contribution gives rise to a loss, this must be deducted from the taxable income in the course of the relevant fiscal year (Article 66(1) of ITA). Finally, if the contributed shares are not considered as financial fixed assets, the assignor can realize a profit/loss which is taxable in the relevant fiscal year.

Following Decree 544/1992 the transfer of an interest in a company may be effected by exchange or contribution

> of shares and quotas, through which one of the subjects (...) buys or integrates an interest of control, according to Article 2359(1)(1) of ICC, from one of the subjects indicated in the same letter, resident in a Member State other than that of the first, attributing to the participants their own shares or quotas in exchange for those received through transfer (or contribution and a possible money settlement not exceeding 10 per cent of the nominal value of said shares or quotas,) provided that one of the participants carrying out the exchange is a resident of the State territory, in other words, that the interest exchanged is relative to a permanent establishment in a State territory of a subject indicated at letter a). (Article 1(e))

The exchange of interest must moreover lead the assignor to "*acquire*" or "*integrate*" an interest in control as in Article 2359(1)(1) of ICC in the contributed company. The literal

24. The third para. of Art. 37 has been introduced into the tax system by Law 154/1989, which provides as follows: "In case of adjustment of the assessed income, or of assessment by the tax-office, a taxpayer may be charged with an income apparently chargeable to another party, provided that the above mentioned taxpayer be the actual owner of the said income through this third party" (cf. Uckmar-Giuliani, "Interposition in Italian taxation on income and international transactions", in *Essays on International Taxation*, Kluwer, 1993, at 385).
25. Art. 10, subsection 1 of Law 408/1990, in the original version (that is, before amendment as per Art. 28 of Law 724/1994), provided that: "Fiscal Authorities may disallow, for fiscal purposes, costs incurred for corporate shareholdings and moreover any tax advantages ensuing from operations involving mergers, concentrations, restructurings, demergers, and the reduction of capital that are undertaken without good business purpose and with the sole aim of fraudulently obtaining a tax saving". Art. 10 of Law 408/1990, following amendments made by Law 724/1994, states that: "Fiscal Authorities may disallow, for fiscal purposes, tax advantages ensuing from operations involving concentration, restructuring, splitting, reduction of capital, liquidation, valuations of shares, assignment of credits, divestment or valuation of moveable property that are undertaken with the sole aim of fraudulently obtaining a tax advantage."
26. Art. 7, subsection 1 of Legislative Decree 358/1997 sanctions the introduction of Art. 37-*bis* in the text of Presidential Decree 600/1973, regarding the identification of transactions of a tax avoidance nature. Based on Art. 37-*bis*, any action, fact and transaction, interconnected in any way, and which is devoid of any valid economic reason and which is intended to elude obligations or prohibitions provided for by the fiscal law so as to obtain tax reductions or refunds which would otherwise not be due, may be disregarded by the tax authorities.
27. Cf. Valente, *supra* note 9.
28. Art. 2342 of ICC.
29. *Contribution on behalf of the company or entrepreneur.*

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interpretation of the said provision,[30] which seems to, however, differ from the similar one prescribed by the regulation, should lead to the application of the community scheme in the following cases: (i) when the control is acquired *uno actu* as a result of the exchange; (ii) when it is acquired as a result of integration of an already partially-owned interest but not sufficient to fulfil the requirement in question before the exchange; (iii) in all those cases where the interest follows the acquisition of control (integration of an interest in control). On the other hand, in the doctrine there are those who sustain (arguing precisely on the basis of the literal document and the *ratio* contained in the regulation itself) that the transfer of interest which *"takes place later going beyond said threshold"* should be excluded from the community scheme.[31] Bearing in mind that various different subjects may participate, it finally seems possible to assume that the acquisition or integration of control can happen as a result of the allocation of shares carried out by various subjects.

As regards the tax system of the intra-Community operation, it must be stressed that the community provision introduces a principle ignored by national legislation. The said regulation in effect establishes that the operation

> does not entail a realization of capital gains or losses in value on shares or quotas given in exchange, the fiscal value of which is presumed from the shares or quotas received, dividing themselves among all of these in proportion to the values attributed to same with the aim of determining the relation of exchange. (Article 2(5) of the Decree)

The exchange of interest can, however, qualify for fiscal neutrality treatment for the assignor/assignee on condition that the interest received in exchange is registered at the same fiscal value as the shares or quotas exchanged/transferred (*see: continuity of fiscal values*).

Legislative Decree 358/1997 provides a new fiscal neutrality system for the exchange of shares between Italian companies.[32] The new regulation consists of the following:

- a *harmonized scheme* characterized by the possibility of operating the exchange according to taxation neutrality; or, at the taxpayer's discretion,
- an *alternative tax system* according to which the capital gain resulting from the exchange is taxed at a rate of 27 per cent.

C. Tax regime of non-EU international share exchanges

The exchange of shares with companies resident in non-EU States is not regulated by Italian law. As in the case of mergers, demergers and transfers of assets with non-EU countries, provisions regulating domestic exchanges of shares can be extended also to international share exchanges. In that case, however, the provisions contained in Legislative Decree 358/1997 relating to the exchange of shares do not apply since they refer only to the case in which the exchange occurs between resident companies. As a consequence, the exchange of shares between an Italian and a non-EU company is treated as a taxable transaction; capital gains arising from the exchanged shares, corresponding to the difference between their arm's length value (based on Article 9 of ITA) and book value, may therefore be taxed in the year when realized or, at the taxpayer's option and provided that the shares have remained calculated as financial fixed assets in the financial statements of the last three years, in equal instalments over five years.[33]

30. Contra Maisto, "Implementation of the EC Merger Directive", 47 *Bulletin for International Fiscal Documentation* 9 (1993), at 480 et seq. See *Survey of the Implementation of the EC Corporate Tax Directives*, IBFD Publications BV, Amsterdam, 1995, at 246.
31. See Zizzo, *Le riorganizzazioni societarie nelle imposte sui redditi*, Milano 1996, at 359; Silvestri, "Il regime tributario delle operazioni di riorganizzazione transnazionale in ambito CEE", *Riv. Dir. Fin. Sc. Fin.*, LV, 3, I, 428-519, 1996, at 695.
32. See Valente-Serbini, "Scambio di partecipazioni: riflessioni a margine della legge delega", *Il Fisco*, 18/1997, at 4850.
33. Based on Art. 54 of ITA.

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LETTERS TO THE EDITOR

THE WINE-BOX INQUIRY

Dear Sir

In the article "The Wine-Box Inquiry: Never Mind the Findings but What About the Recommendations?" (*Bulletin* February 1998) your correspondent Adrian Sawyer comments on the findings of the New Zealand Commission of Inquiry into Certain Taxation Matters. Mr Sawyer would have been on surer ground if he had limited his comments to the recommendations for legislative change made by the Inquiry Commissioner, Sir Ronald Davison.

The origin of the Inquiry were allegations made in Parliament under privilege by a Member of Parliament to the effect that New Zealand companies had committed criminal tax evasion using the Cook Islands tax haven and that Inland Revenue and the Serious Fraud Office were corrupt and incompetent in dealing with those transactions. Sir Ronald concluded, after hearing extensive evidence over a 2-year period that there was no basis for the allegations.

Mr Sawyer repeatedly states that Sir Ronald's view, that the Inland Revenue Department (and the Serious Fraud Office) had acted competently in examining certain transactions, was contrary to the evidence given at the Inquiry. He finds this "surprising" and "almost unbelievable" and speculates on Sir Ronald's motives and integrity.

I have spoken to Mr Sawyer and find that he had not in fact read the Inquiry evidence before writing the article. His article, however, does not disclose this and indeed gives quite the opposite impression. Had Mr Sawyer acted professionally and read the relevant transcripts of evidence before commenting perhaps he would not have been so surprised at the findings.

Further, had Mr Sawyer actually read the evidence, rather than relying on those sections of the media which had prejudged the issue, he may have avoided a number of unfounded and false criticisms of the New Zealand Inland Revenue and its staff which he has felt free to transmit to the international readers of this *Bulletin*.

David Henry
Commissioner/Chief Executive 1988-1995
New Zealand Inland Revenue Department

Dear Sir

The content of the article on the Wine-Box Inquiry, which appeared in the February 1998 issue of the *Bulletin*, which Mr Henry takes issue with, represents a small portion of the total article (approximately one column or half a page out of fourteen and half pages). The article represents the views of the author and other commentators. Others, such as the former Commissioner of Inland Revenue are entitled to hold to different views.

The focus of the article was the Wine-Box Inquiry Report recommendations. A discussion on this point, however, required that the scene or background be set (the first four pages), a brief discussion on the Inquiry report itself (one and one half pages), an outline of the key transactions (two and one half pages), and some conclusions (one page). The recommendations themselves comprised five pages or about fifty per cent of the substantive part of this article.

The article was based upon the Wine-Box Commissioner's Report, and the regular reports on the proceedings of the Inquiry and evidence, contained in both the print and television media. These sources were present throughout the publicly-held Inquiry and they reported on the evidence. The 13,000 or so pages of transcript evidence were not able to be obtained at the time of writing, and, acting professionally, I relied upon the reporting of the investigative media present at the Inquiry and other commentators. To report on 13,000 pages of evidence in practical terms necessitated that only selective but pertinent portions be reported upon by the media. Furthermore, it would be assumed that the media and commentators would have taken appropriate steps and sought advice over the accuracy of their reporting. I do not believe that the article creates the impression that it is based upon a complete analysis of the 13,000 pages of evidence; indeed the absence of citations to the evidence and reference to items reported in the media and by other commentators should make this clear.

The real issue of concern to Mr Henry, I believe, appears to lie with the reporting of the evidence by the media.

Yours sincerely

Adrian Sawyer
Correspondent for the *Bulletin*

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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 54-56 of the January 1998 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

South Africa

The Ernst & Young practical guide to value-added tax. 4th Edition.
Durban, Butterworths. 1997, pp. 148.
ISBN: 0 409 11651 3.
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(B. 13.574)

Schulze, C.
International tax-free trade zones and free ports. A comparative study of their principles and practices with three case studies.
Durban, Butterworths. 1997, pp. 131.
ISBN: 0 409 05257 4.
The publication deals in particular with the topical issue: what instruments and international legal precedents can South Africa employ to achieve a much desired increase in trade, foreign investment and development in general. It attempts to explain the basic principles of free trade zones and free ports from a legal point of view and compares different types of free trade zones and their objectives with one another. Finally, an evaluation is made with a view to establishing a free trade zone in the form of an export processing zone (or a free industrial zone) and a free port in South Africa.
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ASIA & THE PACIFIC

Asia

Trade and investment in the Asia-Pacific region.
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London, International Thomson Business Press, Berkshire House, 168-173 High Holborn, London WC1V 7AA, United Kingdom. 1997, pp. 224. GBP 42.50.
ISBN: 0 415 12321 6.
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Australia

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From the CCH Tax Editors.
North Ryde, CCH Australia Limited. 1998, pp. 1944. ISBN: 1 86264 975 8.
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This study reviews the developments of the overlapping rules applicable to interests in non-resident trusts, explaining where and why they yield complex, and often inappropriate, results. It concludes with recommendations for reform to simplify the law and better achieve consistent and logical policy objectives.
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(B. 116.973)

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(B. 116.977)

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Galli, A.
Das Rechnungswesen im Berufsfussball. Eine Analyse des Verbandsrechts des Deutschen Fussball-Bundes unter Berücksichtigung der Regelungen in England, Italien und Spanien.
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of hidden profit distributions), Becker, Herzig, Lüdicke (taxation of non-residents and EC law and tax treaties), Raupach, Schön (capital transfer law and national tax laws), Söhn (§ 10(5) UStG), Thömmes (tax discriminations and EC-law), Vogel (a classification conflict in the triangle Germany–France–Austria), Woerner (discretion when applying tax law, theory and practical application).
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This annual tax legislation handbook contains the enacted Taxes Consolidation Act 1997, a destination table showing the present location of all pre-consolidation sections, the major statutory instruments for each tax, up-to-date case law notes, up-to-date relevant UK case law, and exhaustive cross-references for each section.
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Murray, D.
Business operations in the Republic of Ireland.
Washington, Tax Management Inc.
Tax Management Foreign Income Portfolios, No. 965. 1997, pp. 100.
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Monograph on Italian cooperative companies. The book is divided into two parts. The first part deals with the aspects of company law and accounting principles which are regular to cooperative companies. The second part focuses on the tax regime applicable to cooperatives with particular reference to the direct and indirect taxes aspects as well as to the constitutional principles and the incentives granted to this type of company.
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Accounting in professional football. Analysis of the law of clubs and associations and the legal environment regarding accountancy for commercial and tax purposes, with a comparison with the rules in England, Italy and Spain.
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The book provides an overview of the effects of EC law on the Italian tax system. It is divided into three parts. The first part deals with EC laws and their effect and enforceability in Italy. The second part deals with the legal tools available to taxpayers wanting to invoke the application of EC law. The last part deals with the proceedings before the European Court of Justice.
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Netherlands

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The Hague, Ministry of Finance. 1997, pp. 64.
This book is based on research of the Ministry of Finance into the differences between the fiscal and commercial accounts and a congress on this theme. The subject is approached from various disciplines such as fiscal law, accounting and economics. In addition the texts of contributors to the congress concerning specific subjects e.g. provisions, the valuation of storage and assignments, derivatives and intangible assets from a commercial point of view are included.
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NLG 66. ISBN: 90 200 1908 2.
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(B. 117.063)

Vertegenwoordiging in het belastingrecht.
Rapport van de Commissie ter bestudering van vertegenwoordiging in het belastingrecht.
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Geschriften van de Vereniging voor Belastingwetenschap, No. 206. 1997, pp. 79.
ISBN: 90 200 2013 7.
This report contains an overview about civil law, fiscal procedural law, value added tax and excise duty aspects of representation. Moreover, it deals with the authority to represent individuals in criminal and fiscal affairs, the attribution of legal acts, liability of the representative and the principle of secrecy in relation to representation.
(B. 116.992)

Wederzijdse bijstand op het gebied van directe belastingen: Nederland; Vervolg-onderzoek; Overkoepelend rapport.
The Hague, Ministry of Finance. 1997, pp. 100.
Report in three parts concerning the Netherlands application of the European rules of mutual assistance and the national transformation of European directives. With commentary, conclusions and recommendations by the Dutch General Audit Office.
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Contributions of a conference on fiscal competition and the European Union. Mr. de Hosson deals with the acceptability of tax incentives and their impact on the establishment of a free market. Mr. Ter Kuile explains certain EC terminology and the relation between European laws, fiscal competition and government incentives. In addition, the legal consequences of an infringement of Community law and the formal procedures concerning government incentives are examined. Mr. Sijben discusses the establishment of the European Monetary Union.
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Inzake persoonlijke financiële planning.
Amsterdam, Coopers & Lybrand. 1997, pp. 44.
This booklet contains an overview of possibilities with respect to personal financial planning. The subject is discussed by taking into account tax laws and the flexibility of social security. Special attention is given to

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investment issues, business succession and estate planning.
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The adjustment of Polish companies to the market economy. Editor Zenon Wisniewski.
Torun, Wydawnictwo Uniwersytetu Mikolaja Kopernika. 1996, pp. 200.
The book contains contributions from the Nicholas Copernicus University Toruń, and its programme "Practical business education and training in Poland". The papers provide an overview of selected macroeconomic aspects of the economic transition in Poland and discuss various problems affecting the restructuring of Polish enterprises.
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Ustawa o podatku dochodowym od osób fizycznych. Komentarz.
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Monograph dealing with the Personal Income Tax Law of 26 July 1991, as amended by the law of 1997.
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Washington, Tax Management Inc.
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This Portfolio contains information designed to enable US and other investors to understand the tax and other considerations relevant to business operations in the United Kingdom. It considers in detail the application of the various direct taxes (corporation tax, income tax, capital gains tax, inheritance tax, stamp duty and stamp duty reserve tax) and the main indirect tax, value added tax. The Working Papers contain some of the most commonly used corporation tax and VAT forms, as well as the texts of the UK tax treaties with the USA.
(B. 117.002)

Self assessment.
London, The Institute of Chartered Accountants in England and Wales. 1996, pp. 16.
Questions and answers guidance note issued in November 1996 by the Tax Faculty.
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(B. 116.952)

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Individual taxes. A worldwide summary.
New York, Price Waterhouse. 1997, pp. 503.
A summary of basic information about individual taxes and tax rates in 117 countries and territories. For most countries, the tax summary is supplemented by a sample individual tax calculation to illustrate the basic rules applicable to individuals. The tax rates and rules are as of 1 January 1997.
(B. 117.068)

Worldwide immigration 1998.
New York, Ernst & Young International, Ltd. 1997, pp. 447.
An introductory guide to immigration procedures for foreign executives in over 120 countries. Topics include residence permits, visas, work permits, driving licences, admission of family members, and a brief outline of tax and social security considerations. The content is based on information available at 1 September 1997.
(B. 117.036)

CIAT

Impacto del proceso de modernización en la administración tributaria.
Madrid, Ministerio de Economía y Hacienda. 1997, pp. 343. ISBN: 84 476 0287 7.
The book contains the topics discussed at the CIAT conference held in Madrid in 1997. Each article reflects the position of the tax authorities of the CIAT member countries with regard to modernization of the tax administration.
(B. 19.010)

OECD

Tax sparing. A reconsideration.
Paris, OECD Organisation for Economic Co-operation and Development. 1998, pp. 85.
FRF 130.
The report examines the practices of OECD member countries and explains why they have become more reluctant to grant tax sparing in treaties. It also provides suggestions on the design of tax sparing provisions in tax treaties.
(B. 117.129)

The tax/benefit position of employees;
La situation des salariés au regard de l'impôt et des transferts sociaux. 1995-1996.
Paris, OECD Organisation for Economic Co-operation and Development. 1997, pp. 404.
FRF 350. ISBN: 2 64 05541 X.
This annual publication replaces the report entitled "Tax/benefit position of production workers". It details the tax/benefit position of employees in 1995 and 1996. The information contained in the report covers personal income tax and social security contributions paid by employees and their employers. The report also presents the resulting average and marginal tax rates. It illustrates how income taxes and social security contributions are calculated and provides a quantitative cross-national comparison of the tax/benefit positions in households.
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LATIN AMERICA

Mexico

Sandoval Galindo, L.E.
La actuación de las areas de auditoria respecto a los medios de defensa de particulares en materia fiscal coordinada.
Guadalajara, Indetec. 1997, pp. 160.
ISBN: 968 7544 27 9.
The author describes the various means of defence for taxpayers during and after tax audits and investigations in Mexico. The book contains a description of the main administrative and judicial remedies and appeal against tax assessments in Mexico.
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Estudio de la reforma fiscal para 1998.
Mexico City, Parás Asesores Fiscales, Bosque de Alisos, No. 47-A, Offna. 2-21, Col. Bosques de las Lomas, Mexico 05120, D.F. 1998, pp. 138.
The book describes and analyses the main aspects of the tax reform for 1998 introduced through a law published in the Official Gazette of 29 December 1997. These aspects refer to income tax, VAT, business assets tax, excise taxes and others.
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NORTH AMERICA

Canada

Sherman, D.M.
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TREATY MONITOR

PROF. DR KLAUS VOGEL

IN COOPERATION WITH THE IBFD'S TAX TREATY UNIT

TREATY NEWS

Prof. Dr Klaus Vogel

The forthcoming IFA Congress, to be held in London from 4-9 October 1998, will deal with some topics of particular interest to those who enjoy groping for their way in the mazes of tax treaties or who just have to work with them. Apart from Congress events touching treaties in a more peripheral way, three are devoted to them exclusively. Thus, persons interested in the field of tax treaties should if not already registered, seriously consider registering now.

I. APPLICATION OF TAX TREATIES – THE PROCEDURES

To enjoy the benefits of a tax treaty it is of foremost importance to be a resident of a contracting state and not to fall under a limitation on benefits clause or any other anti-avoidance provision. But even if those preconditions are satisfied, the most beneficial treaty provision may prove to be of limited value where procedural obstacles show up, such as having to file a claim for repayment, to use a particular form for doing so, to observe time limits, to produce evidence of certain facts, etc. Even among specialists there is often not much knowledge of these practical issues as far as other countries than their own are concerned. Most literature on double taxation conventions flatly disregards the problems involved. Thus, they were never investigated in a systematic way before IFA decided to choose them for one of its two main subjects of the London Congress and found in *Professor David Williams* a General Reporter of great erudition and commitment.

His outstanding General Report, together with thirty National Reports are published in volume LXXXIIIb of the *Cahiers de Droit Fiscal International*, which has recently been distributed to IFA members. Though Professor Williams cautiously observes that the literature and information in many countries are not adequate for definitive statements to be made and that the views expressed in some National Reports are necessarily of a more personal or anecdotal nature, the volume conveys a very good impression of what the practical issues are and how they are handled by different countries. In this respect the book is pioneering. To the practitioner it imparts valuable information on the problems he (or she) may encounter in other countries, and we may expect that more of this practical information will flow from the Congress discussions.

II. DEVELOPMENT AND TOPICAL PROBLEMS OF THE OECD TREATY MODEL

It is meanwhile an established feature of IFA Congresses that in a seminar organized jointly by OECD and IFA high-ranking officials of OECD give an account of current work concerning the Treaty Model and subsequently a panel composed of OECD officials and IFA members discuss selected questions concerning the application of the Model to certain problems. There was no suggestion that this tradition should be discontinued at London. The information "right from the horse's mouth" on what is at present discussed by OECD's Committee on Fiscal Affairs and what can be expected in the near future from them was always esteemed very highly by Congress participants, as were the subsequent panel discussions. Two subjects for those were selected this year. Beneficial ownership: whether the concept when used by a treaty is an autonomous treaty concept or whether it refers to domestic law via Article 3(2), and, if it is a treaty concept, what are its prerequisites and limitations; and retirement income: how it is to be qualified under tax treaty rules, e.g. where employment income (Article 15) ends and retirement income (Article 18) begins, whether and when share options have to be included and what about lump-sum payments? The panellists as always are experts, their majority well known to the international tax community.

III. TRIANGULAR SITUATIONS

If a taxpayer in state (1) has a permanent establishment in another state (2) which receives income from a third state (3), and if between all three states tax treaties of the OECD type exist, but differ in withholding rates, it is clear that the treaty between states 1 and 3 applies to the income received by the permanent establishment, because the latter has no treaty entitlement as such under the Model. Normally the solution may seem satisfactory. This is less so, however, when the permanent establishment pays interest to a lender in state 3: the withholding rate in state 2 is limited by neither treaty, nor is state 3 bound to give any credit. In contrast, if the taxpayer is a dual resident of states 1 and 2 and receives dividends or interest from state 3, both treaties 1-2 and 2-3 may be applicable, but what does this mean? These are highly sophisticated problems to which the OECD devoted a study in 1992, yet did not find a solution which would be satisfactory in all

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cases. Therefore, a panel at the London Congress will take up these questions again. Its chairman will be *John F. Avery Jones*, who is famous for his profound analyses of double taxation problems. This is a guarantee, I think, for an in-depth discussion, and perhaps even for an acceptable solution.

RECENT TREATIES

Countries	Date of conclusion
China–Vietnam (income)	3 April 1998
Taiwan–Vietnam (income)	3 April 1998
Bulgaria–Czech Republic (income)	9 April 1998
Finland–Uzbekistan (income)	9 April 1998
China–Estonia (income)	12 May 1998
Slovak Republic–South Africa (income)	28 May 1998
Japan–Korea (income)	3 June 1998
Canada–Kyrgyzstan (income, capital)	4 June 1998
Luxembourg–Mongolia (income)	5 June 1998
Philippines–Switzerland (income)	24 June 1998
Latvia–Uzbekistan (income)	3 July 1998
Malaysia–Namibia (income)	28 July 1998

None of these treaties are yet in force.

EDITORIAL

In this issue of the Treaty Monitor, which contains articles by Hughes, Lehner and Gammie, we focus on the *Gilly* case, a judgment that offers clarification of certain aspects of EU Member States' powers to conclude bilateral tax treaties. The trilogy commences with an introduction by David Hughes to the facts and legal questions involved and implications for the Most Favoured Nation (MFN) clause argument. Prof. Lehner and Malcolm Gammie then examine specific facets of the ECJ's decision. Prof. Lehner concentrates on drawing attention to the new approach adopted by the ECJ in interpreting the scope of Article 48 EC Treaty. Malcolm Gammie concludes the trilogy by arguing that *Gilly* does not negatively determine the MFN question.

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GILLY AND THE BIG PICTURE

David Hughes*

I. INTRODUCTION

On 12 May 1998, the European Court of Justice (ECJ) delivered its judgment in the case of *Mr and Mrs Robert Gilly v. Directeur des Services Fiscaux du Bas-Rhin.*[1] This case, which dealt with the interpretation of Articles 6, 48 and 220 of the EC Treaty, provides substantial clarification on the issue of the compatibility of bilateral tax treaties with the EC Treaty.

The paper will proceed by outlining the facts of the *Gilly* case, the points at issue and the ECJ's judgment thereon. The article concludes by examining the implications of the case on the question of the applicability of the Most Favoured Nation clause (MFN) under EC law.

II. AN OVERVIEW

A. The facts

1. General

Mr and Mrs Gilly reside in France, close to the German border. Mr Gilly is a French national and teaches in a French state school. Mrs Gilly, a German national who has acquired French nationality through her marriage, teaches in a German state school in the frontier area.

Mr and Mrs Gilly brought proceedings in the *Tribunal Administratif*, Strasbourg, against the *Directeur des Services Fiscaux du Bas-Rhin* (Director of Tax Services for the *département* of Bas-Rhin) concerning the computation of their personal income tax liabilities for the tax years 1989-1993 inclusive. At issue was the operation of the France–Germany Double Taxation Convention of 21 July 1959, as amended by protocols on 9 June 1969 and 28 September 1989 (hereinafter: the France–Germany treaty).

In a judgment delivered on 10 October 1996, the *Tribunal Administratif* referred to the ECJ for a preliminary ruling under Article 177 of the EC Treaty six questions concerning the interpretation of Articles 6, 48 and 220 of that Treaty.

2. France–Germany treaty

Article 13(1) of the France–Germany treaty sets out the basic principle regarding the taxation of employment income:

> Subject to the provisions of the following paragraphs, income from dependent work shall be taxable only in the Contracting State in which the personal activity in respect of which it is received is carried out.

However, Article 13(5)(a) contains an exception to the rule stated in Article 13(1) which applies to certain frontier workers:

> By way of exception to paragraphs 1, 3 and 4, income from dependent work earned by persons who work in the frontier area of one Contracting State and who have their permanent home in the other Contracting State, to which they normally return each day, shall be taxable only in that other State.

The above provisions do not apply to remuneration and pensions from the public sector, which instead are governed by Article 14(1):

> Salaries, wages and similar remuneration, and retirement pensions, paid by one of the Contracting States, by a *Land* or by a legal person of that State or *Land* governed by public law to natural persons resident in the other State in consideration for present or past administrative or military services shall be taxable only in the first State. However, that provision shall not be applicable where the remuneration is paid to persons having the nationality of the other State without being at the same time nationals of the first State; in such cases, the remuneration shall be taxable only in the State in which such persons are resident.

Article 14(1) therefore allocates taxing powers to the residency state where the individual receiving the remuneration is not a dual national and to the paying state where that individual is a dual national.

Article 16 of the treaty makes a further distinction in the case of teachers who are temporarily resident. Where such temporary residence does not exceed two years the remuneration is only taxable in the state of the teacher's original employment.

Article 20(2)(a)(cc) of the France–Germany treaty provides relief from double taxation as follows:

> 2. Double taxation of persons resident in France shall be avoided in the following manner:
>
> (a) Profits and other positive income arising in the Federal Republic and taxable there under the provisions of this Convention shall also be taxable in France where they accrue to a person resident in France. The German tax shall not be deductible for calculation of the taxable income in France. However, the recipient shall be entitled to a tax credit to be set against the French tax charged on the taxable amount which includes that income. That tax credit shall be equal:
>
> ...
>
> (cc) for all other income, to the amount of the French tax on the relevant income. This provision shall apply in particular to the income referred to in Articles ... 13(1) and (2) and 14.

Thus, relief for source state tax paid on income is limited to the effective rate of tax that applies to that income in the residence state.

---

* The views expressed in this article do not necessarily reflect the views of the IBFD.

1. Case C-336/96.

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From the above rules Mrs Gilly's tax position was determined as follows. For the years in question her public sector employment income was taxed under Article 14(1) in Germany as she was a dual national. By virtue of Article 20(2)(a) it was also taxed in France. Double tax relief was provided by the French tax authorities granting a credit for the tax paid in Germany, limited by reference to the effective rate rule mentioned above (Article 20(2)(a)(cc)).

Mr and Mrs Gilly initiated proceedings before the *Tribunal Administratif* on the grounds that the above mentioned provisions of the France–Germany treaty *led to unjustified, discriminatory and excessive taxation which was incompatible with Articles 6 (formerly Article 7 of the EEC Treaty), 48 and 220 of the EC Treaty.*

B. The six questions

As the matter dealt with the interpretation of certain provisions of the EC Treaty the *Tribunal Administratif* stayed proceedings and referred the following six questions to the ECJ:

1. Is the principle of freedom of movement for workers, as embodied in the Treaty of Rome and the implementing legislation, contravened by a tax regime, applicable to frontier workers, of the kind provided for by the Franco-German Convention, in so far as the latter lays down taxation arrangements which are different for people whose remuneration is paid by a public entity as compared with those whose remuneration is paid by private persons and as a result is liable to have an impact on access to posts in the public or private sectors depending on residence in one State or another?

2. Is a rule under which a frontier worker receiving remuneration from a State or an agency thereof governed by public law is taxable in that State, whereas, if the frontier worker has the nationality of the other State but is not at the same time a national of the first State, his remuneration is taxable in the State where the frontier worker resides, compatible with the principle of freedom of movement and the abolition of all discrimination on grounds of nationality?

3. Is a tax provision which lays down for frontier workers employed by persons governed by public law a tax regime which differs according to whether they are nationals only of that State or have dual nationality compatible with Article 7 [now Article 6] of the Treaty?

4. Is the principle of freedom of movement for workers, as embodied in the Treaty, contravened by tax rules which are liable to affect the choice made by teachers in the Contracting States as to whether to work on a more or less long-term basis in another State having regard to the differences, based on the duration of employment, in the tax regimes of the States in question?

5. Must the objective of abolishing double taxation laid down in Article 220 of the Treaty be regarded, in view of the time which the Member States have had to implement it, as now having the status of a directly applicable rule under which double taxation may no longer take place? Is the objective of avoiding double taxation assigned to the Member States by Article 220 contravened by a tax convention under which the tax regime applicable to frontier workers of States party to the convention varies according to their nationality and the public or private nature of the post held? Does a tax credit regime applicable to a household living in one State which does not take into account the exact amount of the tax paid in another State but only a tax credit, which may be lower, meet the objective assigned to the Member States of abolishing double taxation?

6. Must Article 48 be interpreted as meaning that nationals of a Member State who are frontier workers in another Member State may not, by reason of a tax credit mechanism of the type provided for by the Franco-German Convention, be taxed more heavily than persons whose occupational activity is pursued in their State of residence?

III. THE JUDGMENT

A. The fifth question

The ECJ addressed the fifth question first, i.e. whether the second indent of Article 220 of the Treaty is directly applicable.

The second indent 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.

The ECJ found as follows:

> Article 220 is not intended to lay down a legal rule directly applicable as such, but merely defines a number of matters on which the Member States are to enter into negotiations with each other 'so far as is necessary'. Its second indent merely indicates the abolition of double taxation within the Community as an objective of any such negotiations.
>
> Although the abolition of double taxation within the Community is thus included among the objectives of the Treaty, it is clear from the wording of that provision that it cannot itself confer on individuals any rights on which they might be able to rely before their national courts.
>
> The answer to the fifth question must therefore be that the second indent of Article 220 of the Treaty does not have direct effect.

B. The first, second and fourth questions

The ECJ next turned to the first, second and fourth questions, i.e. whether Article 48 which provides for the free movement of workers is infringed by the application of Articles 13(5)(a), 14(1) and 16 of the France–Germany treaty. I.e., did Article 48 prohibit applying different tax regimes to frontier workers according to whether or not:

a. the individual worked in the Public or private sector;
b. they had the nationality of the authority employing them; and
c. in the case of teachers they worked for a short period.

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Prior to considering the above questions the ECJ swiftly rejected a rather weak argument raised by the French Government that Mrs Gilly had not exercised in France the rights conferred by Article 48, since she worked in the state of her origin.

"Compatibility of the fiscal connecting factors with Article 48 of the Treaty"

The ECJ commenced by noting that whilst one of the objectives of the Treaty of Rome was the abolition of double taxation

> apart from the Convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (OJ 1990 L 225, p. 10), no unifying or harmonising measure for the elimination of double taxation has yet been adopted at Community level, nor have the Member States yet concluded any multilateral convention to that effect under Article 220 of the Treaty.

Following from this lack of harmonization "The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation – by means, *inter alia*, of international agreements". The ECJ further notes that many states have concluded such bilateral treaties based in particular on the OECD Model Convention.

It was therefore in this context that the ECJ reviewed certain connecting factors contained in the France–Germany treaty which were used by the states to allocate taxing jurisdiction on income from dependent work.

Reviewing the relevant provisions of the treaty it found that: "Articles 13(1) and (5)(a), 14(1) and 16 of the Convention lay down different connecting factors depending on whether the taxpayer is a frontier worker or not, is a teacher in short-term residence or not, or is employed in the private or the public sector." Furthermore, the criterion of nationality appears as such in the second sentence of Article 14(1) "for the purpose of allocation of fiscal jurisdiction".

The ECJ, however, held "such differentiation cannot be regarded as constituting discrimination prohibited under Article 48 of the Treaty." This flowed from distinct but interrelated factors:

- the absence of any unifying or harmonising measures adopted in the Community context under, in particular, the second indent of Article 220 of the Treaty,
- [–] from the contracting parties' competence to define the criteria for allocating their powers of taxation as between themselves, with a view to eliminating double taxation.

The ECJ went on to comment that when allocating fiscal jurisdiction, it is "[not] unreasonable for the Member States to base their agreements on international practice and the model convention drawn up by the OECD".[2] In the present case, the first sentence of Article 14(1) of the Convention reproduces the tenor of Article 19(1)(a) of the OECD Model Convention.

The ECJ then went on to compare Article 19(1)(b) of the OECD Model Convention with the second sentence of Article 14(1) of the France–Germany treaty and found it to be the "same type of exception".

In the author's opinion, however, the comparison may be inappropriate since the second sentence of Article 14(1) of the France–Germany treaty bases its exception solely on nationality, whilst Article 19(1)(b) incorporates the dual criteria of nationality and the location of the work, i.e. it only applies if the work is carried out in the other state. Perhaps because of the tension apparent in the logic of the comparison the ECJ went on to state that

> even if the second sentence of Article 14(1), the legality of which is challenged by Mrs Gilly, were to be ignored, her tax position would remain unchanged because the paying State principle would still have to be applied to her income earned in Germany from teaching in the State education system.

The ECJ further observed that it had not been established that the choice of the paying state as the taxing state can of itself be disadvantageous to the taxpayer. In this regard the ECJ accepted the submissions of the governments of certain Member States which had pointed out that:

> whether the tax treatment of the taxpayers concerned is favourable or unfavourable is determined not, strictly speaking, by the choice of the connecting factor but by the level of taxation in the competent State, in the absence of any Community harmonisation of scales of direct taxation.

The ECJ concluded that therefore the answer to the first, second, and fourth questions was that Article 48 did not preclude the operation of provisions such as those contained in Articles 13(5)(a), 14(1) and 16 of the France–Germany treaty.

Whilst the author agrees with the ECJ's conclusion, the lack of analysis regarding the question of a Member State's powers of allocation leaves certain questions unanswered. For instance would a clause contained in a bilateral treaty that deviated markedly from the relevant OECD provision be evidence that the powers of allocation may not be being exercised properly? Indeed put succinctly should the powers of allocation be exercised:.

a. purely to reflect national sovereignty;
b. to reflect the spirit of the EC Treaty; or
c. to reflect a balance between a. and b.

At present the answer would appear to be a., provided that there was no deliberate attempt to infringe the EC Treaty, since the taxpayer's position in any event is determined by the scales applying in the relevant Member States. A bilateral tax treaty's failure to eradicate entirely the adverse implications that may affect certain taxpayers because of a lack of harmonization in Member States tax systems does not of itself cause the bilateral treaty to infringe the EC Treaty.

C. The third question

The ECJ then considered the third question, i.e whether Article 7 (now Article 6) of the EC Treaty precluded the application of Article 14(1) of the France–Germany treaty.

2. In paras. 16 and 32, C-279/93 (*Schumacker*) and in C-80/94 (*Wielockx*) the ECJ considered the OECD Model Convention. See H.J. Kamphuis and F.P.G. Pötgens, "Goodbye Mr Bachmann, Welcome Mr Wielockx", 50 *Bulletin for International Fiscal Documentation* 1 (1996), at 5.

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It held that it was unnecessary to rule on the application of Article 6 since it was settled case law[3] that the general principle of discrimination on the grounds of nationality only applies independently to situations where the treaty contains no specific prohibition on discrimination. Here the alleged discrimination clearly fell within the prohibition contained in Article 48 of the EC Treaty.[4]

D. The sixth question

The ECJ next considered the final question, i.e. whether Article 48 of the Treaty precluded the operation of the tax credit mechanism contained in Article 20(2)(a)(cc) of the France–Germany treaty.

This mechanism operated in this instance to limit the credit for German tax paid to the French tax paid on the relevant income.

The ECJ noted that Mrs Gilly's personal and family circumstances were only taken into account in France when determining the total household income.

Mr and Mrs Gilly argued that the tax credit mechanism incorporated in the France–Germany treaty penalized those who exercised their freedom of movement as it did not eliminate double taxation. They further submitted that double taxation could only be fully avoided if full credit was given for the German tax paid.

However the ECJ echoing the opinion of the Advocate General,[5] stressed

> that the object of a convention such as that in issue is simply to prevent the same income from being taxed in each of the two States. It is not to ensure that the tax to which the taxpayer is subject in one State is no higher than that to which he or she would be subject in the other.

The ECJ further considered it to be common ground that any unfavourable consequences entailed in the present case by the tax credit mechanism under the France–Germany Treaty resulted from differences in the tax scales of the Member States. As there had been as yet no Community legislation in the field the determination of the scales were a matter for the Member States.

Furthermore,[6]

> if the State of residence were required to accord a tax credit greater than the fraction of its national tax corresponding to the income from abroad, it would have to reduce its tax in respect of the remaining income, which would entail a loss of tax revenue for it and would thus be such as to encroach on its sovereignty in matters of direct taxation.

The ECJ then confirmed that the German tax authorities were not obliged to take account of her personal and family circumstances on grounds of comparability; Mrs Gilly's German income formed only part of the aggregate household income assessable in France (Case C-279/93 *Finanzamt Köln-Altstadt v. Schumacker* [1995] ECR 1-225, paragraphs 31 and 32).

The ECJ next turned to a submission made by Mr and Mrs Gilly in the main proceedings that Article 20(2)(a)(cc) of the France–Germany treaty discriminated on the basis of nationality contrary to Article 48 of the EC Treaty, since, if Mrs Gilly had only French nationality Article 13(5)(a) of the France–Germany treaty would apply and she would then only be taxed in her state of residence, i.e. France.

The ECJ again perceived this as a question of the division of taxing powers between states and held that

> the fact that in allocating powers of taxation between them the contracting parties have chosen various connecting factors, in particular nationality with regard to public-service remuneration received in the State other than the State of residence, cannot in itself constitute discrimination prohibited by Community law.

In view of the above "the answer to the sixth question must be that, on a proper construction, Article 48 of the Treaty does not preclude the application of a tax credit mechanism such as that provided for in Article 20(2)(a)(cc) of the Convention."

IV. GILLY AND THE MFN CLAUSE

As illustrated above the *Gilly* judgment removes much of the uncertainty regarding the compatibility of bilateral tax treaties with EC Law. Furthermore, the author argues that it provides a clear indication of the likely determination of the MFN issue.

The following key elements of the judgment would seem to be in contradiction of the incorporation of the MFN into EC Member States bilateral treaties:

1. the Member States' powers of allocation;
2. the Member States' sovereignty in direct tax matters;
3. the lack of harmonization of scales of direct taxation;
4. the lack of multilateral coordination measures under Article 220 of the EC Treaty;
5. the weight given to the OECD Model Convention;[7]
6. the lack of comparability between residents and non-residents.[8]

The precise interrelationship between these factors and the weight to be given to each will be determined in a dynamic

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3. Case C-1 31/96 *Mora Romero v. Landesversicherungsanstalt Rheinprovinz* [997] ECR 1-3659, para. 10.
4. "... and by acts of secondary legislation including, in particular, Regulation (EEC) No 1612/68 of the Council of 15 October 1968 on freedom of movement for workers within the Community (OJ, English Special Edition 1968 (11), p. 475)."
5. Point 66 of his Opinion.
6. As has been observed by the French, Belgian, Danish, Finnish, Swedish and United Kingdom Governments.
7. The OECD Model Convention does not incorporate a MFN clause. In particular Jeffrey Owens, Head of Division, OECD Division of Fiscal Affairs, believes "Applying the MFN obligation in trade or investment treaties to direct taxes would turn the existing individually-negotiated compromises into a universal right to be extended to other countries without cost. Future tax treaty negotiations would have to change altogether and might, on the most pessimistic prognosis, become a multitude of Uruguay round negotiations, instead of a series of flexible and responsive exchanges." Jeffrey Owens, "Taxation Within a Context of Economic Globalization", 52 *Bulletin for International Fiscal Documentation* 7 (1998), at 292.
8. The author would argue that comparability is further complicated where what is being compared is non-residents located in different Member States. For a consideration of certain factors affecting comparability see *supra* note 7 at 129. C.f. Josef Schuch, "EC Law Requires Multilateral Tax Treaty" *EC Tax Review* 1998/1 at 32 *et seq.*

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environment and depend on the circumstances of the case before the Court. Notwithstanding this, it would appear to be reasonable to speculate that *Gilly* terminates for withholding taxes at least the MFN clause debate.

V. CONCLUSION

The judgment in the *Gilly* case provides a strong endorsement of the role of bilateral tax treaties within the framework of EC Law. As argued for in my article "Withholding Taxes and the Most Favoured Nation Clause"[9] the ECJ has accepted that differentiation under tax treaties does not constitute discrimination, i.e that Member States may agree on the fiscal connecting factors which apply under their bilateral tax treaties. Further the ECJ has confirmed as also suggested in my earlier paper that the question of a state's taxation rights under a tax treaty is a question of "allocation not discrimination".[10] In short, by considering the France–Germany treaty among other things in the context of both countries' domestic tax regimes rather than by myopically focusing on one national side or the other the ECJ has considered the "big picture"!

9. David Hughes, "Withholding Taxes and the Most Favoured Nation Clause", 51 *Bulletin for International Fiscal Documentation* 3 (1997), at 126.
10. Id., at 125.

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ANNOTATIONS ON THE JUDGMENT OF THE EUROPEAN COURT OF JUSTICE, CASE C-336/96 – THE *GILLY* CASE – OF 12 MAY 1998[1]

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The ECJ judgment in the *Gilly* case concerns the avoidance of double taxation within the European Union. What makes this ruling stand out is the judicial restraint which seems to contrast significantly to the Court's former case law on direct taxes.[2] Article 220 of the EC Treaty explicitly mentions the avoidance of double taxation. However, in the past, the only elements of community law which gained influence upon the sphere of direct taxation have been the non-discrimination rules of the Treaty. Indeed, these two approaches do not contradict each other. The new element is that the Court has for the first time interpreted the non-discrimination rule of Article 48 of the Treaty as a non-restriction rule with respect to tax law.

It has frequently been asked what impact community law has had on the double taxation agreements entered into between EC Member States. The Court has handled this issue in a surprisingly restrictive manner. Indeed, the ruling is in line with the long-standing case law of the ECJ in the field of direct taxation. This states that direct taxes fall into the competence of the single Member States but that this competence must be exercised *in line with Community law*. The Court found that Article 220 of the EC Treaty was "not intended to lay down a legal rule directly applicable as such, but merely [defined] a number of matters on which the Member States are to enter into negotiations with each other 'so far as is necessary'."[3] Taking into consideration the subsidiarity principle (as laid down in Article 3(b) of the EC Treaty), and read in connection with the necessity clause (Article 220 of the Treaty), this view is correct and does not surprise me. It corresponds to the range of other competencies in the field of direct taxation which also in the absence of a respective Community competence have remained with the Member States. Admittedly, the Member States have to exercise their competence in a way which is compatible to Community Law and have to respect the EC non-discrimination rules. But this obligation only applies to those subjects who are covered by the personal scope of the EC non-discrimination rules. After all, domestic tax law remains a matter of the *Member States' genuine legislative competence*.

To assume a contradiction between previous ECJ case law and the *Gilly* decision would be rather superficial. The apparent contradiction can be resolved by taking into account the different areas of application of the various non-discrimination provisions contained in European Law. This is true irrespective of the new interpretation of Article 48 of the Treaty as a non-restriction rule. Until recently, Article 48 has been interpreted by the ECJ as prohibiting discrimination of nationals of other Member States (or non-residents) vis-à-vis domestic citizens (or residents).[4] In contrast, the *Gilly* decision widens this non-discrimination rule into a non-restriction rule which a resident can invoke in his state of residence. The same approach had already been chosen before with regard to other fundamental freedoms, in particular to Article 52.

In spite of this broader personal application, Article 48 remains with little effect with regard to the measures for avoiding double taxation. This is indeed a significant contrast to other ECJ case law on direct taxes which deserves our approval. Other decisions on Article 48 have mostly been based upon the differences between unlimited and limited tax liability in situations where different rules have resulted directly in an unequal distribution of the burden of tax between residents and non-residents. In contrast, the elimination of double taxation is a matter of delimitation of the powers of taxation between two or more states. This inter-state delimitation aims to avoid double taxation in favour of the taxpayer. But the taxpayer is affected mainly because double taxation rules determine which of the two states involved is regarded as the state of residence or the source state. This determination as such does not establish any form of unequal treatment prohibited by Article 48. This is true even if *nationality* serves as one relevant criterion among others, as in the second sentence of Article 14(1) of the Double Taxation Convention between France and Germany. One may ask why Article 48 is indifferent with respect to the delimitation of the different Member States' competence to tax. As the Court points out, referring to Article 220, this is primarily due to the fact that the Member States are entitled to lay down criteria for the delimitation of their respective powers of taxation on a bilateral basis, in the absence of any unifying or harmonizing measures at Community level with respect to the domestic legal order.[5] This interpretation of Article 220 is not wrong. However, it applies, *mutatis mutandis*, to the whole area of direct taxation. The crucial point as to whether Article 48 is violated is not the bilateral delimitation of taxation between the Member States. It is rather the *domestic tax law*

1. These annotations are also published in German, in *Internationales Steuerrecht* (1998), at 341 et seq.
2. I.e. in the *Gilly* case though the Court by virtue of Art. 220 EC Treaty had perhaps an explicit competence to rule on a question of direct taxation, it was very reluctant to do so. Compare this to the enthusiasm which the Court has displayed when commenting on other areas concerning direct taxation where no such explicit authority existed.
3. Paras. nos. 15 et seq. of the decision.
4. Cf. the *Werner* decision, Case C-112/91 of 26 January 1993, O.J. I, 429 (1993).
5. Para. no. 30 of the decision.

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design of each single state within the framework of double taxation rules. The Court has referred to this concept supplementarily.[6] This would have been reasonable if the Court had stayed with its former case law and had consequently interpreted Article 48 as a provision guaranteeing non-discrimination, by the state where an activity is exercised, to non-residents vis-à-vis residents. In this case, Article 48 would not apply to tax credits in the relationship of the taxpayer vis-à-vis his state of residence.

In the *Gilly* case, in contrast, the Court extended the scope of Article 48 and attached to it the meaning of a non-restriction rule which the taxpayer may invoke vis-à-vis his state of residence. This concept leads to unsatisfactory consequences – in particular to disadvantages in connection with the credit method. It is not sufficient for a scrutiny of direct taxation in the state of residence to establish that residents and non-residents are usually not in a comparable situation.[7] In contrast, the crucial point should be whether the particular disadvantages of the credit method can be regarded as a restriction of the free movement of workers under Article 48 of the Treaty and, if so, to what extent they can be justified.

After all, we should welcome the Court's distinction in respect of Article 48 between the inter-state delimitation of taxation which follows from double taxation conventions and the design of tax laws – which are a matter of domestic legislation. As a rule, both aspects must be considered independently from each other. But we should keep in mind that the credit method functions as a missing link between them. The Court's statement[8] that it is merely "no[t] [...] unreasonable" for the Member States to base their double taxation agreements on the OECD Model looks somewhat half-hearted and may only be explained in consideration of Article 234 of the EC Treaty. In any case, the *Gilly* decision does confirm that there is obviously no space for a broader interpretation of the non-discrimination rules of the Treaty towards most favourite nation clauses within the EU tax treaty network.

6. This can be derived from the wording of para. no. 34 of the decision. It reads: "Nor is it established in the present case that the choice of the paying State as the State competent to tax income earned in the public sector can of itself be to the disadvantage of the taxpayers concerned [...]".
7. This has indeed been stated by the ECJ, at para. no. 49.
8. At Para. no. 32 of the decision.

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Mr and Mrs Robert Gilly v. Directeur des Services Fiscaux du Bas-Rhin, Case C-336/96

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The *Gilly* case confirms that Article 220 of the EC Treaty does not have direct effect and that Member States have a basic freedom to conclude bilateral treaties to eliminate double taxation. This basic freedom includes freedom to allocate taxing jurisdiction between the contracting parties. A taxpayer cannot then complain if state A, which by treaty is given competence to tax her, imposes a higher tax burden on her than state B. Nor is state B bound to give credit for state A's tax in excess of whatever tax state B imposes on the income in question.

None of these propositions are surprising. The real question, however, is how far can governments take these propositions before they run foul of EC law? Mrs Gilly had acquired French nationality by marriage and was a resident of France for the years in issue. She was a German national by birth. The first point to note is that her complaint under Article 48 (now Article 39) of the EC Treaty was against the French tax authorities. While not upholding her complaint, the Court accepted that Article 48 applied to domestic French tax rules that might otherwise restrict Mrs Gilly's freedom under Article 48.

Member States may only contract bilaterally in a manner that is consistent with their EC Treaty obligations. But this does not tell us in what circumstances domestic or treaty provisions conflict with the EC Treaty. The normal situation in which this has arisen is in circumstances where discrimination is said to arise, as in *Schumacker* and related cases, i.e. are people in objectively similar positions treated differently?

Thus, countries may not discriminate contrary to the EC Treaty through their bilateral arrangements and *Gilly* does not go against that principle. A taxpayer may claim that provisions are discriminatory either:

- as a result of a single treaty (as was alleged in *Gilly*); or
- by comparing two treaties.

In the first case it is claimed that a bilateral treaty may not allocate taxing rights between two countries (Germany and France in *Gilly*) in a way that discriminates between two taxpayers who are in an objectively similar position. In the second case, it is claimed that a country cannot agree to allocate differently taxing rights under two treaties so as to discriminate between taxpayers who are in an objectively similar position but who are entitled to take advantage of a different tax treaty.

The question principally addressed in *Gilly* was whether, under their treaty, France and Germany were entitled to allocate taxing jurisdiction according to a variety of criteria which then produced a different tax result for people doing essentially the same job and earning the same wage. As a basic proposition the obvious answer to this is that they can for the reasons given by the Court, i.e. there is no Community level harmonization of direct taxes and Member States retain their competence in such matters.

Against that background, it will always be very difficult to establish an EC Treaty infringement in relation to allocation of taxing rights. The situation applies wherever one person generates income in one state (the source state) and has a taxing connection with another state. In those circumstances Member States have to allocate taxing rights and eliminate double taxation. It will be very difficult to say that their choices in this regard restrict an individual's basic freedom.

The mere fact that there is a difference in tax outcome reflects that Member States establish their own direct tax systems rates. Thus, there is always likely to be a difference in tax outcome between earning income in one state or another and that in itself cannot infringe the EC Treaty. The *Gilly* case is authority for saying that two countries may allocate taxing rights between them according to different factors so that people doing the same job and paid the same wage may be taxed differently depending upon the allocation criteria adopted in their circumstances. But this is little different from recognizing that there are different tax outcomes depending upon whether you work in one country or another.

If you teach in France you will be taxed solely under the French regime. If you are resident in France but teach in Germany you will be taxed under both German and French regimes. The fact that the German tax is higher may discourage you from working in Germany rather than France but that does not infringe Article 48. Different salary levels, different social benefits and different costs of living may all account for or compensate for different tax burdens. None of these infringes an individual's freedoms under the EC Treaty.

What France may not do, however, is impose domestic tax rules that penalize a person working in Germany rather than France. In this respect, a bilateral treaty provision might infringe the EC Treaty freedom if, unusually, countries design their criteria for allocating taxing rights to have this penalty effect. But so long as the criteria that countries use are consistent with those contained in the OECD Model there is little chance of any infringement of EC treaty freedoms.

Mrs Gilly made her complaint against the French tax authorities, essentially that they should not have contracted as they did with Germany. Against France her remedy could only be

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that France, having conceded taxing jurisdiction to Germany, should give credit for the entire German tax. But Mrs Gilly's real problem was that she had been taxed in Germany. Ideally, she needed to claim that she should only be taxed in France.

On what basis might she have made that claim? The general rule is that Germany has the primary taxing right for both public and private sector employees working in Germany. However, Germany had agreed with France that it would forego its taxing right in the case of French nationals but not in the case of German nationals under the second part of Article 14(1) of the treaty. The comparison, if one can be made at all, is between a French national teaching in Germany and Mrs Gilly as a dual national.

This part of the Court's judgment is not ideal. The Court refers to the OECD Model Treaty in Article 19(1)(b), but the Court appears to have misinterpreted the circumstances in which that article applies. But even without that apparent misinterpretation, I doubt that the Court would have forced France to give credit for the full German tax.

The real complaint (if any) lay against Germany and the validity of its conceding taxing rights on French nationals to France but retaining them for dual nationals. This is not to say that an action against Germany would have succeeded. Certainly Germany had the primary taxing right because that is where the employment was exercised. Furthermore, even though Germany conceded to France taxing rights for frontier employees in the private sector, it could justify its different treatment of public employees for the reasons given in the OECD Model commentary.

The question then is whether Germany can give up its taxing rights to France for French nationals but not for French nationals who happen also to be German nationals, nor for German nationals who are resident in France. It is clear that Germany cannot justify either reservation by reference to Article 19(1)(b) because that deals with persons working in the German public service *in France*. Germany might justify the reservation of its taxing rights in both cases on the basis given in the OECD Model, i.e. that a government always retains its right to tax its nationals.

Does Gilly affect the issues that arose from comparing different bilateral treaties concluded by a single Member State and the most favoured nation question that arises from that comparison? Here the fundamental question remains whether two taxpayers resident in different Member States and taking advantage of different bilateral treaties are ever in a comparable position.

Mrs Gilly did not attempt to argue that France had entered into a different bilateral arrangement with e.g. Belgium so that, as compared with a person with dual Belgian/French nationality she was in a less favourable position. But suppose that France had agreed different tax credit arrangements with Belgium so that the total tax paid in Belgium was actually credited against French tax. Could Mrs Gilly have asked the French tax authorities to extend that treatment to German tax paid? The Court was not asked to deal with these questions in *Gilly* and the case does not answer finally the MFN issue, even if it suggests the heights that taxpayers must storm to succeed with this issue.

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INTERNATIONAL

THE IMPACT OF ECONOMIC GLOBALIZATION ON TAXATION*

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I. INTRODUCTION

In recent years the world has been enjoying the benefits coming from a progressive integration of the world's economies. Economies that had been autarkic and closed have opened up and are being integrated into a truly world economy. A global capital market has come into existence allowing huge movements of capital and generating a world interest rate.

The benefits from this process of globalization are many and some are obvious: (a) world resources are better allocated; thus, output and standards of living rise; (b) because of the greater access to foreign goods, individuals enjoy a greater range of choice in goods and services; (c) because the cost of travel has fallen significantly (in time and money), many individuals are now able to travel to faraway places; (d) the amount and range of information available to individuals has increased enormously while the cost of getting information has fallen dramatically.

The significance of these benefits can be easily appreciated. But, as is often the case, these developments are also associated with some negative aspects. Globalization can create or aggravate potential problems. It is, thus, important to control these negative developments so that they are prevented from becoming large enough to cast a bad light on the process of globalization and to provoke policies aimed at reversing the recent trends. I will mention just a few of these negative developments.

(a) Open borders and free trade have generated a large increase in the volume of goods that crosses frontiers. World trade is growing twice as fast as world income. Countries that want to facilitate this trade in order to reduce costs to exporters and importers are having growing difficulties in inspecting it to detect unwanted imports, such as illicit drugs, weapons, and hazardous materials. As a consequence, it has become easier to smuggle these unwanted imports into a country. This has created major difficulties for the fight against drugs and for controlling potential terrorist threats.

Thus, a challenge to the world is how to *keep countries democratic and economies open* while still effectively controlling the flow of illicit drugs and other forbidden products.

(b) Free and growing trade increases the likelihood that negative externalities may be imposed by a country on other countries. Think of the possibility for export of products with potential health hazards. The problem with the export of contaminated materials or food is a case in point.

(c) Free movement of individuals and goods and penetration by large numbers of individuals in previously untouched areas (rain forests, etc.) increase the chance that unknown and dangerous viruses or bacteria will move out of these areas and will spread into the open world. Many health officials are truly worried about this possibility.[1]

Thus, the world must face the challenge of how to protect people from these viruses or diseases *without restricting the movements of individuals and things*.

(d) In all its dimensions, globalization has facilitated the flow of knowledge. Today, an individual sitting in China, with access to a computer and a telephone line, can get much of the knowledge available to someone in New York, Paris, or Tokyo.

As the New Growth Theory literature has emphasized, ideas and knowledge influence growth as much as, or more than, the increase in traditional inputs, such as capital and labour. Thus, for some countries, the efficient use of knowledge can bring about fast rates of growth especially for those countries that were behind in per capita income and are able to exploit, to their advantage, the available stock of knowledge (China, Korea, Singapore, etc.). The rates of growth experienced in recent decades by these countries would not have been possible in the absence of the information revolution and of the globalization of markets. Rates of growth that now seem almost normal in some of the countries of Eastern Asia would have been considered extraordinary 30 or 40 years ago.

(e) In the absence of environmental controls, growth can create major environmental problems. Some of these problems are purely domestic. Others spill over national frontiers and become international. The latter can become a concern for the world community. In the absence of effective environmental policies, fast growth can generate significant, negative, international externalities. Just imagine a billion Chinese experiencing 10 per cent real growth in their incomes and all buying cars and refrigerators as the citizens of most industrial countries have done! Given China's rate of growth, that moment may not be too far in the future! Think of the environmental implications of these economic actions for the ozone, especially if the Chinese chose to ignore environmental considerations in their production and use of cars and refrigerators.

The important point is that globalization contributes to the transformation of *national* problems into *international* ones. These problems may bring frictions and eventually conflict between countries unless they are addressed and contained.

* This paper was presented at CIAT's 32nd General Assembly, Bahia, Brazil, 11-15 May.

1. See Laurie Garret, *The Coming Plague* (New York: Farrar, Strauss and Grouz, 1994).

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In today's world, with interlinked markets, even the rise in the discount rate by a major central bank can have international consequences and can give rise to strong reactions by other countries.

Economics has taught us that externalities may justify public sector intervention. This intervention would be aimed at reducing negative externalities or, at least, at making those who generate them bear the cost. This is behind the "polluter pays principle". Public intervention uses instruments such as taxes, subsidies and regulations to achieve the above objective. However, these actions are generally *taken by a government within its territory*. When externalities are international rather than domestic, there is no world government that can deal with them. It is often difficult for independent countries to work out solutions because free rider problems make the resolution to these problems difficult.

It is easy to see a conflict developing over time between the increasing internationalization of externalities and the lack of a political body with the mandate and the power to deal with them. This conflict is likely to intensify in future years.

A keen observer must have noted the growing role that international institutions (such as the DJF, the OECD, the WTO, the YMO, the World Bank, the BIS, the UN, and so on) are playing in connection with issues with international ramifications. Such a role is at times controversial but most observers seem to accept the legitimacy of these institutions even though they may criticize some of their actions or policies. The keen observer must also have noted that there is now no international institution responsible for dealing with the cross-border externalities or spillovers created by tax systems.

II. GLOBALIZATION AND TAX POLICY[2]

Globalization implies that many *national* policies come to have effects beyond a country's borders. It, thus, tends to create frictions between the developments described above and traditional national policies or institutions which, to a large extent, still reflect the closed economy environment and thinking that existed when they were first developed. This conflict characterizes many policy areas and is becoming particularly strong in taxation. The debate on taxation that has raged within the European Union is evidence of this conflict. However, I will argue that this is an issue with world implications.

The tax systems of many countries came into existence or developed when trade among countries was greatly controlled and limited and large capital movements were almost non-existent.[3] At that time, trade flows were discouraged by high tariffs or by physical impediments to the movement of goods, and capital flows were forbidden or, at least, they were greatly controlled. In that environment, enterprises operated largely within the borders of their countries and most individuals earned their incomes from activities or investments in the countries in which they had their legal residence. Thus, trade flows, the profits of enterprises, personal incomes and consumption could all be taxed by the countries' authorities without conflicting claims by other countries' authorities.

In the environment described above the application of the "territoriality principle", which gives the right to a government to tax all incomes and activities within its territory, did not cause conflict or difficulty. Tax policies by any one country could be pursued without much concern about how they affected other countries. Equally, the tax policies of other countries were of only marginal, if any, interest to the country's policy makers. It should be recalled that until recent years the study of taxation was almost exclusively the study of taxation in a closed economy. See, for example, most standard textbooks of recent decades.

Globalization has changed all this. In the present environment the actions of many governments are greatly limited by the actions of other governments and spillover effects across frontiers generated by taxation have become very important. A full treatment of this aspect is beyond the scope of this paper. However, a few examples will illustrate the point.

A. Sales taxes

Some countries try to entice shoppers from other countries by keeping their excise and sales taxes low (especially) on easily transportable commodities. In this way they can "export" some of their tax burden thus reducing other countries' tax revenue. These actions may be particularly advantageous for small countries that can attract buyers from larger neighbours. For these smaller countries the elasticity of tax revenue with respect to changes in the tax rates may be particularly high. Cross-frontier shopping has been increasing as a result of better information, more international advertising, lower transportation costs, greater mobility of individuals, mail-order shopping, and technological developments, such as the use of Internet and of credit cards to pay for cross-border purchases. This process has reduced the degree of freedom of some countries in imposing the taxes they want to impose.

B. Taxes on enterprise income

Many enterprises have become "multinational" and, in some cases, have almost lost their original national identity especially in an economic sense. Some of these enterprises have established integrated production processes in different countries. For example, they may produce raw materials in countries A and B, convert them into intermediate products in countries C and D and convert them into finished products in country E, from which these products are exported to other countries. The production of a given final product, thus, often

2. For a more detailed discussion of the issues presented in this section, see Vito Tanzi, "Globalization, Tax Competition and the Future of Tax Systems", IMF Working Paper, December 1996. There is an overlap between this section and parts of that paper.

3. For example, global income taxes were much influenced by Henry Simons' classic book, *Personal Income Taxation*, University of Chicago Press, written in 1938. Value added taxes were influenced by Maurice Lauré's book written in 1952.

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uses inputs produced by the enterprise's foreign branches or subsidiaries in several countries. Available statistics indicate that a significant part of the growth in world trade is actually trade among different parts of the same multinational enterprises. For example, intra-firm trade is estimated to have increased from about 20 per cent of world trade in the early 1970s to around one third in the early 1990s, excluding intra-transnational corporation trade in services (source: The United Nations 1994 World Investment Report). This situation creates the problem of how to allocate the income of the enterprise among its various parts located in different countries.

Like all taxpayers, multinational enterprises have an incentive to lower their (worldwide) tax liabilities. They can pursue this objective in various ways. The first is by locating their operations in countries where the statutory tax rates are low or where more generous tax incentives are provided.[4] Tax competition among countries legislates lower tax rates or more generous tax incentives than other countries to attract foreign investment. When capital is mobile and the country is small, the revenue cost of providing tax incentives can be low if capital is attracted from other countries. If countries have high unemployment, the employment benefits can be high.

Secondly, multinational enterprises can manipulate the costs of the inputs that they import from subsidiaries located in other countries ("transfer prices"). These inputs, which can represent a large proportion of the value of the final product, are often made specifically for a given final product so that there is no genuine market value that can be used in determining their true market cost. Through the manipulation of transfer prices the multinational enterprises can shift profits to subsidiaries located in jurisdictions with low tax rates.[5] These actions reduce the total tax liabilities of the multinational enterprises and they reallocate the reduced tax revenue among the relevant countries. However, some countries are likely to lose more revenue than others and some countries will gain from these actions. In the views of various tax administrators, this has become a significant problem and has led to an erosion of tax revenue. The technical characteristics of many modern products (planes, cars, electronics and intangibles) make the control of transfer prices particularly difficult.[6] Tax administrations are allocating increasing administrative resources to what may be a futile attempt in the long run to deal with this problem.[7]

C. Taxes on individual incomes

In recent years there has been an explosive growth in the income that individuals derive from investments made, or from activities carried out, in other countries.[8] With the increase in personal mobility and in information technology, and with the freedom to invest savings abroad, the total incomes of many individuals now contain a large and growing component of foreign-earned income. These individuals are likely to under-report (or, often, not report at all) incomes earned abroad when they realistically assume that the tax administrations of their country of residence will be unable to ascertain or discover these foreign-earned incomes.[9] Exchange of information among tax authorities is often unable to prevent the non-reporting of these incomes and the tax evasion associated with them. In fact conflicting objectives among the tax authorities of different countries and especially of tax haven countries insures that in many cases this information will not be provided.[10] As a consequence, official statistics do not fully report these incomes and some countries benefit at the expense of other countries. This leads to total revenue losses and to changes in the incidence of the tax burden. It also leads to changes in the statutory tax systems when policy makers attempt to compensate for these losses by increasing the rates of other taxes.

D. Tax haven countries

The existence of tax haven countries facilitates tax evasion. In recent years there has been a proliferation of countries and territories which allow individuals and enterprises to use them to establish a tax address to which incomes earned in other countries can be channelled.[11] The tax haven countries benefit by the fees or the low taxes that they impose on capital that would not have been channelled to them in the absence of tax considerations. The other countries experience losses in revenue and decreased control over their tax systems.

E. Developments in capital markets

Finally, new capital market instruments (derivatives and other exotic instruments) are creating complex problems for tax administrations. Tax administrators are having increasing difficulties in identifying incomes, in allocating them to particular countries, and in taxing them especially when the firms that handle these operations operate from tax haven territories. This is a problem that can only grow in time. In this area, policies are lagging behind the recent technological

4. For example, Ireland has been a location favoured by many enterprises because of its low tax rate.
5. These shifts do not require specific movements of real capital. Only taxable profits move.
6. A modern plane can use millions of parts, some of which are made specifically for that plane.
7. The above paragraph has emphasized the manipulation of the prices of real inputs. However, the assignment of costs to trademarks, headquarters expenses, expenses for research and development, and loans among different parts of the same multinational enterprise also create opportunities for manipulations aimed at reducing the total tax burden on the enterprise.
8. One indicator of this is the sharp increase in portfolio investment income derived from overseas investments. IMF statistics indicate that for the world as a whole this investment increased from USD 447 billion in 1988 to USD 768 billion in 1994. Another indicator of the surge in transnational financial transactions is that cross-border security transactions expanded from less than 10 per cent of major industrial countries' GDP in 1980 to well in excess of 100 per cent of GDP in 1992 (source: *World Economic Outlook*, May 1995).
9. For example, tens of billions of US dollars of Latin American capital escaped taxation in the country of origin by being deposited abroad, especially in the United States, in non-residents' accounts, which were tax-free.
10. See Vito Tanzi, *Taxation in an Integrating World* (Washington: The Brookings Institution, 1995), at 78-89. See also OECD, *Tax Information Exchange between OECD Member Countries: A Survey of Current Practices* (Paris: 1994).
11. See Caroline Doggard, *Tax Havens and Their Uses* (London: The Economist Intelligence Unit, 1993).

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developments in the financial market. As capital markets become more integrated and more complex and as capital movements intensify,[12] the ability of the national tax administrations to deal with these issues is unlikely to be at the necessary level.

F. Implications

The developments mentioned above and others not discussed are having an impact on the tax systems and on the tax revenues of individual countries. However, this impact is not yet fully understood, and it is difficult to assess quantitatively. Recent news reports have indicated that the tax revenues of particular countries have been lower than anticipated by forecasts, even when other developments (such as cyclical developments) were taken into account. Some finance ministers have expressed concerns about these losses which are not welcome at a time when a reduction in fiscal deficits remains an important objective for the economic policy of many countries. Additionally, some countries have experienced sudden capital outflows when they have attempted to introduce particular changes in tax policy, such as tax withholding for particular kinds of capital income.

Fear of tax base migration has made some countries hesitant to adjust the rates of their taxes or even to tax dividends and interest incomes thus reducing the margin for manoeuvre of policy makers.[13] Concerns have also been expressed about the impact of globalization on the incidence of the tax system and, therefore, on its equity, and on fiscal deficits if it forces countries to reduce tax rates and, especially, tax rates on capital incomes, in order to remain internationally competitive.[14] Tax competition has become a fact of life for many countries and the net effect of such a competition is or will be a reduction in tax revenue for many countries and a forced change in the structure of their tax systems.

Those economists, and there are many of them, who feel that tax reduction is always a good thing, because governments are inherently wasteful, will welcome the downward pressure that the competitive forces mentioned above are having or will have on both tax rates and tax revenue. Those who worry about fiscal deficits or who feel that the downward pressure on tax revenue will reduce the governments' ability to finance necessary or inflexible spending will not see this as a welcome development. In either case, the important result is that spillovers across national frontiers are being created. There is now no official worldwide body, be this a world government or an international institution, with a clear mandate to deal with tax developments which have international implications.

III. AN INTERNATIONAL TAX ORGANIZATION?

The previous two sections have argued that: (a) recent trends in the world's economies (integration of real economies and globalization of capital markets) are contributing to the creation, or the growth in importance, of externalities or spillovers that transcend national borders; and (b) there is no world government to deal with these externalities. In the absence of such a world government, there are three possible ways of dealing with these issues: (i) relying on spontaneous market solutions; (ii) solutions through international agreements; and (iii) the creation of international institutions charged with the responsibility of dealing with the problems created by the above-described developments.

Spontaneous market solutions work in some areas but not in others. In the presence of "commons problems", for example, when access to a given resource (such as air, or fish in the ocean, or the world tax base) is (relatively) free, the market solution is unlikely to be successful. There are simply too strong incentives for some countries to take advantage of the situation or to impose their views on others. This would occur with tax competition.

Solutions through international agreements have worked well in some areas (especially when the costs associated with a problem and the benefits associated with a solution are broadly distributed) but not in others. These solutions are particularly difficult to achieve when free riding on the part of some countries can give them significant advantages and when there are no simple and effective ways of forcing these countries to join the agreement.[15]

The approach of creating an international institution with the mandate to propose, or, in some cases, to force, solutions to given problems has been a popular one over the post-World War II years. As a consequence, the number of international organizations has grown over time. Some of these institutions are, of course, more efficient than others at carrying out their mandate and at contributing to the solutions to particular problems.[16] The inefficiency of some has at times led to criticisms of all of them. In some cases the problem with these institutions is that their mandates are not clear or their resources are too limited.

Section II of this paper has focused on the impact of globalization and economic integration on the tax systems of countries. It has argued that under current and likely future circumstances some countries will try to exploit to their advantage the "commons" which is the world tax base. It has also argued that as countries' economies become more integrated and as capital markets become more globalized, these

12. It is estimated that daily capital movements exceed USD 1 trillion. It must be extremely difficult to determine the (taxable) incomes, if any, associated with these movements and to allocate them to specific countries.
13. For example, there are now several Latin American countries that no longer tax dividends and interest incomes on the assumption that the taxation of these incomes would encourage capital flight.
14. The author has argued elsewhere that progressive global income taxes cannot survive in this environment. See especially: Book Review of Ken Messere's *Tax Policy in OECD Countries: Choices and Conflict*, in *National Tax Journal*, Vol. XLVII, No. 2, June 1994, at 447-450.
15. For a proposal that would rely on international agreements cum sanctions to solve the problem of international money laundering, see Vito Tanzi, "Money Laundering and the International Financial System", IMF Working Paper, WP/96/55 (May 1996).
16. Different observers have different views of the effectiveness of these institutions. For example, while the author was writing this section, Steve Forbes, former US presidential candidate, was reported by Reuters to have called for the "junking" of the IMF.

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problems are bound to become more pronounced. Given the current tax structures and methods of imposing taxes, it is almost inevitable that tax competition will play a substantial and increasing role as some countries will have a strong incentive to export some of their tax burden by attracting consumers, real capital, or taxable income from other countries. They will do so through the imposition of lower statutory tax rates or through the use of incentives that reduce the tax base.

Tax competition may be seen as an attractive development by some but it is likely to lead to friction and conflict among countries. It may also lead to macroeconomic problems by reducing tax revenue. The spontaneous market solution, whereby countries compete rather than cooperate, will lead to downward adjustments to the tax rates especially those applied to mobile tax bases, such as capital and highly qualified labour, and to lower rates for consumption taxes, especially those applied to easily transportable and relatively valuable goods. In the reduction of the tax rates on sales and on capital incomes, small countries may become the pacesetters because they are the ones that can gain the most from attracting buyers and investors from abroad.[17] Other likely developments would be the increase of source-based taxation for taxes on capital and, therefore, the progressive abandonment of the concept of global income taxation. For corporate income, formula-based taxation may eventually replace account-based taxation to deal with the problem of transfer prices mentioned earlier.

The route of pursuing international agreements in tax matters is unlikely to be a productive one as the experience, over the past two decades, of the European Community shows. Countries are not likely to abandon their national objectives and to agree to arrangements that they may see as less beneficial to them than the alternative of going it alone. Also, countries with different political agendas will find it difficult to agree on a given tax structure. Even in the restricted area of the European Community the progress towards tax harmonization has been limited. The experience with negotiating tax treaties indicates that tax agreements, even between two countries, are, at times, difficult to reach and are very demanding in time and effort. In any case there is no institutional set-up that facilitates the discussion of issues and the negotiation of agreements on a world basis.

This leaves the alternative of creating an international organization which would systematically deal with tax matters or alternatively, of giving a specific mandate to an existing institution. There is now a world organization that deals with trade matters (WTO); one that deals with macroeconomic stability and balance of payment equilibrium (IMF); one that deals with economic development (IBRD); and many others that deal with other objectives. The IMF, in particular, focuses on transnational implications of domestic macroeconomic policies. Yet, there is no organization at the world level that supervises, or attempts to influence, tax developments with transnational implications. This situation can be considered unusual because countries are competing less and less through the use of tariffs and quantitative restrictions on trade and through changes in exchange rates and more and more through the use of tax incentives, adjustments in tax rates, changes in administrative treatment of some incomes and so forth. This is the process that in the view of many tax experts is leading to "tax degradation". As trade is liberalized further and as capital becomes freer to move, the advantages to some countries of engaging in tax competition, and the temptation to do so, will increase. The world tax base will become one of the "commons" to be exploited.

A case could then be made for the establishment of a World Tax Organization. What would be the mandate for such an organization? There are many possibilities and this paper can only mention some of them. Of course, its mandate would depend on how much power the member countries would want to give to it. It would also depend on how representative it would be of the whole world community. Because the levying of taxes is one of the most political of all governmental actions, it is unlikely that, at this juncture in time, the countries' governments would want to assign to the World Tax Organization the power to tax. There is still no example of a supranational organization that has been given this power. Even the European Commission does not have such power. However, as the author wrote eight years ago:

> It is conceivable that the day may come when the countries [of the world] create an 'International Revenue Services' to collect taxes that could not be collected by separate governments and to allocate them either to the provision of international public goods or back to the countries.[18]

Recently, James Tobin's idea of an international tax on cross-countries' financial transactions has been adopted by other writers who have proposed international taxes on bases such as airline tickets, financial transactions, or other bases, to finance the United Nations.[19] The collection of such a tax or some version of it, could be assigned to the World Tax Organization. However, it is unlikely that the countries of the world are ready for such a step or for similar steps even though such taxes could provide financing for the activities of some of the international organizations and would remove the decision to finance established institutions such as the United Nations from the frequent political debate within countries. Such a debate creates uncertainty and possibly major problems for the international organizations.

Rather, the World Tax Organization could be given responsibilities other than tax collection.

In brief, some of the main activities of such an organization could be the following:

(1) Identification of main tax trends and problems at the international level. For the OECD countries, the Committee

17. Some of these changes will be in the direction favoured by theoretical economists.

18. See Vito Tanzi, "Forces that Shape Tax Policy", in Herbert Stein, ed., *Tax Policy in the Twenty-First Century* (New York: John Wiley and Sons, 1988), at 277.

19. The Tobin tax was first proposed by James Tobin in "A Proposal for International Monetary Reform", in *Eastern Economic Journal*, Vol. 4 (1978), at 153-59. It has been much studied recently. See, *inter alia*, B. Spahn, "International Financial Flows and Transactions Taxes: Survey and Options", IMF Working Paper, WP/95/60 (June 1995); and P. Shome and Janet Stotsky, "Financial Transactions Taxes", IMF Working Paper, WP/95n7 (August 1995).

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on Fiscal Affairs of the OECD has been doing valuable work aimed at identifying these trends. However, a majority of the countries of the world are not members of the OECD.

(2) The compilation and/or generation of relevant tax statistics and tax information for as many countries as possible. Much of this information may already be available but there is no institution that is compiling it for the whole world. Here the work of the OECD and the IMF would be a particularly helpful input.

(3) On the basis of the above information, a (yearly?) *World Tax Development Report* could be prepared presenting statistics, describing main trends (both statistical and in terms of policy developments), identifying problems, and, perhaps, pointing toward feasible solutions to these problems. Countries' best practices could be identified and made known to other countries. Emerging problems could be highlighted and solutions to them could be studied.

(4) Providing some technical assistance to countries in tax policy and tax administration always keeping in mind that changes recommended should make the tax system of the country receiving the assistance better coordinated or harmonized with the systems of other countries. Technical assistance is already provided by several institutions, including the IMF. However, many needs are not being met because of limited resources. Furthermore, the goal of the technical assistance provided by the new organization would be to make the tax systems more compatible.

(5) Developing basic norms for tax policy and tax administration. This is an area where little progress has been made.[20]

(6) Providing a world forum in which countries' policy makers and experts can exchange ideas on tax matters.

(7) Providing a world forum for tax arbitration when frictions or conflict between countries or among groups of countries arise. Once again, no such forum exists now.

(8) Providing surveillance over tax developments in the same way as the International Monetary Fund provides surveillance on macroeconomic developments. Such a process of surveillance could be conducted: (a) at the country level; (b) at the regional level; and (c) at a world level. The modus operandi of the IMF could provide a useful guide for the new organization.

The World Tax Organization would identify tax developments that create cross-national spillover effects and would bring these to the attention of a board of directors representing all the countries. The board would recommend changes in those areas where the tax behaviour of a country has clearly negative implications for other countries. For example, it would recommend changes in countries that are obviously raiding the world tax base. The Organization would not get involved in tax issues that do not have significant cross-border spillovers. And, of course, it would only recommend changes and not force them.

In broad lines these would be the major activities of such an organization. Of course, more detailed and specific terms of reference might include other activities.[21]

IV. CONCLUDING REMARKS

In this brief paper I have tried to give a feel for world developments that are having a significant impact on tax systems. These developments are cumulative so that their impact on tax systems can only grow. The paper has provided a few examples of areas in which globalization and the growing integration of the world economies are affecting existing tax systems. Many more examples could have been provided.

The paper has concluded that the time may have come to create a world institution that would supervise these developments, encourage countries to coordinate their tax actions, and suggest solutions. The role of this institution would be one of surveillance, distribution of information and provision of a forum for discussion. It is unlikely that for the foreseeable future such an institution would be given the responsibility to collect taxes.

20. For a recent attempt along these lines, see Ward M. Hussey and Donald C. Lubick, *Basic World Tax Code* (Arlington, Virginia: Tax Analysts, 1996).

21. A companion paper on "Globalization Tax Competition, and the Future of Tax Systems", IMF Working Paper 96/141, December 1996, provides additional and complementary information and analysis.

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INTERNATIONAL

TACKLING TAX TREATY TENSIONS: TIME TO THINK ABOUT AN INTERNATIONAL TAX COURT*

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I. INTRODUCTION

There have been calls[1] for the establishment of a world tax organization whose aims would be to minimize opportunities for harmful tax competition which distorts investment and financing decisions and in the process undermines national tax bases through fiscal degradation as countries (both developed and developing) "race-to-the-bottom" in pursuit of foreign investments.

> In the present environment the actions of many governments have come to be greatly constrained or influenced by the actions of other governments, and spill-over effects across frontiers generated by taxation have become common and important. This has opened the possibility for some countries to take advantage of this new situation by attracting to them a larger share of the world tax base, thus exporting some of their tax burden.[2]

This article supports the call for a world tax organization, but more specifically, the paper calls for the establishment of an international tax court (ITC) to resolve tax treaty-related disputes in accordance with international obligations.[3] Preferably, the settlement disputes regime of the proposed ITC should be based around the adversarial, "consensus-based decision making process" of the World Trade Organisation (WTO) rather than the system of compulsory international arbitration (which is favoured mostly by multinational enterprises and some academics[4]). A consensus-based approach is a confidence-building measure which diminishes the fear of Members to be bound by an undesired decision. Hence, the reason why unlike the IMF and the World Bank, there is no weighted vote in the WTO.[5]

The argument relied upon in this paper to justify the existence of an ITC encompasses that which underlies the existence of a world tax organization with explicit responsibility for providing a "sort of surveillance on the behaviour of countries in tax matters", thus making harmful tax competition between countries less likely.[6] However, it is contended

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1. Dr Tanzi first touted the possibility of establishing a world tax organization in "Forces that Shape Tax Policy", in H. Stein (editor), *Tax Policy in the Twenty-First Century* (New York, John Wiley & Sons, 1988). He has continued to pursue the theme in recent articles highlighting the strains placed on countries' fiscal systems created by the globalization process and harmful tax competition practices: "Globalisation, Tax Competition and the Future of Tax Systems", IMF Working Paper 96/141 (December 1996); "Does the World Need a World Tax Organisation?", paper presented at the 52nd Congress of the International Institute of Public Finance, Tel Aviv, 26-29 August 1996; and " The Impact of Economic Globalization on Taxation", at 338.

2. See Tanzi, *supra* note 1, "Globalisation, Tax Competition and the Future of Tax Systems", at 5.

3. The rules for interpreting international treaties (including double taxation treaties (DTTs)) are codified in the *Vienna Convention on the Law of Treaties*. For a general discussion of how these rules operate in relation to DTTs, see *General Report of the 1993 IFA Congress in Florence* by Professor Vogel and Dr Prokisch, which summarizes the various country reports on treaty interpretations. See also *Thiel v. FCT* (1990) 21 ATR 531 esp., at 536 and 541-542, respectively, where Dawson and McHugh JJ (Mason CJ, Brennan and Gaudron JJ concurring) resorted to the Vienna Convention in interpreting Art. 7 of the Australia–Switzerland DTT, despite the fact that Switzerland was not a party to the Vienna Convention. McHugh J went on to note (at 542) that so far as is reasonably possible, DTTs should be construed in good faith in accordance with the ordinary meaning given to the terms of the DTT, so as to avoid double taxation; see also Art. 31(3) of the Vienna Convention.

4. See *Vol. II, Model Tax Convention on Capital and Income* (OECD, Paris, Nov. 1997, loose-leaf), which describes (at R(1)-19 to R(1)-26) the arbitration procedures (and reaction to those procedures) established under the Draft Directive of the European Communities and by the Economic and Social Committee set up under the Treaty of Rome. The EU Arbitration Convention, which was concluded in 1990 and entered into force on 1 January 1995, provides a mechanism for resolving disagreements between EU Member States with regard to transfer pricing and double tax relief issues that arise between related parties operating in different jurisdictions of the European Union.
Similarly, Mr Gary Hufbauer argues for a system of internationally binding arbitration to resolve the growing case load of transfer pricing disputes in order to establish useful precedents by setting "... the guidelines in cases where the parties cannot agree; at a later stage, international arbitration would resolve disputes that arise over application of the guidelines"; G.C. Hufbauer assisted by J.M. van Rooij, *U.S. Taxation of International Income: Blueprint for Reform* (Institute for International Economics, Washington, DC, 1992), at 150. See also L. Hinnekens, "The Tax Arbitration Convention. Its Significance for the EC Based Enterprise, the EC Itself, and for the Belgian and International Tax Law", (1992) 2 *EC Tax Review* 70, esp. at 79-81.

5. See the Farewell Speech of the Chairman of the WTO's General Council, Amb. Celso Lafer, reproduced in (WTO) *Focus* No. 27, February 1998, at 3.

6. See Tanzi, *supra* note 1, "Globalisation, Tax Competition and the Future of Tax Systems", at 20. It should be noted that a special committee was established on 9 March 1998 to oversee the operation of a code of conduct (a draft of which was released on 1 October 1997: *Towards Tax Coordination in the European Union, A Package to Tackle Harmful Tax Competition* (EU, Com (97) 495 final)), aimed at curbing harmful tax competition between members of the European Union. However, the success of such an effort may prove pyrrhic in the end, as the criteria for identifying harmful tax competition are non-legally binding, unclear and give rise to non-transparent application at the administrative level: M. de Bruin and A. van Rooijen, "'Stand Still' and 'Roll Back': EU Ministers Formalize Code of Conduct on Company Taxation", (1998) 3 *Journal of International Taxation*, 43, at 44. At around the same time the OECD was preparing its report defining the factors to be used in identifying harmful tax practices and recommending unilateral and bilateral measures to counteract such practices. The report also emphasized greater international cooperation in dealing with the distortionary influence of taxation on the location of mobile financial and service activities, thus promoting fair competition for real economic activities: *Harmful Tax Competition: An Emerging Global Issue* (OECD, Paris, 1998).

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in this paper that harmful tax practices also manifest in bad treaty practices which may have a significant negative impact on countries' domestic tax bases. To promote good treaty practice and at the same time reduce the risk of fiscal degradation of national tax bases that results from the ad hoc and inconsistent interpretation (and application) of tax treaty obligations based on the OECD Model Tax Convention on Income and on Capital[7] (MTC), it is proposed that an ITC be established. The ITC should be specifically empowered to resolve international tax disputes between governments and private concerns in accordance with the rule of public international law.[8]

The increase in opportunity costs created by bad treaty practice is reflected in the economic waste generated by the large costs and time delays involved with resolving, at the national level, international double taxation issues based on undefined (but not unfamiliar) concepts appearing in the text of Articles comprising the Model Tax Convention. Although there are commentaries expounding on the policy rationale underlying each Article, the scope of operation of these Articles in practice is a matter of great uncertainty causing revenue officials and taxpayers many problems.[9] The uncertainty is exacerbated in the case of countries that have a tendency to introduce domestic legislation which, prima facie, overrides provisions of tax treaties. Such practice is to be distinguished from other unilateral actions which can also have a significant impact on the interpretation of tax treaty obligations, including (i) the introduction of domestic legislation which deviates from explicitly accepted or tacitly implied interpretation of a provision based on the text of a DTT to reverse the effect of a court decision;[10] or (ii) changing the definition of a term used in domestic legislation and in treaty provisions but which is not specifically defined for the purposes of the treaty.[11] To that end, it is noted that non-compliance with WTO rulings rarely occurs.[12] This is because it is easier for the national executive to implement WTO rulings than to ask Congress or parliament to legislatively redress the situation.[13]

In other instances, assertions of extraterritoriality by the larger countries can have a measurable impact on the ability of smaller countries to effectively conform with international treaty obligations.[14] In addition, countries' fiscal authorities are constantly faced with the threat of "treaty shopping" practices undermining the integrity of international obligations by completely circumventing the operation of a particular provision in a DTT in respect of the beneficial owners of the income or capital stream who are able to escape liability by simply diverting the income flow through a separate entity established in a favourable tax treaty country.[15] The enforcement problems in this case are accentuated by the larger number of jurisdictions involved in the tax dispute and also where the tax base of smaller open countries is undermined by treaty shopping. Smaller countries are at a competitive disadvantage in international tax disputes vis-à-vis the more tax aggressive larger countries. For one thing, tax administrators in those countries are more likely to be overstretched coping with enforcing domestic tax measures let alone treaty-related provisions.[16]

As will appear, despite the policy objective of the official commentaries (which were last revised in 1997) of facilitating the smooth operation of DTTs based on the MTC, these commentaries do not resolve many of the tensions and uncertainties that arise when determining how and which Article of a particular DTT applies in allocating fiscal jurisdiction over international transactions conducted between residents of

7. OECD, Paris, November 1997 (loose-leaf). Although the UN has specifically designed its own model treaty (which forms the basis of some 811 treaties currently in operation around the world) emphasizing the taxing rights of developing nations by promoting source-based taxing rights, the model nevertheless broadly mirrors the OECD Model Convention. See also W.F.G. Wijnen and M. Magenta, " The UN Model in Practice", 51 *Bulletin for International Fiscal Documentation* 12 (1997), at 574.

8. It is envisaged that the proposed ITC could also play a pivotal role in resolving disputes arising under bilateral investment protection treaties (BITs) as well as the OECD's Multilateral Agreement on Investment (MAI), if and when it comes into operation. Currently, the future of the MAI is the subject of much debate, in particular whether it should be developed outside the OECD (with its membership limited to the more important developed nations) and instead, in the WTO with its broad-based cross-representational membership. The next meeting of the Negotiating Group for considering the progress made on the MAI is scheduled for October 1998; *Ministerial Statement on the Multilateral Agreement on Investment* (MAI) (OECD Press Release, SG/COM/NEWS(98)50).

9. In France, for example, the very usefulness of tax treaties has recently been debated because of the potential for taxpayers to place reliance on domestic tax rules in view of the difficulty inherent in implementing tax treaties; P. Forget (*Directeur, Chef du Service de la Législation Fiscale*), "A Comment on French Treaty Policy in the Context of International Economic Integration", 49 *Bulletin for International Fiscal Documentation* 9 (1995), at 385.

10. For instance, the decision of the Australian Government to unilaterally amend its internal tax laws to account for the recent decision in the *Lamesa Holdings* case, where it was held by the Federal Court that Art. 13 of the Australia–Netherlands DTT ("alienation of property") did not apply to indirect disposals of assets, has drawn much criticism. Some commentators argue that such action will "fundamentally alter" Australia's existing treaties and generate much opposition from treaty partners, while others predict a more benign outcome in the form of avoidance of the new rules; see R. Krever, "Australian Proposals on Double Tax Agreements Clarified", *Tax Notes International*, 11 May 1998.

11. See the chapter on " Tax Treaty Override" in Vol. II of OECD MTC.

12. The dispute settlement system of the predecessor to the WTO, GATT, has been a quite successful international legal institution with an overall success rate, in terms of compliance with its rulings, of 88 per cent of all disputes resolved under the system between 1948-1989; see R.E. Hudec, *Enforcing International Trade Law: The Evolution of the Modern GATT Legal System* (Salem, NH: Butterworths Legal Publishers, 1993), which is discussed in J.H. Jackson, *The World Trading System* (2nd edition) (The MIT Press, Cambridge Mass., 1997), at 115-118.

13. See Jackson, *supra* note 12, at 342.

14. For instance, it is observed that because of US policy and assertions of extraterritorial jurisdiction with regard to world trade, US economic, commercial and political domestic policy are sometimes "transplanted" to other nations: E.Y. Wu, "Evolutionary Trends in the United States Application of Extraterritorial Jurisdiction", (1997) 10 *The Transnational Lawyer*, at 1-36; C.T. Graves, "Extraterritoriality and its Limits: The Iran and Libya Sanctions Act of 1996", (1998) *Hastings International and Comparative Law Review*, at 715-741, esp. at 736-737 on the interplay between extraterritorial legislation and the obligation to promote free trade under GATT; and Jackson, *supra* note 12, at Chap. 3, especially at 80-99, which provides a useful discussion of the interplay between US domestic policy and recognition of international treaty obligations.

15. See Q.C. Gzell, "Treaty-Shopping", (1998) 2 *Australian Tax Review* 65, and N. Tadmore, "Treaty Shopping and International Tax Avoidance – An Australian Perspective", 2 *Asia-Pacific Tax Bulletin* 4 (1996), at 103, for a description of treaty shopping practices and the possibility of international tax avoidance undermining countries' fiscal jurisdictions.

16. See also J. Owens, " Taxation within a Context of Economic Globalization", 52 *Bulletin for International Fiscal Documentation* 7 (1998), at 290, where it is noted that the risks for small and not-so-small countries from the process of globalization is having their economic choices "severely constrained by decisions which are taken outside of their borders". Hence, the need for greater coordination between the tax policies followed by countries.

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two (and sometimes more) sovereign states.[17] Nor are these tensions comprehensively tackled in *Klaus Vogel on Double Taxation Conventions*,[18] which is perhaps the "most important"[19] book on tax treaties. Understandably, Vogel's book is regularly referred to (despite its complexity[20]) by national courts[21] in resolving treaty interpretation problems in the absence of a universally binding and specifically developed code of treaty practice.

In addition, the constant revision of the OECD MTC and accompanying commentaries, combined with an ever-expanding network of DTTs and treaty-related rulings (also evidenced by the actual increase in the number of pages (approx. 250) from the first English edition of *Vogel* in 1991 to the third in 1997), attest to the increased likelihood that divergent national treaty-related rulings will cause even more uncertainty with regard to treaty obligations thus further undermining their ability to uniformly regulate international income and capital flows. The situation is not improved by the mutual agreement procedure provided under the MTC where "taxation not in accordance with the provision of the Convention" occurs.

Practical experience with the operation of the mutual agreement procedures available under Article 25 of the OECD MTC which, *inter alia*, enables taxpayers to initiate proceedings to seek double tax relief from a relevant competent authority with a view to arriving at some mutually agreeable result, is less than encouraging. It is noted that the operation of the mutual agreement procedure does not compel revenue authorities to reach a settlement, nor to implement an agreement if one is reached. As a consequence, such procedures are normally time-consuming and uncertain in their results. One of the reasons for the uncertainty and the time delays is due to the fact that "legislatures of many countries are generally unwilling to give tax authorities the discretion to decide the tax liabilities of individuals or companies by way of agreement with the tax authorities of another country."[22]

The above problems are symptomatic of a broader problem which is the complexity of international transactions conducted in an increasingly integrated business environment. This environment creates difficulties for tax administrators and national and sub-national courts in effectively enforcing international obligations under DTTs.[23] The enforcement difficulties are accentuated in treaty-related matters which may require the cooperation of recalcitrant tax administrators in other jurisdictions. In other treaty-related instances, the lack of clarity and breadth of the discretion afforded (inadequately trained) tax officials could give rise to national welfare losses from anti-competitive and indiscriminate behaviour which, in turn, leads to lower economic growth.[24] Moreover, because of the complex and technical nature of international tax matters, judges (wisely) are encouraged to pay "respectful consideration" to the practices adopted by tax officials in this area.[25] This, in turn, could feasibly create more welfare losses where the full force of the law is bestowed on bad treaty practice adopted by the Revenue.

Therefore, it can be gleaned from the above that the frequency and prevalence of conflicting rulings (judicial and quasi-judicial) as well as the uncertainty and time delays

17. For an example of the uncertainty of scope and application of DTT provisions, see a recent article by V. Crosland and D. Yeung, "Double Tax Agreements and the Treatment of Capital Gains Derived by Non-residents", (1998) Vol. 27, No. 1, *Australian Tax Review*, at 55-60, which outlines the opportunities to obtain treaty protection under either Art. 7 (business profits) and/or Art. 13 (alienation of property), from Australian taxation of capital gains derived by a non-resident. Both Articles are based on Arts. 7 and 13 of the MTC and are found throughout Australia's as well as other nations' DTT networks. Equally, most OECD, European, Latin American and some of the newly industrialized Asian countries (viz., Taiwan, Singapore, Thailand and Indonesia), to some extent, tax capital gains with the most notable exceptions being the Netherlands (which concessionally taxes share disposals by substantial shareholders) and New Zealand.

18. *Klaus Vogel on Double Taxation Conventions* (3rd edition) (Kluwer Law International, 1997).

19. Per Jonathan Schwartz's review of Professor Vogel's book in the *Financial Times World Tax Report*, April 1998, at 79.

20. See, for example, *Memec plc v. Inland Revenue Commissioners* [1996] STC 1336, at 1343, 1356-1357, where Mr Justice Robert Walker noted that despite the pre-eminence of Professor Vogel as a tax expert and the recognition that his analysis and views reflect a "decisive, that is purposive argument for construing the convention in as symmetrical a way as possible ... [where] Perfect symmetry ... may be an unattainable ideal, so long as domestic tax systems vary so much", his commentary is nevertheless "verging on the incomprehensible".

21. See Schwartz, *supra* note 19, where it is noted that tax and appeal courts in Canada, South Africa, the Netherlands, Germany and the United Kingdom have referred to Vogel's book.

22. See Vol. II of OECD MTC, at R(1)-16 and R(1)-17, where other problems with profit allocation under the associated parties provision based on Art. 9 of the OECD MTC are documented in the chapter on "corresponding adjustments" and the mutual agreement procedure. See also J. Azzi, "Correlative Adjustments to Relieve Double Taxation Arising from an Adjustment by a Foreign Tax Administration", 2 *Asia-Pacific Tax Bulletin* 4 (1996), at 127, which examines the Australian and US rulings on transfer pricing adjustments designed to alleviate double international taxation.
What is not however, documented in the OECD commentary, is the time delays encountered where competent authority officials are constantly changing. This factor made a significant contribution towards lengthening the time taken (13 years) for an American subsidiary of Hitachi of Japan to reach a satisfactory conclusion to its transfer pricing dispute with the revenue authorities of Japan and the US; "Hitachi Explains How Bilateral APA Resolved Decade of Audit, Years of Outstanding Issues", 7 *Tax Management Transfer Pricing Report* (3 June 1998), at 59.

23. It has been observed on numerous occasions that due to the increasing mobility of capital, and the lack of international enforcement of domestic international tax rules, residence-based rules which tax capital income where it is received have been rendered virtually ineffectual; see, for example, J. Azzi, "Historical Development of Australia's International Taxation Rules", (1994) *Melbourne University Law Review*, at 793, and H. Huizinga and B.S. Nielsen, *A Welfare Comparison of International Tax Regimes with Cross-Ownership of Firms* (Economic Policy Research Unit, Copenhagen Business School, 1997-14).

24. In countries with non-transparent tax systems, the scope for corruption and the incentive for individuals and enterprises to pay bribes to public officials increases, especially where those officials have a broad discretionary power over important decisions (such as tax incentives and determination of tax liabilities). Consequently, it has been observed that among the specific situations inviting corruption are complex and vague tax laws which require frequent contact between taxpayers and administrators. In turn, it is widely acknowledged that corruption has a negative effect on growth by making it more difficult for a government to run a sound fiscal policy; V. Tanzi, "Corruption Around the World: Causes, Consequences, Scope, and Cures", IMF Working Paper WP/98/63.

25. In *First Chicago NBD v Comm'r* (delivered on 28 January 1998, No. 11174-87: www.kentlaw.edu/7circuit/1998/jan/96-4006.html), a case concerning the operation of the consolidation rule for indirect foreign tax credit purposes under §902 of the Internal Revenue Code 1954, the US Seventh Circuit Court (Posner, Chief Judge, and Bauer and Coffey, Circuit Judges) advised that Internal Revenue Service rulings should receive "respectful consideration", because the IRS "knows more about tax laws than the judges of the federal appellate courts do." Despite the logic underlying the Circuit Judges advisement, it nevertheless demonstrates the depth and extent of the treaty interpretation problem which can be exacerbated where rulings by revenue officials, on a particular DTT matter, are reflected in national court rulings. To that end, it is noted that the US Internal Revenue Service takes a very conservative stance on the foreign tax creditability issue; C.E. McLure and G.R. Zodrow, "The Economic Case for Foreign Tax Credits for Cash Flow Taxes", (1998) 1 *National Tax Journal*, at 11.

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associated with settling international double taxation disputes under DTTs is likely to increase in the next millennium as the process of internationalization currently shaping the world's economy continues unabated with more and more DTTs being concluded in the hope of enhancing economic relations between countries. As a corollary, the ad hoc and inconsistent application of international treaty obligations, impose significant costs on taxpayers and tax administrators and place undue strain on the judiciary which, in turn, can result in "policy externalities" and "regional arbitrariness" undermining countries' domestic tax bases by distorting foreign investment decisions.[26] Further, as factors become more mobile due largely to falling transaction costs facilitated by the rapid advancement of global information and communications technology (e.g., commerce conducted over the Internet), the prevalence of non-tariff barriers (in the form of discriminatory taxation) to international trade and investment is also likely to increase.[27]

Consequently, it is submitted that an ITC is needed in order to conclusively and objectively determine whether and how international tax rules prescribed in DTTs govern the fiscal relationship between sovereign states and parties without the fear of national bias or discriminatory practice undermining both the operation of DTTs and the domestic tax base of nations, and in the process distorting the globalization process. To that end, the main objective of the ITC would be to fairly allocate national taxing rights over international income and capital flows with the ultimate aim of promoting confidence in and augmenting the benefits of international trade and investment.

II. FISCAL SOVEREIGNTY AND THE JURISDICTION OF THE ITC

The fear of loss of autonomous taxing powers over something viewed "as a strictly domestic affair" has ensured that the idea of an ITC (the call for which was first made in 1925), remains ignored, at least as far as EU Members are concerned.[28] Dr Tanzi expresses similar doubts where he notes that "[b]ecause the levying of taxes is one of the most political of all governmental actions, it is unlikely that, at this juncture in time, the countries' governments would want to assign to the World Tax Organization the power to tax."[29]

In an attempt to introduce uniformity into treaty-related jurisprudence without the threat of encroachment on fiscal autonomy, Professor Cees van Raad proposes the creation of a CD-ROM containing for each country the complete original text (with English translations) of the most important "treaty-related rulings and decisions, indexed according to the OECD Model article." The CD-ROM, it was said, will supplant Michael Edwardes-Ker's *International Tax Treaty Service*, which contains summaries of thousands of judicial and administrative decisions in the area of tax treaties based on the OECD MTC.[30] Although the option of creating a CD-ROM in order to provide a centralized database for treaty-related rulings is highly commended as it would provide a solid basis for monitoring and accessing treaty-related rulings, it would not necessarily lead to the better and faster resolution of treaty-related problems. A CD-ROM would merely consolidate the divergent national rulings into electronic form. Besides, a comprehensive survey of relevant decisions and literature on international taxation generally, backed up by rigorous analysis of individual Articles comprising the OECD, UN and US MTCs, with particular reference to German treaty practice, already exists in the form of *Vogel on Double Tax Conventions*.

With a more limited supranational forum in mind, Dr Avery Jones has suggested that the OECD with its great experience of international direct tax problems should be invited to give an expert opinion to the European Court of Justice in all cases concerning direct taxation. This, it was observed, would provide the Court with an opportunity to view "the big picture when the Court's attention is focused on one small, and perhaps deceptively simple, area."[31] Notwithstanding the merit and validity of this latter option, it is unlikely to draw universal support considering that a majority of the countries of the world are not members of the OECD.

As helpful as the above suggestions are for enhancing and standardizing treaty practice, they, nevertheless, only address part of the treaty practice problem. By the same token, the need for certainty and uniformity in international tax disputes goes above and beyond the limited and very general function served by the official commentary on individual Articles comprising the OECD MTC which is relied upon (to varying degrees[32]) as a supplementary tool for interpreting DTTs

26. Policy externalities are restrictions imposed on national tax policy choices by neighbouring states. A second kind of policy externality is "regional arbitrariness", which is a restriction on national tax sovereignty due to the lack of a simple and universally acceptable way to apply rules for allocating income from the carrying on of business in a number of jurisdictions; see H. Vording, "European Tax Policy: A National Perspective", in Y. Zhang and T. Fuke (editors), *Changing Tax Law in East and Southeast Asia Towards the 21st Century* (Kluwer Law International, The Hague, 1997), 237-275, at 239.

27. It was readily acknowledged at an Arthur Andersen forum, held in Miami in March 1997, of 30 US-oriented tax practitioners in the telecommunications, high-tech, and media and entertainment industries, that the conduct of commerce via the Internet (viz., electronic commerce) creates significant risks of double taxation because of conflicting interpretations among tax jurisdictions of how income should be sourced, characterized and priced; *Arthur Andersen Electronic Commerce Report* (November 1997), at 5.
International double taxation undermines the efficacy and growth of international trade and investment by making international transactions artificially more expensive relative to domestic transactions. In addition, free market economists have observed that international double taxation inhibits the international division of labour; P.A. Samuelson and W.D. Nordhaus, *Economics* 836 (12th edition, McGraw Hill Book Co, New York, 1985): cited in R. Mitchell, "United States–Brazil Bilateral Income Tax Treaty Negotiations", [1997] 21 *Hastings International and Comparative Law Review* 209, at 213.

28. See C. van Raad, "Interpretation and Application of Tax Treaties by Tax Courts", 36 *European Taxation* 1 (1996), at 3, and the OECD MTC (Vol. II), at R(1)-23.

29. See Tanzi, at 338.

30. See Van Raad, *supra* note 28, at 6.

31. J. Avery Jones, "Carry On Discriminating", 36 *European Taxation* 2 (1996), 46, at 49.

32. See A.A. Skaar, "More Catholic Than The Pope? A Norwegian Supreme Court Decision on Permanent Establishment and the 183-day Rule", [1997] 6 *British Tax Review*, 494-517, at 497 for an example of where "unusual" criteria (in view of those prescribed in the commentaries) were applied in ascertaining the existence or otherwise of a permanent establishment (PE). The concept of a PE is one of the most fundamental concepts underlying the basis for distributing tax powers between sovereign states.

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based on the MTC.[33] In this regard, it is submitted that establishing an ITC with power to settle international tax disputes would not only lead to the creation of a centralized database of precedents but would also inject uniformity and certainty into the field of tax regulation of international (as opposed to inter-EU) flows of capital and income, thus substantially removing the likelihood of conflict and opportunity loss inherent in the myriad divergent national and sub-national rulings and interpretations of the various Articles comprising the more than 1,500 DTTs currently in force around the world and which are based on successive versions of the OECD's MTC.

Furthermore, what may be gleaned from the discussion so far, is that it is not intended that the proposed ITC usurp the underlying taxing rights of countries but that it merely facilitate the objective and efficient resolution of treaty-related disputes and oversee enforcement of international treaty rulings.[34] Therefore, it is envisaged that the ITC would fulfil a similar function to that performed by the WTO in ensuring that its members abide by the rules for liberalizing international trade espoused in the General Agreement on Tariffs and Trade (GATT) and WTO agreements which, like obligations imposed under DTTs, must be considered in the context of general principles of international law regarding interpretation of treaties – i.e., Vienna Convention on the Law of Treaties.[35] In this regard, it is important to note that unlike judgments of the International Court of Justice, which provide no binding precedent on those countries that are not party to the particular dispute, WTO deliberations as well as formal dispute settlement panel findings are heavily influenced by precedents. A leading trade law expert, Professor Jackson, observes that because of the "consensus view" approach adopted in the former GATT and WTO forums and the importance of precedents, panel rulings effectively establish a code of practice for future disputes.[36]

Further, it is not suggested that an ITC be established anytime in the immediate future but rather that the current climate is the most appropriate to commence a serious study of the implications of establishing such a Court (including proposals on how to fund it[37]), considering the boundless opportunities that derive from a uniform and transparent system for facilitating the globalization process. The economic and financial havoc wreaked on the economies of South-East Asia through mismanaged and mostly unregulated international financial flows is sufficient proof that an ad hoc approach to regulation increases the risk of systemic collapse.[38]

To that end, valuable lessons can be learned from developments regarding the existing and future scope of the WTO's jurisdiction, as well as the work of the European Commission on the progress towards tax harmonization, albeit in a "restricted area", which in turn could be usefully applied in assuaging potential political opposition to the broad based acceptance of principles defining the jurisdictional scope of the proposed ITC.[39] It is submitted that as much as taxes may be the most politically sensitive of all government actions and hence the continued opposition to the idea of an ITC, the power to regulate the taxation of international income flows in accordance with international obligations is no more politically sensitive than the autonomous power assigned to the WTO, by its members, to effectively regulate the international flow of goods and services through the complex interplay of national and international norms such as "GATT bindings" or "concessions" which stipulate each country's commitment to limit the level of tariffs on imports from other GATT contracting parties.[40]

The urgency in reigniting interest in the idea of an ITC stems largely from the time delays likely to be encountered in reaching a consensus in defining the scope of powers to be bestowed on the ITC given the multifarious and sometimes conflicting incentives of governments and businesses. Therefore, in the interests of facilitating a timely consensus on this matter, it is suggested that perhaps the scope of the ITC be limited to DTT interpretations for the short term with the possibility of expanding its jurisdiction to the overseeing of harmful tax practices in the less immediate future. The long time delays experienced in negotiating and signing the Uruguay Round Agreement in April 1995 which begins with the agreement on the WTO, were largely exacerbated by the wide-ranging matters included in the trade round as well as the fact that the United States and the EC were in positions of

33. See OECD MTC especially at paras. 27-30 in Vol. I. See also, *Sun Life Assurance Co of Canada v. Pearson (Inspector of Taxes)* [1986] STC 335, (English Court of Appeal); *Memec plc v. IRC* [1996] STC 1336 (Walker LJ at 1349); *Thiel v FCT* (1990) 21 ATR 531 (High Court of Australia).

34. It was envisioned by Dr Tanzi that there may yet be an "International Revenue Services to collect taxes that could not be collected by separate governments and to allocate them either to the provision of international public goods or back to the countries [of the world]"; from Dr Tanzi's article at 338, which reproduces the same quote in V. Tanzi, "Forces that Shape Tax Policy", in H. Stein, (editor) *Tax Policy in the Twenty-First Century* (New York, John Wiley & Sons, 1988), at 277.

35. Art. XXXI of the Vienna Convention arguably contains the definitive text for treaty interpretations, because it is considered by many nations, including those who are not signatories to it, to codify generally accepted rules of customary international law; see Jackson, *supra* note 12, at 120-121.

36. Id., at 122-123.

37. The IMF has published two papers on the option of using the "Tobin tax" (viz., an international tax on cross-countries' financial transactions) to fund the United Nations; from Tanzi, at 338.

38. See, for instance, J. Stiglitz, "Boats, planes and capital flows", *Financial Times* 25 March 1998, where it is stated that the East Asian financial crisis is a direct result of volatile international capital flows. See also *NBER Reporter*, Spring 1998, at 38-39, summarizing proceedings of NBER project on "Capital Inflows to Emerging Markets" held in Cambridge, Mass., on 20 and 21 February; and Kaminsky and Reinhart, "Financial Crises in Asia and Latin America: Then and Now", *American Economic Review* (May 1998), at 444.

39. It was noted recently that EU members, especially the United Kingdom, will likely be forced to agree to EC tax harmonization measures as Member States vie to prove they are good Europeans; "Taxing Times" (editorial), *Financial Times*, Monday 8 June 1998, at 17. Expanding on that analogy, it is not a far cry then to envisage a time when an International Tax Code of Practice is universally adopted as countries vie to prove they are good global citizens and at the same time acknowledge the ineffectiveness of unilateral rules to regulate international flows of income and capital.

40. GATT "bindings" are contained in each country's "schedule of tariff concessions" which in turn is incorporated into GATT by language in Art. II of GATT; see Jackson, *supra* note 12, esp. at 51-53, 142-150 and 340-345. Inasmuch as it is fair to say that the GATT agreement applies only to government action and to products, Professor Jackson nevertheless observes (at 53) that "newer trends of international law entertain the possibility that treaties or customary international law may apply to individuals as well as to nations and international organizations." A list of important achievements of the Uruguay Round in relation to services, product standards, textiles, intellectual property, market access, developing country integration, agriculture and dispute settlement procedure is set out in Jackson, at 2-3.

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governmental transition at the time of the talks.[41] However, considering the relatively narrow jurisdiction of the proposed ITC, together with the recent promising attempts to draft a treaty setting up a new International Criminal Court and, in a more limited sense, a multilateral agreement on investment, then it is not unfeasible that governments could agree to the establishment of an ITC with power to enforce international treaty obligations with respect to cross-border transactions. Most recently, a report produced by the UN Committee for Development Planning highlighted the need for a World Financial Organization, patterned on the WTO, in order to reduce systemic risk from financial collapse caused by volatile and unsustainable short-term capital flows.[42]

Therefore, the current climate provides an ideal opportunity to reactivate interest in the idea of an ITC. The recent world focus on expanding the WTO's jurisdiction to Labour and Environmental disputes[43] and the ceaseless drive for economic, monetary, legal and fiscal integration within the European Union and beyond, attest to the utility of regulating international capital and labour flows through international cooperation as well as multilateral organizations.

III. PROMOTING BETTER TREATY PRACTICES

Having examined certain political arguments impeding the establishment of an ITC and why they are overstated in view of the global trend for increased transparency and liberalization, it is prudent to now examine how the ITC could lead to the creation of a better international tax regime by improving and standardizing disparate treaty practices. To start with, it is recommended that ITC rulings be legally binding on all parties concerned with the international tax dispute, thus better facilitating the development of a uniform and widely adopted code of treaty practice to be followed in countries which have implemented laws attributing the full force of domestic law to ITC judgments. To that end, it is advisable that unilateral rules are developed multilaterally between a large number of important trading countries (with input from multinational enterprises) before the ITC commences operation, otherwise more confusion would result from the uncertainty surrounding the legal status of ITC judgments in the domestic forum.

The WTO's procedure for settling trade disputes involves the establishment of a disputes panel comprised of experts who are qualified to hear and settle the matter, with the possibility of appeals on a point of law to the Appellate Body.[44] Each appeal is heard by three members of a permanent seven-member Appellate Body set up by the Disputes Settlement Body and broadly representing the range of WTO membership.[45]

As with any system of law, the WTO's disputes settlement procedure underscores the rule of law and makes the trading system more secure and predictable because it is based on clearly-defined rules, with timetables for completing a case.[46] First rulings are made by the disputes panel and endorsed (or rejected) by the WTO's full membership.[47] There are also a number of other mechanisms and techniques for improving the "rule integrity" of the GATT trading system; including surveillance, the systematic examination of trade measures of particular countries, or the release of regular reports flagging potential discrepancies between measures actually taken and GATT rules, or to raise questions about the appropriateness of such measures.[48] In this regard, the recommendation of Dr Tanzi for a world tax organization to monitor the behaviour of countries with respect to harmful tax practices could prove very useful in enhancing the integrity of the disputes settlement procedure of the ITC.

Also, to facilitate a less costly and more effective means of settling smaller, less complex international tax disputes, regional centres (a concept that is not available within the WTO system) should be established to issue administrative tax rulings in response to taxpayer inquiries in a similar fashion to the way in which rulings on domestic tax matters are issued by the revenue officials of most countries. Such rulings could be appealed from, on a point of law, by any of the parties concerned (in the broad sense) with the dispute. In an effort to underpin the rule of law while providing a source of funding for the ITC, costs of the appeal (to be agreed in a schedule of costs) should perhaps be borne by the losing side, which initiated the appeal action.

However, a more fundamental problem than reducing the costs incurred by parties who seek to settle tax disputes through the ITC system, is the distinct lack of sufficiently trained tax experts with adequate knowledge of Public International Law and its relevance to international taxation who

41. See Jackson, *supra* note 12, at 44-47.
42. Extracted from the *Financial Times*, 27 July 1998, "World finance body urged", at 6.
43. See "Clinton urges new, faster trade round", *Financial Times*, 20 May 1998. It has been observed by one commentator on trade policy that increasing the scope of the WTO's powers to foreign investment, competition policy, and regulatory reform would create a global level playing field while navigating the shoals of "system frictions" related to differences in economic structure; see review by S. Golub of book by S. Ostry, *The post-cold war trading system: Who's on first?* (London & Chicago, University of Chicago Press, 1997), in *Journal of Economic Literature*, Vol. XXXV (December 1997), at 2059. To that end, it is also noted that the WTO has adopted reports by its appellate body and by panels concerning Korean tax policy and Japanese taxes on alcoholic beverages, Argentinian taxation of apparel and footwear imports, and Indonesian tax policy designed to foster development of a "national car": "WTO Ministers adopt Reports on Tax Disputes, Are Likely to Hear More", 6 July 1998, *Tax Notes International*, at 16.
44. See generally *Trading into the Future* (WTO, 1997), where it is noted that panels are like tribunals, except that the panellists are usually chosen in consultation with the countries in dispute. Panels consist of three (occasionally five) experts from different countries who examine the evidence and decide who is right and who is wrong. The panel's report is passed to the Disputes Settlement Body, which can only reject the report by consensus.
For a practical illustration of the workings of the WTO's disputes panel and its Appellate Body, see a report appearing in the *Financial Times* on the Canadian complaint about Australia's ban on salmon imports: "WTO panel report backs Canada plea on salmon ban", *Financial Times*, 8 May 1998, at 8.
45. Members of the Appellate Body have four-year terms, and are individuals with recognized standing in the field of law and international trade and are not affiliated with any government.
46. It is noted that some matters coming before the WTO can take up to one year to resolve depending on the complexity of the matter under consideration and whether the parties wish to avail themselves of the full appeal process.
47. The Uruguay Round agreement made it virtually impossible for the losing country to block adoption of a ruling. Any country wanting to block a ruling has to persuade all other WTO members (including its adversary in the case) to share its views; extracted from *Trading into the Future* (WTO, 1997).
48. See Jackson, *supra* note 12, at 137.

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could competently assist the Court in carrying out its functions.[49] To rectify this situation, it would be necessary to promote the study of Public International Law of Taxation in universities and in the international tax community at large.[50] A closer study of the relatively successful disputes settlement procedure of the WTO is also warranted as the knowledge acquired may be usefully applied in formulating proposals that can best assist the ITC in achieving its objective of standardizing the existing patchwork of treaty-related practice by interpreting DTTs in a way that is consistent with the spirit and intent of those treaties.[51] In that way, the ITC reduces the uncertainty and tension which arises where, for instance, a court in one tax jurisdiction applies criteria and highlights facts which conflict with the views of a court in another transactionally-related tax jurisdiction when interpreting a particular provision of a DTT.

As will appear from the immediately following discussion in Part IV, such an unsatisfactory situation is a common occurrence in practice and stands in contradistinction to the rationale underlying DTTs – that is, to alleviate international double taxation and promote certainty in an area of great uncertainty. If left unchecked, such a dangerous state of affairs may seriously undermine the cost effectiveness and quality of international trade and investment as countries, both developed and developing, increasingly engage in harmful tax competition and at the same time negotiate more and more DTTs in the illusory hope of promoting and protecting international trade and investment.[52]

In summary, if the net benefits of globalization are to be preserved and augmented in view of the high enforcement and compliance costs associated with multi-jurisdictional tax regulation of international trade and investment,[53] then supervision over the fundamental operation of DTTs, which provide explicit and binding rules for distributing tax revenues from transnational trade and investment income, should not be left to national institutions who are obviously more (but not always totally) concerned with promoting national interests over international ones.[54] The sobering lessons from the South-East Asian currency crisis currently preoccupying world economic thought should perhaps serve as a timely reminder that the best way to foster and protect the globalization process is through the multilateral promotion and implementation of architecturally sound practices and principles – both monetary and fiscal.[55] To that end, establishing an ITC to resolve DTT-related disputes would be instrumental in creating a better international tax order, just as the WTO has been instrumental in creating a better international trade order.

IV. ILLUSTRATION OF TAX TREATY TENSIONS

To give focus to the discussion, and at the same time illustrate the minefield of issues that accentuate the uncertainty inherent in interpreting DTT provisions, the discussion in this section will examine how the United Kingdom–France DTT regulates the income flows arising from a simple contracting-out arrangement between a UK resident company (UKCO) and a French resident company (FCO) for the services of X, a British national who is an employee and shareholder of UKCO.[56] Remuneration for X's services is paid by FCO directly to UKCO, which in turn pays a salary to X and makes national health contributions on his behalf in the United Kingdom.

The above arrangement is common practice in the European Union where the Treaty of Rome guarantees the equal treatment and free movement of workers. Such practices will also likely become more prevalent outside the European Union as

49. See Foreword by Dr Avery Jones in A.H. Qureshi (editor), *The Public International Law of Taxation: Text, Cases & Materials* (Graham & Trotman/Martinus Nijhoff, London, 1994). Dr Qureshi (at 3) argues that the aspects of public international law that an international tax practitioner needs to be particularly familiar with are, *inter alia*: sources of international law; principles of state jurisdiction; law of treaties; international economic law (particularly international monetary law, international trade law, investment protection (expropriation), regional economic organization) and dispute settlement.

50. The International Fiscal Association (IFA) has been sufficiently concerned with the bilateral tax treaty interpretation problem, that it has discussed it at more than one Congress; see *General Report of 1993 IFA Congress in Florence*, by Professor Vogel and Dr Prokisch, 55, at 56. See also Dr Avery Jones' summary of panel discussion of Seminar B at the 1985 IFA Congress in London in 40 *Bulletin for International Fiscal Documentation* 2 (1986), at 75-85. In 1994, in conjunction with the OECD Fiscal Affairs Committee, IFA agreed to institutionalize in its Congresses a seminar on current issues of double taxation. The first such seminar was held in the 1995 Congress at Cannes and has been repeated in other congresses.

51. In early 1997, 19 out of 71 cases were settled without going to a full panel hearing. It has also been noted that the fact that more and more cases are being brought to the WTO is evidence that there is a growing faith in the system; *Trading into the Future* (WTO 1997).

52. See, for example, A. Easson, "Tax Competition Heats Up in Central Europe", 52 *Bulletin for International Fiscal Documentation* 5 (1998), at 192, which provides a good analysis of the increasing prevalence of tax competition and its consequences on the "world economy", and the harmful effects inflicted on the economies of some Central European countries, in particular, from "fiscal degradation". See also the OECD Report on Harmful Tax Competition for examples of undesirable tax competition practices.

53. Some of the compliance and administration costs associated with the implementation of the arm's length standard in tackling international profit shifting through transfer pricing, and the regressive effects such high costs have on the conduct of international trade by SMEs were analysed in a paper by the author and presented at the 53rd *Congress of the International Institute of Public Finance* held in Kyoto in August 1997: "A Study of the Regressive Effects of the Arm's Length Standard (ALS) on Small-Medium-Sized Enterprises (SMEs) and Why It Should Be Abandoned in View of CFC Taxation: The Australian and US Experience".

54. E.g., see J. Azzi, "Policy Considerations in the Taxation of Foreign-Source Income", 47 *Bulletin for International Fiscal Documentation* 10 (1993), at 547, esp. at 555, where it is noted that the fiscal policy objectives of the Australian Government (and for that matter most other OECD member countries) "have been set to achieve world efficiency whilst at the same time deviating from such a policy in order to promote national interests ..."

55. Substantially as a response to the South-East Asian crisis, the Interim Committee of the Board of Governors of the International Monetary Fund recently announced that it had adopted a "Code of Good Practices on Fiscal Transparency – Declaration on Principles" in order to increase fiscal transparency and thereby enhance the accountability and credibility of fiscal policy as a key feature of good governance: "Ministers Outline Measures to Strengthen Monetary System; Adopt Code of Good Practices on Fiscal Transparency", 27 April 1998, IMF Survey, at 113.

56. Facts very similar to those considered above came up before the Norwegian Supreme Court (the *Høyesterret*) in 1994; see the *Alphawell* case which is discussed in Professor Skaar's article, *supra* note 32. That case involved a British national who was a geologist, Mr James Pegrum, who also happened to be the main shareholder of Alphawell Ltd., a UK company which entered into a contract with Statoil (a Norwegian oil company) to the effect that a consultant (Mr Pegrum) at Statoil's request was to work for up to nine months a year under Statoil's "directions" as an "exploration advisor". The contract between the two companies was renewed on an annual basis. In that case, the Supreme Court held that Alphawell did not have a PE in Norway during the years 1983-1986.

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barriers to trade and labour mobility continue to fall.[57] For present purposes, however, it is merely intended to flag some of the broader treaty-related issues that will likely cause problems for the UK and French tax authorities as well as the companies and individuals involved. The income tax treatment under UK and French tax laws of the income arising from the contracting-out arrangement will be considered briefly in the Appendix.

The minefield of issues involved with allocating sovereign taxing rights over cross-border transactions in accordance with DTT rules may be gleaned from the basic and simple facts presented above. These facts give rise to a number of competing fiscal claims, such as:

(a) which jurisdiction has the strongest fiscal claim over income derived by UKCO?;
(b) which jurisdiction has the strongest claim over income derived by X?;
(c) (related to the above two questions) which jurisdiction is obligated to provide double tax relief?;
(d) who is liable to pay VAT (and where) in relation to services supplied by X?

The issues raised in (a)-(c) are generally covered by the United Kingdom–France DTT which was concluded in May 1968 for the principal purpose of avoiding double taxation of income and capital derived in the United Kingdom and/or France by UK and/or French residents. As for who is liable to VAT, it is noted that no UK VAT liability accrues in relation to invoices issued by UKCO to FCO for X's services, because the services, which are performed in France, fall outside the scope of the UK VAT system.[58] However, such treatment does not preclude the services from being characterized as taxable supplies for French VAT purposes in accordance with internal law and the Sixth EC Directive. In fact, under French VAT regulations, foreign taxable persons (which includes UKCO and X) who have a PE[59] in France are liable to French TVA.[60] The most common manner in which TVA is discharged is by way of a reverse-charge arrangement whereby FCO accounts for the TVA liability of UKCO when discharging its obligation to pay for X's services under the contracting-out arrangement.

In contrast to the territorial scope of VAT systems and in accordance with international practice, the fiscal parameters of income-based taxes generally extend beyond national boundaries in search of the real origin and ownership of income in order to determine how such income is to be taxed.[61] To this end, the international income tax regimes of many countries implement both residence-based rules which tax income wherever it is earned, and source-based rules which operate to impose tax on income generated within the jurisdiction. However, given the potential for over-taxation, most countries generally provide double tax relief in the form of a foreign income exemption, a foreign tax credit or both.[62]

The above internationally accepted norms for defining the fiscal parameters of unilateral tax systems in relation to worldwide income, also effectively underscore the operation of bilateral tax systems based on the OECD MTC when allocating primary taxing rights over cross-border income. The relief from double taxation provided in DTTs is usually in the form of a credit for foreign tax paid. With those preliminary remarks in mind it is appropriate now to consider the more problematical aspects of the operation of the United Kingdom–France DTT in relation to the above facts. (It should be noted that the discussion in this section does not set out to conclusively deal with every treaty interpretation problem likely to arise from the facts presented, but to merely signpost certain of the more significant tensions resulting from the ad hoc and irregular implementation of treaty provisions.)

A. Does UKCO have a French permanent establishment?

One of the most important principles established in the MTC for allocating primary taxing rights over business profits generated by a non-resident in a particular jurisdiction, is to determine whether the non-resident has a PE there. The existence of a PE (which is a defined concept[63]) in a jurisdiction denotes an economic presence in the host state which, in turn, implies that business profits were generated there and hence taxable by the source country on the basis that it provided the infrastructure from which the income was generated. In such a case, the residence country is theoretically compelled, by

57. See, for example, the declaration made at the Osaka meeting of APEC Leaders in November 1995, which highlighted the need for increased efforts to streamline work permit requirements for business travel within the region.
58. Secs. 4 and 9(4) of the Value Added Tax Act 1994. The territorial scope of UK VAT laws is consistent with the approach advocated in the EC's Sixth Directive which offers solutions for the place of supply of services. Under the EC approach, the place of the taxable supply of a service is the sole decisive factor. Thus, services supplied in connection with immovable property (e.g., real estate agents, contractors and architects) are deemed performed where the property is situated. On the other hand, the supply of cultural, artistic, sporting, scientific, educational or entertainment activities, or work performed on movable property are deemed performed where they are physically carried out; see Arts. 9(1), (2)(a) and (2)(c) of the Sixth Directive and B.J.M. Terra and J.A. Cajus, *Guide to the European VAT Directives – Commentary on the Value Added Tax of European Community* (IBFD Publications BV, Amsterdam, loose-leaf), Vol. 1 Chapter VI, at 23.
59. A "permanent establishment" for TVA purposes is defined widely and includes a warehouse, an office, a factory, a workshop or construction or assembling project that customers are aware of and which is managed by the owner of the undertaking or on his behalf; Doc. Adm. 3 A 2131 No. 3.
60. *Code général des impôts* or CGI, Art. 259. UKCO is obliged to appoint a fiscal representative in France who must take care of its TVA obligations (viz., submit a declaration in France or seek TVA refunds, etc. – CGI Art. 289A(I); Ruling 3 CA-92 No. 245). However, this requirement is waived generally where the non-resident taxable person supplies intangible services (e.g., consultancy services provided by accountants, lawyers, engineers etc.) to a taxable person who is established in France and who is subject to TVA (CGI, Art. 283(2)).
61. For a general discussion of the extra-territorial reach of residence-based accruals taxation rules, see Azzi, *supra* note 54, esp. at 565. For a discussion of the tension and uncertainty caused by the interaction of Australia's residence-based tax rules with source of interest and dividend income rules, see J. Azzi, "The Need for Further Reform of Australia's International Tax Rules in View of the Spotless Services Case", 50 *Bulletin for International Fiscal Documentation* 4 (1996), at 164, and Azzi, *supra* note 23, esp. at 796-798.
62. Determining source of income is important for determining whether the home country will provide the taxpayer with relief from double international taxation. See also Azzi, *supra* notes 23 and 54, for a discussion of the operation of exemption, foreign tax credit, and deduction methods for alleviating double international taxation.
63. It has been observed that the commentaries to Art. 5 of the MTC establish three conditions for determining the existence of a PE: objective (i.e., physical features of the home abroad); subjective (i.e., the taxpayer's relationship to the home abroad); and functional (i.e., what goes on in the home abroad); Skaar, *supra* note 32, at 497.

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the MTC, to provide relief against international double taxation that would result if those profits were subject to both residence and source country taxation. However, what happens sometimes in practice is that disputes break out as to whether there is double taxation of the same income in the first place (i.e. characterization and timing issues, etc.). This is further precipitated by the general lack of uniformity and coherence between national courts in their application of commentaries to the MTC to real-life facts.[64] The somewhat "controversial" decision handed down on 30 October 1996 by the court of last resort for German tax matters, the *Bundesfinanzhof*, amply demonstrates the varying nuances and unique features that national courts observe in determining the existence of a PE and which in turn create anomalies and inconsistencies that are difficult to reconcile internationally.[65]

For example, where UKCO is deemed to carry on business through a PE in France (e.g., where it operates from a fixed place of business), the "industrial or commercial profits" (defined in Article 6) shall be taxable in France. In calculating the amount to be attributed to the PE, France is entitled to apply its customary rules (Article 6(6)); however, there shall be allowed as deductions, expenses which are incurred for the purposes of the PE including executive and general administrative expenses whether incurred in France or the United Kingdom (e.g., expenses incurred by UKCO in respect of or for the purposes of the French operation). In this regard, expenses that would not have been deductible if the PE were treated as a separate entity (i.e., subsidiary) are not deductible.[66] Although a non-resident taxpayer with a French PE is generally taxable under the same rules as a resident taxpayer, the non-resident usually (but not always necessarily) incurs a higher rate of tax because France imposes a branch profits tax (BPT) of 25 per cent on the after-tax profits of the PE.[67]

Whether France could legitimately levy a BPT on French-source profits derived by UKCO is uncertain because of Article 25 of the France–United Kingdom DTT which forbids discrimination on the grounds of nationality, although Article 25(3) allows the taxation of a PE in accordance with Article 10 which, prior to its deletion in 1987, restricted the BPT to 15 per cent of two-thirds of the after-tax profits of the PE. The uncertainty is accentuated in this case because there is no corresponding adjustment in Article 25(3) to account for the removal of Article 10 from the United Kingdom–France DTT. To that end, it is important to note that Article 25 and every other provision contained in a DTT prevails over national laws.[68]

Notwithstanding the uncertain scope of Article 25(3) which refers to a non-existent Article 10, according to some commentators, despite tax treaty protection, the French BPT is "clearly" in breach of the EC treaty, particularly the freedom of establishment rules set out in Articles 52 and 58 which are designed to ensure that nationals of an EU Member State are treated in the same way as nationals of the host EU Member State.[69] The basis for such a conclusion, however, is drawn into some question in view of the recent European Court of Justice decision in *Gilly* which seems to confirm the primacy of DTT rules over multilateral obligations set out in the Treaty of Rome.[70] This is to be distinguished from the obligations on EU Member States to exercise their direct taxation powers "consistently" with European Community law which does not extend to the direct taxation of economic activities conducted by EU nationals in non-EU Member States.[71]

Conversely, where UKCO is not operating out of a "fixed place of business"[72] in France (see Article 4(1)) and does not have a registered office, or operate other such similar premises in France (see Article 4(2)), then it falls to be determined whether the services performed by X on behalf of his UK employer constitute a French PE of UKCO. In this regard, any services performed that are of a "preparatory or auxiliary character" (which is also a matter of some contro-

64. In an "unusual" interpretation of Art. 5 (PE) of the United Kingdom–Norway DTT (which was based on Art. 5 of the MTC and concluded in 1969 and 1985), the *Hoyesterett* in the *Alphawell* case found that the "three objective" criteria for deciding whether a PE existed in Norway were: the nature of the work carried out by the employee, Mr Pegrum, in Norway; the duration of Mr Pegrum's stay there; and Alphawell's (i.e., the UK employer's) association with offices where Mr Pegrum was working; cf. criteria discussed at *supra* note 63 and at Skaar, *supra* note 32, at 497.

65. See the *Pipeline* case, *BStBl* II 1997, 12, where it was held that a submerged pipeline system traversing the Netherlands for the purpose of delivering oil and oil products to Germany, constituted a PE for the purposes of the 1959 Netherlands–Germany DTT. For an analysis of the "*Pipeline* case", see M. Lampe, "Broadening the definition of a Permanent Establishment: The Pipeline Decision", 38 *European Taxation* 2 (1998), at 67. The uncertainty created by the pipeline decision should not be underestimated given that the PE concept was originally devised in Germany late last century and with Germany continuing to lead the field on the PE front, this century.

66. See Arts. 6(3) of the United Kingdom–France DTT and French domestic law.

67. From 1 January 1998 the withholding tax on branch profits is abolished for EU resident companies meeting certain requirements. However, the new exemption regime has drawn some criticism from practitioners, especially with regard to the interpretation by tax officials of residency rules; see M. Lescot, "France Issues Circular on Branch Tax Exemption", 13 July 1998, *Tax Notes International*, at 77-78.

68. For a general discussion of the scope of the non-discrimination Article in OECD MTC, see 1997 Commentary on Art. 24. For an analysis of how non-discrimination operates with respect to the PE Article in the MTC, see C. van Raad *Nondiscrimination in International Tax Law* (Kluwer Law and Taxation Publishers, Deventer, 1986), at Subpart 3, esp. at 125-135.

69. See J.F. Avery Jones, "Flows of Capital between the EU and third countries and the consequences of disharmony in European tax law", (1998) 2 *EC Tax Review*, 95, at 99. See also *Survey of the Implementation of the EC Corporate Tax Directives* (IBFD Publications BV, Amsterdam, 1995), esp. at 365-369 and 417-418. In July 1997, the EC issued an opinion stating that French BPT offends against Art. 52 and 58 of the EEC Treaty: "European Commission attacks French branch tax", (1997) *Tax News Service*, at 350 (IBFD Publications BV, Amsterdam).

70. In C-336/96 *Gilly v. Directeur des Services Fiscaux du Bas-Rhin* (http://curia.eu.int/jurisp/cgi-bi...) the taxpayer alleged that the taxation regime for frontier workers established under the Germany–France DTT (concluded on 21 July 1959 and as amended by the protocols of 9 June 1969 and 28 September 1989), was discriminatory and resulted in double taxation. The tax regime established distinguished between frontier workers of the public sector and those in the private sector. The European Court of Justice, in a decision handed down on 12 May 1998, noted that there was not yet a harmonizing measure for the elimination of double taxation at the EU level (at para 23.) and as a consequence upheld the validity of relief measures provided under the Germany–France DTT.

71. See *ICI v. Colmer* C-264/96 (judgment handed down on 16 July 1998), at paras. 19-23 and 33.

72. As to what constitutes a "fixed place of business" for the purposes of the PE Article in the MTC (upon which the United Kingdom–France DTT is based), see *Klaus Vogel on Double Taxation Conventions* (3rd edition), esp. at 285-290. See also discussion on PEs generally, in P. Baker, *Double Taxation Conventions and International Tax Law* (2nd edition) (Sweet & Maxwell, London, 1994), at 140-154.

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versy) are not deemed to constitute a PE.[73] Although, according to Article 4(4) (which is identical to Article 5(5) of the OECD MTC), a PE is established in France where a person (other than an agent of an independent status) is acting in France on behalf of a UK enterprise. A person is deemed to be acting on behalf of a UK company in France if she/he has, and habitually exercises in France, authority to conclude contracts in the name of the UK enterprise, unless her/his activities are limited to the purchase of goods or merchandise for the enterprise.[74]

Ascertaining the independent/dependent status of X vis-à-vis UKCO is very important because Article 4(4) extends the scope and operation of the PE Article in the United Kingdom–France DTT by deeming X to be an agent of UKCO where he performs employment services in France even though UKCO may not have a fixed place of business within the terms of Articles 4(1) and/or (2). In this regard, Professor van Raad observes that it could "prove useful" for national courts to consult foreign decisions and literature on the scope of the operation of the agency principle in the context of Article 5 of the OECD MTC.[75] He reaches this conclusion after examining three decisions handed down between 1994 and 1995 by the US Tax Court, the *Bundesfinanzhof* and the *Hoge Raad* (Dutch Supreme Court) in which all three courts did not follow the recommendation of the OECD Committee of Fiscal Affairs with regards later clarifications of the Commentary. Instead, the US and German courts followed previous domestic case law, although the US Court mentioned a foreign tax court ruling in its decision. The Dutch Court, it is noted, never (explicitly) refers to its own previous decisions.[76]

The proper characterization of X's services also bears directly on whether income generated from those services are taxable as business profits of UKCO which are generated from activities conducted in France. According to Article 6(5), the industrial or commercial profits of a PE include amounts derived from "the conduct of a trade or business including income derived ... from the furnishing of services of employees or other personnel, but ... not ... income received by an individual as compensation for personal (including professional) services".[77] This, in turn, gives rise to a number of related questions including whether X was performing independent or dependent personal services which, in turn, raises the question of which jurisdiction has primary taxing rights over the income he derives. There is also the issue of whether there is economic double taxation where the business profits generated by UKCO essentially reflect the salary paid to X (see below).

B. Is X performing dependent personal services in France?

The next question that must be addressed is whether X is liable to French tax on the income he is paid by UKCO in respect of employment services performed in France? The answer to this question depends largely on the residency status of X which, in turn, is determined by application of French tax law (see Article 3(1) of the United Kingdom–France DTT). Without embarking on an in-depth analysis of French residency rules, it is more likely that X would be regarded as a French resident where the contract period is for at least six months in a particular year (see Appendix). However, such treatment does not preclude X from also being characterized as a UK resident where his constant return visits to the United Kingdom add up to at least 183 days in a tax year.[78] In that case, X would lose the benefit of the foreign employment exemption discussed in the Appendix.

In the event that X is deemed a resident of both the United Kingdom and France, then Article 3(2) of the United Kingdom–France DTT (based on Article 4(2) of the MTC) sets out rules for giving preference to the attachment to one State over the attachment to the other State in resolving the dual residency issue. To that end, it is provided that the attachment must be "of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the right to tax devolves upon that particular State."[79] Consequently, it is necessary to identify where the taxpayer's permanent home or his "centre of vital interest" is situated. Where this is not possible, then it is necessary to determine the taxpayer's place of habitual abode. In both instances resolution of the dual residence conflict, as with resolution of many DTT related issues, is a cumbersome and very costly exercise with national authorities having great latitude to exercise their discretion freely without the need to consider matters of fairness from an international perspective.

Therefore, determining which jurisdiction has the strongest claim over X's income will invariably involve delay costs as the competent authorities of both the United Kingdom and France operating within the framework of the mutual agreement procedure in Article 26, seek to reach a mutually agreeable position on this matter. This is despite the tie-breaker rule provided in Article 3(2), which determines X's residency

73. See Art. 4(3) of the France–United Kingdom DTT which provides that a PE shall not include use of facilities solely for the purpose of storage, display or delivery of goods belonging to UKCO or "the maintenance of a fixed place of business solely for the purpose of advertising ... for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise".
74. It has been held that the authority must not only cover contracts relating to the operations of the UK company but must also be "habitual" (i.e., repeatedly and not merely in isolated cases); see the *Alphawell* case, where the *Høyesterret* considered the scope and operation of the "agency" principle contained in Art. 5 of the United Kingdom–Norway DTT (which is almost identical to Art. 4 of the United Kingdom–France DTT). It was held that "habitual" exercise of authority means that the authority should be exercised regularly. The *Høyesterret* further held that an automatic extension of the "consultancy" agreement three times during the period 1983-1986, in addition to the original entering into the agreement in 1982, did not constitute a habitual exercise of the authority. See also official OECD commentary on para. 5 of Art. 5 of MTC.
75. It should be noted that the utility of pursuing such a course of action may nevertheless prove limited given the unusual and controversial interpretation of the PE Article propounded by the *Høyesterret* in the *Alphawell* case and by the *Bundesfinanzhof* in the *Pipeline* case (both of which were discussed above).
76. See Van Raad, *supra* note 28, at 5-6.
77. Art. 6(5) of the France–United Kingdom DTT is not found in the business profits Art. 7 of the OECD MTC.
78. See Appendix and October 1996 brochure issued as part of UK Inland Revenue Department's International Series *IR 20* entitled *Residents and non-residents*, esp. at para 1.2.
79. See 1997 OECD commentary regarding Art. 4(2), at para. 10.

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based on where his "permanent home" is or where his centre of vital interests is located. As will appear, the uncertainty surrounding administration of the 183-day rule and resolution of the residency status of X, generates extra costs for all concerned without attendant substantial or permanent benefits as the practice established/adopted by one court is generally not binding on another court.[80]

Where X is deemed a UK resident, then Article 15(1) of the United Kingdom–France DTT (which is based on Article 15 of the OECD MTC) effectively provides that the employment income (other than pensions), shall be taxable in France (i.e., the State where the employment is actually exercised). However, a general exception to this rule is found in Article 15(2) which effectively provides that X shall be taxable in the United Kingdom where remuneration for employment services is paid by a French non-resident employer, the remuneration is not borne by a PE of the employer, and X is in France for a "period not exceeding in the aggregate 183 days in any period of 12 months".

The terms "employer", "salary, wages or other similar remuneration" appearing in Article 15 are not defined in the DTT and consequently, it is necessary to resort to domestic law for the definition relating to those terms. However, doing so still does not avoid the problems that may arise with regard to the distinction between dependent personal services (Article 15) and independent personal services (Article 14), nor does it ameliorate the necessity to determine which jurisdiction is the most appropriate in resolving a dispute of this nature. Broadly speaking, it is generally understood that dependent personal services are performed where a person (i.e., the employer) has rights on the work produced and bears the relative responsibility and risks associated with the work of the employee.[81] Further resolution of this issue requires examination of the terms of the contracting-out agreement between FCO and UKCO in order to ascertain which party bears the responsibility or risks for the results produced by X and with whom the authority to instruct X lies. There are other indicia that are also relevant (e.g., how is remuneration calculated, who controls the place at which the work is performed, etc.), but it will not serve the purposes of this paper to embark on a discussion of this nature.[82]

Assuming that UKCO is the employer for Article 15 purposes, then from the facts ascertained thus far, it appears that the biggest hurdle X must overcome in order to avoid possible liability for French income tax, is the 183-day rule set out in Article 15(2) which contains a very important limitation to the taxing regime established under Article 15(1). The formula used to calculate the 183-day period is "days of physical presence", including weekends, public holidays, days of sickness, etc. Days spent outside France should not be taken into account, although as will appear from the immediately following paragraph, such a result is not a certainty. Nevertheless, where the conditions set out in Article 15(2) are satisfied, then X will be subject to French tax on the remuneration for services provided in France (CGI, Article 4 A.2).

To gauge how the 183-day rule applies in practice it is instructive to turn to the *Høyesterret*'s decision in the *Alphawell* case, where a similar 183-day rule (to that contained in Article 15(2) of the United Kingdom–France DTT) was considered under Article 15(2) of the United Kingdom–Norway DTT. In that case the judges found that during the period 1983-1986, Mr Pegrum had spent around 600 days (excluding travelling days) in Norway spread over some 50 visits. He worked in different places at the office facilities of Statoil. For one tax year, 1985, the judges found that Mr Pegrum had stayed in Norway for longer than 183 days and accordingly his employment income for that year was taxable in Norway. The judges reached this conclusion by counting the days that he spent travelling to Norway. It is not certain whether courts or tax officials in other countries would follow the *Høyesterret*'s construction of the 183-day rule in view of the administrative inconvenience and cost associated with its implementation.

At any rate, whichever method the French authorities apply in implementing the 183-day rule in relation to X, they are nevertheless obliged under Article 23(2) of the United Kingdom–France DTT to provide UK-resident individuals "the same personal allowances, reliefs and reductions for the purposes of French tax as French nationals resident in the United Kingdom", and vice versa. However, this rule will be of little assistance where X is not characterized as a UK resident (see Appendix).

By the same token, there is the possibility that UKCO could derive an unintended benefit whereby it is eligible for a deduction domestically for the salary it pays X and at the same time is exempt in the United Kingdom and France from being taxed on income it receives from FCO. This result, of course, depends on the domestic tax regime of the home state and the existence of anti-avoidance provisions to deal with such arrangement. In this regard, it is noted that the United Kingdom does not operate a general anti-avoidance regime.

In summary, the above discussion attempted to illustrate some of the potential problems associated with the interaction of the business profits Article, the PE Article and the dependent services Article of the United Kingdom–France DTT, all of which are based on the OECD MTC. It was noted that tensions arose because of the uncertainty surrounding the criteria necessary to establish the existence of a PE under Article 4(4) (dependent agent) and whether profits taxable under Article 15 are excluded from taxation under Article 6(5). In addition, the relief from double taxation provided under Article 24 is generally only available where the same income is taxed in more than one jurisdiction (i.e., double juridical taxation). Consequently, it will not apply to alleviate

80. See, for instance, P.J. Douvier and D. Bouzoraa, "Compatibility of CFC Rules with Tax Treaties: Lower Courts Reach Conflicting Conclusions", 37 *European Taxation* 3 (1997), at 103, which discusses the conflicting decisions given by two French Local Courts on the scope and operation of the France–Switzerland DTT and French controlled foreign corporation (CFC) rules.

81. See Baker, *supra* note 72, at 270-271, 294, and 304-305.

82. For an elaboration on the criteria for the existence of a master/servant relationship which are applied in identifying certain payments, such as "salary or wages" for internal tax law purposes; see Income Taxation Ruling IT 2129, issued by the Australian Commissioner of Taxation on 19 March 1985. At Appendix B, the Commissioner provides a 23-point list of factors bearing on whether an employer/employee relationship exists.

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any economic double taxation that arises where the salary income of X is also deemed business profits of a PE and taxable to UKCO. Resolution of this form of double taxation potentially involves major costs where UKCO attempts to dispute any adverse administrative rulings by the French authorities in French courts based, for example, on a wide or unjustified interpretation of Articles 4(4) and 6(5). The costs of resolving tax disputes in this manner are compounded where the UK authorities refuse to accept some of the indicia of a PE highlighted by French authorities and consequently tax UKCO on income paid by FCO for the services of X.

Clearly therefore, there is little doubt that establishing a central body to uniformly apply DTT provisions (as opposed to recommending national courts to refer to other court decisions and literature on DTTs) would be conducive to enhancing confidence in the ability of DTTs to efficiently and equitably allocate sovereign taxing rights over cross-border income flows. This is a particularly important function considering the potential for under-taxation or over-taxation that is created by the ad hoc and inconsistent interpretation of DTT provisions at the national and sub-national level and the high costs of compliance associated with conducting business in a multi-tax jurisdictional system which can act as a non-tariff barrier to international trade and investment.

V. CONCLUSION

To further enhance world economic growth in view of the strains and opportunities created by the globalization process, it has been suggested that a world tax organization specifically charged with reducing the prevalence of harmful tax competition be established. The potential benefits of a world tax organization are indisputable given the growing awareness of taxes as a non-tariff barrier to trade. However, given the fear of loss of fiscal sovereignty, it is unlikely that such a body would be established in the near future. Consequently, it was argued above that perhaps the international community give serious thought to the establishment of an ITC with the power to settle DTT-related disputes. Although, the logistics, costs and time involved in establishing an ITC in view of the political fear and reluctance of countries to relinquish any degree of fiscal sovereignty may ultimately mean that the ITC never progresses beyond the conceptual stage. Nevertheless, considering that the world's nations have finally agreed to seriously debate the possibility of an International Criminal Court with power to judge genocide and crimes against humanity, then theoretically the possibility of establishing an ITC with limited jurisdiction becomes more appealing and feasible as a result.

There would be little point for all parties concerned if the ITC rulings could be blocked by individual countries. For that reason, it was suggested that the adversarial, consensus-based resolution of international trade disputes in the WTO be broadly followed by the proposed ITC. Admittedly, such an approach may be costly and may even involve a frustratingly long and drawn-out procedure, but it is nevertheless necessary to assuage the tensions created by divergent national and sub-national rulings (which can take a number of years to issue) with regard to international treaty obligations. In this way, the ITC could best facilitate the effective and comparatively prompt resolution of international double tax disputes and in the process create a uniform and universally adopted code of treaty-related practice.

DTT tensions have generated unnecessary economic costs and national welfare losses due to the protracted, costly and uncertain resolution of international tax disputes in national courts or under the mutual agreement procedure set out in DTTs. In some instances the ad hoc and inconsistent application of treaty obligations can result in economic and/or juridical double taxation of multinational taxpayers where the contracting states cannot agree on the scope of a particular provision of a DTT. The uncertainty associated with current treaty practice can manifest in what economists call, policy externalities and regional arbitrariness. It was also contended that because of the non-binding nature of national rulings on other states, there is little economic merit and logic in clogging up local courts' time with complex international tax disputes, especially where such courts lack sufficient expertise to conclusively resolve these matters.

To give focus to the argument postulated in this paper, the scenario presented in Part IV and the Appendix was used. As was noted, the taxation of income from the contracting-out arrangement was governed by both domestic law and by the United Kingdom–France DTT. Tensions arose, however, because of the potential for economic double taxation largely caused by the uncertainty surrounding the operation of Articles 4, 6 and 15 of the United Kingdom–France DTT. These problems are compounded when considering their interaction with national tax laws as well as duties imposed under multilateral treaties, such as the Treaty of Rome, which embodies the principle of freedom of movement and establishment within the European Union. This unsatisfactory state of play will likely result in an ever increasing confluence of sometimes-coherent, sometimes-incoherent and irreconcilable differences in treaty practice.

Accordingly, it was observed that it would be healthier for the world economy if a uniform, predictable and consensus-based approach for equitably and conclusively resolving international tax disputes was established. In this regard, it is more than likely that the ITC will be expected to strike a difficult but important balance of supporting the globalization process while at the same time recognizing the importance of sovereign responsibility of governments to conduct domestic policies in view of the divergent political, economic, social and cultural concerns of nations. Achieving this objective should go a long way to ameliorating concerns about the exercise of fiscal extraterritoriality by some countries, thus creating a global level playing field.

The ITC could provide smaller countries with some level of protection from the overarching fiscal practices of the larger countries which tend to undermine the domestic tax base of the smaller open countries. At the same time, the fiscal claims of small and developing countries may be better protected from complex tax planning arrangements by powerful multinationals who are comparatively better able to secure favourable tax outcomes, perhaps, at the expense of national

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revenue. Support for this claim comes from observations about the WTO system which provides its less powerful members with an important guarantee of fair trade by the larger more powerful nations, by reducing the scope of unilateral action.[83]

Consequently, there is little doubt that the establishment of an ITC would enhance international trade and investment by protecting the interests of the comparatively weaker countries in augmenting opportunities arising from the globalization process while at the same time strengthening and standardizing the intended operation of DTTs. To that end, as with members of the WTO's Appellate Body, members of the ITC should be drawn from recognized experts in taxation and public international law who, preferably, are not affiliated with any particular government. However, as noted above, this could prove to be a tall order in view of the lack of practitioners in the area of what Dr Qureshi calls the Public International Law of Taxation. Raising the knowledge base in this area of the law is, therefore, both crucial and conducive to better enforcement of international obligations and the creation of a more coherent international tax order.

In summary, the success of the ITC in achieving the above objectives depends on a number of factors including (i) the costs (which should be borne equally by governments as well as large multinational enterprises) to the international community of maintaining such a system, (ii) the accessibility and affordability of the system to aggrieved parties, and (iii) the binding nature of ITC rulings. To that end, it was recommended that regional centres be established in order to speed up resolution of smaller, less complex tax disputes. However, the costs expected to be incurred in settling disputes before the ITC could prove an effective natural control mechanism for limiting the number of cases coming before the Court and at the same time could go a long way in ensuring that only very important and complex cases are considered.

APPENDIX[84]

The UK income tax position

Without embarking on a detailed analysis of the legitimate fiscal claims by the UK and French authorities, it is noted that for UK tax law purposes, the income X derives from performing employment services in France will be exempt from UK taxation where X is away from the United Kingdom for a substantial part of a year of income. This rule is known as the 1/6th rule and will generally be satisfied where X is away from the United Kingdom for more than 62 days over a qualifying period of at least 365 days and the days spent in the United Kingdom must not exceed 1/6th of the overall number of days in the qualifying period.[85]

X would not ordinarily or otherwise be resident in the United Kingdom where he performs all his duties abroad, his absence from the United Kingdom and his employment abroad both last for at least a whole tax year and his visits to the United Kingdom total less than 183 days in any tax year and average less than 91 days in a tax year where the average is calculated over a 4-year period.[86]

There is also the issue of UK tax liability for income derived by UKCO in relation to services performed by its employee, X. Broadly, UKCO will be obliged to set up a payroll register from which salary payments to X are made and to make national insurance contributions on behalf of X.[87] At the same time, however, UKCO is entitled to claim deductions in respect of salary paid to X.[88] To that end, and with some forward planning, UKCO could possibly minimize its exposure to UK taxation where its main source of income is from the foreign employment service performed by X on its behalf.

The French income tax position

X will be regarded as a French resident where either he has (i) a principal place of residence in France, (ii) carries on a trade, business or profession in France, or (iii) has the centre of his economic interests in France.[89] Assuming that X usually stays in France while performing employment services, then he will be deemed a French resident. In this regard, a principal place of residence is where the taxpayer *usually* stays. Thus, a taxpayer can have his principal place of residence (and be resident) in France, even if (i) the spouse and/or the children do not live in France, or (ii) the individual spends a sufficient amount of time in France but not necessarily a minimum 183 days. An individual may be considered as having his principal place of residence in France during a given tax year, if it appears that, in fact, France is the one place where such individual has, during such given year, spent most of his time.[90]

83. Extracted from the speech of the Director-General of the WTO, Renato Ruggiero, delivered on 17 April 1997 and reproduced in *Trading into the Future* (WTO, 1997). See also Jackson, *supra* note 12, at 340-341, where it is noted that the WTO system may be the only mechanism to reduce small countries' vulnerability to blocking of its exports by other nations.

84. Information on French domestic tax laws is obtained from *Value Added Taxation in France* (IBFD Publications BV, Amsterdam, 1995, loose-leaf); *Taxation of Individuals in Europe* (IBFD Publications BV, Amsterdam, 1997, loose-leaf); and *French Tax and Business Law Guide* (CCH Editions Limited & Editions Francis Lefebvre, 1994-1997, loose-leaf). Information on the UK tax system is derived from legislation; *Orange Tax Handbook* 1996-97 (21st edition) (Butterworths, London, 1996); and *Yellow Tax Handbook* 1996-97 (35th edition) (Butterworths, London, 1996).

85. See Sec. 193 and Sch. 12 of TA 1988. For ease of administration, most developed nations provide a foreign employment income exemption for residents temporarily working abroad, although the United Kingdom, in the 1998 Budget, announced the repeal of the exemption for income derived by taxpayers satisfying the 1/6 rule; see highlights of "UK Budget 1998" in Vol. III, No 2 (1998) *Offshore Red*, at 46.

86. See October 1996 edition of UK Inland Revenue Department's International Series *IR* 20, entitled *Residents and non-residents*, at para. 2.2.

87. See M.R. Moore, "Taxation of Individuals in the United Kingdom", in *Taxation of Individuals in Europe* (Guide VI) (IBFD Publications BV, Amsterdam, loose-leaf), at 10.3.1., for a description of the national insurance contributions scheme for expatriate employees.

88. See generally Sec. 203 of the *Income and Corporations Taxes Act* 1988 (TA 1988).

89. CGI Art. 4 B.

90. See M. Henderson, "Taxation of Individuals in France", in *Taxation of Individuals in Europe* (Guide VI) (IBFD Publications BV, Amsterdam, loose-leaf), at 1.2.1.

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Where X is deemed a French resident, then his worldwide income will be subject to French tax.[91] Where, on the other hand, X is deemed a French non-resident deriving employment income in respect of an activity performed in France, then a withholding tax may be levied in order to ensure that tax owed by non-residents is effectively collected. The withholding tax (*retenue à la source* or *prélèvement*) is levied at source at the time of payment on certain categories of income (viz., income derived from professional activities, whether salaried or not, performed in France[92]) and is regarded as a payment on account of the taxpayer's liability to income tax. However, it will be in complete satisfaction thereof to the extent that the taxable income does not exceed FRF 177,430. Where the income exceeds this threshold, the excess will be taken into account when assessing the taxpayer's liability to income tax the following year.[93] Failure to pay the withholding tax or knowingly failing to make a sufficient payment, may result in a penalty equal to the withholding tax payment that was not made.[94]

The above tax treatment depends largely on how the French authorities characterize the income derived by X from activities carried out in France – i.e., whether it is employment income or professional services income, which, in turn, is dependent on whether X is regarded as an employee of FCO. Professional income is defined in CGI, Article 92 widely to include profits from exercising a liberal profession (e.g., lawyer, chartered accountant, architect, etc.) and is computed on a purely cash basis subject to the possibility of the taxpayer electing for an accruals basis under CGI, Article 93. Computation of employment income, on the other hand, entails deduction of social security, health, unemployment and retirement fund contributions which are to be withheld at source by the employer.[95]

91. CGI, Art. 13.2.
92. CGI, Art. 164 B.
93. CGI, Art. 197 B.
94. CGI, Art. 1768 and decision of the Paris administrative court of appeal Ct App Paris, 91-850 and 91-1006, 18 March 1993.
95. CGI, Art. 83. See Henderson, *supra* note 90, at 2.2.6., for description of deductions available to the employee.

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NEW ZEALAND

THE COALITION GOVERNMENT'S SECOND BUDGET – LITTLE EVIDENCE OF SIGNIFICANT TAX CHANGES

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I. INTRODUCTION

On Thursday, 14 March 1998, the New Zealand Coalition Government delivered its second Budget. With the next general election scheduled for October 1999, this was the opportunity for the government to set the fiscal scene in the lead up to the election. Instead, what emerged appears closer to the budget typical of the previous National Government, with minimal increases in taxes, continued deregulation measures, and cutbacks in government spending on welfare beneficiaries. The Treasurer, Hon. Winston Peters (also leader of the junior coalition partner party, New Zealand First), delivered a budget with the hallmarks of the Minister of Finance and senior National Party member, Rt. Hon. Bill Birch. This was also the first budget delivered under the leadership of the new Prime Minister, Rt. Hon. Jenny Shipley.

The key developments introduced in the Budget are set out below.

Key initiatives in the 1998 Budget

Revenue items

(1) A fiscal surplus of NZD 2.8 billion, NZD 1.3 billion bigger than forecast;
(2) confirmation of the 1 July 1998 tax cuts, reducing the lower statutory rate to 19.5 per cent and increasing the threshold for the higher rate to NZD 38,000;
(3) net debt repayments to total NZD 2.2 billion over 3 years;
(4) a bond programme of NZD 2.7 billion;
(5) increasing the tax on tobacco by NZD 0.50 per packet of 20 cigarettes;
(6) removing motor vehicle tariffs as from midnight on Budget night;
(7) increasing road user charges to 15 per cent and increasing the excise tax on petrol and other fuels;[1]
(8) closing the scheme for Farm and Fishing Vessel Ownership;
(9) Accident Compensation Corporation to be put into a competitive environment for compulsory workplace insurance in terms of the delivery of the Employer's Account of the ACC scheme from 1 July 1999;
(10) stamp duty to remain.

Expenditure items

(1) A single agency from 1 October 1998 for all employment and related services;
(2) social welfare benefit reform, including cutbacks in invalid and sickness benefits to match the unemployment benefit, and a community wage, by which certain beneficiaries must work for their benefit;
(3) additional funds of NZD 101 million over 3 years for the Children's and Young Person's Services (CYPS);
(4) increasing the health vote to reach NZD 6.2 billion for 1998/99;
(5) increasing the education vote to reach NZD 7.1 billion for 1998/99;
(6) providing an additional NZD 157 million over 3 years for the law & order vote and a further NZD 8 million for the corrections programme;
(7) injecting an extra NZD 23 million over 3 years for immigration;
(8) further funding for conservation (NZD 10.5 million) and energy efficiency (NZD 4.3 million).

Business issues

(1) Removing the statutory backing of producer boards (such as for dairy products and produce);
(2) continuing with the process of reviewing compliance costs of doing business, such as reviewing legislation governing occupational regulation;
(3) parallel importing legislation introduced to free up use of copyright material.

Further key Budget economic initiatives for the next 3 years include: divesting the Crown (or government) of its ownership of Auckland International Airport in a manner to ensure all New Zealanders have the opportunity to buy shares; and selling the Crown's ownership of two further state-owned enterprises. Of particular interest are the tax changes and initiatives announced in the Budget, and these will now be examined in turn.

1. Including long-term changes for managing and funding roads.

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II. TAX CHANGES ANNOUNCED IN THE BUDGET

A. General economic and fiscal forecast

The forecast fiscal surplus of NZD 1.3 billion in 1998/99 is around NZD 500 million lower than forecast in the 1997 December Fiscal Update. However, fiscal surpluses are expected to rise again after the 1998/99 year as steady growth in revenue outpaces increases in expenditure. Underlying the current uncertainty of the timing and speed of the rise in economic conditions is the timing of the expected recovery in Asia, and vulnerability of New Zealand with its high current account deficit. The current account deficit is estimated to peak at 8 per cent of GDP in the year to March 1998 and to remain around these levels in the year to March 1999. From 1998/99 the deficit is expected to fall gradually to below 6 per cent of GDP in 2000/01. Consequently, the fiscal forecasts predict operating surpluses of 2.8 per cent of GDP in 1997/98, falling to 1.3 per cent in 1998/99, and then rising to 2.6 per cent in 2000/01.

A further casualty of the lower short-term nominal economic growth and the removal of tariffs on motor vehicles is tax revenue. This is expected to fall in 1998/99 and 1999/2000 by NZD 850 million and NZD 300 million, respectively. Consequently expenditure must be closely watched and if necessary, further reductions made to ensure surpluses are maintained.

Striving to achieve fiscal surpluses is mandatory with the enactment of the Fiscal Responsibility Act 1994. This Act rests on the principles of responsible fiscal management. To this end, the Budget states that the government's key fiscal management objectives are:

(1) expenditure management to get spending below 30 per cent of GDP;
(2) tax revenue management to ensure tax rates are predictable, fair and as low as possible;
(3) net public debt reduction to below 20 per cent of GDP in 2000/01 (this compares to 50 per cent of GDP in 1991/92 and 25 per cent in 1997/98);
(4) building up the net worth of the Crown to significantly positive levels.

To further improve operating surpluses, the government has set aside NZD 300 million of the NZD 5 billion policy initiative intentions proposed under the Coalition Agreement. However, with the forecast improvement in the New Zealand economy in 1999 and beyond, tax revenue is expected to turn in a positive direction for the government and be NZD 220 million higher than earlier forecast in the 1997 December Update for 2000/01.

B. Second round of tax cuts

The second round of tax cuts is expected to continue with no move to repeal legislation passed in late 1996 to delay the scheduled tax cuts of 1 July 1997 by 12 months to 1 July 1998. The two statutory rates and thresholds are set out in Table 1.

Table 1:
Statutory rates and thresholds: 1997/98 and 1998/99

Threshold income	Year to 31/3/98 NZD	As at 1/7/98 NZD	Year to 31/3/99 NZD
up to	34,200 (21.5%)	38,000 (19.5%)	34,200 (20%)
over NZD 34,200, and up to			38,000 (22.875%)
over	34,200 (33%)	38,000 (33%)	38,000 (33%)

For example, the 1 July 1998 tax cuts will for a person earning an average salary of approximately NZD 36,000, increase their take-home pay by over NZD 900 a year (NZD 18 per week). This is equivalent to a 3.3 per cent pay rise. However, the company tax rate will remain at 33 per cent of taxable income.

With the poor state of New Zealand's economy and lower than expected fiscal surpluses, it is not surprising that there was no mention of any further tax cuts after 1 July 1998. Therefore, with the absence of any reference to tax cuts, further cuts are at least three years away unless there is an unexpected pick-up in economic growth. However, if the tax cuts on 1 July 1998 boost economic growth, then pressure will grow on the government to adopt a more positive approach to further tax cuts.

Taxes as a percentage of GDP are not projected to drop over the next three years. Taxes exceed 33 per cent of GDP currently, with the main sources of tax revenue for 1997/98 set out in Table 2.

Table 2:
Key sources of revenue for the 1997/98 financial year

Item	NZD million	Percentage
individuals – business and non-business	15,512	46.2
company taxes	4,952	14.7
goods and services tax	8,080	24.1
excise taxes & customs duty	2,695	8.0
other	2,361	7.0
total	33,600	100.0

C. Excise taxes

1. Tobacco

The tax on tobacco will increase by NZD 0.50 for a packet of 20 cigarettes from midnight 14 May 1998 (that is from Budget night). The tax increase is expected to raise an extra NZD 7 million in 1997/98; NZD 56 million in 1998/99; NZD 57 million in 1999/2000; and NZD 61 million in 2000/01. Tobacco companies are required to build this cost into their price, which will also increase the amount of Goods and Services Tax (GST) on the final price of a packet of cigarettes.[2]

2. It is not surprising that smokers are not happy with this change, especially since the amount of the excise tax has increased the price paid for a packet of cigarettes over 100 per cent during the past ten years.

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2. Motor vehicle tariffs

Tariffs imposed on motor vehicles were abolished effective midnight, 14 May 1998. With tariffs set at 22.5 per cent, they contributed NZD 300 million to the government's consolidated fund in 1997. It was originally intended by the Coalition Agreement that these tariffs would be removed on 1 December 2000, or sooner if the local car assembler industry closed. The industry has not closed but it is expected that the last remaining assemblers will close by the end of the year.

The tariff reduction applied to vehicles landed in New Zealand before 14 February 1998, but which had not been sold by dealers. Several motor vehicle dealers commenced a process to frustrate the spirit of the change by exploiting a loophole in the Budget proposal. Specifically, they proposed a scheme by which these vehicles could be shipped out of New Zealand to either Australia or Fiji, and then reimported, and the customs duty previously paid (in the range of NZD 5,000 to NZD 6,000) claimed back. The government has acted to close this loophole and prevent approximately NZD 30 million being paid in refunded duties.

3. Roading

Measures were announced in the Budget to raise an additional NZD 140 million in funding for road construction and maintenance. To this end, road user charges for 1- to 3-tonne diesel vehicles are to be increased by 9 per cent to a total of 15 per cent.

Furthermore, the excise duty on LPG and petrol has been increased by 2 to 2.1 cents per litre. Oil companies have responded with average pump price rises of approximately 3 cents per litre. Importantly, this 2.1 cents per litre of excise petrol duty will be utilized for roading purposes. However, further directions for change in managing and funding roading for the longer term will be announced later this year.

D. Farm and Fishing Vessel Ownership Scheme

Amendments to the Farm Ownership Savings Scheme Act 1974 and the Fishing Vessel Ownership Savings Scheme Act 1977 have been introduced to close these schemes by 30 June 2001. Accounts that are closed before 30 June 2001 will be entitled to all subsidies earned up to 14 May 1998. These schemes have been a legacy of the late 1970s and early 1980s environment, with their closure representing a tidying up exercise.

E. Compliance costs

Legislation regulating occupations, such as the various trades and professions, is to be reviewed in 1998. As a further step in facilitating the operation of the free market, the government announced its commitment to making it easier to do business. To give effect to its intentions, it proposes introducing processes that will stop poor-quality regulations being introduced and to remove unnecessary and outdated laws. Several pieces of legislation are under review, including the Commerce Act 1986, the Securities Act 1978 and the Resource Management Act 1991.

There are further measures in place to review – but not actually reduce – compliance costs. These include revisiting the new penalties regime and levels of overall tax compliance.

F. Corporate and other taxes

Corporate taxes, in particular, are projected to rise significantly over the next three years from NZD 4.9 billion (14.7 per cent of tax revenues) to NZD 6.0 billion (16.1 per cent). This substantial increase in tax collections from companies reinforces the change in environment from the 1980s when corporates bore less than their fair share of tax.

It is interesting to note that the Crown's Accounts do not separately classify use of money interest or tax penalties. This non-disclosure makes it difficult to accurately determine the effect of earlier attempts to tighten the tax rules and consequently the effects of the recently revamped penalties regime. The range of tax shortfall penalties only started to have real effect in the 1997/98 income year for PAYE and GST returns. Income tax audits on tax returns for the 1997/98 and subsequent income years will also be able to utilize this new regime.

Taxpayers' attitudes towards meeting their tax obligations have changed significantly as a result of the introduction of the last round of penalties and the significant extension of the use of money interest regime. While New Zealand's interest rates are currently very high by world standards for developed nations, the current 13.9 per cent (14.69 per cent from 7 July 1998) on underpayments of tax is regarded as sufficiently punitive to motivate corporates to overpay their tax (and receive interest at the rate of 7.1 per cent (8.26 per cent from 7 July 1998)).

With over NZD 1 billion collected each year in Resident Withholding Tax (RWT) on interest and the government projecting 90-day interest rates to remain at nearly 8 per cent or higher over the next three years, it is a little surprising that the estimates predict RWT to increase, even though the RWT rate falls from 21.5 per cent to 19.5 per cent on 1 July 1998 as a result of the tax cuts.

G. Committee of Tax Experts

One of the sources of this expected increase in company tax could flow from the recommendations to be made by the Committee of Tax Experts, formed in late March 1998. This Committee of Experts on Tax Compliance is chaired by retired Court of Appeal judge, the Rt. Hon. Ian McKay. The committee of four tax experts also includes Dr Tony Molloy QC, Professor John Prebble and Mr John Waugh.

Dr Molloy is a controversial tax expert with his criticisms of the activities and parties involved in the Commission of Inquiry into Certain Matters Relating to Taxation (the Wine-Box Inquiry – see article in February 1998 issue of the *Bulletin*). He recently released a book criticizing the activities of

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one of New Zealand's leading law firms concerning their involvement in promoting and operating special partnerships carrying on bloodstock and film investments.

Professor Prebble, an acknowledged tax expert in avoidance and evasion, and leading tax academic and writer, is an outspoken critic of the activities of the parties involved in the Wine-Box Inquiry. Like Dr Molloy, he takes the view that the activities referred to in the Wine-Box Inquiry amount to tax evasion.

John Waugh is a well-respected tax accountant who has chaired one consultative committee on tax simplification and made numerous contributions on behalf of the Institute of Chartered Accountants of New Zealand to submissions, seminar presentations and taxation texts.

The Committee has the brief of making recommendations on improving tax laws and policy to ensure compliance with those laws. Particularly, the Committee will focus on policy recommendations to reduce compliance costs, make tax laws more coherent and understandable and keep the tax system robust against avoidance and evasion. The government considers this body may lead to "fiscally positive policy changes", which, in the absence of tax rate increases, can only mean tighter tax rules for calculating and collecting taxes. The Committee will not consider the recommendations set out in the Wine-Box Inquiry Report.

The terms of reference for the Committee of Experts on Tax Compliance includes several considerations. First, tax compliance costs will be reviewed. The level of compliance costs and efforts aimed at their reduction has been an important policy issue in New Zealand for the past four to five years.

Secondly, the Committee will consider how tax laws may be simplified and made more coherent and understandable, while ensuring an appropriate balance between the levels of complexity, fairness, accuracy and economic efficiency. Effectively, the Committee is charged with taking New Zealand's tax system closer to the theoretical "good tax system" as originally promoted by Adam Smith in his 1776 book *An Inquiry into the Wealth of Nations*.

Thirdly, the tax system needs to be more robust in order to guard against avoidance and evasion. The Committee will be expected to identify and bear in mind the underlying causes of such activity, and have particular regard to:

- the use of tax-driven structures lacking business reality;
- abuse or complicity by tax advisers;
- standards of conduct for tax advisers;
- concealment and other tax-related offences and the possibility of confiscating concealed profits;
- the lack of prosecutions to prevent harmful tax practices and schemes;
- the adequacy of the current penalties regime, including criminal penalties;
- achieving disclosure of tax schemes affecting the amount of tax payable by more than NZD 100,000;
- the possibility of treating the failure to disclose (or falsification of material facts) by a person experienced in tax matters as a serious criminal offence, and establishing it as punishable by a maximum penalty of ten years imprisonment where more than NZD 5 million in tax revenue is involved;
- the possibility of recovering from large-scale tax evasion schemes (say NZD 100,000 and over), and from those who aid them, profits attributable to the use of unpaid tax (unjust enrichment); and
- the internationalization of the economy, including electronic commerce and how the taxation collection base can be maintained.

The recommendations on the above issues which the Committee makes must be consistent with:

- the Coalition Agreement of the government;
- the government's revenue strategy;
- the Generic Tax Policy Process;
- the maintenance of a broad-based, low tax rate system;
- the maintenance of the existing tax rates and tax mix;
- there being no decrease in the extent to which the income tax laws focus on the taxation of a comprehensive definition of income;
- there being no decrease in total tax revenue; and
- there being no increase in overall compliance costs.

Given the enormous scope of its brief and potential impact that the recommendations may have on tax law and practice in New Zealand, the government has imposed an extremely tight time frame on the Committee to report by 21 December 1998.

H. Stamp duty to remain

This year's Budget projects NZD 189,000 to be collected from stamp duty in the year to 30 June 1998. Many commentators have argued persistently that it is time that stamp duty was abolished (it has been narrowed in scope over the years), but to no avail. No rational policy reason for retaining stamp duty has been raised. Furthermore, as it stands, stamp duty distorts decision-making, adds substantially to compliance costs and collects minimal revenue, the worst qualities that any tax or duty may have.

I. Funding for the Inland Revenue Department

The appropriations for 1998/99 for the IRD provide interesting, if not confusing signals:

- There is no increased funding to be allocated to the Adjudication and Rulings Unit which manages tax disputes and issues binding rulings. This service operates on a user-pays basis. The delays in obtaining rulings are now unacceptably high, especially for private rulings. Without increased funding (by way of appropriations or by users) the scheme may cease to operate viably. The appropriations statement notes that 95 per cent of private rulings will be completed within 14 weeks of receipt (a 50 per cent increase from the time taken 12 months ago).
- On audits of companies undertaken by the IRD's Corporates Unit, NZD 2,500 in tax is expected to be assessed for every hour spent on the audit. However, the government does not state that it will require the IRD to actually col-

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lect this amount as part of a service performance objective criteria.
- A material discrepancy is expected to be identified in all audits and investigations completed by the Corporates Unit, although materiality is not defined.

III. CONCLUSIONS

A. Tax announcements

The 1998 New Zealand Budget is low-key in terms of major tax changes, although there are several important developments which will have an impact on tax revenues. The Fiscal Responsibility Act 1994 removes most surprise fiscal announcements from the Budget. Rather, important developments are foreshadowed during the preceding months with the detail left to the Budget and ensuing political debate.

The important tax developments confirmed by the Budget include confirmation of the 1 July 1998 tax cuts (with no further tax cuts foreshadowed for the next three years), increasing the tax on tobacco, removing motor vehicle tariffs, increasing road user charges, opening up the Accident Compensation Corporation to competition, and the retention of the inefficient stamp duty. Great expectations are held of the Committee of Tax Experts, when it delivers its report, to recommend significant changes to the New Zealand tax system, especially for corporate taxpayers.

B. Internet resources

Full Budget documentation is available at the New Zealand Treasury's web site.[3]

3. At: http://www.treasury.govt.nz/pubs/bmb/budgets/1998/toc_bud.htm Statements from the Treasurer and Minister of Finance, all Budget 1998 press releases and highlights from various portfolios are available at the New Zealand Cabinet's web site: http://www.executive.govt.nz/budget98

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VIETNAM

BUILDING SYSTEMS OF INCOME TAXATION IN A TRANSITION ECONOMY: THE CASE OF VIETNAM

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I. INTRODUCTION

Vietnam started its tax reforms in 1990 and since then the entire tax system has undergone numerous changes. Unlike many countries in transition, Vietnam has been able to maintain and even raise the level of tax revenues to over 20 per cent of the Gross Domestic Product (GDP) in the past three years. Despite this remarkable level of revenue mobilization, the pace of tax reform has slowed down in the past two years, and the overall effectiveness of the tax system in raising revenues may be declining.[1] The objective of this paper is to analyse the current system of business and personal income taxation in Vietnam, assess the progress of the reforms to date, and make suggestions for future changes.

II. DEVELOPMENT OF DIRECT TAXATION IN VIETNAM

Prior to Vietnam's economic reforms in the late 1980s, the government relied on state-owned enterprises (SOEs) for a large proportion of its revenues. Since the government played the double role of owner and tax collector, the means of extracting revenues from SOEs, whether profits tax, turnover taxes, depreciation charges, capital fees, etc., was immaterial. By setting the prices of inputs and outputs, and determining the re-investment plan for SOEs, the government would determine the surplus of an SOE and could subsequently extract as much of the surplus as desired. With price liberalization and the ensuing competition between private enterprises and SOEs, as well as among SOEs, such surpluses were expected to fall or disappear. Indeed the surpluses did decline. Consequently, the government was in need of a new tax system that would extract revenues within a legal framework from the incomes of both state-owned and private enterprises. While designing a tax system compatible with a market economy, Vietnam needs to sustain, to the extent possible, a fiscal balance by avoiding sharp declines in government revenues.

Towards this end, Vietnam proceeded to enact a number of taxes in the early 1990s. In 1990, the business profits tax, which had proved to be a main source of revenues for socialist economies both during the periods of central planning and transition, was one of the first in a series of taxes to be implemented. The profits tax was introduced together with the special consumption (excise) tax and the turnover tax, although the profits tax was limited in its first four months to the non-state sector before being extended to the state sector. The natural resource tax law was also enacted in 1990. This was followed by the personal income tax law in 1991, and the remaining wealth tax laws were enacted between 1992 and 1994.

III. INCOME TAXATION IN PERSPECTIVE

Direct taxes include income and wealth taxes. In Vietnam, these consist of the business profits tax (to be replaced by the corporate income tax in January 1999), the natural resource tax, the personal income tax on high-income earners, the agricultural land tax, the land and housing tax, and the tax on the transfer of land use rights. As is typical of developing countries, the contribution of direct taxes to government revenues in Vietnam has been substantially lower than that of indirect taxes.[2] While indirect taxes have accounted for 56 per cent of tax revenues over the past three years in Vietnam, direct taxes have accounted for 29 per cent of tax revenues; with income taxes, and wealth and property-related taxes, contributing 25 per cent and 4 per cent of tax revenues respectively (see Table 1).

* The authors would like to express their gratitude to Glenn P. Jenkins and David Dapice for many insightful comments. They would also like to thank the officials from the Ministry of Finance of Vietnam for their assistance. Discussions with John Bentley, Frederick Burke, and Jimmy Thai Trong Hoa have been extremely useful. This paper was developed from a study completed as part of a project undertaken by HIID and financed by the Ministry of Finance, Government of Japan. The authors are responsible for all remaining errors.

1. The authors have discussed the evolution of the tax system and analysed indirect taxation in Vietnam in "Reform of Indirect Taxation in a Transition Economy: The Case of Vietnam", 1997, Working Paper No. 1007 in Working Paper Series by Harvard International Tax Program.
2. World Bank (1991) provides a number of statistics on direct taxes in developing countries and discusses their contribution to gross tax revenues.

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Table 2 provides a comparison of revenues from income taxes, the largest revenue source of direct taxation in Vietnam, for a number of countries of higher income levels in the region.[3] One can also infer from the table that the contribution of income taxes, both as a percentage of tax revenues and as a percentage of GDP will increase as incomes rise. For example, in Thailand, income taxes grew from 2.6 per cent of GDP (20 per cent of tax revenues) in 1980 to 5.5 per cent of GDP (33 per cent of tax revenues) in 1994; income taxes in Malaysia grew from 5.4 per cent of GDP (33 per cent of tax revenues) in 1970 to 9.5 per cent of GDP (45 per cent of tax revenues) in 1994.

Table 1*: Composition of tax revenues

	1991	1992	1993	1994	1995	1996
	(billions of current Vietnamese dong)					
tax revenues	**8,842**	**16,004**	**25,606**	**34,982**	**46,920**	**52,506**
indirect taxes	3,903	7,114	12,339	18,680	26,947	30,206
direct taxes: comprised of –	1,824	5,701	8,602	10,399	12,740	15,474
business profits tax	1,019	2,495	4,959	6,748	7,878	9,538
personal income tax	62	153	193	336	400	700
natural resource tax	31	1,742	1,914	1,988	2,432	2,800
agricultural land tax	707	1,293	1,351	1,107	1,450	1,782
land and housing tax**	5	18	185	220	260	324
tax on transfer of land use right					320	330
	(in per cent of tax revenues)					
indirect taxes	44.1	44.5	48.2	53.4	57.4	57.5
direct taxes: comprised of –	20.6	35.6	33.6	29.7	27.2	29.5
business profits tax	11.5	15.6	19.4	19.3	16.8	18.2
personal income tax	0.7	1.0	0.8	1.0	0.9	1.3
natural resource tax	0.35	10.9	7.5	5.7	5.2	5.3
agricultural land tax	8.0	8.1	5.3	3.2	3.1	3.4
land and housing tax**			0.7	0.6	0.6	0.6
tax on transfer of land use right					0.6	0.7

*. Rounding etc. differences exist.
** This is currently a tax on land only. No provisions in the law were made for taxing housing or other types of construction.

Source: Data provided by Ministry of Finance, and Statistical Yearbook in Vietnam (1995).

Table 2: International comparison of income tax revenues*

	Income tax revenues as a percentage of tax revenues*	Income tax revenues as a percentage of GDP
Vietnam (1994-6)	25	5.0
Malaysia (1970)	33	5.4
Malaysia (1994)	45	9.5
Thailand (1980)	20	2.6
Thailand (1994)	33	5.5
Korea (1980)	26	4.0
Korea (1994)	45	7.6
India (1980)	22	2.1
India (1994)	29	2.8
Philippines (1980)	24	n/a
Philippines (1995)	34	n/a

* Taxes on income, profits, capital gains, natural resources, as well as social security.
n/a Not available.

Source: Vietnam estimates based on data from Vietnamese Ministry of Finance. Malaysia data for 1970 from Asher (1989). All other estimates based on data from Table 4.17 in World Development Indicators 1997.

Revenues from income taxes (including natural resources) amount to about one fourth of total tax revenues collected in Vietnam and have increased from 1.4 per cent of GDP in 1991 to 5 per cent in 1996. The growth in income tax revenues as well as direct tax revenues, however, has been fairly volatile as shown in Table 3. From 1992 to 1994, income tax revenues were characterized by their buoyancy, but failed to grow in 1995. In 1996, income tax revenues bounced back growing at a rate faster than that of GDP.[4] The high buoyancy for certain taxes in the early 1990s reflects the fact that tax revenues were initially very low when tax laws first came into effect. As the awareness and enforcement of these laws increased, revenues grew very fast compared to GDP growth. In other words, during the early 1990s, it is fair to say that both the tax administration and taxpayers were still in the process of getting to grips with these taxes.

The volatility in growth rates and buoyancy is not unusual given that the tax system in Vietnam is very young and that changes and adjustments are being constantly made in order to reach a state of equilibrium. Nevertheless, the country's

3. World Bank (1991) presents averages for Asian and industrial countries.
4. A buoyant revenue system is one where tax revenues have been growing at least as rapidly as the rate of growth in GDP and the growth in revenues includes the impact of all discretionary changes in the tax rates and tax base.

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own short experience in designing and fine-tuning its tax system and the lessons learnt from the experiences of other countries, make it possible for Vietnam to approach this equilibrium rather quickly. More importantly, Vietnam is at a sensitive stage in its economic development where it *must* reach this equilibrium soon as both foreign and domestic investors alike are looking for stability, transparency and equity in the tax system. Furthermore, the government needs stable and adequate revenues to be able to finance its badly needed social and physical infrastructure expenditures.

Table 3: Buoyancy of tax revenues*

	91/92	92/93	93/94	94/95	95/96
total tax revenues	4.24	4.94	2.19	1.29	0.33
indirect taxes	3.46	7.40	3.48	1.97	0.59
direct taxes	15.78	3.95	0.63	(0.01)	1.32
income taxes	23.0	5.04	1.38	(0.13)	1.30
business profits tax	9.84	9.12	2.14	(0.24)	1.23
personal tax	10.01	1.28	5.91	(0.04)	6.52
natural resource tax	(0.48)	(1.06)	0.25	0.65	
wealth taxes	4.52	0.31	(2.79)	0.82	1.44
agricultural land tax	4.41	(1.06)	(3.23)	1.01	1.41
land and housing tax	19.94	98.67	0.44	(0.12)	1.58

* Buoyancy is the ratio of percentage change in real taxes to percentage change in real GDP. The rate of growth in revenues includes the impact of all discretionary changes in the tax rates and tax base.

Source: Buoyancies estimated on basis of data from International Monetary Fund, and Vietnamese Ministry of Finance.

IV. TAXATION OF BUSINESS INCOME

A corporate income tax (CIT) law (03/1997/QH9) was passed by the National Assembly in Vietnam on 10 May 1997 to replace the existing business profits tax law and will come into effect on 1 January 1999. We start the analysis with the existing business profits tax and then proceed to the recently passed new CIT law to provide the readers a better sense of the progress of the reforms.

A. Existing business profits tax[5]

The profits tax was first introduced in 1990 and is currently levied on the income of all business enterprises whether private, state, joint ventures or foreign owned. The tax has broad coverage with many exemptions and reductions to be decided or confirmed by the Ministry of Finance on a case-by-case basis. Profit tax revenues collected in 1996 are estimated to be about 18 per cent of total tax revenues and 3.6 per cent of GDP. Profits tax revenues have almost tripled from 1.3 per cent of GDP in 1991 to 3.6 per cent in 1996, although the rate of growth in these revenues has been highly variable. There are three different tax structures, one for private domestic companies, one for state-owned enterprises (SOEs) and one for foreign-invested enterprises, which could be either joint ventures or 100 per cent foreign-invested companies.

1. Main features

Private domestic enterprises: Domestic companies face three statutory tax rates; 25 per cent on heavy industries, 35 per cent on light industries and 45 per cent on services. Monthly profits earned by private domestic enterprises in excess of 10 million Vietnamese dong (VND) are subject to an additional extra profits tax of 25 per cent. For example, if a shoe manufacturing business earned a profit of VND 15 million in any given month, the first VND 10 million would be taxed at 35 per cent, and the remaining VND 5 million would be taxed at 60 per cent.

State-owned enterprises: In principle, SOEs are subject to three tiers of business taxation. First, all income is taxed at one of the three statutory rates faced by private domestic businesses. Second, profits in excess of a certain amount are then taxed according to a certain formula. Finally, any remaining profits will be subject to a third tax although very few SOEs, if any at all, pay the third-tier tax. SOEs also have to pay a capital use fee of 0.2 per cent-0.5 per cent per month and a depreciation allowance. The capital use fee is, in fact, an interest charge by the government on any capital provided to SOEs by the State. Recently, the payments of depreciation allowance have declined and are being phased out because SOEs are allowed to keep the depreciation allowances provided they reinvest them in the business. Although this may have a small short term impact on revenues as these payments had reached a high of 8 per cent of total government revenues in 1994, the government has gradually reduced the grants to SOEs who now use more commercial bank credits.

Both SOEs and private businesses enjoy certain exemptions and deductions in tax liability that are mostly decided by the Ministry of Finance.

Foreign-invested enterprises: Foreign-invested enterprises include both joint ventures and 100 per cent-foreign investments. In principle, foreign-invested enterprises face a single rate of 25 per cent. However, various types of investments enjoy preferential rates. For instance, projects employing 500

5. Sources of data for this section: Interviews at Vietnamese Ministry of Finance and Jonathan Haughton (1995). See the latter for a general discussion of the profits tax in Vietnam prior to 1995.

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workers or more, high-tech investments, production for exports, and capital investments of USD 10 million or higher are subject to a 20 per cent profit tax. Heavy industries and long term industrial crops are among investments taxed at 15 per cent. Reforestation projects and infrastructure investments in mountainous areas are subject to a 10 per cent tax rate. In certain cases, the rates are even lower, with enterprises enjoying two years of exemption from the profits tax and up to six years of 50 per cent reduction in the tax rate. Exemptions and lower rates are applicable for a maximum of eight years. The taxation of foreign investment is regulated through the 'Foreign Investment Law' passed by the National Assembly in November 1996. The taxes paid by a particular foreign enterprise will be governed by the terms of its licence. Foreign-invested enterprises are not subject to the extra profits tax and generally pay a lower profits business tax but they are also subject to a profits remittance tax of 5 per cent, 7 per cent or 10 per cent. The appropriate tax rate on remittances is determined on a case-by-case basis depending upon the technology used, the scale of production, the location of the industry and the employment generated. Furthermore, foreign-invested enterprises have to set up a reserve fund using 5 per cent of their after-tax profit. This fund is limited to 10 per cent of the legal capital.

A feature common to all three categories of investors is the reduction of profits tax levied on any profits that are reinvested. The amount of profits subject to the reduced tax rate is estimated using a certain formula and is not unlimited.

2. Assessment of business profits tax

In the years of transition, the business profits tax or the corporation income tax plays a unique role that is not often considered to be the role of such taxes in a more mature developing or industrialized country. Although Vietnam is in transition to a market economy, its markets are far from being competitive. Licences, approvals, privileges and tariff protection are sources of significant financial rents. The business profits tax is an instrument to share these rents (or implicit taxes on consumers) between business organizations and the government. Hence it can be expected that for some years into the future, the revenue function of the corporate income tax will be to extract funds from firms rather than to obtain significant revenues from profits. While the corporate tax will have the usual distortionary effects on the margin, business taxation will be mainly a tax on financial rents.

The situation is quite different when we consider the tax treatment of foreign-owned enterprises or, more broadly, foreign investors. Generally speaking, these investors operate in a competitive environment where any financial rents they acquire are likely to be transitory. In addition, there is a need to attract the technology and the markets that foreign investors dominate. Hence some differences in tax treatment of domestic and foreign enterprises might be warranted. How to do this in an efficient manner that does not alter the structure and integrity of the tax system is a question that we address below.

There is also a great difference between the market forces facing state-owned enterprises (SOEs) and the emerging private sector in a transition economy. SOEs often have heavy social obligations and yield little surplus to be taxed by a profits tax. Also, many SOEs may be the collectors of financial rents because of their privileged positions. Furthermore, it is never clear what is a true measure of profits for SOEs as these enterprises have often received either free equity investment or large quantities of loans from the government. The private sector, on the other hand, may or may not be generating substantial surplus, and the most appropriate corporate income tax would be similar to that found in market-oriented and more developed countries.

Over time as the economy becomes more market-oriented, with fewer distortions, we would expect to see the income tax systems that apply to these three different types of organizations start to merge together. This process is already beginning to happen in Vietnam. However, the profits tax as applied in its present form has several problems.

Multiplicity of tax rates: Domestic enterprises face three base tax rates and foreign-invested enterprises face four different base tax rates. However, due to the possible exemptions and reductions, and the different tiers of taxes, the number of rates is in effect much larger and these rates vary substantially both across and within industries. This kind of variation has four major defects. First, it creates distortions in the deployment of capital. The relatively lower tax rate on heavy industries for both domestic and foreign-invested projects is likely to create a bias in favour of these industries even if other investments yield higher social returns. Second, a system with a large number of exemptions and reductions that vary by sector, geographical location and government discretion creates a lack of transparency and consequently discourages investment. Third, revenue forecasting and tax planning will be extremely difficult for the government; and finally the administration of the system will be very complex.

High tax rates: The highest rate is 45 per cent with an additional 25 per cent tax on any profits in excess of VND 10 million per month. In other words, the marginal rate faced by certain businesses may be as high as 70 per cent. Such high rates provide a strong incentive for tax evasion. Moreover, one should not forget that in an open economy where capital is mobile, labour will almost always bear a certain proportion of the business tax.

Extra profits tax on private businesses: There is not much of an economic or social justification for the extra profits tax. Whereas one can understand a progressive *individual* income tax, progression for *companies* does not make much sense. The extra profit tax could result in the fragmentation of businesses instead of maintaining an economic size. Furthermore, this tax may result in bias against any business activity that follows a seasonal pattern because the profits tax is levied on a monthly basis. If a seasonal business such as fruit processing and canning generates most of its annual income during a few months every year, and their profits during these months exceed VND 10 million (about USD 800) per month, the enterprise will be subjected to the extra profit tax even though the *average* monthly income calculated on an annual basis may be less than VND 10 million.

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Exemption of reinvested profits: This, in effect, is an investment tax credit with all its distortionary impacts. Such credits may end up encouraging short term investments at the expense of more economically rewarding long-run investments (Harberger, 1991).

Low capital use fee: The capital use fee payable by SOEs is low. The rates vary between 0.2 per cent and 0.5 per cent per month while the bank lending rates have varied between 1 per cent and 2 per cent. This provides a major direct subsidy to state sector enterprises.

Exemption of interest payments: While interest on debt is tax deductible, there is no tax on the interest earnings of the debt holders.

Difference in tax treatment: Tax laws in Vietnam are more favourable to foreign investment than to domestic investment. Foreign firms not only enjoy preferential tax rates in general, but they may also be exempt from paying taxes. These incentives create distortions in the deployment of capital and generate political pressure for further tax incentives and tax holidays for other causes. Moreover, the underlying assumption that Vietnamese capital is captive is questionable. This discrimination against domestic businesses may ultimately result in a flight of domestic capital out of Vietnam as the country becomes more integrated with the world economy.

Unclear definition of expenses: The expenses associated with running a business are not clearly defined, particularly the valuation of inventories and calculation of depreciation allowances. This lack of clarity erodes the tax base and also adds to the costs of administration and compliance.

Poor accounts keeping: Small enterprises do not keep accounts and their tax assessments are based on negotiation between the business concern and the tax department. This both erodes the tax base and provides an opportunity for rent seeking.

B. New corporate income tax

Over the past few years, the government has become aware of the problems created by the present business profits tax and a great deal of thought has gone into replacing the current tax by a new corporate income tax law (03/1997/QH9; CIT) that will come into effect on 1 January 1999. The prominent features of the new law are presented below.[6] This is followed by an assessment of the new features and changes.[7]

1. Main features

Broader definition of income:[8] The tax base will include income from leasing assets as well as loan interest.

Tax rates:[9] In principle, there is a uniform rate of 32 per cent applicable to business income. However, there are many exceptions. A few are transitory while others appear to have a longer-term nature.

(a) Foreign-invested companies will still be governed by the Law on Foreign Investment and face the existing lower rates. Foreign companies continue to pay the tax on repatriated profits.
(b) Certain businesses currently taxed at a rate of 25 per cent may continue to face that rate for a maximum of three years if they face 'difficulties' as a result of the increase in the tax rate. At the end of the three-year period, such businesses will face a 32 per cent CIT rate.
(c) The 25 per cent supplementary tax on high profits will still be applied to certain businesses.
(d) New investments in economic and geographical areas of priority are subject to lower rates of 15 per cent, 20 per cent and 25 per cent.
(e) Corporations doing business in some sectors such as oil, gas and other precious natural resources may be subject to a higher tax rate not to exceed 50 per cent.

Loss carry-over provisions:[10] Losses can be carried forward for up to five years.

Exemptions:[11] Several categories of income earners are exempt: farmers paying agricultural land tax,[12] individuals and households engaged in business activity and subject to personal income tax, and cooperatives not enjoying the status of legal entities and subject to personal income tax. In effect, individuals and households engaged in business are not really exempt from the corporate tax but rather from the personal income tax because their income is taxed at 32 per cent and not at the personal tax rates. Other exemptions include income generated from research and development (R&D) contracts, income from technical services for agriculture, and income generated from vocational activities targeted at certain underprivileged groups.

Clear definition of deductible expenses:[13] The new law seeks to clearly define deductions such as depreciation allowance, costs of inputs and utilities, wages and salaries. The actual provisions have to be interpreted with care to ensure that deductions are genuine and that there are not too many categories of assets for the purposes of depreciation allowance. Provisions also have to be interpreted in a consistent manner and expeditiously to reduce uncertainties for the investors and too many possibilities for rent seeking.

Incentives:[14] Many businesses enjoy incentives under the new law:

(a) Newly established enterprises enjoy two years of tax holiday starting from the first profit-making year and a 50 per cent corporate income tax reduction for the following two years. Newly established businesses in the

6. The translation of the CIT law from Vietnamese into English, used as a basis for this analysis, was carried out by the daily newspaper, the *Saigon Times*, and was published on 5 June 1997.
7. Frank Meier (1997) presents a good overview of the new tax law and discusses many of its ambiguities.
8. CIT Law (1997), Art. 7 (2).
9. CIT Law (1997), Art. 10.
10. CIT Law (1997), Art. 22.
11. CIT Law (1997), Art. 2.
12. Farming families engaged in *large* scale commercial activities will not be exempt. It is most likely that these families will be subject to the CIT instead of the agricultural land tax. This, however, is not certain.
13. CIT Law (1997), Art. 9.
14. CIT Law (1997), Arts. 17 to 21.

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mountainous areas may be entitled to an additional two years of tax reduction.

(b) Newly established businesses in 'preferred' sectors enjoy two years of tax holiday starting from the first profit-making year and a 50 per cent tax reduction for the following four years. New businesses undertaking 'preferred' projects in the mountainous areas enjoy three to four years of tax exemption followed by a period of three to eight years of a 50 per cent tax reduction.

(c) Newly established enterprises in the trade and services sector enjoy a 50 per cent tax reduction for one to two years starting from the first profit-making year. If these enterprises are established in mountainous areas or impoverished inland areas, the business will enjoy one to two years of tax holiday starting from the first profit-making year followed by a 50 per cent tax reduction for up to five years. Also, a 50 per cent tax reduction of one year may be given to production units that produce import substitution items.

(d) Foreign-invested enterprises will continue to enjoy the same benefits enjoyed under the current business profits tax which may include up to a maximum of eight years of tax exemption.

(e) Businesses investing to develop new production lines, expand scale, upgrade technology, improve the environment or enhance production capacity enjoy exemption from CIT on the incremental income for the first profit-making year and a reduction of 50 per cent of CIT for the following two years.

(f) Total or partial refund of CIT paid on income that was reinvested in the enterprise. The rate of refund will depend on the economic sector, the locality and period of investment.

(g) Businesses relocating to the mountainous regions or offshore islands will enjoy three years of tax exemption starting from the first profit-making year.

Penalties:[15] Penalties can be divided into three broad categories depending on the type of breach of law. For failing to comply with regulations regarding registration, declaration or use of accounting methods and vouchers, the violators will be warned or fined. For evasion or false declaration, violators will face fines ranging from 1 to 5 times the tax owed. For late payments, there is a fine of 0.1 per cent per day on the amount due. For major violations, offenders may be prosecuted according to the criminal code.

Also, tax officers who are found to act in contravention of the provisions of the law will be subject to administrative action as well as criminal investigation. Officers who perform their tasks satisfactorily and those who discover breaches of law made by taxpayers will be rewarded by the government.

Appeals:[16] Appeals may be lodged with the tax agency responsible for the first assessment within 30 days of the notice of settlement. Full payment, however, must be made before such an appeal is entertained. A second appeal may be filed with the next superior authority. In case of successful appeals, refunds will be made along with compensations that may be due. Appeals are to be settled within 30 days of the receipt of the complaint.

2. Assessment of CIT law

There are very few significant differences between the newly passed CIT law and the existing business profits tax law. On the positive side, loan interest is taxed, the tax base appears to be broader, expenses are better defined, and taxes are assessed on annual instead of monthly income. In principle, the tax rate faced by domestic investors appears to be unified at 32 per cent, but this is not really the case as projects in the heavy-industry sector (mostly producing import substitutes) may enjoy lower CIT rates if they are considered to be a 'priority' sector, as is the case under the current business profits tax. The law falls short in terms of remedying many of the defects of the existing business profits tax. Although many of the problems were addressed in the proposals that were being debated, it appears that very few of the suggested remedies were implemented. Some of the main problems that remain are addressed below:

- Foreign-invested enterprises and domestic enterprises are still taxed at different rates with no apparent plan on the horizon to unify these rates.
- The large number of tax rates and their differentiation by sector, by project type, by geographic location, or by project length remains a problem.
- The law has too many tax incentives in terms of tax exemptions and reductions.[17] Tax holidays or reductions in tax rates for all newly established units in the production or service sectors will erode the tax base and complicate the administration and are unlikely to bring in commensurate benefits to the economy. In any case, studies have not clearly demonstrated any definite gains to countries offering tax holidays or reductions in tax rates. These measures often turn out to be exercises in window dressing and are of questionable value in attracting more investment. A stable and transparent tax system with a comprehensive base and low rates is more effective than short-term gimmicks.[18]
- It would be better to remove the ambiguity in tax rates relating to the natural resource sector. The new rates will vary from 32 per cent to 50 per cent on rare and special natural resources, and will be 50 per cent on oil and gas. It would help create a better investment environment if the same uniform rate of 32 per cent applicable to all other sectors of the economy is also applied to this sector. Similar to the case of oil and gas, an *ad valorem* royalty should be used in conjunction with the CIT for capturing additional rents. This will avoid sub-optimal exploitation of the resource rent from the natural resource sector from Vietnam's perspective. As the market prices of metals, minerals and oil are stochastic in nature, a combination

15. CIT Law (1997), Arts. 24 to 27.
16. CIT Law (1997), Art. 28.
17. There may be some justification for providing tax holidays or reductions of tax rates for companies that operate in mountainous and inaccessible inland areas although it may prove more effective and efficient in the long run to assist these communities by increasing their access to better education, health care, credit and markets.
18. Richard Goode (1984) presents an excellent discussion of why benefits of tax incentives are doubtful and why non-tax factors may be more relevant for attracting investment.

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of royalty and corporate income tax will be a better instrument for the natural resource sector.

– The low capital use fee charged to SOEs still remains in place. This should be replaced by a market rate to help eliminate a serious anomaly between state-sector and private-sector investments.

Interestingly most of the defects of the new CIT are common to the enterprise tax implemented in many economies in transition (EITs) in Eastern Europe and Central Asia.[19] Among the common pitfalls are the multiple rates, the many and generous exemptions and deductions,[20] the complexity of the law and the use of the distortionary investment tax credits.[21] On the positive side, Vietnam has refrained from disallowing legitimate expenses unlike certain of the EITs.

While a comparison with the economies in transition may yield some interesting similarities and differences, perhaps a more telling and important comparison will be with neighbouring countries as Vietnam's taxation system will ultimately have to converge to those of the ASEAN countries. The basic rate of 32 per cent is quite comparable and falls well within the ASEAN range of 27 per cent in Singapore and 35 per cent in the Philippines.[22] The extent to which countries in ASEAN use the corporate income tax to guide investment varies but Vietnam's multiple rates, exemptions and deductions exceed those of ASEAN and should be reconsidered and reduced.

There is often a mistaken view that special incentives must be given to foreign investors in developing countries in order to attract them to do business in the country. A lower effective tax rate on foreign investment may be desirable but special tax incentives might not be warranted given the very special financing capabilities that foreign investors have compared to domestic investors.

Typically, domestic private investors in developing countries operate with high ratios of equity to debt due to the financial risks involved and the requirements of the local banking sector. With the relatively larger amounts of equity, the profits gained by domestic equity provide a substantial base for levying the corporate income tax. This financing constraint does not apply to a foreign investor who can finance any investment entirely by debt, entirely by equity or by any combination of debt and equity.

Consequently, in the absence of thin capitalization rules[23] the effective tax rate per dollar invested is likely to be much lower for foreign investors because they will generally finance foreign investment with much more debt, whose interest is tax deductible. In this situation, the effective tax rate is $W^e t^e + W^d t^d$, where t^e and t^d are the corporate rate of tax on profits and the withholding tax on interest respectively; and W^e and W^d are the respective shares of equity and debt financing. To the extent that the withholding tax on interest is less than the corporate tax on profits, foreign investors will be facing a lower effective tax rate on their business income without any need for tax incentives that alter the structure of the tax system.

V. TAXATION OF PERSONAL INCOME

The personal income tax (PIT) was introduced in April 1991 primarily as a tax on high incomes (incomes in excess of VND 500,000 per month) and has undergone several changes since then. The replacement of the existing personal income tax is under serious consideration by the government and a draft law is expected to be brought to the attention of the National Assembly in the near future.

In developing countries, the personal income tax generally has a narrow base, high rates and generates less revenues than a PIT in an industrialized country. The average contribution of personal income and social security taxes for developing nations in Asia is well below that for other developing countries in the world.[24] In 1996, the PIT in Vietnam generated 1.3 per cent of the total tax revenues (0.25 per cent of GDP) which is also far below the Asian average for developing countries (8 per cent).[25] However, since the enactment of the PIT law in Vietnam, PIT revenues have been growing at a much faster pace than the growth rate of GDP (see Table 3).

A. Existing personal income tax[26]

The PIT in Vietnam is scheduler with two structures; one for 'regular' worldwide income such as wages and salaries and one for 'irregular' income such as lottery winnings, income from trademarks and patents, and income from technology transfers.

1. Main features

Certain changes have been made over the past six years to broaden the tax base and to increase the exemption level for regular income. The exemption currently stands at VND 2 million per month for Vietnamese citizens and VND 5 million for foreign residents. For Vietnamese citizens, there are eight marginal tax rates ranging from 0 per cent to 72 per cent. The highest rate is applicable to monthly income in excess of VND 11.75 million. For foreigners residing in Vietnam, there are six marginal tax rates ranging from 0 per cent to a high of 50 per cent for monthly incomes in excess of VND 70 million (see Table 4).

19. See, for example, J. Martinez-Vazquez and R. McNab (1997).
20. These are given in an attempt to use CIT as an instrument for social engineering.
21. In Vietnam, these take the form of the exemption of reinvested profits.
22. The rates for Singapore and the Philippines are for 1996 (World Bank, 1997, Table 5.8).
23. See Glenn Jenkins (1996) for a discussion of thin capitalization rules.
24. In 1985, the contribution of PIT to total tax revenues in Asia was 8 per cent, the lowest among four groups of developing countries consisting of Sub-Saharan Africa, the Middle East and North Africa, Asia, and Latin America. The contribution of PIT revenues was the second lowest in Sub-Saharan Africa at 14 per cent (see World Bank, 1991).
25. The figure for Vietnam is somewhat misleading as agricultural income is taxed under the agricultural *land* tax and not under the business tax or the personal income tax. Agricultural taxes constituted 3.4 per cent of tax revenues in 1996.
26. Sources of data for this section: Interviews at Vietnamese Ministry of Finance and Vietnam Political Publisher (1995).

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Table 4: Personal income tax structure in Vietnam (income levels are in millions of Vietnamese dong)

Regular income				Irregular income**	
Vietnamese		Foreigners			
Monthly income	Tax rate	Monthly income	Tax rate	Income	Tax rate
0 to 2	0%	0 to 5	0%	0 to 2	0%
2+ to 3	10%	5+ to 12	10%	2+ to 4	5%
3+ to 4	20%	12+ to 30	20%	4+ to 10	10%
4+ to 6	30%	30+ to 50	30%	10+ to 20	15%
6+ to 8	40%	50+ to 70	40%	20+ to 30	20%
8+ to 10	50%	70+	50%	30+	30%
10+ to 11.75	60%*				
11.75+	72%*				

* Statutory rates are 60% for income over VND 10 million but net income of VND 8.0 million is subject to an additional 30% tax.

** Irregular income includes income from trademarks, patents, copyrights, construction and engineering designs and some advising and training services. Certain types of irregular income are taxed at different rates. Income earned from technology transfers and gifts (excluding cash) from abroad in excess of VND 2 million are taxed at a rate of 5 per cent levied on the entire amount; and lottery earnings in excess of VND 12.5 million are taxed at 10 per cent levied on the entire income.

Source: Ministry of Finance of Vietnam; Vietnam National Political Publisher (1995) and Price Waterhouse in Vietnam Investment Review (3-9 March, 1997).

Non-resident foreigners who are in Vietnam for more than 30 days and less than 183 face a flat tax of 10 per cent on Vietnam-source income. Foreigners in the country for less than 30 days pay no income tax. The tax is collected mainly from foreigners and Vietnamese employed by foreign companies or joint ventures and, therefore, contributes very little to the overall revenue yield. Irregular income is taxed at lower rates than regular income.

2. Assessment of current personal income tax

There are clearly many problems with the present personal income tax system; some of which are endemic to many developing countries while others are somewhat more specific to the Vietnamese situation. The main pitfalls of the current tax are listed below:

High marginal tax rates: These rates provide an incentive for tax avoidance and tax evasion.

Large disparity in taxation of nationals and foreigners: As a result of the large difference between the tax structure for foreigners and for Vietnamese nationals, it becomes very costly to hire a skilled Vietnamese worker for a high paying job. For example, if one were to pay a Vietnamese citizen a net take-home salary of USD 1,000 per month, one would have to pay a gross of about USD 3,800 inclusive of social and health insurance and service fees.[27] Paying the same net salary to a foreigner performing the same job requires a gross-of-tax salary of about USD 1,100 only, a substantial difference in taxes of USD 2,700.[28] As long as this difference persists, that is as long as nationals are taxed at these high rates, the take-home pay of nationals will be much restricted.

Large disparity in taxation of residents and non-residents: While residents (those who spend more than 183 days in Vietnam) face the tax structure described above, non-residents face a flat rate of 10 per cent on their income. This has led some foreigners to set up offices in nearby countries such as Cambodia and Thailand where they spend half the year to avoid the higher tax rates on residents in Vietnam. Also, foreigners who spend one month or less in Vietnam are not subject to income tax.

Exemption of household businesses subject to the profits tax: Although this measure does avoid double taxation of income, it is still highly inequitable. Whereas a business owner would face a profit tax rate of 25 per cent to 40 per cent, an employee would face a PIT at a marginal rate of up to 72 per cent. For example, if the income of a businessman investing in light industries is USD 1,500 per month, his tax liability would be USD 525. If a person earns the same amount of income as wages, he would have to pay around USD 703 in personal income tax. This problem will be mitigated to a great extent if the excessively high tax rates on the top income brackets are lowered and the personal and business income taxes are integrated.

Low revenue yield: The revenue yield from this tax is about 1 per cent of total tax revenues, a percentage much lower than that of ASEAN countries and probably one of the lowest in the world. As the experience of both developing and industrialized countries has shown, the contribution of personal income tax revenues is likely to increase as the country con-

27. Health insurance and social insurance constitute 3 per cent and 20 per cent respectively of gross wage, while management and service fees constitute 2.5 per cent of the gross wage. (The exchange rate used for the calculation is VND 12,500 per USD 1.)

28. The gross wage for an expatriate does not include social and health insurance and management fees. If these additional amounts were included, the gross wage would increase to around USD 1,400.

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tinues to develop and income levels rise.[29] To ensure and facilitate the increase in a more equitable and less distortionary manner, several changes to the current system are necessary.

First, the base needs to be broadened as currently many sources of income are not taxed. Untaxed sources include rental income (only subject to turnover tax), interest, and dividends. (It would be reasonable to exempt dividends from the personal income tax if there is to be no direct integration between personal and business taxes.) Second, allowances need to be reconsidered and reduced. The existence of many allowances (such as allowances for having to work at night,[30] allowances for surgical operations, allowances for working conditions, etc.) erode the tax base and also make tax avoidance easier. For example, if an allowance for working conditions goes untaxed, it would be to the benefit of an employee to receive most of his compensation as an allowance and very little as wages. Third, the definition of regular income needs to be changed to include income from services such as advising, training and technical and architectural designs that are currently taxed as irregular income at lower rates. Fourth, if small household businesses are to be subject to either the CIT or the PIT, they should be subject to the PIT. Fifth, although maintaining a relatively high exemption level is desirable, the current level should be reduced. Table 5 shows that the current level set at about eight times the average per capita income is too high both in absolute terms and relative to per capita income when compared to other countries in Asia. If reducing the basic exemption level proves politically difficult, perhaps the different brackets should be adjusted at a rate lower than that of inflation for a number of years, effectively reducing exemption levels.[31] Finally, the awareness of taxpayers needs to be enhanced to increase compliance, and the tax administration should be improved. At the present rates, there is widespread evasion of tax as only about 150,000 Vietnamese paid PIT in 1996 which reflects a substantially smaller number than the number of people who earned more than VND 1.2 million per month in 1996.[32]

No self-assessment: At present, there is no system of self-assessment and the tax department conducts a 100 per cent checking of returns filed. Auditing every tax return is a legacy from the past where taxpayers constituted a small number of SOEs. This is clearly inefficient. Although it is feasible at the present time due to the small number of personal income taxpayers, it will require a lot of resources as this number increases.

Table 5: Basic exemption levels from personal income tax for certain Asian countries (1996)

Country	Average per capita income (US dollars)	Annual exemption level (US dollars)	Exemption level/ per capita income
Malaysia	4,219	1,000	0.24
Philippines	1,110	95	0.09
Thailand	2,960	0	0
South Korea	10,529	0	0
Sri Lanka	737	2,835	3.9
India	359	833	2.3
Hong Kong	24,060	0	0
Taiwan	13,741	0	0
Vietnam	264	2,150	8.1

Sources:
1. Average per capita income was obtained from the Asian Development Bank (1997). These were based on USD figures for GNP/capita for 1995, a per capita growth rate in GNP for 1996 and an inflation rate for the USD of 2.5 per cent in 1996.
2. Exemption levels were obtained from: country reports (International Bureau of Fiscal Documentation) for Malaysia, Thailand, South Korea, Hong Kong, and Taiwan; Department of Inland Revenue for the Philippines; Sri Lanka Department of Inland Revenue for Sri Lanka; Budget Document 1997 for India; Vietnam Ministry of Finance for Vietnam.

B. Proposed personal income tax

In an attempt to rationalize and strengthen the personal income tax structure, the government is preparing a draft legislation for the consideration of the National Assembly. It is being debated at various forums including the business community, and the shape that it will finally take is not known at present. The main features of the draft law are presented and discussed below.

1. Main features[33]

Broader base: The proposed tax broadens the base in two ways. First, certain types of income that are currently not taxed at all are brought under the purview of the income tax

29. As examples of developing countries, Nasution (1989) reports that the contribution of personal income tax revenues as a percentage of total revenues in Indonesia grew from 3 per cent in 1973 to 10 per cent in 1987, while Asher (1989) reports that the equivalent percentages for Malaysia grew from 8 per cent in 1974 to 13 per cent in 1987. As an example of an industrialized country, Porter and Trengove (1990) report that the contribution of personal income tax revenues as a percentage of total revenues in Australia grew from 35 per cent in 1954 to 54 per cent in 1988.
30. Although income from regular overtime is taxed and income from a 'standard' night shift is also taxed.
31. The nature of the exemptions and allowances needs to be reconsidered and redesigned with some relief provided for dependants.
32. Personal income tax revenues collected for 1996 were based on an exemption level of VND 1.2 million. The exemption level was changed from VND 1.2 million to VND 2.0 million on 18 February 1997. The estimate of the number of taxpayers was obtained from officials from the Ministry of Finance.
33. Ministry of Finance, Government of Vietnam, Draft Personal Income Tax Law (1997).

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either as regular or irregular income. Current non-taxable items to be added to the tax base as *regular* income include in-kind benefits to employees such as the private use of motor vehicles provided by the employer and fixed meal allowances. Rental income, dividend earnings, capital gains made on the disposal of property and interest earnings from bank deposits or bonds will be brought under the purview of the proposed tax as *irregular* income and will be taxed at a rate of 10 per cent. Incomes of foreigners who are in Vietnam for less than 30 days in a tax year will no longer be exempt from the non-resident tax. Second, certain types of income that are classified as irregular income and taxed at the lower rates appear to have been reclassified under the proposed PIT law as regular income. These include income from professional services such as advising, training, engineering and architectural designs. Irregular income such as gifts (other than cash from abroad) and lottery winnings are still included in the tax base and are taxed at the lower rates applicable to this type of income.

Reduction in tax brackets and changes in tax rates: The proposed PIT structure for regular income of Vietnamese nationals includes seven tax brackets instead of the current eight. The highest marginal tax rate under the proposed law is 60 per cent instead of the existing 72 per cent. The number of rates for foreigners (six rates) has not changed and ranges from 0 per cent to 50 per cent. For both Vietnamese nationals and foreigners, the tax brackets have been adjusted to account for the impact of inflation although the adjustment is smaller for foreigners. The proposed tax structure for irregular income has been greatly simplified with the number of tax rates reduced to two; 5 per cent on income derived from gifts (other than cash from abroad) and 10 per cent for all other income. The tax rates for non-residents on Vietnam-source income will be increased from 10 per cent to 15 per cent.

Fewer tax returns: The new tax rates are now based on annual income rather than monthly income. Taxpayers deriving income from business activities will be obliged to file only two tax returns, one at the end of the first half of the year and the second one at the end of the year. The tax payment will be made every month. Those earning income from salaries and wages will have to file only one return at the end of the year. The employers will be required to withhold the tax at source and deposit it with the government treasury every month. The tax payment for non-residents will be considered on a case-by-case basis.

Personal identification number: All individuals and very small household businesses that are outside the scope of corporate income tax will be required to register with the tax department and will be awarded a personal identification number (PIN).

Exemptions: The main exemptions that will remain intact include the income of farmers who are subject to the agricultural land tax, reimbursements for travelling expenses, and allowances for some night work (not standard shifts) and for hazardous working conditions, as well as regional allowances.

Business income: Income of personal household businesses that is out of the purview of the current tax on high income earners is now covered under the proposed tax law. This income is taxed at the proposed corporate income tax rate.

Penalties and appeals: Penalties and appeals are similar to those outlined for the corporate income tax.

2. Assessment of proposed personal income tax

The two welcome features of these proposals are a broader tax base and the provision of fewer tax returns both for wage earners and for those earning income from business activities. Treating employees' benefits in-kind as taxable income is a sound idea in principle, but it may not have much of an impact given the small number of taxpayers. It may be more effective to stop businesses obtaining a tax deduction for expenditure incurred in providing such benefits.

The simplification of the structure of the PIT on irregular income and the partial integration of the personal income tax and the corporate income tax as demonstrated by the lower tax rates on dividends are commendable developments although a full integration or an outright exemption of dividends would be preferable. Some problems, however, still persist.

High tax rates: Although the highest marginal rate on Vietnamese residents in the proposed law has dropped from 72 per cent to 60 per cent, it is still very high compared to other countries in the region. Table 6 shows that the highest marginal rate for ASEAN nations is 37 per cent or less. This would necessarily suggest that Vietnam should further lower the top rates and reduce the number of tax brackets. Table 7 shows the tax liability for different incomes under both the existing system and the proposed system. Although the proposed exemption level is lower than under the existing tax, the tax burden is generally lower under the proposed system. Relief for dependants has still not been built into the system. Building in automatic adjustments for increases in the general price level should be considered.

Table 6: Highest marginal tax rates on personal income (1996)

Country	Tax rate (%)
Indonesia	30
Malaysia	30
Philippines	35
Singapore	30
Thailand	37

Source: 1997 World Development Indicators, The World Bank, 1997.

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Table 7: Tax burden for different income levels under the current and proposed PIT laws (income levels and tax liabilities are in millions of Vietnamese dong)

	Current system		Proposed system	
Annual income	Liability	Average tax rate	Liability	Average tax rate
24	0.0	0.0%	0.6	2.5%
48	3.6	7.5%	3.8	7.9%
72	10.8	15.0%	8.6	11.9%
120	32.4	27.0%	22.2	18.5%
180	73.1	40.6%	49.2	27.3%
240	116.3	48.5%	85.2	35.5%
480	289.1	60.2%	229.2	47.8%

Note: The hatched cells indicate lower tax liabilities.

Source: Ministry of Finance and calculations in this study.

Regular versus irregular income: The broadening of the base has involved reclassifying some types of irregular income as regular income. However, the reclassification needs to be further extended to include income from seminars, lectures and research as regular income. Their proposed classification as irregular income is unnecessary and may erode the tax base. Dividends should be kept outside the scope of the personal income tax system if no integration between the personal and corporate income taxes is to take place.

Taxation of small businesses: Introducing the taxation of small businesses under the purview of the personal income tax and applying the corporate income tax rate may avoid some of the complicated rules of corporate income taxation but is inequitable. Table 8 shows the tax liability for small businesses at the personal income tax rates and at the corporate rates as proposed. It is evident that for incomes that many small businesses are likely to earn, the tax liability will be higher under the proposed rate of 32 per cent. Furthermore, the draft law does not state how expenses will be defined for small businesses and whether interest expense incurred for a business purpose will be deductible or not. The magnitude of the inequity will be larger if small businesses are not allowed to deduct all their business expenses. The change has no impact on incentives, equity considerations or revenue collections. It simply proposes to move some of the revenues that were collected under the profits tax to the personal tax account.

The tax system in its proposed form will continue to be complex and problematic because of the multiplicity of tax brackets and very high top tax rates. The administration of this tax structure will be difficult and costly. Excessively high tax rates create a strong incentive for tax evasion. These two facts are bound to erode the tax base and adversely affect revenue collections. The key elements of any good tax system are a broad base and low tax rates. In these proposals, the base has been suitably expanded but the large number of brackets and tax rates substantially reduce the benefits of the broader base. Thus, two changes are essential to these proposals. The number of tax brackets should not be more than three or four and the highest marginal tax rate should not exceed 50 per cent.

Table 8: Taxation of small businesses at the corporate rate (as proposed) and at the personal tax rates (income levels and tax liabilities are in millions of Vietnamese dong)

	Taxation under PIT		Taxation at proposed 32%	
Annual income	Liability	Av. tax rate	Liability	Av. tax rate
24	0.6	2.5%	7.7	32%
48	3.8	7.9%	15.4	32%
72	8.6	11.9%	23.0	32%
120	22.2	18.5%	38.4	32%
180	49.2	27.3%	57.6	32%
240	85.2	35.5%	76.8	32%
480	229.2	47.8%	153.6	32%

Note: The hatched cells indicate lower tax liabilities.

Source: Ministry of Finance and calculations in this study.

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Ideally, Vietnam should opt for a *full* form of integration of the personal income tax and the corporate income tax where the corporate income tax acts as a withholding device. This is necessary as a long-term incentive for the private sector as stock-holding private companies will not flourish unless this happens. Also, full integration should not have any adverse effect on tax revenues since most corporations today are either state owned or foreign owned. For this type of integration to happen, the highest tax rate of the personal tax should be lowered to be closer to the corporate tax rate.

VI. CONCLUDING COMMENTS

The Vietnamese Government has been well aware of the shortcomings of its system of direct taxes and has made some efforts to reform the system. However, these reforms, particularly, the newly passed corporate income tax law have fallen short of expectations. Although earlier drafts of the CIT law raised and addressed the main issues: reducing the many exemptions and reductions, levelling the playing field for foreign and domestic investors, etc., the actual law hardly presented any significant changes from its predecessor.

A well-defined corporate income tax that does not discriminate between domestic and foreign capital needs to be implemented. There is no need to provide foreign investors too many exemptions and deductions given that they face a low effective rate of taxation due to their ability to finance projects by debt. The longer it takes to develop a credible and fair law, the more difficult it will be for Vietnam to provide a fiscal environment conducive to investment. However, expectations of more changes may slow down investors, both local and foreign, as investors generally dislike uncertainty.

The fact that the corporate income tax law was being debated and was passed without much attention to the personal income tax, or the agricultural land tax strongly indicates the lack of a systemic approach to direct taxation. The tax laws have to be in congruence with the country's overall strategies. At a time when Vietnam is attempting to attract high tech industries, its personal income tax rates are extremely high and are likely to prove a hindrance to attracting the professionals that the country needs if it is to successfully develop these industries. Needless to say, all the suggested policy reforms will not succeed without additional emphasis on the administrative reforms. Fortunately, Vietnam has the advantage of a relatively strong and fairly skilled labour force that should facilitate these reforms. In the end, it may be said that Vietnam has made some progress in reforming its tax system but it still has a long way to go.

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KAZAKSTAN

TAX REFORM IN KAZAKSTAN

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I. INTRODUCTION

Kazakstan's experience in fiscal reform may seem anomalous. Although a poor and relatively obscure nation in Central Asia, in 1995 Kazakstan adopted what was at the time perhaps the most modern tax code of any member of the Commonwealth of Independent States (CIS).[1] The new system includes a standard credit-method value added tax,[2] an income tax on both individuals and enterprises,[3] and a variety of excises, as well as several less important taxes. Although the new tax code provided a framework for the taxation of natural resources, details were left for subsequent action. Similarly, the new tax code does not deal adequately with tax aspects of intergovernmental fiscal relations.

Of particular note is the fact that the system was initially relatively "clean", in that, with a few exceptions, it did not provide special treatment for selected sectors or regions. Then in 1997, much to the consternation of its Western advisers, Kazakstan introduced a system of tax holidays intended to spur economic development.

This paper examines several aspects of Kazakstan's recent experience with tax reform. Section II sets the stage by providing background information on the country, its economy, and its tax system. Sections III and IV describe the objectives of tax reform and the broad outlines of the 1995 reforms. Section V explains the failure to consider a cash-flow tax, which I believe to be quite unfortunate. Section VI describes several defects of the 1995 legislation, notably the failure to provide immediate refunds (or suspension) of value added tax (VAT) on capital goods, the excessively restrictive limitation on the carry-forward of losses, the lack of a comprehensive inflation adjustment in the taxation of business income, the treatment of expatriate employees, and the VAT treatment of intra-CIS trade. Section VII discusses the recent retrograde introduction of tax holidays. Section VIII discusses two issues that were not considered in the 1995 legislation, the taxation of natural resources and intergovernmental fiscal relations. Section IX provides concluding remarks.

II. KAZAKSTAN: THE COUNTRY, ITS ECONOMY, AND TAXATION[4]

Kazakstan is the ninth largest country on earth, and one of the least densely populated. (It has five times the surface area of France, but 30 per cent of the population.) Prior to the Soviet period, the native people were mostly nomadic, relying primarily on raising livestock and minor trading. In addition to spurring the development of mining (which was economically justified), planners in the former Soviet Union (FSU) undertook industrialization and the cultivation of the "virgin lands" of the area, largely for defense and ideological reasons. Since much of Kazakstan's industry and agriculture does not accord with comparative advantage, transition to a market economy involves wrenching adjustments.

Kazakstan has enormous reserves of oil and gas, as well as substantial other mineral resources. (One estimate places proven and provable reserves at the level of those of Western Europe. Another estimates oil reserves at 10 per cent of those of Saudi Arabia.) Located south of Russia and between China and the Caspian Sea, Kazakstan is land-locked; thus pipelines must be constructed in order to export oil and gas. Once the pipelines are built and the oil begins to flow, Kazakstan will probably suffer a problem common to many resource-rich nations, "Dutch disease", the inability to export anything but a few natural resources.[5]

Since the dissolution of the Soviet Union, economic output has fallen by about 50 per cent. This has produced devastating effects on public finances, as well as on real wages and living standards. If tax revenues had fallen only in proportion to output, fiscal resources would have been cut in half. In fact, the ratio of tax revenues to GDP fell from almost 37 per cent in 1992 to just above 22 per cent in 1995. Moreover, Kazakstan lost the transfers that it had previously received from Moscow as a relatively poor member of the FSU. Table 1 traces the evolution of public expenditures and revenues, as a percentage of GDP, from 1985 to 1995.

* The author wishes to acknowledge the useful comments of Richard Bird, Emil Sunley, and Victor Thuronyi. This paper was prepared for the International Seminar in Public Economics held in Tokyo, 29-30 August 1998.

1. The Commonwealth of Independent States consists of 12 of the 15 nations created by the dissolution of the former Soviet Union; it excludes the Baltic republics of Estonia, Latvia, and Lithuania.
2. While the VAT is standard in that it employs the credit-method and taxes foreign, non-CIS trade on the destination principle, it follows the origin principle for trade with other members of the CIS. See also section V.
3. Legally there is a single income tax on individuals and enterprises. In what follows it will generally be convenient to distinguish between the taxation of individuals and of enterprises.
4. This is drawn from McLure (forthcoming, a), which contains references to source materials.
5. Gelb and Associates (1988) examines the experience of several oil-rich countries in combating Dutch disease.

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Table 1: Government expenditure, revenues and budget balance, 1985-1992, as a percentage of GDP*

Year	Expenditures	Revenues			Surplus (+) or deficit
		Excluding grants	Grants	Total	
	(a)	(b)	(c)	(d)	(e)
1985	37.8	34.4	4.4	38.8	1.0
1986	35.0	30.0	5.6	35.6	0.6
1987	36.9	30.4	7.3	37.7	0.8
1988	37.3	28.6	10.3	38.9	1.7
1989	39.2	29.0	11.7	40.7	1.5
1990	38.4	27.7	13.6	41.4	2.9
1991	44.1	27.0	8.1	35.1	-9.0
1992a	31.9	22.8	1.7	24.6	-6.9
1992b	46.2	36.7	2.1	38.9	-7.3
1993	41.0	38.3	1.3	39.6	-1.4
1994	29.4	22.4	0.5	22.9	-6.5
1995	25.3	21.4	0.6	22.0	-3.4

* Rounding differences exist.

Figures up to and including 1992a are for general government; those for 1992b and later include extrabudgetary funds (which had expenditures/revenues of 15.8/15.3, 15.6/18.6, 13.0/5.4, and 7.3/7.6 per cent of GDP in the four years). Extrabudgetary receipts include those from privatization, which were important only in 1993, at 2.9 per cent of GDP.

Source: World Bank, *Kazakhstan: Transition of the State*, 1996.

When Kazakstan became an independent nation at the end of 1991, it inherited the Soviet tax system, which relied heavily on turnover taxes and transfers of enterprise profits.[6] While some changes had been made between 1991 and 1995, the pre-reform tax system was woefully inadequate for a market economy, in part because the first reforms adopted simply mimicked the flawed changes being made in Russia. Table 2 provides information on the composition of tax revenues, both as a percentage of total tax revenues and as a percentage of GDP, in 1995.

Table 2: Composition of taxes, 1995*

	Revenue (billions of tenge)	Composition of tax revenues (per cent)	Revenues (per cent of GDP)
income taxes	47.1	39.7	4.2
individual	22.4	18.9	2.0
corporate	24.7	20.8	2.2
taxes on goods and services	34.4	29.0	3.1
VAT	26.0	21.9	2.3
excises	8.4	7.1	0.7
taxes on international trade	10.4	8.8	0.9
other taxes	26.8	22.6	2.4
stamp taxes	1.9	1.6	0.2
natural resources	10.0	8.4	0.9
investment fund	6.0	5.2	0.5
other	8.8	7.4	0.8
total taxes	118.8	100.0	10.6
non-tax revenue	53.3	n/a	4.8
total current revenue	172.0	n/a	15.3

* Rounding differences exist.

Source: International Monetary Fund, *Kazakhstan – Recent Economic Developments*, March, 1996.

Income tax rates generally were not unreasonable (except for certain idiosyncrasies and sporadic episodes of excessive rates), but tax bases contained inappropriate provisions, since they reflected the Soviet system of accounting. For example, interest on long-term debt was not a deductible expense for enterprises, but investment financed from own resources (rather than budgetary sources) could be written off immediately, and repayment of loans was deductible under the same circumstances. Losses could not be carried forward. The income of individuals (except for interest) was subject to a variety of schedular taxes; there was no global individual income tax.

Although Kazakstan replaced the turnover tax with a value added tax (VAT) at the beginning of 1992, its VAT, being patterned after that in Russia, differed from the standard destination principle, consumption-based tax implemented using the credit-invoice method in several ways. First, the subtraction method, in which tax is paid on the difference between sales and purchases, was used in the taxation of commerce. Second, no credit was allowed for purchases of capital goods. Third, the origin principle, rather than the destination principle, was applied to trade with other members of the CIS; this was also true of excises.

III. THE OBJECTIVES OF TAX REFORM

In January 1994 the Vice-President of Kazakstan, Mr Asanbaev, asked the International Tax and Investment Center (ITIC) to help the Government of Kazakstan prepare a new tax code for the country.[7] ITIC suggested, and Mr Asanbaev agreed, that the formulation of the new tax code should follow a two-stage process: first a "White Paper" defining the objectives of tax reform would be prepared and then the code would be drafted, based on those objectives. This would allow Kazakstan to avoid an error that has commonly plagued tax reform in Central and Eastern Europe (CEE) and the FSU, beginning the process of tax reform with no clear idea of the proper objectives of reform and no strategy for reaching them (an approach the ITIC likened to starting on a trip without a road-map, or even a destination) – creating instability, complexity, inequities, and distortions and discouraging both foreign and domestic investors.[8] The following are the objectives proposed in the ITIC White Paper,

6. For more details, see McLure (forthcoming, a); more generally, see Martinez and McNab (1997).
7. ITIC is a small non-profit organization created in late 1993 to help improve the investment climate of Russia and Kazakstan. In its work on tax reform in Kazakstan ITIC was eventually joined by advisers from the Legal Department of the International Monetary Fund, the Organisation for Economic Cooperation and Development, the US Treasury Department, the Barents Group (the US Agency for International Development's contractor for fiscal reform in the CIS), and the EU-TACIS (Technical Assistance for the CIS) program. The government's "Concepts Paper" had, however, been prepared before this inter-agency cooperation began.
8. McLure (1995a) notes that the instability of tax laws is one of the primary impediments to investment in small business in the Czech Republic, Hungary, and Poland.

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which formed the basis for the government's "Concepts Paper". Since they are essentially the conventional wisdom among tax experts, they are presented with little elaboration and almost no references to the literature.[9]

A. Revenue adequacy

Revenues must be adequate to finance the proper functions of government, without resort to inflationary finance. The transition to a market economy has profound effects on both the need for revenues and the capacity to raise revenue. It means that government(s) must assume responsibility for social services (e.g., education and health care) formerly provided by state enterprises and that a social safety net must be provided to cushion the transition for those who are thrown out of work. Yet it becomes more difficult to raise revenues, as enterprises fail, as privatization of state enterprises places enterprise managers and tax administrators in a more adversarial relation, and as the development of the private sector increases the workload and difficulty of the problems facing the tax administration.

B. Economic neutrality

If markets are to allocate resources efficiently, taxation must not distort economic decisions. To be neutral, indirect taxes must apply equally to all forms of consumption (and not to business purchases), and direct taxation should tax all income uniformly, without regard to its source or use. There are two important exceptions to this rule of uniformity: taxes on economic rents and taxes related to the benefits of public spending do not distort choices; indeed, benefit taxation is needed to avoid artificially favouring such spending.

Academic critics may frown on this explicit advocacy of uniform taxation, instead of optimal taxation. This advocacy is offered without apology, for several reasons: Kazakstan lacks both the information needed to design an optimal tax regime and the tax administration required to implement it; the theory of optimal taxation generally ignores horizontal inequities and perceptions of inequity; and differentiation introduced in the name of optimal taxation places tax policy on a politically slippery slope that can easily lead to indefensible differentiation.[10]

C. Encouragement of saving and investment

Tax policy should not discourage saving and investment, which are important to the transition to a market economy, the economic development of the country, and a higher standard of living. Yet, as described more fully in Section V, an early decision was made to propose a standard income tax, instead of a direct consumption-based tax, which would arguably have been more favourable to saving and investment.[11] (Whereas consumption-based taxes do not penalize saving and investment, income taxes do.[12]) Considerations of economic neutrality, equity, and administrative feasibility militated against the use of tax holidays and investment incentives to encourage saving and investment; see also Section VII. In short, Kazakstan should have a "clean" income tax, instead of a "Swiss cheese" system of the type found in much of CEE in the early days of transition to a market economy.[13]

It was equally important to avoid including provisions in the tax code that would unduly discourage saving and investment. Thus, for example, there should be no VAT on capital goods, and it should be possible to carry losses forward and offset them against future income. To prevent double taxation of income originating in Kazakstan, which could create an overwhelming impediment to investment, it would be essential that the income tax qualified for foreign tax credits in capital-exporting countries.[14] (Section V notes exceptions to this argument.)

9. McLure (forthcoming, b) states and explains these objectives more fully. See also Martinez and McNab (1997).
10. See the papers in Newberry and Stern (1987) for attempts to apply the theory of optimal taxation in developing countries. Deaton (1987, p. 112) notes, "The global knowledge of demands and of preferences required for optimal taxation is simply not obtainable in developing countries and probably not in developed countries... [T]he quality of our empirical knowledge clearly decreases as we move away from previous experience, and advisers would be wise to recognize that fact when they tender advice." These caveats would seem to be especially telling in countries in transition from socialism, where massive changes are being made and data are notoriously weak. On the quality of data in the FSU, see Schmelev and Popov (1989). For a general critique of optimal taxation, see Slemrod (1990), who notes (at 167), "...a sense that the uniform tax system is less susceptible to political pressures favoring tax changes that serve special interests and which are unrelated to optimal tax considerations."
11. Whether a consumption-based tax is more conducive to saving than an income tax is not clear even from a theoretical point of view; see the next footnote. Which tax is actually more conducive to saving is an empirical question, and a difficult one. For a survey of evidence, see Bovenberg (1988). For very different views on how saving is affected by the ability to postpone taxes on income that is saved, see Engen, Gale, and Scholz (1996), Hubbard and Skinner (1996), and Poterba, Venti, and Wise (1996). Of course, none of this evidence may be relevant for Kazakstan.
12. Strictly speaking, income taxes discriminate against postponement of consumption, not against saving per se. It is entirely possible that, even ignoring income effects of taxation, a reduction in taxation of the return to saving will decrease saving. This is true because current saving is an expenditure on future consumption, not the quantity of future consumption. If the rate of return increases, the quantity of saving needed to finance a given amount of future consumption falls. The price elasticity of future consumption with respect to its price exceeds the elasticity of saving with respect to the same price by one. See Feldstein (1978a) and (1978b) or, for a simplified exposition, McLure (1980).
13. McLure (1991b) argues in favour of a cash-flow tax in lieu of such a system.
14. Many countries, including the United States, tax the worldwide income of their residents, but allow a credit for income taxes paid to other governments. The US credit is available only for taxes that have the predominant character of income taxes in the US sense. Such taxes generally must provide deductions for all expenses of earning income. Concern for creditability was heightened by the knowledge that other members of the FSU (e.g., Russia and Ukraine) had imposed (in the Russian terminology) an income tax instead of a profits tax. Because the former allows no deduction for labour costs, it does not qualify for foreign tax credits. Moreover, some countries that allowed deductions for such costs limited such deductions, as an alternative to imposing a separate tax on excess wages (wage payments in excess of some standard), presumably to prevent inflationary wage hikes in state enterprise, especially those subject to labour management. While Kazakstan never considered levying an income tax, it briefly limited deductions for wages, even after the passage of the new tax code, thereby jeopardizing ratification of its tax treaty with the United States. Under pressure from potential foreign investors and their governments, it eventually eliminated the limitation.

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D. Fairness

Fairness has both horizontal aspects (commonly described as equal treatment of equals) and vertical aspects (commonly reflected in progressive taxation intended to take account of differences in ability to pay). But the perception of fairness may be as important as the actuality, especially in a country with a justified mistrust of government. Fortunately, both horizontal equity and the perception of fairness are furthered by the same type of system that achieves economic neutrality, a uniform system. The proper degree of progressivity, and thus the proper structure of income tax rates, is not something on which foreign advisers (or domestic ones, for that matter) are well qualified to offer advice, beyond noting the disadvantages of high rates.

E. Low statutory rates

Low tax rates minimize the adverse effects of taxation, including the inequities and economic distortions that are inevitable in any tax system, as well as disincentives to work, save, and invest. Moreover, it is generally desirable to have rates that approximate those in the home countries of potential investors, to avoid discouraging foreign investment.[15]

F. Simplicity

Simplicity is perhaps the most important objective of tax policy for a country in transition from socialism, because neither local taxpayers nor the tax administration has the experience or the expertise needed to cope with a complicated tax system. Unfortunately, it is difficult to design a system that provides both the simplicity required by local taxpayers and the certainty needed by multinational corporations. Again, a uniform system is often simpler than a highly differentiated one. The decision not to propose a cash-flow tax (CFT) on business (an integral part of most consumption-based direct taxes) implied that the simplicity advantages of the CFT would be lost. A reduction in the number of taxes, many of which yielded little revenue, would, however, simplify compliance and administration.

A simple system would rely heavily on withholding and would require relatively few individuals to submit tax declarations. Primarily those engaged in business would need to submit declarations. This implies the acceptance of certain schedular elements, such as final withholding taxes on interest and dividends. A system in which the individual is the tax-paying unit is simpler than one based on the joint income of couples or families. Deductions for the taxpayer and dependents can be used to "personalize" the income tax (that is, to make it reflect the circumstances of the taxpayer). But it would be a mistake to allow deductions for personal expenditures; this adds to complexity, as well as often being indefensible on grounds of equity and economic neutrality.

G. A note on process

Lest the fact be missed, it should be noted explicitly that these were the principles stated in the ITIC White Paper. While the government's Concepts Paper was generally consistent with them, there were some differences. These differences presumably reflect, in some unknown combination, greater allowance for local circumstances, political compromises, failure to understand completely economic concepts and the advantages of the proposed objectives. After all, the government officials responsible for the Concepts Paper had grown up and been educated under a socialist system, had had no formal training in either market economics or tax policy, and were being brought "up to speed" very quickly, sometimes by mentors who had very different ideas about what was desirable and practical, and perhaps – not to be forgotten when working in this type of environment – misunderstandings based on faulty translation. While it is tempting to be disgruntled when only part of one's advice is accepted, it is far more realistic and reasonable to recognize that hardly any government is likely simply to rubber-stamp the suggestions of outsiders. Moreover, when the ITIC White Paper was converted to the government's Concepts Paper, ownership was transferred from the foreign advisers to the government officials who prepared the Concepts Paper; the concepts became theirs, with all the psychological and political advantages that implies.[16]

Had the transfer of ownership of ideas expressed in the White/Concepts Paper not been effected, there is no way of knowing how the process of tax reform would have turned out. It is tempting to say that reform would have occurred, because the need for it was so evident. However, the lack of similar success in most of the former FSU belies that temptation.

Presumably the government would have received advice, perhaps similar to that offered by the ITIC, from many of the same organizations that were actually involved, but perhaps in a less coordinated manner. Since government officials provided much of the coordination that occurred, the lack of coordination might not have greatly harmed the process. But one never knows. Nor does one know whether the successful experience in Kazakstan can "be bottled and sold" in other countries. One suspects not, except under the right circumstances.

A key ingredient of the success of the tax reform effort in Kazakstan was the fact that the same government officials (especially the Minister of Finance, the Deputy Minister in charge of preparing the new tax code, the head of the State Tax Committee, and staff members from the Ministry and the State Tax Committee), and the same key foreign advisers

15. This simple statement glosses over many complications. Slemrod (1995) provides a masterful exposition of the issues involved.
16. Keenly aware of the need for our counterparts to "own" the White Paper; I asked several Russian-speaking colleagues whether this concept of ownership could be translated into Russian. They agreed that the concept would translate but they did not know how to effect the transfer of ownership. It occurred automatically, when, based on a translation of the ITIC White Paper, the government officials prepared their own document, the Concepts Paper.

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were active throughout much of the process.[17] Thus, it was possible to build personal relations and trust.[18] Without that, reports are likely to gather dust.

IV. THE 1995 REFORMS[19]

The new tax code contains the basic legal framework for taxation at all levels of government, except for customs duties, contributions for social insurance, and state duties (essentially fees for legal documentation).[20] Whereas there were almost 50 different taxes before the tax reform, there are now only about a dozen. This section describes the most important of these: the income tax, the VAT, and excises; Section VIII discusses the mineral resource tax.[21]

A. The income tax

1. Taxpayers

Both legal entities and individuals are subject to income tax. Simple partnerships (including consortia), other than those engaged in exploitation of mineral resources, are not taxpayers; the partners pay tax on the shares of income attributed to them. (Partnerships and similar entities engaged in exploitation of mineral resources are treated as taxpayers, not conduits.) Resident individuals and resident legal entities are taxed on their worldwide income (with credit for income tax paid to other nations). Foreign enterprises and non-resident individuals pay tax only on income from local sources. Entities are residents if they are incorporated in Kazakstan or have their place of management there. An individual is considered a resident if he or she is physically present in the country for 183 days during a 12-month period.

2. Income of individuals

Individuals comprise the tax-paying unit. Taxpayers are allowed an exemption equal to one "monthly calculation index" (MCI) for the taxpayer and each dependent family member. Because this figure (which replaced the minimum wage in this calculation) has always fallen well below the cost of living, it has had a minimal effect in creating a tax-free threshold. (The MCI was KZT 380 in May 1996, KZT 520 at the end of 1996, and KZT 585 in July 1997, at a time when the exchange rate was roughly 60 tenge per dollar.) Among the types of income that are exempt from tax are interest on state securities, scholarships, alimony, state pensions, various other benefits (e.g., for pregnancy, disability, and loss of breadwinner), and most income of veterans of World War II.

3. Business income

Deductions are allowed for most business expenses. There are, however, limitations on interest expense (intended to combat thin capitalization), reserves for bad debts (limited to actual losses), research and development (which must be amortized, instead of deducted when incurred), and charitable contributions (limited to 2 per cent of taxable business income). In the case of transactions not made at arm's length with related parties that are non-resident or that benefit from tax preferences, the tax administration can adjust transfer prices to reflect arm's length prices.

Essentially all businesses are subject to the same rules for the determination of taxable income; there is no simplified regime for small taxpayers. Whereas initially taxpayers were allowed to choose between cash and accrual accounting, the use of accrual accounting is now mandatory.

Accounting for tax purposes (e.g., for inventories) generally must conform to financial accounting, except in the case of depreciation. Depreciation is based on pooled accounts, rather than individual asset accounts, except in the case of structures (for which individual accounts are required). That is, depreciation is allowed up to specified percentages of the undepreciated values in six asset pools (plus individual structures). The maximum depreciation rates allowed for the six categories of assets and assets in the categories are:

Category	Rate	Types of assets in pool
1	30%	computers; peripherals and data-processing equipment
2	25%	pipelines; equipment used for extraction and processing of natural resources
3	20%	automobile and tractor machinery to be used on the roads, inventories and accessories, special-purpose tools
4	15%	automobiles; trucks; trailers; buses; machinery and equipment, including metal-working equipment; electronic equipment; construction equipment; agricultural machinery and equipment; office furniture
5	10%	depreciable assets not included in another category
6	8%	equipment used in rail, sea, and river transportation; machinery and equipment used in generation and transmission of electric power and heating; power transmission lines; communications devices
7	7%	buildings, facilities, and structures

Expenses incurred for geological study and preparatory work for the extraction of natural resources (including subscription and commercial discovery bonuses, described in Section VIII) form a special group to be depreciated at the same rate as group 1 (25 per cent) for the first five years after commencement of extraction, with the balance written off anytime after that at the option of the taxpayer. (It is unclear whether the taxpayer has the latitude to postpone these deductions by choosing a rate of depreciation below the max-

17. The State Tax Committee is the official body charged with tax administration.
18. This view is consistent with that of Gillis (1989b, at 505): "... the few examples of successful comprehensive reform are associated with a relatively high degree of continuity among decision makers responsible for economic policy in general and tax policy in particular."
19. This description draws heavily on McLure (forthcoming, c). For the most part, the description does not distinguish between the tax code as it was introduced in 1995 and amendments that have been enacted since then.
20. In the case of some of the relatively unimportant taxes of purely local applicability, local governmental units are allowed some discretion over tax rates, but not over the definition of the tax base.
21. See McLure, (forthcoming, c) for brief descriptions of the securities transactions tax, land tax, property tax, and vehicle registration tax.

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imum rate allowed.) In addition, "technological equipment" with a life of at least three years can be written off at any time at the discretion of the taxpayer; this is tantamount to allowing first-year write-off of such investment, but with an option to delay these deductions. Deductions for the costs of reclamation can be taken over the life of a natural resource project.

Repairs are deductible, up to 10 per cent of book value. First in, first out (FIFO), last in, first out (LIFO), and average cost are acceptable methods of inventory accounting. Inflation adjustment is allowed for inventories and, since 1998, for book values of depreciable assets. Business losses can be carried forward five years (seven years in the case of taxpayers engaged in extraction of natural resources), but are not indexed for inflation. The fact that the taxpayer has the option not to claim the maximum allowable depreciation provides some latitude to extend the effective loss carry-forward period.

4. Tax rates

Marginal tax rates on the taxable income of individuals range from 5 to 30 per cent. By comparison, legal entities pay a tax rate of 30 per cent, except in the case of entities devoted primarily to farming (10 per cent rate) and for legal entities registered in a special economic zone (20 per cent rate). A withholding tax of 15 per cent is levied on interest paid to legal entities and on all dividends; interest received by individuals is tax-exempt. The withholding tax on dividends is a final tax; dividends need not be included in income subject to individual income tax. There is a branch profits tax of 15 per cent.

5. Withholding and advance payments

Tax is withheld on employment income, pensions, and payments to foreign persons. Those with taxable income not subject to withholding (essentially those engaged in business) must make advance payments of tax on a monthly basis.

6. Filing requirements

Individuals and legal entities must file tax declarations if they have: income not subject to withholding (essentially business income); construction or purchases in the tax year exceeding 1,000 MCIs; foreign bank accounts; or foreign-source income. Given the withholding of tax on income from employment and the exemption of dividends, most individual taxpayers will not be required to file tax returns; the primary exception is those engaged in business.

7. Imputation of income

Business taxpayers operating mainly with cash or having few employees can employ a simplified method of accounting for tax purposes. Where there are accounting violations, or loss or destruction of records, the State Tax Committee can impute income based on assets, turnover, or production costs. Where income declared for tax purposes is inconsistent with personal expenses, the latter can be employed to impute income.

B. Value added tax

The VAT is essentially a standard consumption-based, credit-invoice method, destination-principle tax of the type found in most advanced Western nations. That is, tax liability is calculated by subtracting tax shown on purchase invoices from tax on sales. Credit is allowed for tax on capital goods, as well as tax on other business purchases. Imports from non-CIS countries are subject to VAT; exports to such countries (and international transport) are zero-rated; that is, no VAT is due on exports, but credit can be claimed for VAT on purchased inputs. Trade with the CIS is treated differently; like most other members of the CIS, Kazakstan applies what is sometimes called a "restricted origin method" VAT to CIS trade. Exports to the CIS are taxed, and credit is allowed for VAT on imports paid to other members of the CIS.

The base of the VAT is relatively comprehensive; it includes services, as well as goods. Exemptions are more or less standard; they include the lease and sale of land and buildings, financial services, activities of non-profit organizations, funeral services, services provided by the state, and privatization and sale of enterprises.

There is a single tax rate of 20 per cent. It is applied on a tax-exclusive basis, that is, to the value of sales net of VAT itself. Excises, customs duties, and fees are, however, included in the base for VAT. Initially the tax code provided the option of using either cash or accrual accounting, but the cash option was soon eliminated.[22]

Taxpayers are legal persons and individuals engaged in business that are registered for VAT. Registration is mandatory for businesses with turnover in excess of a minimum amount. Voluntary registration is allowed for those with turnover below the minimum.

C. Excises

Excises are imposed on such commonly excisable goods and services as alcoholic beverages, tobacco products, motor fuels, passenger vehicles, and gambling, and also on sturgeon and salmon and their roe, furs and hides, apparel made of fur or trimmed with fur, crystal, and firearms. In addition, there is a 5 per cent tax on crude oil. Rates on alcoholic beverages and tobacco products are specific (i.e., a certain amount per litre), but are stated in European Currency Units, to prevent their being eroded by inflation; *ad valorem* rates are applied to other goods and to gambling. The base for *ad valorem* excises excludes the excise, VAT, customs duties, and fees. Like the VAT, excises are imposed on the restricted origin basis; that is, they apply to production, except that for export beyond the CIS, and to importation, except from the CIS. Rates applied to non-CIS imports of alcoholic beverages and

22. When a cash-basis taxpayer sells to an accrual-basis taxpayer, VAT revenues can suffer. The buyer takes credit for accrued VAT liability on purchases, but the seller does not report taxable sales until cash is received. While this treatment is problematic and open to abuse, it is not nearly as troublesome as the situation in which the same taxpayer reports sales on a cash basis and claims credits for accrued liability for tax on inputs. See Sunley and Summers (1995).

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tobacco products are generally substantially higher than those on local products. (Rates on other products do not show this differentiation.)

D. Administrative matters

The tax code covers administrative matters, as well as the tax structure. It provides a statute of limitations, collection powers, appeals procedures, confidentiality of taxpayer information, and rules against conflicts of interest. While some of the collection powers accorded the State Tax Committee are standard, others are potentially quite onerous and subject to abuse. The State Tax Committee can require banks to assign it priority in collection orders; it can demand payment from the bank accounts of the taxpayer's debtors; it can place liens on the taxpayer's property and sell it at auction; and it can suspend the taxpayer's export operations.

E. Appraisal

Judged by the objectives described in the previous section, the 1995 tax code, as initially enacted (that is, before the retrogressive introduction of tax holidays, to be considered in Section VII), rates fairly highly. (It is difficult to judge revenue adequacy, which depends in part on both expenditure reform and the quality of tax administration, as well as the tax structure.) On paper, the new tax code is relatively neutral and fair, and rates are relatively low. But it does not treat losses, VAT on capital goods, and expatriate employees appropriately. These major defects are described and discussed more fully in Section VI.

The tax code is not as simple as would have been desirable, especially for individuals and small business. The complexity for small business may have been inevitable; as noted earlier, it is difficult to craft a "one size fits all" solution that is simple enough for small domestic business, while providing adequate certainty for large multinational investors.[23]

The VAT may be more complex than is appropriate for a country at Kazakstan's stage of development. This reflects the genesis of the tax: a model statute patterned after the VAT currently employed in the European Union. A simpler system might have been more appropriate, at least as an interim measure.

The chief problem with the new tax system is perhaps not structural, but administrative; Kazakstan lacks the trained personnel to implement a modern tax system. In this it is hardly unique among countries in transition from socialism. Administrative deficiencies undermine achievement of all the goals identified above: revenue suffers, the system is not as fair or as neutral as it appears to be, and it is not as simple – except to the extent it can be ignored.

V. A MISSED OPPORTUNITY: DECIDING AGAINST CASH-FLOW TAXATION

I believe that during the early 1990s countries in transition from socialism provided a uniquely favourable environment for the introduction of a CFT.[24] A CFT is arguably simpler than a standard income tax, especially since it avoids two problems: timing of the recognition of income and the deduction of expenses; and the need for inflation adjustment in the definition of income from capital.[25] Because it provides a zero marginal effective tax rate,[26] a CFT is more conducive to the saving and investment that is so badly needed in such countries. Yet, unlike tax holidays, it captures for the fisc a portion of the economic rents that could be expected to result from transition to a market economy and is less subject to abuse through the manipulation of transfer prices. Finally, if adopted quickly, a CFT would avoid the troublesome transition problems that have plagued CFT proposals in developed countries. Of course, the passage of time, which has seen the introduction of other forms of taxation, has reduced this last advantage.

Proposals for a CFT are plagued by a potentially insuperable obstacle; the United States may not allow US multinational corporations a credit against US income tax for a CFT paid to other countries.[27] This argument is easily overstated, since no US tax is due until income is repatriated, and many US multinationals have excess foreign tax credits.[28] Even so, creditability is a form of "good housekeeping seal of approval," without which investors may be reluctant to commit funds.

George Zodrow and I (McLure and Zodrow, 1998) have argued that credit should be allowed for a CFT. Even so, it would be risky for a country to adopt a CFT, in hopes that these arguments are found persuasive, by either the US Internal

23. A proposal by foreign advisers that small business be allowed to utilize the cash method, including expensing for capital investment, was rejected.
24. I have expressed this view at greater length in McLure (1992a, b) and (1991b), applying it to the situation in Bulgaria in McLure (1991a), and in Russia in McLure (1992c).
25. On the relative simplicity of cash-flow and income taxes, see Zodrow and McLure (1990). A CFT provides immediate deductions for purchases of capital goods and additions to inventories, and thus avoids the need for depreciation allowances and inventory accounting. One version, the consumed income tax (CIT), would include interest income and the proceeds of borrowing in the tax base and allow deductions for interest expense and repayment of debt (and opposite adjustments for the lender). Another ignores both interest and principal transactions; that is, it provides yield exemption treatment (YET) of the return to capital. McLure and Zodrow (1996a, b) proposed a hybrid system that would provide YET for individuals and CIT for companies. Croatia has recently adopted a tax that allows a deduction for the cost of equity finance that achieves a similar result, the taxation of only returns that exceed this cost; see Schmidt, Wissel, and Stöckler (1996).
26. The marginal effective tax rate (METR) is the percentage by which taxation changes the before-tax return to a marginal investment (an investment that would provide a return equal to the discount rate, in the absence of taxation). If taxable income and economic income are equal, the METR equals the statutory rate. But METRs can be negative (for example, because of investment incentives) and they can exceed 100 per cent (for example, if deductions are not allowed for all expenses or if inflation erodes the value of depreciation allowances).
27. For a description of how fears of non-creditability overwhelmed Bolivia's recent interest in a CFT, see McLure and Zodrow (1996).
28. In either of these cases, worldwide taxation has economic implications more nearly like those of a source-based tax – one that taxes only income having its source within the taxing nation. See Slemrod (1995) for an excellent exposition of these points.

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Revenue Service or the US courts. Equally, it is easy to understand why US multinationals would prefer a standard income tax with its certain creditability over a potentially non-creditable CFT. Ultimately these arguments were dispositive; none of Kazakstan's foreign advisers advised adoption of a CFT.[29]

VI. DEFECTS OF THE 1995 LEGISLATION

Although the 1995 legislation followed fairly closely the advice of foreign advisers, it deviates in several respects that are likely to discourage investment.

A. VAT on capital goods

The tax code appropriately provides immediate credit for VAT on capital goods, but excess credits are not subject to rapid refund. (Firms making limited taxable sales in the domestic market, such as those in the natural resource area, generally have excess credits. Excess credits can be used to offset liability for other taxes. This is of little value until a venture shows a profit.) The need to pay tax on capital goods that can be reclaimed only much later, if at all, can be a major impediment to investment, especially in capital-intensive industries where investment is subject to long gestation periods.[30] The problem is especially serious in a time of high inflation, since postponed credits quickly lose real value.

It is admittedly administratively difficult and risky to implement a full-blown system of refunds for excess VAT credits, due to the possibility of fraud.[31] It would be desirable, however, to introduce a system that relieved the existing burden on investment. For example, imports of capital goods might not be taxable when undertaken by approved investors. In the first instance, exemption might be limited to capital goods that could not conceivably be diverted to household use (e.g., oilfield and mining equipment and equipment used in processing natural resources). Eventually the exemption might be broadened to encompass most, if not all, imports by approved buyers, and sales by the domestic suppliers of such firms might also be zero-rated. While this approach would discriminate against those not eligible for this special treatment, this would be an acceptable cost to pay to avoid disincentives to the development of the nation's natural resources.

B. Loss carry-forward

It is common for new ventures to incur losses during their early years of operation. If such losses cannot be used to offset future income, taxation discourages investment. The five-year limitation on loss carry-forwards (seven years in the case of taxpayers engaged in exploitation of natural resources) is likely to be much too restrictive in the case of major capital investments with long gestation periods, for example, in the natural resource area. The latitude to postpone deductions for depreciation alleviates this problem, but does not eliminate it; the carry-forward period should be lengthened or perhaps made indefinite.[32]

C. Lack of inflation adjustment

If the measurement of income from business and capital is based on nominal amounts (that is, amounts fixed in monetary terms), such income is likely to be mismeasured during a time of inflation. The failure to adjust the value of depreciable assets, inventories, and outstanding credit (or interest income) would result in overtaxation, but the failure to adjust the value of indebtedness (or interest expense) would produce undertaxation, with the net effect depending on the debt and asset structure of an enterprise.

It is possible to avoid part of the overtaxation by accelerating depreciation, allowing LIFO accounting for inventories, or providing periodic revaluation of assets, as contemplated in the new tax code. Indeed, from 1998 taxpayers may revalue assets in line with inflation. But this neglects the effect inflation has on the real value of debt and interest. An accurate measurement of real income requires adjustment of the balance sheet to reflect the effects of inflation. While this is done in several Latin American countries that have previously experienced rapid inflation (e.g., Chile and Colombia), and was introduced in Romania several years ago, it is complicated and could not reasonably be required of all business taxpayers in Kazakstan.[33]

An alternative that is reasonable for foreign investors is to allow the use of a foreign ("functional") currency (the dollar in the case of US firms) for tax accounting. This would insulate the tax liabilities of such investors from the differential effects of inflation experienced in Kazakstan, relative to that in the currency used for accounting. The obvious problem with this approach is that it discriminates against local investors (and perhaps against investors from countries with relatively high rates of inflation).[34]

There is no good solution to this problem. I remain convinced that the most satisfactory approach is the CFT, which is immune to the effects of inflation. Unlike inflation adjust-

29. I should clarify that I would have been the strongest advocate of a CFT; some advisers (especially those from the IMF) would probably have opposed the idea. Since I had decided not to push the issue before the other institutions joined the ITIC in the tax reform effort, the issue never arose in discussions with the government.
30. Sunley and Summers (1995, p. 2061) note that there will also be economic distortions, because effective tax rates will depend on the capital intensity of production. Moreover, there may be a disincentive to export.
31. At the ISPE conference Parta Shome noted that even developed countries do not allow refunds, except to exporters.
32. The problem was especially severe under the original tax code, since the values of depreciable assets were not indexed for inflation. Even indefinite carry-forward would not provide a fully satisfactory solution in a time of rapid inflation, as losses not utilized to offset income quickly would lose substantial real value.
33. For descriptions of the inequities and distortions caused by the interplay of inflation and an unindexed income tax and of the type of "integrated" system of inflation adjustment used in Chile and Colombia, see McLure et al. (1990), chap. 7. For a more detailed analysis of the integrated system, see Thuronyi (1996). The primary complication is that all business taxpayers must employ books of accounts – which the tax law anticipates. But the tax code was enacted before the accounting reform was finalized. Moreover, as noted elsewhere, the tax administration has difficulties in implementing the tax code, even without comprehensive inflation adjustment.
34. Foreign advisers proposed such a system, but it was rejected.

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ment, which is more complicated than an unindexed system, the CFT is *less* complicated.

D. Taxation of expatriates

The income tax makes no allowance for benefits paid to expatriates working temporarily in Kazakstan, such as home leave, educational benefits for children, and cost of living allowances. Moreover, the tax code provides only a distinction between non-residents (who pay tax only on Kazakstan-source income) and residents (who pay tax on income from all sources, including income earned by expatriates on investments in their home countries). It would be appropriate to have a third category, non-permanent residents (who would pay tax on income from foreign sources only to the extent remitted to Kazakstan).[35] Failure to provide a more appropriate treatment of expatriate workers can be a serious impediment to foreign investment, much of which depends on the expertise of expatriates.

E. VAT on intra-CIS trade

It is generally agreed that the VAT's "restricted origin principle" treatment of trade within the CIS is unfortunate. It restricts national autonomy over VAT rates. (Ideally, all members of the CIS would levy the same tax rates under such a system.) Moreover, it is inconsistent with the generally accepted view that revenues from a VAT should go to the jurisdiction where consumption occurs, not where production occurs.[36] Unfortunately, this is not a problem that Kazakstan can easily solve for itself; it needs the cooperation of the other members of the CIS, especially Russia. Any attempt to implement the destination principle for intra-CIS trade would be stymied by the lack of adequate border controls.[37]

VII. TAX HOLIDAYS

One of the remarkable phenomena of the past 40 years has been the rise and fall of interest in tax holidays and various forms of investment incentives.[38] This pattern is seen perhaps most clearly in Latin America, where, during the 1950s and early 1960s, tax holidays and other incentives were seen as a means of encouraging saving and investment and channelling investment into activities "of special importance for economic development".[39] Already in decline, this strategy received an intellectual body blow from the US Tax Reform Act of 1986, which eliminated many tax incentives and lowered tax rates dramatically.[40] Even so, this pattern of interest in tax incentives has been repeated in much of CEE and in the FSU. While some countries of CEE that were in the forefront of offering incentives have learned from their mistakes, Kazakstan apparently has not.[41]

During 1996 officials in some of the "miracle" Asian economies apparently sold visiting high-ranking government officials from Kazakstan on a policy of industrialization based on tax holidays,[42] despite the existence of research that questions the efficacy of such a policy.[43] Even if that had not happened, it is quite likely that holidays would have eventually been proposed. First, virtually every other country in transition from socialism has tried them. There is no reason to expect Kazakstan would long remain immune to the virus. Second, as Kazakstan's oil comes on line, and nothing else can be exported, there may be a temptation to try to swim upstream against the dictates of comparative advantage, as many other resource-rich countries have done.[44] Again, there is no reason to expect Kazakstan to be able to resist this temptation.

Tax incentives suffer from a variety of problems.[45] First, they reflect the *dirigiste* mentality of central planning – a mentality that impoverished the countries of the Communist bloc. There is little evidence that politicians and bureaucrats can reliably pick "winners and losers" better than the market; if they cannot, tax incentives distort the allocation of resources.[46] Second, tax incentives undermine both the fact and the perception of equity. They inherently violate horizontal equity, because income is treated differently, depending on its source, and they commonly also violate vertical

35. Foreign advisers also proposed such a system, but it was rejected.
36. It is also one reason once given by government officials for refusal to allow credits and refunds for tax on capital goods (a view that has since been abandoned): why should Kazakstan give credits for tax that has been paid to Russia or Ukraine, which export substantial amounts of capital goods to Kazakstan?
37. For further discussion, see Sunley and Summers (1995, at 2062-66).
38. Gillis (1989a, at 19-20) writes, "with notable exceptions, ... the evolution of tax systems until the late 1960s was marked by growing reliance upon provisions designed to guide private firms and individuals toward (or away from) investments favoured (disfavoured) by government ... Later reform efforts in the 1970s and 1980s reflected greater emphasis on neutrality and greater scepticism of the efficacy of differential tax incentives, particularly tax holidays."
39. The words in quotation marks paraphrase the typical target of incentives. Another component of this interventionist strategy was the use of protective tariffs to encourage import substitution in selected sectors.
40. On the worldwide tax reform movement of the 1980s, including foreign reactions to US tax reform, see Tanzi (1987) and (1988) and Whalley (1990). It should be noted that the United States was not the first important industrial country to follow this path. The United Kingdom had done so in 1984. On this, see Sanford (1993).
41. See OECD (1995).
42. President Nazerbaev highlighted tax holidays in his presentation to the economic summit at Davos in December 1996. One can only wonder – without attributing cause and effect – whether a policy of industrialization based on tax incentives would have seemed so attractive had this visit occurred after the crash of the Asian economies in late 1997.
43. See the papers in Shah (1995).
44. Gelb and Associates (1988) discuss the disappointing experience of other oil-rich nations that have pursued this strategy.
45. The remainder of this section draws heavily on McLure (1997b). See also the papers in Shah (1995).
46. It is common to offer the example of MITI, the Japanese Ministry of Industry and Trade, as a counterexample. This is not the place to examine the "Japanese miracle", or MITI's role in it; on that, see Ishi (1997). Ishi states, "it was widely recognized that government officials had more knowledge, information, and experience than that available in the private sector." Yet he notes that MITI initially failed to support radio, television, computers, motorbikes, and optical goods, fields in which Japan became a world leader. Discussion at the ISPE conference suggested that Japan's post-war performance may have been unique in several respects. First, much of its capital stock had been destroyed. Second, because of its previous policy on economic isolation, much of its industry was not competitive. Third, demographic factors cannot be ignored; the population was exceedingly young. Fourth, substantial amounts of money were pumped into the economy during the Korean War. The question is whether the Japanese experience "travels well". Much of Kazakstan's industry is not competitive, but – for better or worse – it has not been destroyed. Its population is not young, and there is not likely to be an infusion of foreign purchasing power similar to that in Japan during the Korean War, except in the mineral sector.

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equity, because only the wealthy (along with foreigners) can take advantage of incentives; since such inequities are not likely to go unnoticed, the perception of equity also suffers. Third, tax incentives – especially tax holidays – complicate tax administration and compliance, something a country in transition from socialism can ill afford.[47] Fourth, tax incentives provided to investors from countries that tax the worldwide income of their residents and allow source-country taxes to be credited against liability for home-country taxes may provide little or no incentive for investment in Kazakstan (i.e. they may simply benefit the treasury of the home country.)[48] Finally, if – as is common – incentives are provided at the discretion of bureaucrats and politicians (implicitly, via pressure on bureaucrats, if not explicitly), they are an open invitation to corruption.

Tax holidays are vastly inferior to investment incentives, *if* tax incentives are to be provided. Perhaps most important, under a regime of tax holidays, affiliated enterprises engaged in both taxed and exempt activities can be expected to manipulate transfer prices to shift income from taxable activities to exempt activities. If, for example, agriculture is exempt (or accorded a preferential rate, as in Kazakstan), but agro-industry is not, prices of agricultural products will be inflated. If both these sectors are exempt, forward vertical integration into marketing will allow shifting of profits from marketing back into the exempt sectors. In principle, this abuse can be controlled by monitoring transfer prices, but only at the expense of enormous administrative resources.[49] Moreover, as noted above, holidays exempt all returns to investment, including economic rents.

Nor does business generally advocate tax incentives. Serious potential investors are much more likely to be interested in political and economic stability.[50] In this regard it is useful to quote the Business and Industry Advisory Committee (BIAC) of the OECD (1990):

> Given the choice between lower tax rates and incentives, foreign investors will generally prefer the former, since it results in a simpler tax system with greater certainty and fairness to all investors.

Similarly:

> ... the international business community believes generally that it is preferable to have lower tax rates rather than incentives. This approach leads to a simpler, more predictable tax system in which foreign investors have confidence that their projects are not being treated less favorably than those of their foreign or domestic competitors.

While theoretically less desirable than tax holidays, because they encourage the substitution of capital for labour, investment incentives are less easily abused. But not all investment incentives are equally desirable. Investment credits tend to stimulate short-term investment, because they apply to reinvestment of capital as well as to net new investment.[51] For this reason, I have advocated the use of partial expensing, *if* Kazakstan is to provide tax incentives in the effort to stimulate economic development. Like both economic depreciation and immediate expensing, partial expensing (with economic depreciation of the remainder) is neutral with respect to investment decisions.[52]

It is against this backdrop that Kazakstan introduced legislation during 1997 authorizing the grant of tax holidays for selected industries. Such a policy represents a serious retreat from the principles of uniformity and economic neutrality that, for a while, gave the country the only modern tax system in the former Soviet Union. Rather than following this bankrupt policy, Kazakstan should eliminate the existing defects that deter investment, identified in the previous section; only then should it even consider tax incentives. If it is to provide tax incentives, it should allow partial expensing, and not provide tax holidays. Under no circumstances should it provide incentives on a discretionary basis.

VIII. DEFERRED ISSUES IN TAXATION

A. Taxation of mineral resources

The development of the new tax code did not adequately address two important issues, the taxation of mineral resources and the so-called tax-assignment problem. The next two sections discuss these issues. Of course, much of the discussion of previous sections (e.g., of VAT on capital goods, loss offset, and the taxation of expatriates) is also highly relevant for the mineral resource sector.

The new tax code provides for three types of taxes on natural resources, bonuses (due on subscription, commercial discovery, and extraction), royalties, and excess profits tax, but does not specify details of any of them. Subsequent legislation (passed at the end of 1996) provides a few more details, but is still not adequate. A matter of continuing tension is the extent to which provisions should be specified by law or decided in negotiations with potential investors.

Excess profits tax (EPT) is to be due if the rate of return on a project exceeds 20 per cent. Tax is to be paid at marginal rates that climb from 4 per cent to 30 per cent as profitability rises from 20 per cent to 30 per cent. For this purpose (and for income tax purposes) projects are to be "ring-fenced". That

47. Gillis (1989a, at 19-20), writing before the fall of the Berlin Wall, notes, "These interventionist goals required a degree of fine-tuning of tax structures inconsistent with present realities of tax administration and tax compliance in virtually all developing, if not developed, nations. ... Arguably it was not coincidental that the most extensive use of special tax incentives to promote growth and development occurred in the period and in the countries when and where the least attention tended to be paid to issues of tax administration and tax compliance."

48. One should recognize that not all countries tax on a worldwide basis and some of those that do (but not the United States) allow tax sparing credits "as if" the source country had imposed tax. In these cases incentives may have their intended effects.

49. Vito Tanzi, head of the Fiscal Affairs Department of the International Monetary Fund (1995, at 139) has expressed the following view about the use of transfer pricing in the international arena:
"It may not be too far-fetched to predict that in a technologically evolving world, the allocation of income by the use of transfer prices may be subject to increasing challenges and may thus become progressively more controversial."
It is hard to believe that a country such as Kazakstan, which lacks administrative resources, can handle the analogous problem, as it must if it is to prevent the type of abuse described in the text.

50. This view is also supported by two surveys of investors in Kazakstan conducted by the ITIC.

51. Sunley (1973) and Harberger (1990) make this point. To offset this bias, investment credits commonly are larger (as a percentage of investment) for longer-lived assets.

52. Harberger (1980) demonstrates this.

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is, EPT and income tax must be paid on highly profitable projects, even if the same taxpayer is involved in other projects that are less profitable (or even losing money). The method of calculating the rate of return for the purpose of determining liability for EPT is not clear.

The 1996 amendments provide that there will be two regimes that must produce an equivalent effect: one based on the tax code (including EPT) and one (including all taxes other than EPT) based on profit-sharing agreements (PSAs). Thus the code implicitly recognizes that EPT and PSAs are alternative ways of reaching profits in excess of some specified amount or rate. It will, however, be difficult to meet the requirement that EPT and PSA must reach equivalent results. Neither the tax code nor the regulations indicate how this is to be done.

Several specific provisions deserve special notice. First, taxpayers are not allowed to consolidate the activities they conduct under various contracts; instead, such activities are "ring-fenced" for purposes of both income tax and EPT. It would be more common and more appropriate to allow consolidation, at least for income tax purposes, so that losses incurred under one contract can be offset against income from another. This avoids the disincentive to investment caused by the asymmetry that occurs when income is taxed but losses cannot be offset.

Ring-fencing makes more sense for the EPT, and is customary under production-sharing agreements, to which the EPT is supposed to be equivalent.[53] Without ring-fencing, those with existing successful activities have an advantage over new entrants. (Even an economically marginal discovery may be profitable, because it reduces EPT.) Moreover, they have an incentive to engage in tax-motivated contracts to reduce EPT. (Thus they may offer to pay a greater proportion of costs than the proportion of profits they receive, because of the implied reduction of EPT.) Assuming that EPT is ring-fenced, it may be desirable to make the EPT a deductible expense in calculating the income tax (instead of following the reverse "stacking" procedure). This avoids the necessity of allocating the income tax between contracts that are ring-fenced for EPT purposes.

Contrary to normal practice (in both the new tax code, as it applies to other sectors, and the taxation of mineral resources in some other countries), Kazakstan treats partnerships in the mineral resource sector as taxpayers, rather than as "flow-through" entities (with taxation of the various partners on their shares of income derived from activities in Kazakstan). This has the effect of unduly limiting the way partners in joint ventures can arrange their activities for tax and other purposes; for example, the way they organize their worldwide operations. Since investors in a particular project organized as a joint venture may come from more than one nation, they will be governed by the treaties their respective countries have concluded with Kazakstan. Treating a joint venture as a taxpayer limits the possibility to arrange activities to reduce taxation in home countries and thus to reduce the cost of doing business in Kazakstan.

B. Tax assignment[54]

The issue of tax assignment – who (which level of government) should tax what?[55] – is important, since the "system" of tax assignment inherited from the Soviet Union is embedded in a system of intergovernmental fiscal relations (IFRs) that is totally inappropriate for a market economy. Unfortunately, the only significant change made in tax assignment in the new tax code went in the wrong direction; it shifted the individual income tax from a source of subnational revenue to a "regulating tax" (a term to be explained below).[56] Even though the government has had a comprehensive report on IFR (Asian Development Bank, forthcoming) since early 1996, it has taken no action to rationalize the system of IFR.[57]

The broad outlines of this system can be described as follows. Target levels of expenditures are determined for each level of subnational government.[58] (At one time this was done by the application of "expenditure norms" – quantities and prices set by the planners; more recently there has been a tendency simply to adjust prior budgetary allocations for inflation.) Some of the revenues needed to finance these expenditures are budgeted to be provided by subnational taxes – taxes whose revenues flow only to the subnational governments, although they are administered by the central government's State Tax Committee. The remaining budgetary gap is covered by subnational shares of "regulating taxes" and, if necessary, subventions from the central government. Sharing rates for regulating taxes are not uniform across *oblasts*; they are set at levels that are estimated to cover the expenditure needs of individual *oblasts* (and are, in this sense, "regulating"). Subvention *oblasts* tend to be poor *oblasts* whose level of taxable economic activity would be inadequate to provide the revenues needed to cover budgeted expenditures, even if they were allowed to retain all revenues collected in their territory. Despite – or perhaps because of – the technocratic origins of this system, discretion and bargaining play a large role in determining the fiscal resources available to various jurisdictions.

There are many problems with this "gap-filling" system of revenue assignment. First, it provides virtually no fiscal autonomy to subnational governments, since these governments have essentially no control over target expenditures or

53. This discussion draws heavily on the ideas of Emil Sunley.
54. This discussion is based on McLure (forthcoming, d and e).
55. This formulation of the question, from Musgrave (1983), may seem to be more appropriate to a federal system of government, such as that of Russia, than to a unitary system such as exists in Kazakstan. Even so, the question has arisen throughout the FSU and CEE, more or less without regard to the form of government.
56. In fairness to our counterparts, I note that the Western advisers paid altogether too little attention to this issue until this change had been made by inadvertence. Despite explicit instructions from Vice-President Asanbaev to consider tax aspects of IFR, this issue simply "fell between the cracks", due in part to the pressure of crafting the rest of the system.
57. Charles McLure, Jorge Martinez, and Sally Wallace prepared this report. They are not listed as its authors (but are listed as authors of individual chapters) because of ADB policy.
58. The process described here for determining the budgets of *oblasts* (regions) also occurs at lower levels of government, with budgets of each level being "nested" in that of the next higher level. Under the FSU, the budget of Kazakstan, like that of the other 14 republics, was decided in a similar way. Thus this system is sometimes called the "matrushka doll" model of IFR.

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their financing. Shared taxes are better seen as grants than as subnational taxes.[59] Second, leaving aside this issue (which renders the allocation of revenues from particular regulating taxes largely irrelevant), the allocation of revenues from shared taxes makes no sense. Excises are allocated to the subnational jurisdiction where importation or production occurs, not to the jurisdiction where consumption occurs, as is more appropriate and common in the West. Revenues from the value added tax and the enterprise income tax go to the *oblast* where enterprises are chartered. These allocations could not form the basis of a conventional system of tax assignment – at least not a rational one.

I have argued that it is useful to decompose the tax assignment problem into four choices: which taxes subnational governments are allowed to levy, which level of government defines the tax base(s), which level sets the tax rate(s), and which level administers the tax(es).[60] Of these, the choice of tax rate(s) is by far the most important for subnational fiscal autonomy – provided, of course, that the tax bases assigned to subnational governments provide adequate revenues in the aggregate. By comparison, some taxes are inappropriate for subnational governments (for example, taxes that interfere with either external or internal trade), and excessive subnational discretion over the definition of the tax base and tax administration can be counterproductive, in the sense that it can cause complexity and duplication of administration and compliance. This suggests that the optimal approach to tax assignment would rely on subnational surcharges on taxes legislated and collected by the central government.[61]

I have suggested that tax assignment in Kazakstan should follow the following general principles:

- the individual income tax should be assigned to the *oblast* where taxpayers reside;
- excises should be assigned to the *oblast* where consumption occurs;
- enterprise profits should be divided among *oblasts* on the basis of a formula;
- the VAT should be a levy of the central government.

The assignment of revenues from the taxation of natural resources is inevitably controversial in a resource-rich country such as Kazakstan.[62] There are questions of equity (the division of the "spoils" between levels of government), neutrality (the possibility that resources will be misallocated to resource-rich regions that can levy lower non-resource taxes or provide higher levels of public services than other regions), political philosophy (whether the taxed resources are the "heritage" or "patrimony" of the entire nation or only of the region), and implications for political stability. (Whereas it might be necessary to assign a substantial portion of revenues from resource taxes to subnational governments to preserve the Russian Federation, this issue may not arise in Kazakstan.) Even so, it seems a fair bet that the resource-rich *oblasts* of Kazakstan will have more fiscal resources, per capita, than most other *oblasts*.

A system such as that described above is likely to suffer from two structural problems: vertical fiscal imbalance and horizontal disparities. The former occurs when one level of government is unable to finance the services appropriate to it with the taxes assigned to it. Commonly, as in Kazakstan, the top level of government has relatively greater fiscal capacity than the lower levels of government. The usual solution, and the one proposed for Kazakstan, is a system of grants. Grants are also likely to be needed to overcome the second problem, horizontal differences in the fiscal capacity of *oblasts*, which are commonly related to the level of economic activity in various regions (and exacerbated by the assignment of revenues from taxes on natural resources to subnational governments where resources are located).

It is crucial that such grants do not follow the "gap-filling" model of the past and that they are not based on bureaucratic discretion and bargaining. Rather, to create incentives for local autonomy and responsibility, they should be structured in such a way as to preserve, to the extent possible, the marginal incentives that would face subnational governments in the absence of grants.[63] Moreover, they should be based on formulas that limit the latitude for discretion and bargaining.

IX. CONCLUDING REMARKS

Until recently Kazakstan has performed remarkably well in the area of tax reform. The tax code it adopted in 1995 was the only modern one in the CIS at the time. While the new tax code had some defects, it was relatively free of the types of special incentives that have commonly characterized the tax systems of both developing countries and countries in transition from socialism. Unfortunately, this has changed with the adoption of legislation authorizing the granting of tax holidays. One hopes this authority will not be used and that the legislation establishing it will be rescinded. Even so, perhaps the chief deficiency in the tax system of Kazakstan is in tax administration, not tax policy; it seems that the State Tax Committee is simply unable to implement the new tax code. Finally, the country needs to move quickly to provide a comprehensive fiscal framework for the development of its natural resources and to rationalize its system of tax assignment (and of IFR in general). The former is needed to improve the economic well-being of the country, the latter to bring democracy to the subnational level.

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59. Bahl and Linn (1992, at 434) express the same view.
60. See McLure (forthcoming, e), (1995b), (1997a) and (1998).
61. This sentence and the one that follows hide a multitude of qualifications and practical problems; see McLure (forthcoming, e).
62. Again, this topic is too big to cover here; see McLure (1994).
63. There is an obvious theoretical exception to this rule: grants provided to induce subnational governments to take account of spillovers of benefits between jurisdictions should reflect marginal benefits to non-residents. Decision-making in Kazakstan is very far from the model of rational decentralization underlying this theory.

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LUXEMBOURG

LUXEMBOURG SOPARFI REGIME REMAINS ATTRACTIVE

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A law of 23 December 1997 has introduced important changes to the Luxembourg Soparfi regime. In view of these amendments it is interesting to summarize the legal framework applicable to Luxembourg holding companies.

I. HISTORICAL BACKGROUND

Luxembourg has a long tradition as a location for holding companies. In 1929, the Luxembourg authorities created a regime favourable to companies whose activities are limited to the acquisition and management of a portfolio of participations. The 1929 holding companies were intended to avoid double taxation of dividends and thereby to attract foreign investors to Luxembourg.

The law of 31 July 1929 enables a Luxembourg holding company to derive dividends and realize capital gains on the sale of securities without suffering Luxembourg tax. The activities open to 1929 holding companies are however strictly limited.

Ordinary commercial companies are, on the contrary, free to carry out any activity, subject to certain regulatory requirements. As a counterpart, their profits are subject to Luxembourg corporate income taxes[1] at an aggregate rate of 37.45 per cent (in Luxembourg-City).

Traditionally, Luxembourg tax law in certain circumstances eliminated double taxation on dividend distributions. During World War II, Luxembourg adopted the German tax rules. For that reason, reference is quite often made to German doctrine and case law. During the German occupation, an exemption of dividend distributions made between fully taxable Luxembourg companies became available. In 1967, the current income tax law[2] was passed. This law maintained the participation exemption in a domestic context and provided for a 50 per cent exemption of qualifying foreign source dividends. In 1978, this partial exemption was turned into a full exemption. Finally, in 1990, a *grand-ducal* decree[3] extended the participation exemption to capital gains.

In 1990, the term "Soparfi" (*sociétés de participations financières*) appeared. This denomination proved to be an excellent marketing tool as it often happens that clients and foreign practitioners think that a Soparfi is a particular corporate form, while it is in fact only an ordinary commercial company benefiting from a comprehensive participation exemption. Ironically, although Spain has in the past denied the Luxembourg Soparfi[4] the benefit of both the Luxembourg–Spain double tax treaty and the EC Parent-Subsidiary Directive 90/435 of 23 July 1990, Spanish authors have copied what they consider a good idea and market a similar product overseas.[5] Admiring the Soparfis, they suggest that reference should be made in Spain to Separfi, as an abbreviation for "Sociedad Española de Participación Financiera".

The Luxembourg Soparfi regime covers four different aspects of tax exemption:
- exemption of dividend income;
- exemption of capital gains on the alienation of shares;
- exemption of wealth tax; and
- exemption of withholding tax on dividend distributions.

This article will address each of these exemptions respectively, focusing in particular on the amendments of the income tax law by the law of 23 December 1997. Similar conditions, however, have to be met in all four situations. For that reason, cross-references and comparisons will often be made.

II. EXEMPTION OF DIVIDEND INCOME (ARTICLE 166 LIR)

Article 166 LIR provides for the corporation tax exemption of inbound dividend income. Business undertakings are, however, also subject to a municipal business tax on their income. The tax rate depends on the municipality where their operations are located. The provisions in the municipal business tax law covering the participation exemption are slightly different from those contained in the LIR. For instance, only dividends may escape the municipal business tax, while capital gains remain taxable.

However, as a general rule, the municipal business tax law refers to the LIR for the determination of taxable income, meaning that an exemption which is available for corporation tax purposes will automatically also apply to the municipal business tax.[6] Tax lawyers have therefore to examine the

1. Corporation tax (*impôt sur le revenu des collectivités*) and municipal business tax (*impôt commercial communal*).
2. *Loi concernant l'impôt sur le revenu*, dated 4 December 1967, which covers, *inter alia*, the corporation tax; "LIR".
3. *Règlement grand-ducal*, dated 24 December 1990.
4. Stella Raventós, "Tax Authorities Recant on Luxembourg SOPARFIs", 35 *European Taxation* 8 (1995), at 266.
5. José Luis Gonzales, "For Spain read *Separfi* not *Soparfi*", *International Tax Review* (June 1997), at 9.
6. § 7 *Gewerbesteuergesetz*.

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municipal business tax law only if the conditions of Article 166 LIR are not observed, to see whether it is at least possible to avoid municipal business tax.

Article 166 contains a set of conditions for the dividend exemption, which pertain to the tax status of the parent and of the subsidiary, as well as to the participation threshold and the holding period.

A. Qualifying parent companies

The participation exemption is available to Luxembourg fully taxable companies, having a capital divided into shares, to certain public entities and to permanent establishments of foreign companies. Luxembourg companies which have their capital divided into shares are public limited companies, private limited companies and partnerships limited by shares.[7] Cooperative societies are, despite their subjection to corporation tax, excluded from this exemption.

The reference to public entities was not contained in the former version of Article 166 LIR. The new wording offers welcome clarification in particular in respect of the tax treatment of dividends earned by the State and Savings Bank (*Banque et Caisse d'Epargne de l'Etat*), which is defined as an autonomous public body having legal personality.[8] In fact, the State and Savings Bank is a government-owned bank which has, for the sake of competition, to be treated in the same way as all other banks operating in Luxembourg.

Finally, permanent establishments of a company either falling under the scope of the EC Parent-Subsidiary Directive or being a tax resident of a country with which Luxembourg has signed a tax treaty may since a law of 28 December 1995 enjoy the participation exemption on dividend income. In 1995 the Luxembourg authorities felt that the exclusion from the participation exemption of permanent establishments was contrary to the freedom of establishment principle existing within the European Community. In the *Avoir fiscal* case, the European Court of Justice held that the EC Member States have to grant equal treatment to permanent establishments of non-resident EC companies and to resident companies.[9] Domestic provisions, for instance the participation exemption, may not be designed to oblige a foreign company which wants to invest in Luxembourg to set up a separate legal entity. The EC investor should be able to freely choose between a subsidiary and a branch.

In a treaty context, the Luxembourg authorities considered that Article 24(3) of the OECD Model Tax Convention on Income and Capital imposes an obligation to assimilate permanent establishments with own enterprises for purposes of the participation exemption. The Commentary on the OECD Model shows that this equal treatment is controversial and that no clear position exists among the members of the OECD. The Luxembourg position is therefore remarkable, as it evidences a flexible approach towards the participation exemption.

The extension of the participation exemption to permanent establishments offers an interesting opportunity to circumvent the withholding tax on dividend distributions. A treaty country company may establish a permanent establishment in Luxembourg to earn tax-exempt dividends. As Luxembourg has no branch tax on after-tax profits of a permanent establishment, the profits derived by this permanent establishment may be repatriated to its foreign head office without additional tax charges in Luxembourg.[10]

B. Participation threshold

A direct participation of the parent in its subsidiary is required, and the owner must have full ownership of the relevant shares. Usufruct or bare ownership of shares is not equivalent to a participation in the company's share capital.

The participation held by the parent company must further be substantial, to differentiate it from a mere portfolio investment. Two alternative tests are available in this respect. A participation of 10 per cent in the share capital of the subsidiary is deemed qualifying. It is not relevant whether the shares are voting.

The law does not say if the 10 per cent participation is to be understood as subscribed or paid-in share capital. No specific answer to this question can be found under Luxembourg law. The equality of shareholders is, however, a principle of public order policy under Luxembourg company law. It may therefore be suggested that if one shareholder fails to pay in capital which has been called by the board of directors, reference should still be made to the paid-in share capital. Indeed, the failure will most likely be temporary, so that the genuine participation percentages will be restored in the future. As long as subscribed shares have not been paid in, the shareholder has merely a commitment towards the company, which may ultimately lead to a debt. This interpretation is also consistent with the valuation rules for wealth tax purposes, and it is shared by the Luxembourg doctrine and tax administration.[11]

As an alternative to the 10 per cent threshold, a participation is substantial if its acquisition price amounts to at least LUF 50 million. Additional costs which are viewed as part of the purchase price are also taken into consideration.[12] The same applies to issue premiums. If the acquisition price is denominated in a foreign currency, the relevant exchange rate on the day of acquisition has to be applied.

If a parent company has acquired and subsequently sold shares forming part of a substantial participation, it has to be determined whether the condition of the acquisition value remains satisfied over a certain period of time. In principle the accounting method usually applied by a company, for example LIFO or FIFO,[13] has to be relied on for the exam-

7. *Sociétés anonymes*, *sociétés à responsabilité limitée* and *sociétés en commandite par actions*, respectively.
8. Law of 24 March 1989, Art. 1.
9. ECJ of 28 January 1986, *Commission v. France*, C-270/83.
10. In addition, no capital duty is due in Luxembourg on the setting up of a branch by an EC company. The main drawback of this structure exists if capital gains are realized; see III.A.
11. Roger Molitor, "Le régime des sociétés mère et filiales", *Etudes fiscales* (April 1994), at 20 and 24.
12. Art. 25 LIR.
13. Last in, first out or first in, first out.

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ination of this condition. Assuming that the company has not yet made a choice, it may use whatever commonly accepted method fits. This choice will then be binding in the future. Such freedom does, however, not exist if the accounting method conflicts with the common practice in a given branch of activity.

Hidden capital contributions are also considered to determine the value of one shareholder's participation in another company. A hidden contribution exists in the case, where a shareholder has granted an advantage to a company solely or chiefly because of the existence of a shareholder's link, regardless of whether this contribution has been subject to the capital duty.[14, 15]

Difficulties exist in the presence of certain "hybrid" rights, such as beneficiary rights (*parts bénéficiaires*; Article 37 of the Luxembourg company law of 10 August 1915). Beneficiary rights do not as such represent a fraction of the company's share capital. The articles of association of the issuing company freely determine the rights attached thereto. From a company law perspective, the holders of beneficiary rights are, in general, deemed members of the company, vested with particular rights, and not creditors. In particular, beneficiary rights are addressed by the company law in the same section as ordinary shares and the 1 per cent capital duty is due upon their issuance. From an accounting perspective, beneficiary rights are classified as equity, not as debt. In the author's view, it should therefore be possible to claim that beneficiary rights may qualify for the acquisition threshold of LUF 50 million.[16] It is, however, uncertain whether the tax authorities will agree with this position.

On the contrary, convertible bonds are not equivalent to share capital prior to their conversion. Following their conversion, the historical acquisition cost has to be taken into consideration for the appraisal of the acquisition value of the participation. The reason for this is that the conversion itself does not give rise to a taxable event under Article 22 (5) LIR.[17]

No assimilation is possible for profit-sharing bonds either, although they entitle the holder to a participation in the issuer's profits. These bonds are in fact viewed as debt instruments and thus are excluded from the participation exemption.

Finally, in the past Luxembourg sister companies were able to jointly meet the holding condition, provided one Luxembourg company owned more than 50 per cent of the share capital of all the Luxembourg companies involved. This condition, which has never been encountered in practice by the author, was complicated and because of its apparent discriminatory character, possibly contrary to EC law. Its suppression by the law of 1997 will not significantly affect the scope of the participation exemption, as the above alternative tests are designed to be suitable for both participations in small undertakings and large companies.

C. Holding period

The qualifying participation has to be held for at least 12 months.

Two significant changes have been introduced by the law of 23 December 1997. First, the holding period may be met before or after the relevant dividend distribution. Under the old version of Article 166 LIR, the parent company had to hold its shareholding for at least 12 months at the end of the financial year during which the dividend was earned and, further, since the beginning of the financial year of distribution. This last requirement was in fact not relevant in most cases, as Luxembourg companies are in general not allowed to have a financial year exceeding 12 months.

Where a parent received a dividend from a subsidiary it had already controlled for a few years, and immediately afterwards sold its participation, the exemption was denied. This was held contrary to the EC Parent-Subsidiary Directive by the European Court of Justice. The Directive allows Member States to impose a holding period on EC parent companies not exceeding two years but without requiring that this condition has to be met a priori, before any profit distribution. The present amendment of the Luxembourg law is thus intended to comply with the findings of the European Court of Justice in the *Denkavit* case.[18, 19]

Second, under the new law it is no longer necessary that all the shares in respect of which dividends are distributed individually comply with this holding period requirement. It is now possible for a parent company owning a qualifying participation to acquire additional shares, which will not be held for 12 months, without jeopardizing the dividend exemption in respect of these newly purchased shares. Again, the old law was in conflict with the EC Parent-Subsidiary Directive, according to which a 25 per cent participation continuously held for two years was sufficient evidence that the participation was bought with a long-term perspective and was not a mere speculative investment.

What is the starting point of the holding period? In general, economic ownership is relevant. A company which has surrendered the holding company status of the law of 31 July 1929 to become a fully taxable entity, may compute the holding period from the day of acquisition of the participation despite the fact it was not a taxable entity at that time.

However, according to the tax authorities, in the case of conversion of convertible bonds into shares, the date of conversion will be relevant. This interpretation is, in the author's view, somewhat inconsistent with Article 22 (5) LIR. According to this provision, the conversion does not give rise to a taxable event, and the securities received after the con-

14. *Droit d'apport.*
15. See Roger Molitor, *supra* note 11, at 20.
16. Roger Molitor, Patrick Kinsch, "Tax consequences of international acquisitions and business combinations, Luxembourg report", *Cahiers de droit fiscal international*, Kluwer 1992, at 423; see also Léon Kunsch, "La réforme de l'impôt sur le revenu des collectivités", *Etudes fiscales* (December 1969), at 53.
17. Hubert Dostert, Emile Stoffel, "L'impôt sur le revenu", *Etudes fiscales* (December 1984), at 286.
18. ECJ of 17 October 1996; *Denkavit-VITIC-Voormeer*; cases C-283/94, C-291/94 and C-292/94.
19. Jean-Pierre Winandy, "Le Luxembourg devra modifier sa loi fiscale", *Luxemburger Wort*, (25 October 1996); Dali Bouzoraa, "The Parent-Subsidiary Directive: Denkavit's Lessons", 37 *European Taxation* 1 (1997), at 14; Dirk Schelpe, "The Denkavit-Vitic-Voormeer case", *EC Tax Review* (1997/1), at 17.

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version are deemed the same assets as the securities they replace.[20]

Finally, if the subsidiary is liquidated before the 12-month holding period has elapsed, it may nevertheless be considered that the parent company has observed its holding obligation, as it has not alienated the relevant shares.[21]

If dividends are distributed before a qualifying participation is held for 12 months, the parent company has to commit itself to respect this condition in the future. Indeed, the law says that the exemption will be cancelled if the holding period is not subsequently satisfied.

D. Conditions to be met by the subsidiary

The subsidiary has to be a fully taxable company, having a capital divided into shares. This condition does not give rise to particular difficulties in the presence of a domestic subsidiary. Distributions by 1929 holding or by investment companies with variable share capital[22] are not exempt, because they do not meet this requirement.

In the case of foreign companies, one must first investigate if the company may be equivalent to a company having a capital divided into shares. In practice, the Luxembourg tax authorities will primarily analyse whether the foreign entity is transparent for tax purposes or subject to corporation tax in its jurisdiction. Dividend payments made by a French general partnership[23] having opted to be subject to French corporation tax may therefore qualify for the participation exemption, although a Luxembourg general partnership is, in any event, a transparent entity.[24]

The investigation should then focus on the tax burden in the foreign jurisdiction. It is the practice of the tax administration to deem a company to be fully liable to corporation tax in its jurisdiction of residence if the nominal foreign corporation tax rate is at least 15 per cent, and provided the tax basis is determined by application of rules similar to those existing in Luxembourg. This last test has to be considered on a case by case basis and this analysis may prove difficult in certain instances. For example, a foreign jurisdiction may have different depreciation rules than Luxembourg, particular incentives for certain business undertakings or a participation exemption which is more generous than the Luxembourg Soparfi regime.[25]

Belgium, for instance, exempts capital gains on the sale of shares without requiring the observance of a holding period or a minimum level of participation. Nevertheless, the Belgian tax rules appear similar to those existing in Luxembourg and the participation exemption should be available in respect of dividends distributed by a Belgian subsidiary, originating from the alienation of shares. Similarly, Belgian coordination centres may benefit from a favourable tax ruling, in respect of certain administrative activities, and recently, a similar tax regime has been made available to distribution and service activities. In the author's view, as Luxembourg also accepts the cost-plus method for purposes of determining an arm's length profit, the tax authorities should consider that these Belgian coordination, distribution and service centres are qualifying subsidiaries for the Soparfi regime. (The determination could be different if a significant amount of costs was not considered for the cost-plus method.)

Further, one has to determine if the comparison has to be made annually or on a long-term basis. In principle, this test should be applied on an annual basis.[26] Alternatively, one might require the Luxembourg parent to trace the tax burden applied to every item of income distributed to Luxembourg. Although this approach may be difficult to comply with in practice, it has been referred to in the new United States–Luxembourg tax treaty of 3 April 1996. This treaty, which is not yet effective, provides for a conditional exemption from Luxembourg withholding tax on dividends paid out of profits originating from the active conduct of a trade or business, while the exemption is not granted for the redistribution of passive investment income.[27] The origin of the profits must therefore be determined. In the context of the participation exemption, one may try to demonstrate that the dividends earned by the Luxembourg company originate from profits which have been fully taxed, although the general tax regime of the distributing subsidiary is too favourable for the Luxembourg participation exemption to apply.

If a foreign subsidiary, which is subject to a low tax regime in its jurisdiction, makes a distribution to a Luxembourg parent company, the parent also has to examine if a tax treaty does not grant an exemption which can not be obtained under Article 166 LIR, because of the subsidiary not being fully taxable in its jurisdiction. This possibility is given, for instance, for Irish companies benefiting from a tax rate of 10 per cent under the International Financial Services Centre (IFSC) regime or for certain Swiss companies established in low tax cantons. In general, these companies are nevertheless deemed Irish or Swiss residents under domestic law and under the tax treaties these countries have concluded with Luxembourg. Article 23(3) of the Ireland–Luxembourg treaty of 14 January 1972[28] and Article 23(1) of the Switzerland–Luxembourg treaty of 21 January 1993[29] also provide for an exemption of Irish or Swiss source dividends.

The conditions differ however from those of the domestic participation exemption. The parent company may therefore choose between the domestic and the treaty exemption, without however cherry-picking the most favourable provisions of both exemptions.

20. See II.B.
21. See Roger Molitor, *supra* note 11, at 27.
22. *Sociétés d'investissement à capital variable* – SICAV.
23. *Société en nom collectif* (SNC).
24. Alex Sulkowsky, "International tax problems of partnerships, Luxembourg report", *Cahiers de droit fiscal international*, Kluwer 1995, at 369.
25. Philip J. Warner, *Luxembourg in International Tax Planning*, IBFD Publications BV 1997, at 192.
26. See Roger Molitor, *supra* note 11, at 17.
27. Jean Schaffner, "Highlights of the New United States–Luxembourg Double Tax Treaty", 51 *Bulletin for International Fiscal Documentation* 4 (1997), at 164.
28. The Luxembourg parent has to control directly at least 25 per cent of the voting rights of the Irish distributing subsidiary; no holding period or taxation requirements exist.
29. The Luxembourg parent company has to hold, since the beginning of its financial year, at least 10 per cent of the share capital of its Swiss subsidiary.

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Of course, it may appear that the foreign entity has been set up exclusively to circumvent restrictive Luxembourg tax rules. In that event, the Luxembourg tax authorities may challenge the relevant structure under the abuse of law doctrine. The tax administration has, for instance, already relied on the abuse of law doctrine dealing with an Irish company, set up to derive interest income that would be fully taxable in Luxembourg but was subject to a reduced level of taxation under the IFSC regime, which income was supposed to be repatriated to Luxembourg under the participation exemption.[30] It should be stressed that there is no particular anti-abuse provision existing in respect of the Soparfi regime. Once all the conditions for the exemption of inbound or outbound dividends or capital gains are met, this exemption may be secured, except for the general prohibition of any abuse of law. Basically, the tax administration may reproach a taxpayer with abuse of law if a transaction is fictitious or if it has been entered into exclusively for tax reasons. The existence of business reasons next to a tax objective is sufficient to avoid the application of the abuse of law doctrine.

The law of 23 December 1997 introduces additional flexibility in respect of this "subject to tax" condition. Under the new regime, this test will not have to be passed anymore by companies listed in the EC Parent-Subsidiary Directive. Accordingly, Luxembourg may not deny the participation exemption to an entity covered by the Directive, but which enjoys a favourable tax regime. Portugal is the only EC Member State not having a tax treaty with Luxembourg. No treaty relief for dividends is therefore available. To avoid, for instance, dividends paid by a pure Madeira holding company (the SGPS regime) being taxable in Luxembourg, a Luxembourg parent company can now rely on the new Article 166 LIR. Indeed, Madeira SGPS companies are deemed to benefit from the EC Parent-Subsidiary Directive.[31, 32] It is therefore no longer necessary to analyse whether SGPS companies actually pay tax in Portugal at a rate of 15 per cent, under tax rules similar to those existing in Luxembourg.

Finally, there is no activity condition imposed on the subsidiary.

E. The participation exemption covers income from participations

This category includes dividends, payments of a liquidation surplus, hidden profit distributions and income from beneficiary rights. A parallel has indeed to be drawn between the exempt income and the appraisal of the participation threshold.[33] As, for example, beneficiary rights, having an acquisition value of at least LUF 50 million, might be viewed as a substantial participation, income derived therefrom should be exempt under the participation exemption. Conversely, income from profit-sharing bonds, interest paid on convertible bonds prior to their conversion, or dividends paid to the holder of a usufruct right over shares are not exempt. It is also worth noting that the allocation of free shares, resulting from the incorporation of reserves into the subsidiary's share capital, is not treated as taxable income under Luxembourg law.[34]

Another interesting although controversial issue pertains to the treatment of a step-up in basis in the case of the acquisition of a target company. Let us assume that a Luxembourg company acquires a target company for 100 which has either distributable reserves of 80 or is about to realize a capital gain of 80 on the sale of an asset valued at 20 in its books[35] and that the target distributes 80 to its new parent company, which distribution qualifies a priori for the participation exemption. This distribution entails a decrease of the net asset value of the target's shares from 100 to 20, enabling the parent to write off 80 in respect of these shares. Certain scholars have taken the view that the distribution of 80 does not qualify for the participation exemption, as it does not correspond to income from a participation. The distribution is, in their view, deemed the counterpart of a reduction of the substance of the participation.[36]

However, the depreciation of 80 is reversible. In the case where the participation is subsequently sold, the capital gain realized will be taxable to the extent it corresponds to a depreciation previously deducted for corporation tax purposes.[37] Further, the law provides for a denial of the exemption if the distribution corresponds to a liquidation surplus only, which is compensated by a corresponding depreciation of the participation. This provision (Article 166 (4) LIR) may not be extended by analogy to other situations. Actually, Article 166 (4) LIR applies in the presence of a total or partial liquidation of the target, i.e. in a situation where in principle the tax loss, corresponding to the fact that the liquidation value of the participation is lower than its acquisition value, may not be recaptured in the future on the sale of the underlying shares.[38]

Interest charges in relation to the participation are deductible only to the extent they exceed exempt dividend income. It is worth mentioning this aspect in particular because of the importance of thin capitalization rules. Luxembourg tax authorities impose on Soparfis a debt/equity ratio of 85:15, to avoid excessive deductions of interest charges from the tax basis of the debtor and to prevent the avoidance of the Luxembourg capital duty through massive debt financing. A Luxembourg company may therefore deduct interest charges only if it complies with the 85:15 debt/equity ratio and provided its interest charges exceed exempt dividends.[39]

30. See André Elvinger, Jean Kauffman, "Deductibility of interest and other financing charges in computing income, Luxembourg report", *Cahiers de droit fiscal international*, Kluwer 1994, at 272.
31. Francisco de Sousa da Câmara, "Madeira Free Zone Legislation Amended", 34 *European Taxation* 1 (1994), at 2.
32. Madeira SGPS companies benefit from a complete exemption from non-EC dividends, and from a 95 per cent exemption of EC source dividends.
33. See II.B.
34. Art. 97 (3) LIR.
35. The sale of this asset may enable it to create a higher basis for the depreciation of the main asset of the target in the future.
36. See Léon Kunsch, *supra* note 16, at 56.
37. Regardless of the application of the participation exemption on capital gains, see III.
38. Jean-Pierre Winandy, *Les impôts sur le revenu et sur la fortune*, Editions Promoculture 1996, at 566.
39. Jean Schaffner, "Thin Capitalization and Transfer Pricing, Luxembourg report", 4 *International Transfer Pricing Journal* 4 (1997), at 162.

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III. TAXATION OF CAPITAL GAINS

As is the case for dividends, a Luxembourg parent company may benefit from an exemption of capital gains realized on the transfer of shares forming part of a substantial participation. The exemption may be claimed on a sale, and also on other changes of ownership, such as a contribution to the share capital of a company. The exemption should, in the author's view, also be applied in a situation where a fully taxable company, holding shares, is converted into a holding company, governed by the law of 31 July 1929 or if it is transferred abroad. In both cases, the company is deemed to be liquidated and latent capital gains become taxable. As this operation gives rise to a deemed alienation of the shares, an exemption may be claimed. Otherwise, were the participation exemption to be denied, in the absence of change of legal ownership of the holder of the shares, the company would have to look for "artificial" solutions, such as a sale and repurchase of its shares, to achieve an exemption.

The exemption of capital gains is not included in Article 166 LIR itself. This Article merely provides that a *grand-ducal* decree may extend the participation exemption to income resulting from the alienation of a participation. A *grand-ducal* decree of 24 December 1990 has introduced this exemption.

As the rules applicable to capital gains are similar to those applying to dividend income, reference is often made to the above regime.

A. Conditions pertaining to the parent company

The Luxembourg parent which realizes a capital gain may be a public or a private limited company or a partnership limited by shares. The exemption has, however, not been made available to Luxembourg permanent establishments of foreign companies.

The denial of this exemption to branches of foreign companies may conflict with the freedom of establishment principle which exists at the EC level. Indeed, a company originating from another Member State must, under the current rules, set up a subsidiary in Luxembourg, if it is contemplated that a capital gain will be realized on the sale of shares forming a substantial participation.[40] A request for a preliminary ruling made by the Tax Court of Cologne to the ECJ on 30 June 1997 (C-307/97) will hopefully enable tax experts to have a precise opinion on this issue. As discussed above, the extension of the participation exemption to permanent establishments of non-EC countries is less obvious. Nevertheless, one might try to invoke treaty provisions reflecting Article 24(3) of the OECD Model to claim that taxation of a permanent establishment should not be less favourable than the taxation of domestic companies carrying out the same activities.

B. Conditions pertaining to the subsidiary

The subsidiary, the shares of which are sold, must be fully taxable in its jurisdiction. A Luxembourg subsidiary must therefore be subject to corporation tax and a foreign subsidiary must be liable to a tax equivalent to the Luxembourg corporation tax. The nominal rate of this foreign tax must be at least 15 per cent and the tax basis has to be computed by application of rules similar to those existing in Luxembourg.

Luxembourg's tax treaties never contain a specific wording confirming the participation exemption on capital gains, as they do, in most cases, for dividend income. A Luxembourg parent may therefore not rely on tax treaties to achieve an exemption not granted by domestic law. Further, the law of 23 December 1997 does not provide that subsidiaries listed in the EC Parent-Subsidiary Directive are deemed equivalent to fully taxable companies. As a consequence, IFSC companies are, for example, not qualifying subsidiaries for the participation exemption because their nominal tax rate is only 10 per cent. To limit the tax exposure in the presence of a Luxembourg company holding shares of an IFSC company which it wants to alienate, it may be possible to have the IFSC company sell its assets and distribute the profit realized to its Luxembourg parent. These dividends may be exempt at the level of the parent company by application of the Luxembourg–Ireland tax treaty or under the new wording of Article 166 LIR.[41]

It may further be considered that the exclusion of relief for a gain realized on the sale of shares of an IFSC company is contrary to EC law. Indeed, the European Community has authorized the application of a low tax rate of 10 per cent in the IFSC as part of a scheme for business development in a region suffering from severe unemployment. Luxembourg may not impede EC aid programmes by denying favourable tax provisions to companies fulfilling the requirements of such programmes worked out at Community level.[42]

C. Qualifying participation

The availability of the participation exemption is conditional on the observance of a holding period requirement. The parent company must have held a participation of 25 per cent in the subsidiary's share capital or, alternatively, the acquisition cost of this participation must amount to at least LUF 250 million or its foreign currency equivalent.

This qualifying participation must have been held for at least 12 months at the beginning of the financial year of alienation. This means that the seller may alienate various blocks of stock during a given financial year, even if, as a consequence of previous sales made during the same year, his participation drops below 25 per cent. However, it is not sufficient that the participation has merely been held for 12 months. Assuming that a company's financial year corresponds to the civil year, this company may not alienate in 1998 shares only acquired in the course of 1997. The participation exemption is avail-

40. See II.A.
41. See II.D.
42. Albert Rädler, Martin Lausterer, Jens Blumenberg, "Tax abuse and EC law", *EC Tax Review*, 1997-2, at 86; two recent decisions of the Lower Tax Court of Baden-Würtemberg of 17 July 1997 have, however, considered that the use of an Irish IFSC for tax saving purposes was abusive under German law, see *Tax News Service* (2 January 1998), at 6.

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able in 1998 only in respect of shares already held before 1 January 1997.

Further, all shares in respect of which the exemption is claimed must comply with this holding period requirement. In other words, a company having owned a 25 per cent stake for 12 months on 1 January 1998 may not benefit from an exemption in respect of additional shares purchased in 1997 or 1998 and sold in the course of 1998. This provision constitutes an important difference from the dividend participation exemption.

To determine which shares are alienated, generally accepted accounting methods[43] should be used. One exception to this rule exists in the case of a capital increase of the subsidiary. The newly issued shares qualify immediately for the exemption, provided the participation held prior to the capital increase was substantial. This favourable rule may be relied on in a scenario where new shares are issued to all shareholders as a result of the incorporation of reserves into the share capital or if the parent company subscribes for new shares pro rata to its original participation in the subsidiary's share capital.[44]

D. Additional conditions

The exemption is not available to the extent it corresponds to expenses or depreciations pertaining to the participation which have been deducted for tax purposes in the past.

If the parent company has taxable profits, which are not exempt under the Soparfi regime, it may have deducted from these taxable profits of previous financial years value adjustments on a given shareholding or finance costs in relation to the acquisition of the said shareholding (to the extent they exceed exempt dividend income). To avoid the parent company benefiting twice from a tax advantage – at the time of the deduction and at the time of the sale – the original deduction is recaptured when the shares are sold. It may be reminded that all ordinary commercial companies may qualify for the participation exemption. The above rule is intended to prevent these companies reducing their taxable industrial or commercial profits by investing borrowed funds into participations which they later sell to realize tax-exempt gains.

The participation exemption is also not available for certain deferred capital gains. For example, Article 54 LIR enables a Luxembourg company to defer a capital gain realized on a corporate reorganization if an amount corresponding to the gain realized is reinvested into fixed assets, including substantial participations. Upon the sale of such participations, the participation exemption is denied. This conclusion also applies to the tax-neutral transfer of assets to a Luxembourg company under Article 59 LIR.

IV. WEALTH TAX

Luxembourg ordinary commercial companies are subject to wealth tax,[45] in respect of their net wealth existing on 1 January each year. This date is called the valuation day.[46] The taxable wealth which is taken into consideration is that reflected in the balance sheet as of 31 December of the preceding year. In the case where the company's financial year does not end on 31 December, it may, in principle, opt to refer to the consistence of its balance sheet established at the end of its last financial year or to establish an interim financial situation as of 31 December. Where no exemption is available for shares, the values considered for tax purposes are those of 31 December. The reason for this rule is to avoid two taxpayers having different financial year-ends but holding the same securities, use different valuations for these securities.

The wealth tax rate is currently 0.5 per cent. As of 1 January 1997, the municipal business tax on capital, also levied at a rate of 0.5 per cent, was abolished. The law of 23 December 1997 has further provided that the wealth tax paid by a taxpayer may be set off against its corporation tax liability, provided the taxpayer books an amount corresponding to five times the wealth tax burden into a special reserve account in its balance sheet. This reserve account is blocked for five years. If the taxpayer has no corporation tax liability, this imputation is not available and the wealth tax then corresponds to a minimum tax burden.

In all other events, the wealth tax is de facto neutralized, as shown in the following example.

If a Soparfi has 100 of retained earnings and no other taxable assets, its wealth tax liability equals 0.5. If these retained earnings generate a taxable income of 8, its corporation tax liability (tax rate of 30 per cent) will be 2.4 – 0.5 = 1.9, because of this new tax credit. In total, the taxpayer will pay taxes of 2.4 corresponding solely to its initial corporation tax exposure.

A wealth tax exemption in respect of substantial participations is available to Luxembourg companies having a capital divided into shares, to public entities and to Luxembourg permanent establishments of companies falling under the scope of the EC Parent-Subsidiary Directive or of a tax treaty entered into by Luxembourg. The list of beneficiaries of the wealth tax exemption is thus identical to the dividend exemption list.

The exemption is nowadays available provided the parent company holds, at the end of the financial year preceding the valuation day, a participation of at least 10 per cent in the subsidiary's share capital or if the subsidiary had an acquisition price of LUF 50 million or the equivalent amount in a foreign currency. As for the dividend exemption, the law of 23 December 1997 abolished the particular threshold for participations jointly controlled by sister companies.

Since the law of 28 December 1995 a holding period is no longer required. Before this law, the parent company had to have held the qualifying participation for at least 12 months as at the valuation day, except if this participation was acquired during the year of incorporation of the parent com-

43. LIFO, FIFO, etc., see II.B.
44. See Roger Molitor, *supra* note 11, at 27; see also *Circulaire Eval.* 38 of 14 February 1992.
45. *Impôt sur la fortune.*
46. *Date clé de fixation.*

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pany. This requirement was a major obstacle to corporate reorganizations involving existing Luxembourg holding companies. Indeed it was costly to transfer shares to a Luxembourg company, as in the year following the reorganization wealth tax was due on shareholdings so transferred to a Soparfi.

The subsidiary must be (i) a domestic fully taxable company, having a capital divided into shares, or (ii) a foreign company, having a capital divided into shares, fully liable to corporation tax in its jurisdiction, or (iii) a company addressed by Article 2 of the EC Parent-Subsidiary Directive. This list is identical for both the wealth tax exemption and the inbound dividend exemption.

In the past, the criterion of a fully taxable company was interpreted in a different way than for corporation tax purposes. It was sufficient, according to administrative practice, that the subsidiary was subject to corporation tax in its jurisdiction, without a minimum level of taxation being required. The reason for this was that Article 166 LIR required the foreign subsidiary to be subject to a tax equivalent to the Luxembourg *impôt sur le revenu des collectivités*, while the corresponding provision applicable for the wealth tax exemption[47] merely demanded that the subsidiary be a taxable entity, without mentioning the Luxembourg corporation tax.

The new § 60 *Bewertungsgesetz* contains an explicit reference to the application of a foreign tax equivalent to the Luxembourg *impôt sur le revenu des collectivités*. It is therefore possible that the tax authorities will, in the future, analyse the "subject to tax" test in the same way for wealth tax and corporation tax purposes. The parliamentary discussions show that the law of 1997 purports to harmonize the conditions for the various exemptions, which may confirm this interpretation.[48] The author, however, believes that this new wording will, in any event, have little adverse consequences in practice. On the one hand, the new § 60 *Bewertungsgesetz* introduces an exemption for foreign subsidiaries listed in the Parent-Subsidiary Directive and on the other hand, most tax treaties containing an exemption for dividend income, which corresponds to the domestic participation exemption, also extend this exemption to the wealth tax.

Finally, debts in relation to a participation which is exempt from wealth tax are deductible from the tax basis only if they exceed the value of the exempt participation.

V. WITHHOLDING TAX ON DIVIDENDS

A. Tax basis

Luxembourg levies a withholding tax of 25 per cent on dividend income and on interest payments on profit-sharing bonds. This withholding tax is reduced by the tax treaties signed by Luxembourg. The treaties signed with Switzerland, the United States[49] and Sweden[50] even include a conditional exemption.

No tax is withheld on the distribution of a liquidation surplus. Article 101 LIR qualifies the income generated at the time of the liquidation of a company as a capital gain.[51] Indeed, a foreign shareholder realizing a capital gain on the sale of shares in a Luxembourg company is taxable in Luxembourg only if he has held a participation of more than 25 per cent in the company's share capital which is alienated within six months of its acquisition or if he had been a resident taxpayer for 15 years and has surrendered his tax residence less than five years before the alienation.[52] The taxation of a liquidation surplus derived by a foreign shareholder is possible only in the second of these two situations, where a taxpayer has transferred his tax residence abroad prior to the liquidation of the company.

An important issue is the exact borderline between a partial liquidation of a company and a redemption of its shares (i.e. a mere capital decrease). In the case of a capital decrease, Article 97 LIR provides for the application of a dividend withholding tax on reserves which have been incorporated into the company's share capital and, if the reduction does not obey sound business reasons, even on the amount of share capital refunded to the shareholder. The existence of an appropriate economic justification has to be satisfied at the level of the company itself, and not at its shareholders' or its group level. A decrease of corporate activity no longer justifying the existence of a large share capital, but which implies a high wealth tax burden is an example of a valid economic reason. In the case of a reduction of share capital, no withholding tax may be assessed on retained earnings, except if the tax authorities consider, by relying on the abuse of law doctrine, that the company has chosen to reduce its share capital, although it has significant reserves, to elude the dividend withholding tax.

As indicated above, no withholding tax is due on a total or partial liquidation, or on a redemption of shares in accordance with Article 101. A redemption of shares is an operation where a company uses distributable reserves to acquire its own shares. These own shares have either to be cancelled or to be sold. A company may, for example, redeem its own shares if one shareholder, who wants to get rid of all or part of his shares, is not in a position to do so, because a clause in the articles of association prevents the sale to third parties, because there is no market for the shares of the relevant company or because the remaining shareholders do not want newcomers to join the company. It should, however, be borne in mind that the tax authorities may try to challenge this operation if it has been made solely for tax reasons, and assimilate it to a reduction of share capital, implying a dividend withholding tax.[53]

The author, however, is of the opinion that a redemption of shares usually may not be requalified as a mere dividend dis-

47. §60 *Bewertungsgesetz*.
48. Parliamentary document No. 4361, at 9.
49. 3 April 1996; not yet effective.
50. 14 October 1996.
51. Although Art. 166 LIR assimilates a liquidation surplus to dividends for the purposes of the participation exemption at the level of the beneficiary of the payment.
52. Art. 156 (8) LIR.
53. Alain Steichen, *Précis de Droit fiscal de l'entreprise*, Editions Emile Borschette 1996, at 312.

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tribution or capital decrease. A company redeeming its shares is governed by the law of 10 August 1915 on commercial companies. Between different possible routes available to achieve a capital decrease, the company chooses the one which is the most efficient from a tax perspective. Further, no difficulty should exist if the redeemed shares are sold by the company to a third party, as this operation appears identical to a direct sale of the relevant shares, not giving rise to any withholding tax for the original shareholder. The abuse of law doctrine could be applied if all shareholders have an identical portion of their shares redeemed by the company, as this might evidence that the redemption is actually a profit distribution.

B. Withholding tax exemption

An exemption from withholding tax may be secured under Article 147 LIR. Article 147 LIR, which has also been amended by the law of 23 December 1997, applies to dividends paid by a Luxembourg company having a capital divided into shares[54] to (i) an other Luxembourg resident company having a capital divided into shares, (ii) a public entity, (iii) a company benefiting from the Parent-Subsidiary Directive, (iv) a permanent establishment of an EC company, (v) a permanent establishment of a company having a capital divided into shares, enjoying treaty protection, or (vi) the State and Savings Bank. This wording slightly differs from that of Article 166 LIR.

Contrary to the exemption for inbound dividends, it is not sufficient that the foreign parent is a company subject to corporation tax in its jurisdiction. French SNCs, having opted for corporation tax, or *sociétés par actions simplifiées*, which are not mentioned in the Directive of 1990, do not qualify for the exemption of withholding tax.

Further, non-EC parents are also excluded. As permanent establishments of non-EC companies originating from a country having a tax treaty with Luxembourg may benefit from the exemption, such companies should consider the establishment of a branch in Luxembourg instead of the incorporation of a separate legal entity.[55]

The participation threshold and the holding condition are the same as those for the dividend exemption, namely a 10 per cent participation in the subsidiary's capital or a participation having an acquisition value of LUF 50 million, which must be held for 12 months. In accordance with the *Denkavit* case law, this holding period may also be met after the relevant dividend distribution.

If the parent company receives a dividend although the holding period has not yet elapsed, the parent may either commit itself to observe the 12-month holding period in the future or have the withholding tax applied and subsequently file a claim for a refund.[56] A *grand-ducal* decree yet to be taken is supposed to determine the exact conditions for this commitment.

The new law thus reduces the holding threshold of formerly 25 per cent and no longer requires all shares in respect of which dividends are paid to meet the holding test. The new law also abolishes the distinction which was made in the past between foreign and domestic parent companies,[57] thereby eliminating another provision which was possibly discriminatory from an European Community perspective.

VI. ENTRY INTO FORCE

According to Article 5 of the law of 23 December 1997, the new provisions are applicable in the tax year 1998, as well as, in respect of the wealth tax, as of the valuation day of 1 January 1998. This article is, in the author's view, not sufficiently precise. The reference to the tax year 1998 means in principle all financial years which end in 1998. Consequently, a company having a financial year beginning, for instance, on 1 July 1997 and finishing on 30 June 1998 should be able to avail itself of the new participation exemption, even on dividends paid before 31 December 1997, during the second semester of last year.

For purposes of the dividend withholding tax, all payments made in 1998 should benefit from the new wording of Article 147 LIR. It is questionable whether the tax authorities also wanted to grant the exemption to dividends distributed by a Luxembourg company in 1997.

VII. CONCLUSION

The new version of the Soparfi regime shows that Luxembourg wishes to avoid any criticism that it does not comply with EC law or that it is not following the case law of the European Court of Justice and that it wants to simplify its participation exemption, without rendering it more severe. The law of 1997 is thus evidence of the flexibility which governs the participation exemption, helping taxpayers to find a Luxembourg solution to most of their international joint-venture problems.

54. A public limited company, a private limited company or a partnership limited by shares.
55. See II.A.
56. Art. 149 LIR.
57. Domestic parent companies had to comply with less strict holding conditions.

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CANADA

REFORM OF TAXATION OF CANADIAN BUSINESS?

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I. INTRODUCTION

At present Canada has a comprehensive tax system pursuant to which (1) residents of Canada (individuals, corporations or trusts/estates) are subject to tax on (a) worldwide income and (b) in some cases on undistributed and in other cases only distributed income and profits of non-resident corporations of which they are shareholders, and (2) non-residents are generally taxed on passive items of income derived from Canada (dividends, interest, royalties, etc.) at a flat rate of 25 per cent subject to treaty reduction and fully taxed on incomes and gains derived from Canadian real estate or resource properties or from carrying on business in Canada or from disposing of shares of private Canadian corporations or other Canadian-based assets.

For individuals, integrated and combined federal and provincial taxes range up to a top marginal rate of some 53 per cent and for corporations, depending on circumstances, the rates (including federal and provincial corporate taxes) can range from the low 30s to the high 40s. In a purely Canadian domestic context, there are a number of incentive-based tax benefits (write-offs or special tax rates), and in the international context there are a significant number of opportunities for Canadian-based multinationals to defer or avoid Canadian tax on foreign operations (even on profits which are repatriated), and for inbound foreign investors various rules which can help reduce overall Canadian taxes otherwise applicable. In the cross-border context Canada's wide network of tax treaties may, of course, modify the tax results otherwise arising (either in Canada or in the other country involved).

The purpose of this article is to review a recent report to the Department of Finance containing recommendations for changes to the taxation system respecting business activities.

An academic-led task force on taxation of Canadian business has made recommendations to the government which would (1) adversely affect the financing of foreign subsidiary operations, (2) tinker moderately with other aspects of Canada's "foreign affiliate" system[1] for taxing foreign operations, (3) provide a mixed bag of changes for foreign investors in Canada, (4) import a corporate level tax on dividend distributions (just as the United Kingdom is phasing out its ACT), (5) moderate slightly transfer pricing proposals now before parliament, (6) tinker moderately with the system as a whole in a domestic context, and (7) in general be revenue neutral.

The Technical Committee on Business Taxation (hereinafter: the Committee) was appointed by the Canadian Department of Finance on 6 March 1996 to review and make recommendations for improvement of the tax system in relation to Canadian business. The specific mandate was to identify ways of:

> improving the tax system to promote job creation and economic growth in an open economy;
>
> simplifying the taxation of business income to facilitate compliance by taxpayers and administration by Revenue Canada; and
>
> enhancing fairness in the tax system by ensuring that all businesses share the cost of providing government services.

The Committee was also asked to consider constraints arising under the Canadian federal-provincial dichotomy for raising revenues and financing government programmes. The Committee submitted its study and recommendations to the Department of Finance in December of last year and the Department released the report on 6 April 1998.[2] The government's press release accompanying the report stated in part:

> The Committee's report contains a wide range of recommendations on the business tax structure, including changes to federal and provincial corporate and capital taxes, employment insurance premiums, and excise taxes. The report stressed that, without a high degree of cooperation between federal and provincial governments concerning the implementation of its recommendations, the Committee's objectives will not be achieved. Finance Minister Paul Martin underlined that the report was prepared by an independent technical committee and its recommendations reflect the views of the Committee and not of the government.... The Minister said he will ask the Standing Committee on Finance of the House of Commons to review the report in the context of its ongoing examination of policy issues over the coming years. Given its wide-ranging content and recommendations, other committees of Parliament may also be interested in reviewing particular recommendations of the report. The recommendations will also have to be carefully examined by the federal and provincial governments, industry and other interested Canadians.

1. See, *inter alia*, Secs. 90-95 and 113 of the Income Tax Act (Canada), R.S.C. 1985, Chap. 1 (5th Supp.), as amended (hereinafter: the Act, or ITA).
2. Department of Finance Release 98-037, 6 April 1998.

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In the days following its release the Department signalled that there would be no rush to enact and adopt the recommendations and that, in fact, its priority was easing the tax burden on middle-class Canadian individuals. Perhaps, therefore, the Committee's recommendations will not see the light of day for at least two to three years, if at all.

As noted above, tax rates can be high and in many (if not most) cases exceed, both at the individual and corporate level, those found in other countries. The Committee focused on business taxation and it concluded that Canada's combined federal and provincial corporate tax rate (averaging some 43 per cent) is higher than that of most other countries and that the implications of this adverse comparison are as follows:

> Higher corporate tax rates on non-manufacturing activities in Canada relative to the United States and some other countries have discouraged the location of business operations in Canada.
>
> Internationally non-competitive tax rates have influenced large multinationals to increase borrowings in Canada and therefore interest expense deducted here. The resulting erosion in the Canadian tax base has reduced the potential revenue available from corporations through income taxation. This has resulted in governments levying greater amounts of other taxes, such as capital taxes on corporations, thereby impeding prospects for job creation in Canada.

The Committee's report summarized its findings as follows:

> In our report, we recommend measures to make the tax system more neutral by:
> - lowering corporate income tax rates for business toward international norms and correspondingly broadening the tax base;
> - making certain profit-insensitive taxes fall more heavily on those who derive related benefits from public programs or contribute to costs imposed on Canadians – the principle of user pay;
> - reducing compliance costs and improving enforcement within the tax system; and
> - facilitating the co-ordination and disentanglement of federal-provincial corporate tax policies within Canada's economic union.
>
> ....
>
> We would broaden the corporate income tax base to make it more neutral and less distorting. We propose some reductions in research and development tax incentives, still leaving them among the most generous in the world.... We propose a general review of capital cost allowances to ensure that rates are closer to economic depreciation, along with a reduction in some accelerated classes.
>
> ....
>
> Small Canadian-owned businesses would continue to benefit from preferential federal-provincial tax rates ranging from 18 percent for those small firms with substantial payrolls to 21 percent on average for firms with no employees.
>
> ....
>
> Tax policies related to inbound and outbound investment are driven by two important objectives: domestic economic growth and job creation on the one hand, and protection of Canada's revenue base on the other. The Committee believes that adopting its proposals – lower corporate tax rates competitive with those of our major competitors, offset by base broadening that includes international tax measures where appropriate – would achieve increased domestic investment and job creation, greater fairness and better protection of Canada's domestic tax base. Specifically with regard to international tax measures, the Committee proposes:
> - a modification of our system of taxing income received by Canadian corporations from their foreign affiliates to require a higher ownership threshold to benefit from the system;
> - that, with respect to income from transactions between foreign affiliates of the same Canadian taxpayer, the right to repatriate such income free of tax to Canada be limited to those affiliates fully entitled to tax treaty benefits with Canada;
> - that Canadian taxpayers should no longer be able to claim a current deduction for interest expense traced to investments in foreign affiliates;
> - that the ability of non-residents to shift interest to related Canadian business enterprises be more restricted by modifying current thin capitalization rules, and repealing the rules related to non-resident owned investment corporations; and[3]
> - that interest payable to arm's length non-residents be exempt from Canadian withholding tax, regardless of the term of the related indebtedness.
>
> The Committee favours maintaining the existing dividend tax credit to give recognition to individuals receiving dividends from Canadian corporations for the tax already paid by the corporation on its income. But to achieve greater efficiency and fairness, we recommend that the dividend tax credit be more closely tied to the actual taxes paid by the corporations through the introduction of a joint federal-provincial Corporate Distributions Tax.
>
> We also favour retaining the current exclusion of one-quarter of capital gains from income so that capital gains and dividends are taxed at roughly the same rate and that the double taxation of corporate income is partially relieved. However, we recommend that the lifetime capital gains exemption for farm property and shares of Canadian-controlled private corporations be replaced by a new retirement saving measure that recognizes the difficulties that some farmers and owners of small busi-

3. A subsequent portion of the Committee's introductory comments elaborates this comment as follows:
"that the ability of non-residents to shift interest expense to related Canadian business enterprises be more restricted, by reducing the existing thin capitalization ratio of 3 to 1 to 2 to 1, by broadening the thin capitalization rules so that they apply, not only to investments in Canadian corporations, but also to Canadian branches of foreign corporations and to partnerships and trusts, and by repealing the rules related to non-resident owned investment companies."

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nesses have in accessing the current system of tax-assisted savings for retirement.

....

The Committee recommends several measures it believes would result in improved compliance and enforcement:

- federal and provincial governments should harmonize the structure and administration of certain business taxes – notably capital taxes – to provide significant reductions in compliance costs;
- new procedures for drafting should be adopted to improve the application and understanding of tax legislation;
- new mechanisms should be introduced to enable Revenue Canada to apply commercial practices to settle disputes and collect taxes owing;
- civil penalty provisions in the tax legislation should be expanded to apply to advisors and promoters who are grossly negligent.

The report also deals with "moving toward the user-pay principle" and recommendations concerning environmental taxation as well as means of improving the coordination of federal-provincial tax policies.

II. RECOMMENDATIONS RESPECTING INBOUND INVESTMENT

A. Overview

The Committee's recommendations with respect to foreign investment in Canada (inbound investment) focused on three separate but sometimes interrelated aspects of financing Canadian operations. Two of the cases, thin capitalization rules and the use of "NROs" (as explained below) involve foreign-owned Canadian corporations, and a third case (exemption from Canadian withholding tax on interest payments to non-residents) is potentially applicable, regardless of whether the Canadian corporations are foreign or domestically owned.

In general terms, foreign-based multinationals which acquire or otherwise carry on business in Canada would give thought to "earning stripping" stratagems. As in the case, for example, of foreign investors in the United States (negotiating the thin capitalization rules under US Internal Revenue Code Sections 163(j) and/or 385) foreign investors in Canada are faced with restrictions on the amount of investment which can be provided by way of interest bearing debt to a Canadian operating subsidiary under the specific-mechanical thin capitalization rules of Section 18(4) et seq. of the Act. In particular, under those rules no more than 75 per cent of overall foreign shareholder funding of a Canadian subsidiary (which takes into account retained earnings) can be provided by way of interest bearing debt.

Interest on any portion of foreign shareholder debt that exceeds three times the relevant equity base [that is the paid-up capital of shares owned by a foreign person[4] together with the retained earnings of the corporation] is not allowed as a deduction, notwithstanding that it retains its character as interest payments for withholding taxes under Part XIII of the Act. Accordingly, under this thin capitalization rule, a foreign group purchasing a Canadian company for say CAD 100 million would, typically, establish a Canadian acquisition company, funded with CAD 25 million of capital stock and CAD 75 million of interest bearing debt, acquire the target, merge the two, and thereafter be in a position to deduct against Canadian profits of the target company the interest paid to the foreign parent on the CAD 75 million of inter-group debt.

Sometimes, and generally for purposes related to the non-Canadian tax considerations of the group (particularly for United States-based groups), a Canadian corporation qualified under the "non-resident-owned [NRO] investment corporations" rules of the Act[5] may be interposed in the structure. Such a corporation can receive and then distribute interest payments from the Canadian operating subsidiary without any (net) corporate level tax in Canada, and instead withholding taxes are applicable on dividend distributions by the NRO. Although, in concept, the interjection of an NRO does not, from the Canadian standpoint, change the overall Canadian tax effects for the group, it can in some circumstances produce overall benefits for a United States-based group (tying into various aspects of the rules under the Code respecting various baskets for foreign source income and foreign taxes) and it may also produce benefits for other foreign-based groups where the receipt of interest directly from a Canadian operating company might be subject to home country tax.

Whether the borrowing by a Canadian company arises in the context of the foregoing inter-group financing context or entails borrowings from unrelated non-residents, an important question is whether there will be Canadian withholding tax on the interest payment made by the Canadian corporate borrower. Under Part XIII of the Act[6] there is, in general, a 25 per cent withholding tax on such interest payments. Such rates are generally reduced to 10 per cent under treaty. Further, more germane to this discussion, there is an exemption under the Act from such withholding where (1) no more than 25 per cent of the borrowing must be repaid by the Canadian corporate borrower within the first five years of the loan, and (2) the non-resident lender is not affiliated (within the specific terms of such affiliation under the Act) with the Canadian borrower.

Obviously the latter exemption raises no particular issue where there is straight third party, medium- or long-term borrowing (although there are a number of technical issues that always arise in such context, which must be carefully dealt with). Complexity arises where foreign-based groups, which in concept cannot utilize this statutory exemption, seek to achieve its benefits through indirect or multi-party or multi-step transactions (including back-to-back loan arrangements, etc.) In the latter context, although there is, with respect to the

4. The foreign person's interest must be alone or together with affiliated parties, 25 per cent or greater.
5. Sec. 133 of the Act.
6. Sec. 212(1)(b).

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thin capitalization rules discussed above, a specific statutory anti-back-to-back loan rule, the five-year Part XIII exemption rule does not address such possible arrangement.[7]

In general, the Committee's recommendations respecting the thin capitalization rules and NROs rules are adverse although favourable changes are proposed in the case of the five-year exempt debt rules. The recommendations are discussed in the following sections.

B. Changes to the thin capitalization rules

Having due regard to the foregoing, the Committee has come to the conclusion that the thin capitalization rules should be toughened by reducing the debt-equity ratio respecting foreign parent or other affiliated party debt to equity from 3:1 to 2:1, and extending them to a wider range of situations. The Committee believes that the 2:1 ratio will closely resemble financing that generally is available in an arm's length context.[8] However, given that most countries adopt the 3:1 rule and presumably have adopted same in light of arm's length relationships, the validity of this recommendation may be in question.

The present thin capitalization rules do not apply to foreign investments in Canada through arrangements other than Canadian subsidiaries. For example, they do not apply to Canadian branches of foreign corporations nor to operations in Canada through partnerships or trusts. This means that in those cases the operations can effectively be 100 per cent leveraged, thus potentially reducing the Canadian tax base. The Committee acknowledges that the extension of thin capitalization rules to other situations may result in additional complexity and cites the example of discretionary trusts, where the relevant beneficial interests of each party cannot be determined but where in a broad brush approach the thin capitalization restrictions will apply to all debt attributable to any actual or potential non-resident beneficiary.

The current anti-avoidance rules respecting back-to-back loan arrangements designed to avoid the limitation under the thin capitalization rules will of course be continued and, in the view of the Committee, should be strengthened "to include all indebtedness including amounts on deposit between relevant parties to an overall financing arrangement."

C. Non-resident-owned investment corporations

As noted above, an NRO can be used by foreign groups in financing a Canadian subsidiary with the objective of improving non-Canadian tax results. At the Canadian level the NRO pays a fully refundable 25 per cent tax on its investment income, such tax being refunded when it pays a dividend from its income, resulting, at the end of the day, in a withholding tax applicable to dividends under Part XIII of the Act (25 per cent subject to treaty reduction). The NRO rules were originally established to assist foreigners wishing to invest in the Canadian securities market through Canadian corporations without necessarily attracting overall Canadian tax which would differ from that had they invested directly in the Canadian securities market. The Committee apparently concluded that the current use of NROs for group financing did not comport with the reason for the original enactment and that since there is no need to continue these rules they should be abolished.

In coming to its recommendation, the Committee noted that NROs had originally been introduced to provide non-resident investors with neutrality as between investing in Canadian companies directly or through a Canadian subsidiary, but that in recent years NROs have been used "primarily for tax planning purposes".[9]

In the latter respect, the Committee noted that a foreign-based multinational can, within the constraints of the thin capitalization rules, flow interest payments by a Canadian operating subsidiary through an NRO with Canadian taxes being withholding tax on the dividend paid by the NRO. Furthermore, the Committee noted that the arrangements can serve to reduce home country tax of the investor (by deferral or elimination).[10] Somewhat vaguely the Committee notes that the foregoing factor may indirectly adversely affect the overall Canadian situation by encouraging "non-resident investors to transfer indebtedness to the Canadian subsidiaries, in circumstances where this might not otherwise have occurred". Such speculative basis for a repeal of a long-standing aspect of the Canadian tax system is rather suspect given that there presumably would be other alternatives available to foreign investors to tax plan their domestic requirements (such as, in the case of the United States, certain now in vogue hybrids). Further, these alternatives may be coupled with direct financing of Canadian subsidiaries where the overall results are no different than those (from the Canadian perspective) that arise with the use of NROs.

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7. The exemption for five-year non-affiliated party debt is provided under Sec. 212(1)(b)(vii) of the Act.
8. The Committee states that: "there is little evidence that higher industry averages are in fact required" (that is, to paraphrase, higher ratios (than 2:1) of debt to equity are not ordinarily seen in practice).
9. The Committee explained the operation of an NRO in the following terms: "An NRO is, in general terms, a company incorporated in Canada that elected to be taxed as an NRO, and complies with various conditions, including the following:
   - All of the issued shares and indebtedness are owned by non-residents of Canada.
   - Its income for each taxation year is derived from prescribed sources, including interest, rents and royalties.
   - Not more than 10 percent of its gross revenue for each taxation year is derived from rents.
   - Its principal business is not the making of loans or trading or dealing in bonds, shares, debentures, mortgages, notes or similar property.

   Various special rules apply for purposes of computing the income of an NRO, and it is then taxed at a flat rate of 25 percent on such income. The 25 percent tax is refunded when the income is distributed as dividends to non-residents and, at that time, Canadian dividend withholding tax applies. This means that, ultimately, the final tax payable on most income earned by an NRO is the Canadian dividend withholding tax."
10. In this respect, the Committee cited the example of a United States-based multinational as follows:
"For example, in certain jurisdictions (such as the United States), the payment of a stock dividend is generally not a taxable event. In such circumstances, it may be possible for the NRO to pay stock dividends and reduce the effective tax rate on the NRO from 25 percent, to the dividend withholding rate applicable to NROs under the relevant tax treaty, without any income inclusion in the investor country."

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However, the Committee's recommendation could be supported on the simple basis that NROs are not widely used whether for their original purposes or otherwise. The Committee states that in 1994 there were less than 100 NROs in existence. The Committee also questions whether NROs function to attract additional capital in Canada but rather are employed and put in place after the investment decision is made. In light of the Committee's concerns that NROs act as an incentive to thinly capitalize Canadian subsidiaries (assuming that an alternative from the home country standpoint will not be available) the recommendation is reasonable. However, if the latter were the only reason for the recommendation, it is an unfortunate and probably unfounded initiative.

D. Withholding tax exemption on interest paid to foreign lenders

As noted above, interest paid by Canadian corporate and other borrowers is generally subject to 25 per cent withholding tax unless reduced by treaty, although there is the "five-year" exemption rule referred to above. This restrictive window for Canadian companies to raise debt financing abroad has over the years led to a plethora of stratagems designed to broaden the window, including, for example, special purpose vehicles used to marry the "five-year" rule to what is really short-term commercial paper financings. The Committee would eliminate the charades and, in particular,[11] the Committee recommends that Canada broaden the circumstances where Canadian corporations can borrow from non-residents without the imposition of Canadian withholding taxes on interest payments.

The Committee recommends deletion of the five-year 25 per cent maximum principal repayment feature of the current exemption rule as explained above. The Committee's explanation of this change notes that the present restrictive five-year rule was introduced as a temporary measure in 1975 to allow Canadian multinationals to access international capital markets and that it became a permanent feature of the Canadian tax system in 1988. However, because withholding taxes tend to be shifted to the borrower, in any event, where there is no exemption, it is now appropriate to recognize the reality and extend the exemption to arm's length lenders regardless of the term of the credit facility. In this respect, the Committee states:

> We see little compelling rationale for limiting the exemption to longer-term debt. While it can be argued that restricting the exemption in this manner may provide some degree of control over monetary conditions or may facilitate the regulation of Canadian financial institutions, in today's global environment, such arguments have little validity.

On the other hand, the Committee, ever alert to "tax planning", recommends that any arrangements intended to effectuate tax-exempt interest payments to affiliated non-residents be curtailed and, in particular, that back-to-back loan arrangements (and "similar financial support arrangements") be denied exemption pursuant to the anti-avoidance rules which are now part of the thin capitalization provisions (discussed above). In this respect, the Committee stated:

> At present, there is no provision in the income tax rules that specifically denies the exemption in situations involving back-to-back arrangements by non-resident investors through third party, financial intermediaries, or similar arrangements. While the exemption does require that the Canadian borrower and the financial institution deal at arm's length, at present the issue of whether otherwise unrelated parties are dealing at arm's length with respect to a particular transaction has to be determined in each case, thereby introducing uncertainty and complexity.

III. TRANSFER PRICING RULES

Canada's transfer pricing rules are based on the arm's length principle and thus beset with the host of uncertainties, subjectivity, and potential controversy surrounding those rules which exist in every other country that deals with intercompany transactions based on the arm's length principle as opposed to mechanical apportionment methods. However, the Canadian Government has been caught up in the United States led initiatives (commencing with the enactment of super royalty in 1986 and the 1988 White Paper et seq.) to try to somehow toughen transfer pricing rules. In particular, the government wishes to protect the Canadian tax base of Canadian companies in multinational groups, and to level the playing field with the United States by adopting transfer-pricing-related penalty rules and contemporaneous documentation exemptions thereto.

In September 1997, with modification in December, the Canadian Government tabled proposals which basically leave intact the arm's length principle-based approach to regulating intercompany transactions.[12] There was no attempt to "legislate" transfer pricing methods, although the new legislation[13] (Section 247 of the Act) purports to grant Revenue Canada the authority to ignore or rewrite intercompany transactions which depart from commercial norms and which are primarily intended to deliver tax benefits. It would appear, however, that any such extraordinary arrangement could be struck down either under the pre-existing anti-avoidance rule of Section 245 (Canada's "business purpose test" – known as the general anti-avoidance rule) or under case made anti-avoidance doctrine.

There will be a 10 per cent penalty imposed on the amount by which the under-reported income stemming from the incorrect prices exceeds a threshold unless the company has complied with burdensome "contemporaneous documentation" requirements. (Without compliance, there will be no excep-

11. This development is not surprising, having due regard to the approaches of other countries.
12. Nathan Boidman, "Canada's Transfer Pricing Proposals", 4 *International Transfer Pricing Journal* 5 (1997), at 239; Nathan Boidman, "Canada's Transfer Pricing Proposals of 11 September 1997", 5 *International Transfer Pricing Journal* 1 (1998), at 10.
13. At the time of writing, the measures were in the final stages of parliamentary enactment.

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tion from the penalties, but compliance does not automatically exclude the penalties.) It is to be borne in mind, however, in considering the true parameters and threat of transfer-pricing-related penalties that the last time Revenue Canada tried to win a straight transfer pricing case in court (as opposed to an offshore trans-shipment arrangement) it lost, and that was back in 1962.[14]

The Committee's report appears to have been completed with respect to transfer pricing prior to the tabling of the 1997 proposals, as it consists of recommendations based on a research study on transfer pricing prepared for the Committee and released in December 1996 which had recommended the introduction of penalties and related contemporaneous documentation requirements. The Committee states that it supports such recommendations (and presumably hence the 1997 proposals) but had made certain recommendations which in fact have not been followed by the government's 1997 proposals. The recommendations not followed were as follows:

- The penalty should only apply to any net adjustment against the taxpayer, where a taxpayer has both upward and downward adjustments.
- If a taxpayer is in a loss position, the penalty should apply to reduce the taxpayer's loss, rather than require the immediate payment of cash penalties.
- Canadian law relating to transfer pricing should be consistent with the OECD guidelines.
- In other than exceptional circumstances, the actual nature of transactions entered into by taxpayers should not be disregarded or other transactions substituted for them. Such a rule would be arbitrary, and would also lead to double taxation if the tax administration of the other country does not share the same view as to how the transaction should be restructured. The existing general anti-avoidance rule should be sufficient to deal with those exceptional circumstances where it is appropriate to disregard the structure adopted by the taxpayer.

The divergences between the foregoing recommendations and the 1997 proposals are as follows:

- with respect to downward adjustments in arriving at the base for penalties, the 1997 proposals provide for same but on a restricted basis;
- contrary to the second recommendation noted above, cash penalties will apply whether or not the taxpayer is in a loss position;
- there are several aspects of the proposals which are not consistent with the OECD guidelines;
- as noted above, the Government's proposed new Section 247 does in fact purport to contain a transaction recharacterization rule.

IV. RECOMMENDATIONS RESPECTING OUTBOUND INVESTMENT

A. Overview

Under Canada's foreign affiliate rules (*supra* note 1) where a Canadian corporation owns 10 per cent or more of any class of stock of a non-resident corporation (e.g. a foreign subsidiary) such corporation is a "foreign affiliate" vis-à-vis the Canadian corporation (with the same status vis-à-vis an individual Canadian resident shareholder).[15] Under a combination of (1) rules related to the attribution[16] of passive income (known as "Foreign Accrual Property Income" (FAPI)[17]), (2) converse rules for income from the conduct of an active business[18] (and the consequential treatment of "exempt surplus",[19] denoting earnings related to a treaty country foreign affiliate, or "taxable surplus",[20] denoting earnings related to a non-treaty country foreign affiliate), and (3) domestic rules respecting the deductibility of interest[21] (which permit a deduction for a Canadian resident against any source of income of interest on loans made to finance foreign investments, including interests in foreign affiliates) Canadian-based multinationals have been able to manage their overall group taxes (or more particularly minimize same) through "earnings stripping" arrangements in respect of operations carried on in other high tax jurisdictions, such as the United States, countries in Europe, or countries in the Far East (where, generally, domestic corporate tax rates are in the area of some 30-40 per cent).

In particular, under these rules Canadian companies have been able, for example, to do "double dip" financing arrangements whereby a Canadian parent borrows, and then funds (through equity) a foreign affiliate which acts as a group finance company (and is located in a jurisdiction where little or no taxes apply to its income or at least to its interest income). In turn, the finance company funds by way of interest bearing loans, an operating subsidiary in a high tax country (the shares of which either are held directly by the Canadian parent or perhaps through the captive finance company or other non-Canadian foreign affiliate holding company). The objective of the structure is to achieve a deduction of the borrowing costs in Canada against Canadian source income and a second deduction against host country operating profits for the inter-affiliate interest payment.

Although interest income of a foreign affiliate is generally passive (that is comprises part of FAPI), a special rule, which recognizes that the source of such inter-affiliate interest payment is active business profit, provides a statutory recharacterization of the interest as active business income and not FAPI.[22] That recharacterization together with the rules related to allocation of active business income as between "exempt surplus" for a foreign affiliate resident in a prescribed treaty

14. *J. Hofert Ltd. v. M.N.R.*, 62 DTC 50 (T.A.B.). In *Dominion Bridge Co. Ltd. v. The Queen*, 75 DTC 5150 (F.C.T.D.) and 77 DTC 5367 (F.C.A.), and *Indalex Limited v. The Queen*, 86 DTC (F.C.T.D.) and 88 DTC 6053 (F.C.A.), the Crown did succeed in what superficially were transfer pricing cases but were really offshore trans-shipment tax avoidance cases and which did not effectively test the ambit of transfer pricing law, that is the manner in which a court deals with determining the proper prices in respect of straight commercial dealings between members of a multinational group.
15. Secs. 95(1) and 95(4) of the Act.
16. Sec. 91 of the Act.
17. Sec. 95(1) of the Act.
18. Id.
19. Sec. 5907(1) of the Income Tax Regulations.
20. Id.
21. Sec. 20(1)(c) of the Act.
22. Sec. 95(2)(a)(ii) of the Act.

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country (with Canada)[23] provides the basis for the "stripped" earnings of the operating subsidiary to reduce the high tax base in the operating country (ideally substituting zero or low withholding taxes out of the host country) and a flow of such interest payments back to Canada with little or no overall tax. For example, if the operating affiliate is located in the United States and CAD 100 million has been borrowed by the Canadian parent to fund a US acquisition, there may be (having due regard to US debt-equity recharacterization rules[24]) CAD 25 million thereof invested in stock of the operating company and CAD 75 million advanced through the captive finance company. In the result, there would be deductibility in Canada of interest on the CAD 100 million borrowing (and tax relief at prevalent Canadian corporate rates of say 35-45 per cent) and a second effective deduction (in the United States) on the CAD 75 million inter-affiliate loan, which produces interest payments which reduce profits otherwise subject to US corporate level withholding taxes in the area of say 35-45 per cent (including state taxes). Where the captive has negotiated the hurdles of US anti-treaty-shopping rules etc. (and bearing in mind the 1998 hit at the use of LLCs by Canadian-based multinationals to finance US operating subsidiaries – Code Section 894(c)) and has found a base in a country which benefits from reduced US withholding and does not impose substantial tax, the overall tax burden of the Canadian-based group can be significantly reduced.

As noted, the cornerstones of the foregoing arrangements from a Canadian perspective are (1) the deductibility in Canada (against Canadian source profits) of interest payments made to fund the foreign affiliate group, (2) the Canadian FAPI rules which will recharacterize inter-affiliate interest paid out of operating profits as active business income, and (3) the exempt surplus rules which will permit active business profit or deemed active business profit (e.g. the inter-affiliate interest payments) of a foreign affiliate located in a prescribed treaty country to be repatriated to Canada without Canadian tax (at least in the hands of a Canadian corporate shareholder but not a Canadian individual shareholder).

The Committee targets two of these three elements in its recommendations. These are covered in the next two sections.

B. Recommendations respecting financing costs

In the foregoing context, the Committee considered several different modifications to the current rules ranging from full or partial denial of deductibility of interest incurred by Canadian companies to finance the acquisition of or investment in foreign subsidiaries to totally abolishing the system described above for exempting from Canadian tax inter-affiliate financing income. At the end of the day, the Committee recommended that Canadian companies no longer be entitled to deduct, against Canadian source profits, interest on borrowings made to finance investments in foreign affiliates. In so doing the Committee rejected fungibility-based approaches to permitting partial deductibility (based on comparing Canadian corporate level debt to overall Canadian and foreign assets) and instead recommended total disallowance except to the extent of taxable dividends received from foreign affiliates.

Thus, the denial will also apply to individuals who borrow funds to finance Canadian corporations which invest in foreign affiliates, and it will be based on the tracing principle pursuant to which there will be identified the amount of indebtedness allocable to investments in foreign affiliates, including an anti-avoidance provision designed to ensure that this tracing is effective. The disallowed interest would be added to the tax basis in shares of foreign affiliates and serve as a measure pursuant to which deductions would be permitted where taxable dividends out of "taxable surplus" (see above) are received at a later time. Further, such interest will serve to offset FAPI inclusions referred to above.

To assist small businesses as well as to "address the administrative and compliance burden in small and medium sized businesses" the Committee recommended an exemption for up to CAD 10 million in accumulated indebtedness related to investment in the foreign affiliate.

The Committee also believes that there should be either "grandfather" rules for pre-existing arrangements or a "generous transition period". The Committee stated:

> Grandfathering or transitional provisions are particularly significant in this area, having regard to the fact that taxpayers have made significant borrowing and investment commitments based on existing rules.

In coming to their recommendations the Committee adopted the view that "... the tax system of the foreign country in which the business activities are carried on (and not that of the home country from which the investment is made) should bear the preponderance of the cost of financing the foreign business activities". The Committee also believes that the lower corporate income tax rates it proposes will, together with this recommendation, produce a net benefit to Canada.

C. Recommendations with respect to tax-haven-like treaty jurisdictions

As noted, the right to repatriate profits of a foreign affiliate without Canadian tax for corporate shareholders rests on two prongs, one being that the income be derived from an active business (or as noted be characterized as being derived from an active business) and the second being that there be a nexus to a prescribed treaty country (see note 23). Where both of these requirements are met, the earnings qualify as "exempt surplus" and dividends out of "exempt surplus", although included in income of the Canadian corporate shareholder,[25] are deductible in their entirety in computing taxable income.[26]

The treaty nexus requirement in the straight case (that is where there are profits of an operating affiliate itself) turns on

23. Secs. 5907(1) and (11) et seq. of the Act.
24. Sec. 385 of the Internal Revenue Code, 1986, as amended.
25. Sec. 90 of the Act.
26. Sec. 113(1)(a) of the Act and Part 5900 of the Regulations, which establish the basis for assigning income to exempt surplus as opposed to taxable surplus; see *supra* notes 19 and 20.

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the affiliate being resident in the particular country where it is operating under both the Canadian-English case-law-based mind and management rule and the tax treaty between Canada and that country. Furthermore, if that affiliate operates through a permanent establishment in a third country, such third country must also be one with which Canada has prescribed treaty relations.

In the case of recharacterized inter-affiliate interest payments as described above, the requirement is that the operating/paying affiliate meet the requirements just described *and* the recipient captive finance affiliate be resident in the fashion described above in a prescribed treaty country.

In the foregoing context, given that Canada has treaties with many countries that offer low tax regimes (such as IBCs in Barbados or the International Financial Services Centre 10 per cent rate in Ireland) or pliant arrangements (such as the Netherlands and Luxembourg),[27] Canadian-based multinationals can have much flexibility, depending upon the country of operation, to locate a captive finance company (or one that enters into inter-affiliate licensing arrangements (which attracts the same recharacterization rule from a FAPI standpoint as inter-affiliate interest payments)) to achieve both the requisite treaty status for the captive finance or licensing company as well as low net tax in that "stepping stone" country.

The Committee's review of the FAPI rules and the interrelated question of characterizing as between exempt and taxable surplus in relation to treaty nexus led it to conclude that the former (the FAPI rules) should not be changed but that the ambit of treaty-related exempt surplus classification be narrowed to exclude income of affiliates located in tax treaty jurisdictions which are subject to special regimes of tax which would exclude such affiliate from benefits under the treaty between that country and Canada with respect to Canadian source income.

> We recommend that the FAPI exemption for inter-affiliate transactions be maintained, but that such payments be included in taxable surplus where income is received by an entity that, while located in a tax treaty jurisdiction, is expressly denied benefits under that treaty.

For example, a Barbados IBC, treated for Canadian purposes as a resident of Barbados, can earn under current rules exempt surplus notwithstanding that an IBC is denied treaty benefits under the Canada–Barbados treaty with respect to Canadian source income. In a related recommendation, the Committee urges the government to "... actively renegotiate its existing tax treaties, to ensure that all tax-privileged entities in treaty countries are denied access to the exemption system with respect to income from inter-affiliate transactions".

From a pure policy standpoint not only is the foregoing recommendation ostensibly not appropriate, but it could well be argued that the current rules which deny exempt surplus treatment for shifting of profits from a high-taxed treaty jurisdiction such as the United States to a pure tax haven are not appropriate. Given that the entire purpose of recharacterizing from FAPI to active business income (inter-affiliate payments) is to recognize that, essentially, such arrangements simply serve to reallocate what otherwise is active business income being earned in a particular country, there is no apparent reason why such shifted income should lose its essential underlying character (as being earnings from carrying on business in a treaty country) simply because it has been shifted to another jurisdiction with which Canada does not have a treaty. Thus, one could rationalize the view that the Committee's recommendation is entirely inadvisable and that it should, instead, have recommended an expansion-extension of the exempt surplus concept to treaty country profits shifted to pure tax haven affiliates. After all, the only purpose and effect of such arrangements is to reduce tax in the operating country and, absent such shift, the reduced profit after host country taxation can be received by the Canadian parent without Canadian tax. Why should that Canadian company be penalized when it takes steps to ultimately repatriate even more dollars to Canada (that is the tax-spared high tax treaty country profits shifted through the inter-affiliate arrangements)?

D. Other recommendations with respect to foreign affiliates

A foreign corporation is a "foreign affiliate" for purposes of the foregoing system where a Canadian owns, directly or indirectly (alone or together with related parties) 10 per cent or more of *any class* of shares of the corporation. Because such threshold can include situations where the interests of the Canadian is relatively limited (say having invested in preferred shares only), the Committee recommends that "... the present definition relating to foreign affiliates be strengthened, so that only foreign companies in which Canadian corporations have a significant equity interest can be considered as foreign affiliates".

The Committee goes on to state that, for example,

> ... the ownership threshold might be increased to require the ownership (either directly or indirectly and by the Canadian taxpayer and/or by related parties) of at least (i) 10 percent of shares having full voting rights under all circumstances, and (ii) 10 percent by value of all outstanding shares. At the present time there is an inter-relationship between the rules defining foreign affiliates, and those defining controlled foreign affiliates that are subject to the FAPI rules. The Committee does not consider it appropriate to loosen the scope of the FAPI rules. We suggest, therefore, that the present definition related to controlled foreign affiliates be maintained.

The Committee also finds offensive the use of the foregoing rules with respect to finance arrangements involving foreign members of a *foreign controlled group* of which the Canadian taxpayer is a subsidiary, where Canadian source profits can effectively be used to finance the foreign operations of the foreign parent, without Canadian taxes on dividend distributions to the foreign parent nor Canadian taxes on the inter-

27. Other treaty countries which often are considered include Malta, Cyprus, Labuan (Malaysia).

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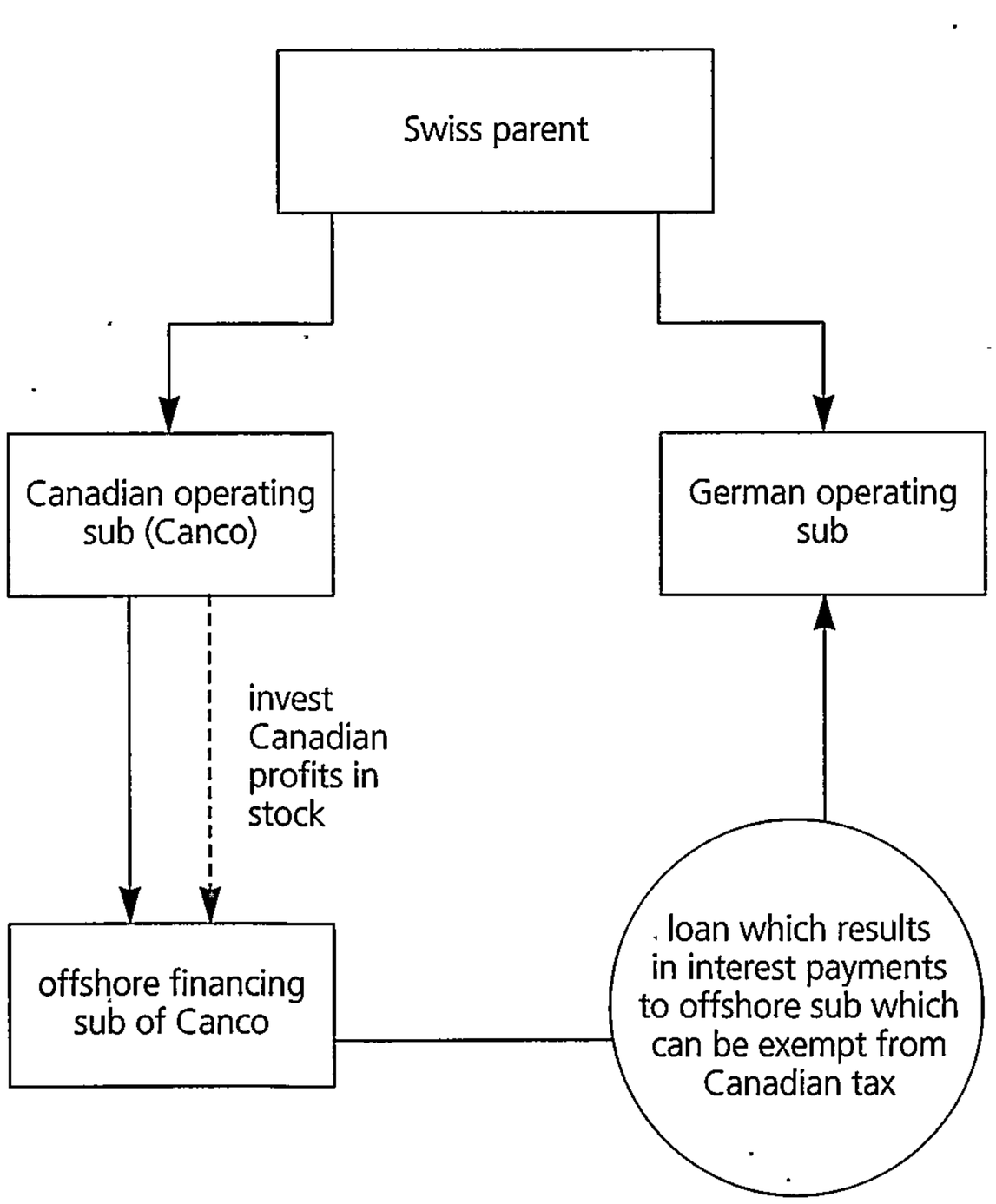
group financing income. In particular, the inter-affiliate FAPI exemption for inter-affiliate payments not only applies to payments between foreign affiliates of a Canadian-based multinational but, also, to payments to a controlled foreign affiliate finance company which is making loans to a member of a foreign-owned group of which the direct Canadian parent of the financed affiliate is a member subsidiary. For example (see diagram below), if a Swiss company has a Canadian subsidiary, that subsidiary can establish a foreign finance subsidiary to make loans to a German subsidiary of the Swiss parent, with the interest payment by the German subsidiary to the finance affiliate qualifying for the FAPI exemption. The problem from the Canadian tax policy standpoint is that this arrangement encourages the group to avoid repatriating the surplus of the Canadian subsidiary which would be subject to a withholding (say 5 per cent under the current Canada–Switzerland treaty) and instead utilize the funds for the purposes of the foreign-based group without incurring that 5 per cent withholding tax but yet in a fashion which does not penalize the group by having Canadian tax applied to the inter-affiliate income. In other words, the inter-affiliate FAPI exemption encourages foreign-based groups to defer Canadian withholding taxes on repatriation of Canadian profits and instead achieve the benefits of repatriation, that is investment in other foreign subsidiaries through the foreign affiliate captive finance company arrangements.



The results: Swiss parent uses Canadian operating profits to finance German sub without either paying Canadian withholding taxes on dividend distributions or paying Canadian tax on the earnings derived from the investment in (loan to) German sub.

The Committee could have made two different recommendations to deal with the apparent "abuse". It could have recommended that such arrangements be treated for Canadian purposes as taxable distributions to the foreign parent thus invoking the foregone withholding taxes on effective distribution of Canadian operating profit. Or, the Committee could have recommended, and it did, that the arrangements be discouraged by terminating the FAPI exemption for group payments in the latter context. In particular, the Committee recommended that the "... provision that provides FAPI exemption for payments from related non-resident corporations that are not foreign affiliates of the Canadian taxpayer, be revised to exclude situations in which related party status arises solely as a result of share ownership of foreign parent companies outside Canada."

Finally, the Committee addressed the question of offshore assets of Canadians held through trusts (which can be brought within the FAPI rules referred to earlier) and recommends that "... foreign trust structures identified by Revenue Canada be challenged in the courts, in circumstances in which the trust income may be subject to the FAPI rules, and that, if such challenges prove to be unsuccessful, appropriate amendments be made to the tax legislation".

V. INTERNATIONAL IMPLICATIONS OF PROPOSED CORPORATE LEVEL DISTRIBUTION TAX

Under present law, dividends paid by a Canadian corporation (1) do not generally attract a corporate level distribution tax,[28] (2) are received either without any tax or with a fully refundable tax by another Canadian corporation, (3) are taxed in the hands of Canadian individual shareholders at preferential rates (reflecting a partial imputation of corporate level taxes whether or not actually paid) and (4) attract a 25 per cent withholding tax, subject to treaty reduction, when paid to non-resident shareholders.

Somewhat surprisingly, having due regard to the planned phase-out of the UK advance corporation tax and related mechanism, the Committee recommends the adoption of a 25 per cent corporate distribution tax applicable to dividends, whether paid to residents or non-residents, and that such tax be offset by federal and provincial corporate income tax, with any excess being recoverable through a three-year carry-back and ten-year carry-forward mechanism.

Having due regard to the foreign affiliate system, discussed earlier for Canadian corporations operating abroad through foreign subsidiaries, the corporate distribution tax would not apply to dividends paid from a Canadian corporation stemming from exempt surplus dividends received from foreign affiliates nor from taxable surplus dividends carrying sufficient underlying foreign tax. Furthermore, in the case of Canadian corporations carrying on business abroad directly

28. Under Part VI.1 of the Act corporate level tax may apply to dividends paid in circumstances considered to entail disguised financings, although the rules can cast a wider net than the latter generalization indicates. See also Part IV.1 of the Act.

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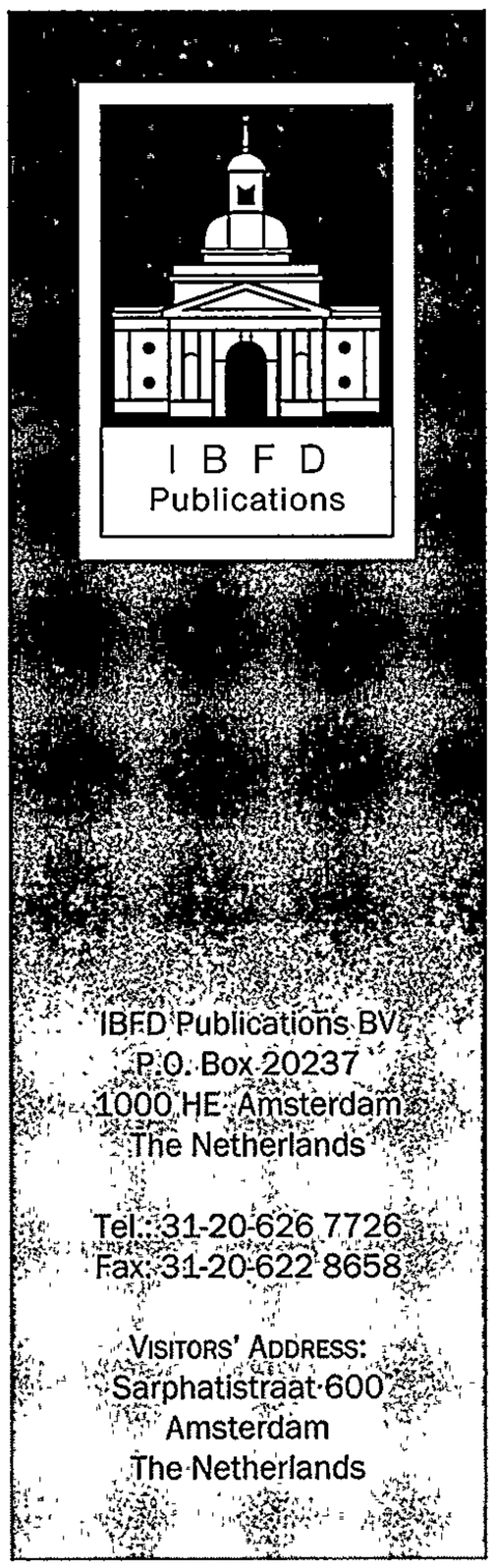
through a branch, foreign branch profits which have been sufficiently taxed in the host jurisdiction would also be excluded from the corporate distribution tax upon dividend payments.

Because there would be no direct relationship between corporate level corporate distribution tax and the taxation of dividends received by a shareholder, the system would not provide for any type of direct tax credits or refunds for dividend-receiving shareholders, whether resident or non-resident.

VI. CONCLUDING COMMENT

The Committee's recommendations (as well as the underlying discussions of the issues, policy options and decisions, set out in the report) clearly reflect, in part, a sensitivity to, and concern respecting the effect of tax planning on Canada's taxable income base and in particular a concern of erosion thereof by such initiatives. It would appear, however, that, notwithstanding the obvious validity of such concerns – and the obvious conflict with the biases of "tax planners" – some of the proposals, at least, are not appropriate in the sense that they are based on either inadequate or inaccurate factual conclusions or are tainted by excessiveness. As already noted, the starting point for some of the analysis and resulting recommendations also appears to be open to question, e.g., in arriving at the recommendation that a shift of profit from high tax treaty country operations to low tax treaty-based finance or licensing affiliates ought to be curtailed – no consideration was given to the appropriateness of the present limitation itself and whether there should be an extension of the present rule to allow exempt surplus treatment for profits shifted to pure tax havens.

What will come of the recommendations will apparently, as already noted above, not be known for a considerable period of time given the initial comments from the Department of Finance that the report and its recommendations would not be enacted upon any time soon. In the interim, tax planners will of course be well advised to develop their approaches with one eye on current law and the other on possible changes which would stem from any future adoption of the Committee's recommendations.



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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.

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Umsatzsteuer im Binnenmarkt. 2. Auflage.
Herne, Verlag Neue Wirtschafts-Briefe. 1998, pp. 301. DEM 68. ISBN: 3 482 45982 7.
Value added tax in the internal market of the European Union. Guide to VAT in the European Union. Explains the main principles, important procedural rules (refund, fiscal representative, identification number, etc.) and the German official forms. With index, and many instructive examples.
(B. 117.042)

Lang, M.; Mössner, J.M.; Waldburger, R.
Die Auslegung von Doppelbesteuerungsabkommen in der Rechtsprechung der Höchstgerichte Deutschlands, der Schweiz und Österreichs.
Vienna, Linde Verlag Wien GmbH. Schriftenreihe zum Internationalen Steuerrecht, Band 6. 1998, pp. 136. ATS 267.
ISBN: 3 85122 651 8.
The interpretation of tax treaties. The book deals with the interpretation of tax treaties by the highest courts in Austria, Germany and Switzerland. The German and Swiss parts contain tables which show the application of different elements of interpretation for each important judgement.
(B. 117.144)

Steuersysteme der Zukunft. Herausgegeben von G. Krause-Junk, J.H. von Thünen-Vorlesung und R. Richter.
Berlin, Duncker & Humblot GmbH. Schriften des Vereins für Socialpolitik, Band 256; Zeitschrift für Wirtschafts- und Sozialwissenschaften, No. 6. 1998, pp. 380. DEM 158. ISBN: 3 428 09270 8.
Tax systems of the future. Collection of talks given at the annual meeting of the Association for Social Policy – Organisation for Economic and Social Sciences on 25-27 September 1996 in Kassel. Articles by Vito Tanzi (English, "Globalization, Tax Competition and the Future of Tax Systems"), Ulrich Schreiber, Jochen Sigloch, Christian Scheer, Hans Fehr, Wolfgang Wiegard, Manfred Rose, Gebhard Kirchgässner and Rudolf Richter.
(B. 117.142)

Weltweite Rechnungslegung und Prüfung. Bericht über die IDW Fachtagung 1. und 2. Oktober 1997 in Hannover.
Düsseldorf, IDW Verlag GmbH. 1998, pp. 535. DEM 88. ISBN: 3 8021 0772 1.
Worldwide accounting. Report on the congress of the IDW on 1 and 2 October 1997 in Hannover. Collection of articles on the mentioned subject. Other subjects are consultancy, business advice, selected issues regarding the Joint Stock Company Law (Aktienrechtsreform), the principle of compliance of tax accounting with commercial accounting, and three tax-policy articles.
(B. 117.093)

Leker, J.; Möhlmann, T.
Die Berichterstattung in Anhang und Konzernanhang von Kapitalgesellschaften.
Düsseldorf, IDW Verlag GmbH. 1997, pp. 314. ISBN: 3 8021 0754 3.
Reporting requirements for companies (including groups). The book is a practical handbook for accountants and auditors on reporting requirements for stand-alone companies and group companies as regards the information required in the annex of their balance sheet. Each requirement indicates the statutory source, a correct and incorrect illustrative example and literature references.
(B. 117.227)

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Endres, D.; Hug, M.; Miles, A.; Jacobs, O.H.; Spengel, C.
Taxes in the Federal Republic of Germany. An overview for foreign investors.
Bonn, Federal Ministry of Economics. 1997, pp. 88.
Brochure giving an overview of the structure of the German tax system and discussing tax planning aspects from the point of view of a foreign investor. Covers chapters on income taxes, special features of international operations, mergers, acquisitions and reconstructions.
(B. 116.922)

Watrin, C.
Erbschaftsteuerplanung internationaler Familienunternehmen.
Düsseldorf, IDW Verlag GmbH. 1997, pp. 272. ISBN: 3 8021 0763 5.
Inheritance planning for international family-owned businesses. This book provides a detailed insight into the tax implications of and planning for business transmissions from the point of view of German businesses with foreign interests. Consideration is also given to the inheritance tax systems in five other countries. The significance of the choice of business form is explained as well as the problem of double taxation and methods for its avoidance. An extensive bibliography is included.
(B. 117.226)

IWB Textsammlung: Internationales Steuerrecht.
Herne, Verlag Neue Wirtschafts-Briefe. 1998, pp. 624.
Text of Germany's most important double taxation treaties including protocols and exchanges of notes. The basic loose-leaf work will be supplemented with texts of further income and capital tax treaties as well as treaties on estates, inheritance and gifts.
(B. 117.192)

DBA-Kommentar.
Doppelbesteuerungsabkommen auf dem Gebiet der Steuer vom Einkommen und vom Vermögen, auf dem Gebiet der Erbschaftsteuer. 2 Bänden. Herausgebers Helmut Becker, Horst-Dieter Höppner, Siegfried Grotherr und Heinz-Klaus Kroppen.
Herne, Verlag Neue Wirtschafts-Briefe. 1998, pp. 3458. DEM 298. ISBN: 3 482 47861 9.
Detailed and comprehensive loose-leaf publication containing commentary on OECD Model treaties as well as individual German treaties on income and capital, estates, inheritance and gifts. Each model or treaty is analysed by various authors according to their respective specialisms. Additional features include: a general principles section covering subjects such as the relationship between treaty and national law, treaty interpretation and abuse, and qualification conflicts; a section on German withholding tax; and a specialized two-way German–English translation of double taxation terms.
(B. 117.191)

Die Steuergesetze (StG). Gesetze, Verordnungen, Richtlinien und Grundsatzerlasse einschliesslich Doppelbesteuerung. 5 Bänden.
Bielefeld, Erich Schmidt Verlag. 1998. DEM 228. ISBN: 3 503 02954 0.
The work comprises all the relevant laws, regulations, directives and other basic rules of the tax administration. The latest official texts of the laws and regulations as well as ordinances and announcements from the Ministry of Finance are regularly included in this loose-leaf.
(B. 117.165)

Pirker, S.
Bilanzierung von Software.
Vienna, Linde Verlag Wien GmbH. 1997, pp. 141. ATS 346. ISBN: 3 85122 726 3.
This thesis deals with the accounting of software by the manufacturer, especially with respect to the prohibition of the capitalization of development costs under Austrian and German law. International accounting rules are considered in the second part.
(B. 117.145)

Sozialversicherungsbeitrag Handausgabe 1998.
Bearbeitet von H. Hungenberg und H. Tonscheidt.
Bonn, Stollfuss Verlag. 1998, pp. 1440. DEM 69.80. ISBN: 3 08 367398 1.
Handbook on the 1998 social security contributions in Germany.
(B. 117.247)

Abschlussprüfung nach International Standards on Auditing (ISA). Vergleichende Darstellung deutscher und internationaler Prüfungsgrundsätze.
Düsseldorf, IDW Verlag GmbH. 1998, pp. 1350. DEM 215. ISBN: 3 8021 0771 3.
Annual audit according to International Standards of Accounting (ISA). Chosen ISA relating to responsibilities, planning, internal control, audit evidence, using the work of others and audit conclusions and reporting are discussed and explained. Comparison is made to the German auditing principles. The ISA are provided in English, and the book contains a glossary.
(B. 117.092)

Heddäus, B.
Handelsrechtliche Grundsätze ordnungsmässiger Bilanzierung für Drohverlustrückstellungen.
Düsseldorf, IDW Verlag GmbH. 1997, pp. 332. ISBN: 3 8021 0747 0.
Commercial law principles for proper accounting treatment of anticipated losses. Published dissertation aimed at developing and explaining the commercial law principles for proper accounting treatment of anticipated losses. Particular focus on the question of general or specific provisions.
(B. 117.225)

Die Vorbereitung auf den Euro. Rechtlicher Rahmen, strategische und organisatorische Anpassung, Vermögenssicherung und Rechnungslegung. Vorträge und Diskussion IDW-Seminar "Euro" am 6. Juni 1997.
Düsseldorf, IDW Verlag GmbH. 1997, pp. 139. ISBN: 3 8021 0744 6.
Preparing for the Euro. A collection of seminar papers dealing with legal, organizational and accounting implications of the introduction of the Euro.
(B. 117.228)

Beiträge zum neuen Insolvenzrecht.
Herausgegeben von Jörg Baetge.
Düsseldorf, IDW Verlag GmbH. 1998, pp. 204. DEM 78. ISBN: 3 8021 0773 X.
Essays relating to the new insolvency law. Collection of articles. Issues covered are substantial changes in the new law (Landfermann), reasons for insolvency: disability to pay and overindebtedness (Uhlenbruck), accountancy in the state of insolvency (Wagner), discussion on these topics, insolvency plan and obligation to continue the business (Braun), current results of the empirical study of insolvencies on the basis of annual accounts (Baetge). The new Insolvency Law is annexed.
(B. 117.204)

Gesetz zur Fortsetzung der Unternehmenssteuerreform.
Düsseldorf, IDW Verlag GmbH. 1998, pp. 951. ISBN: 3 8021 0769 1.
Law on the Continuance of the Company Tax Reform. Collection of legal material concerning the tax laws that entered into force in late 1997 (instead of the big tax reform). Contains text, initial proposal, proposal of the parliamentary group, evaluation of the Upper House, and resolution of the Upper House.
(B. 117.205)

Armeloh, K.H.
Die Berichterstattung im Anhang.
Düsseldorf, IDW Verlag GmbH. 1998, pp. 418. DEM 98. ISBN: 3 8021 0742 X.
The reporting requirements in the annex to the balance sheet. A theoretical and empirical study of the quality of reporting in the annex to the balance sheets of companies which are registered on a stock exchange. Microeconomical dissertation with much sample material and many statistics. Extensive literature references. With index.
(B. 117.203)

Hungary

Foreign nationals working in Hungary.
Amsterdam, Coopers & Lybrand. 1997, pp. 36.
Booklet providing foreign nationals planning to work in Hungary with a general background of the Hungarian tax law and other relevant issues. It reflects tax law and practice as of July 1997.
(B. 117.307)

Italy

Bondavalli, D.
Operazioni societarie straordinarie.
Milan, Dott. A. Giuffrè Editore. 1997, pp. 146. ITL 20,000. ISBN: 88 14 06757 0.

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Commentary on the new law regarding the tax treatment of business reorganizations (Law No. 358 of 8 October 1997). The author explains the new rules applicable to the following domestic transactions: assignment of a going concern, capital contribution, mergers, de-mergers, exchange of shares. The book provides a useful picture of the new rules, especially for those who are not yet familiar with them.
(B. 117.118)

Lupi, R.
Diritto tributario. Parte generale. 4th Edition.
Milan, Dott. A. Giuffrè Editore. 1996, pp. 292.
ITL 34,000. ISBN: 88 14 06224 2.
Tax law. The book deals with the general aspects of Italian taxation (applicable to all the different taxes) like the interpretation of the law, tax avoidance and evasion, tax returns, audits, collection of taxes, litigations and sanctions.
(B. 117.146)

Carpentieri, L.
Redditi in natura e valore normale nelle imposte sui redditi.
Milan, Dott. A. Giuffrè Editore.
L'Ordinamento Tributario Italiano. 1997, pp. 257. ITL 34,000. ISBN: 88 14 06604 3.
The book is a monograph on the concept of "normal value" (i.e. market value) in the domestic system of direct taxation. The author carries out a very detailed analysis of how the "normal value" concept is applied under the various categories in which income is divided for direct tax purposes (e.g. employment income, business income, etc.). In particular, the author focuses on the relationship between payments in kind and "valore normale". He also describes the importance of the "normal value" concept in the assessment and collection stages, and pays attention to transfers between related parties.
(B. 117.120)

Ghia, L.
I contratti di finanziamento dell'impresa. Leasing e factoring.
Milan, Dott. A. Giuffrè Editore. 1997, pp. 256.
ISBN: 88 14 06446 6.
The book provides an overview of the Italian rules applicable to leasing and factoring. The author focuses on the civil law as well as on the insolvency law aspects of the two contracts. The doctrinal and jurisprudential developments are explained. The author also describes at length the leasing of airplanes, carrying out a comparative analysis in the United States, France, Germany and the United Kingdom.
(B. 117.117)

Foreign nationals working in Italy.
Amsterdam, Coopers & Lybrand. 1997, pp. 39.
Brochure providing foreign nationals with basic information with regard to the Italian tax and social security system as well as general information about working in Italy.
(B. 117.308)

Antonini, L.
Dovere tributario, interesse fiscale e diritti costituzionali.
Milan, Dott. A. Giuffrè Editore.
Università degli Studi di Milano, Pubblicazioni dell Istituto di Diritto Pubblico, No. 35. 1996, pp. 445. ITL 54,000.
ISBN: 88 14 05767 2.
This is a book on taxation and constitutional principles. It is divided into two parts. The first part contains an historical survey of the issues. The second part describes the principles contained in the Italian Constitution dealing with taxation. The author discusses at length concepts such as "fiscal sovereignty", "fiscal duty", and tests the "ability to pay" principle.
(B. 117.121)

Luxembourg

Foreign nationals working in Luxembourg.
Amsterdam, Coopers & Lybrand. 1997, pp. 31.
Information guide providing expatriates coming to work in Luxembourg with a general background to Luxembourg tax law and other relevant issues. It reflects tax law and practice as of January 1997.
(B. 117.309)

Netherlands

Geld, J.A.G. van der.
Hoofdzaken vennootschapsbelasting.
Deventer, Fed.
Fiscale studieserie, No. 31. 1997, pp. 291.
ISBN: 90 6002 682 9.
The book contains an explanation of the most important provisions of the corporate income tax, such as the tax subject, the tax base, the participation exemption, mergers, split-up of companies, group taxation and the fiscal regime for investment companies.
(B. 117.066)

Bouwman, J.N.
Wegwijs in de vennootschapsbelasting. Theorie en praktijk.
Lelystad, Koninklijke Vermande B.V. 1996, pp. 664. NLG 84. ISBN: 90 5458 303 7.
Commentary on the corporate income tax with figures and the laws, decrees and case law until 1 January 1996.
(B. 117.098)

Belastingkompas 1998.
Amsterdam, Coopers & Lybrand; Lelystad, Koninklijke Vermande B.V. 1998, pp. 79.
Concise overview of the most important provisions in the Dutch tax law, as applicable in 1998.
(B. 117.153)

Meussen, G.T.K.
Bedrijfswaarde.
Deventer, Kluwer.
Fiscale monografieën; No. 83. 1997, pp. 380.
ISBN: 90 200 1986 4.
This thesis deals with the concept of business valuation. The research is approached from various disciplines, accounting, civil law, fiscal law and business economics. In addition a comparison is made with the systems of Germany, France, Sweden, the United Kingdom and the United States. Finally an overview is given concerning harmonization possibilities concerning the definition of a business valuation concept.
(B. 117.064)

Kluwer belastinggids 1998.
Deventer, Kluwer. 1998, pp. 558. NLG 28.50.
Annual guide to help individuals to file their 1997 income tax form and calculate their 1998 net wealth tax.
(B. 117.169)

Cnossen, S.; Bovenberg, A.L.
Belastingen in de 21e eeuw: een kritische verkenning.
Rotterdam, Erasmus University. 1998.
OCFEB Research Memorandum 9801, pp. 26.
ISBN: 90 5539 063 1.
The tax regime for the 21st century, A critical study. The authors deal especially with the proposal concerning a forfeit levy on property, which should replace the net wealth tax. It is investigated whether this proposal is in accordance with the ability to pay principle, neutrality and simplicity. Proposed options are (1) an extension of the forfeit levy, or (2) to tax the actual capital income.
(B. 117.185)

Kluwer tabellenboek 1998. Inkomstenbelasting
1998, premie volksverzekeringen 1998.
Editors T. de Bondt and E. Eikelboom.
Deventer, Kluwer. 1998, pp. 545.
ISBN: 90 200 2026 9.
Tables for individual income taxes combined with social security contributions as of 18 December 1997.
(B. 117.155)

Wiebes, M.A.
Consumptieve rente en fictieve inkomsten.
Deventer, Fed.
Fed fiscale actualiteiten, No. 31. 1997, pp. 50.
ISBN: 90 6002 736.
The author gives a comprehensive overview of all aspects concerning deemed income and the restrictions on an interest deduction for loans for private spending. Those measures have been introduced in 1997 under the bill to change the regime for substantial shareholders and they are aimed at counteracting structures where no income is received and the preventing of a creation of deductions.
(B. 117.152)

Burg, M.P. van der; Groenewegen, G.; Makkinga, F.J.H.L.; Sheer-Mahomed, G.I.
Compendium gemeentelijke belastingen.
Deventer, Kluwer. 1997, pp. 530.
ISBN: 90 200 1911 2.
Comprehensive commentary on municipal fiscal laws and their formal procedures.
(B. 117.067)

Heijdra, B.J.; Kooiman, J.P.
Efficiency and redistributional aspects of environmental tax policy in a small open economy.

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Rotterdam, Erasmus University. 1997.
OCFEB Research Memorandum No. 9709, 42 pp. ISBN: 90 5539 059 3.
A study on the efficiency and the intergenerational welfare effects of environmental policy.
(B. 117.065)

Jaarboek voor de Belastingdienst en de belastingadviespraktijk. Editors E.W. Nijgh and J. Hoogeweg.
Deventer, Noorduijn. 1998, pp. 504.
ISBN: 90 203 0436 4.
Annual edition of yearbook useful for the tax administration and tax consultants.
(B. 117.156)

Bartel, J.C.K.W.; Brunschot, F.W.G.M. van.
Van Soest Belastingen. Inkomstenbelasting, vermogensbelasting, vennootschapsbelasting. 19th Edition.
Deventer, Gouda Quint. 1997, pp. 661.
ISBN: 90 387056 11.
Handbook considering the individual income tax, corporate income tax and net wealth tax. The texts of the laws as of January 1997 are appended.
(B. 117.175)

Dijck, J.E.A.M. van.
Persoonlijke verplichtingen (zonder lijfrentepremie-aftrek). 2nd Edition.
Deventer, Fed. 1998.
Fed fiscale brochures, pp. 144. NLG 67.50.
ISBN: 90 6002 753 1.
Personal obligations (except annuity premium deduction). In this book a comprehensive overview is given of all deduction possibilities with respect to personal allowances. Special attention is given to periodical payments and interest payments on debts. Moreover, the deduction possibilities with respect to interest on loans contracted for consumption purposes and the new incentives concerning loans to new entrepreneurs are explained.
(B. 117.171)

Dietvorst, G.J.B.
De jaren tellen....
Deventer, Kluwer. 1997, pp. 54. NLG 27.50.
ISBN: 90 200 1938 4.
The author discusses the three pillars of the old age reserve: the government old age reserve, the employee pensions and the life insurance system and proposes a new system for the 21st century.
(B. 117.224)

Grapperhaus, F.H.M.
Fiscaal beleid in Nederland van 1800 tot na 2000.
Deventer, Kluwer. 1997, pp. 125.
ISBN: 90 200 1933 3.
Extended version of retirement speech as extraordinary professor of tax history at Leiden University. The book deals firstly with a number of economic principles such as the ability to pay and benefit principles and their historical development, continues with a description of the main direct taxes in the Netherlands in the 19th century and the tax burden in that century and the 20th century as well as the developments over this period. The final chapter speculates on taxation in the 21st century. Bibliography appended.
(B. 117.223)

Norway

Cnossen, S.
Dual income taxation: the Nordic experience.
Rotterdam, Erasmus University.
OCFEB Research Memorandum, No. 9710.
1997, pp. 34. ISBN: 90 5539 060 7.
This paper reports on the design, rationale and experience with the dual income taxation. It describes the basic features of the DIT along with its practical application in the Nordic countries.
(B. 117.160)

Poland

Foreign nationals working in Poland.
Amsterdam, Coopers & Lybrand. 1997, pp. 34.
Booklet providing foreign nationals assigned to Poland with a general background of Polish tax law and other relevant issues. It is designed to assist both the foreign employee and employer in dealing with their tax planning and social matters. The law is stated as of February 1997.
(B. 117.311)

Portugal

The Portuguese tax system.
Lisbon, Centro de Estudos Fiscais. 1997, pp. 171. ISBN: 972 653 149 7.
The book provides a descriptive and synthetic account of some major aspects of tax legislation concerning Portuguese main taxes. The text is current to 31 December 1996.
(B. 117.328)

Serbia

Popović, D.
Nauka o porezima i poresko pravo.
Beograd, Savremena administracija. 1997, pp. 927.
The science of taxation and the tax law. This book (published in the Serbian language) is a detailed theoretical analysis of the science of taxation (i.e. the political, economic and technical aspects) and tax law. The first part covers theoretical issues ranging from the definition and classification of taxes, the relationship between taxpayer and tax administration, double taxation, principles of taxation, tax avoidance, as well as the micro- and macro-economic effects of taxation, The second part contains a detailed account of the development and reform of the Serbian Republic's tax system. Extensive bibliography.
(B. 117.056)

Spain

Baguena, A.B.; Canelles, R.B.; Cura, I.C.; Munté, H.P.
Todo sobre la nueva ley del impuesto sobre sociedades.
Barcelona, Editorial Praxis, S.A. 1996, pp. 442. ISBN: 84 7197 364 2.
A complete guide on the Spanish corporate income tax and some procedures.
(B. 115.715)

Sweden

Cnossen, S..
Dual income taxation: the Nordic experience.
Rotterdam, Erasmus University.
OCFEB Research Memorandum, No. 9710.
1997, pp. 34. ISBN: 90 5539 060 7.
This paper reports on the design, rationale and experience with the dual income taxation. It describes the basic features of the DIT along with its practical application in the Nordic countries.
(B. 117.160)

Meussen, G.T.K.
Bedrijfswaarde.
Deventer, Kluwer.
Fiscale monografieën, No. 83. 1997, pp. 380.
ISBN: 90 200 1986 4.
This thesis deals with the concept of business valuation. The research is approached from various disciplines, accounting, civil law, fiscal law and business economics. In addition a comparison is made with the systems of Germany, France, Sweden, the United Kingdom and the United States. Finally an overview is given concerning harmonization possibilities concerning the definition of a business value concept.
(B. 117.064)

Switzerland

Pfund, R.; Zwahlen, B.
Die Eidgenössische Verrechnungssteuer. I. Teil, 1971: Einleitung und Erläuterungen zu Art. 1 bis 20 des Gesetzes; II. Teil, 1985: Erläuterungen zu Art. 21 bis 33 des Gesetzes (Steuerrückerstattung).
Basel, Verlag für Recht und Gesellschaft AG. 1985.
Die Eidgenössische Steuern, Zölle und Abgaben, Band 5/1971 und Band 6/1985, pp. 783.
Anticipatory Tax (withholding tax). This is one of the most famous commentaries on Swiss taxes. Volume 5 provides commentary to Articles 1 to 20 of the federal law on withholding tax of 13 October 1965. The book contains almost every important detail with respect to the withholding tax on dividends, interest, lottery prizes and certain payments from life insurance. Volume 6 deals with Articles 21 to 33 (refund system).
(B. 117.199)

Safarik, F.J.
Doppelbesteuerungsabkommen

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Schweiz–Tschechien.
Basel, Frantisek J. Safarik, Dufourstrasse 11, P.O. Box 336, CH-4010 Basel, Switzerland. 1997.
Commentary on the Switzerland–Czech Republic tax treaty which was signed on 4 December 1995. The text of the treaty is published in the English, German and Czech languages.
(B. 117.147)

Lang, M.; Mössner, J.M.; Waldburger, R.
Die Auslegung von Doppelbesteuerungsabkommen in der Rechtsprechung der Höchstgerichte Deutschlands, der Schweiz und Österreichs.
Vienna, Linde Verlag Wien GmbH. Schriftenreihe zum Internationalen Steuerrecht, Band 6. 1998, pp. 136. ATS 267.
ISBN: 3 85122 651 8.
The interpretation of tax treaties. The book deals with the interpretation of tax treaties by the highest courts in Austria, Germany and Switzerland. The German and Swiss parts contain tables which show the application of different elements of interpretation for each important judgement.
(B. 117.144)

Kommentar zum Schweizerischen Steuerrecht.
Band I/1: Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden (StHG).
Herausgegeben von Martin Zweifel und Peter Athanas.
Basel, Helbing & Lichtenhahn Verlag AG. 1997, pp. 825. CHF 278.
ISBN: 3 7190 1583 1.
The tax harmonization Law entered into force in 1993. The Swiss cantons have to bring their legislation into line with the federal law by 31 December 2000. This is the first complete commentary on the entire Tax Harmonization Law. It often goes into details and shows the scope of cantonal sovereignty with respect to legislation in the field of direct taxes. There is also a detailed index.
(B. 117.207)

Höhn, E.; Waldburger, R.
Steuerrecht. Band I: Grundlagen – Grundbegriffe – Steuerarten. 8. Auflage.
Bern, Verlag Paul Haupt. 1997. Schriftenreihe Finanzwirtschaft und Finanzrecht, Band 8, pp. 793. DEM 110.
ISBN: 3 258 05666 8.
Tax Law. Principles, terminology, types of taxes. Student book for Swiss tax law. The first part covers, *inter alia,* the following general topics: tax terms, Swiss tax system, constitutional principles, interpretation of tax law, object of taxation and assessment. The second part contains the most important taxes, e.g. individual and corporate income taxes, net wealth and capital taxes, withholding taxes, real estate profit tax, VAT and transfer taxes.
(B. 117.164)

United Kingdom

Homer, A.; Burrows, R.
Tolley's Taxwise I, 1997-98. Income tax and national insurance, corporation tax, capital gains tax.
Croydon, Tolley Publishing Company Ltd. 1997, pp. 800. GBP 29.95.
ISBN: 1 86012 540 9.
This book offers practical guidance on how tax law applies in practice. It contains 100 worked examples covering income tax and national insurance, corporation tax and capital gains tax. Fully updated to include the relevant changes brought about by the Finance (No. 2) Act 1997.
(B. 117.126)

Dolton, A.; Saunders, G.
Tolley's tax cases 1997. 21st Edition.
Croydon, Tolley Publishing Company Ltd. 1997, pp. 828. GBP 39.95.
ISBN: 1 86012 439 9.
A comprehensive digest of reported tax decisions relevant to current legislation from 1875 to 1 January 1997. Coverage includes cases on income tax, corporation tax, capital gains tax, inheritance tax and petroleum revenue tax. This latest edition includes some new chapters on clubs and societies, farming and mutual trading, summaries of all important court decisions reached in 1996, including decisions of the Special Commissioners, and additional subsections within the partnerships chapter.
(B. 117.113)

Simon's tax cases 1997.
Editor Susan J.Murphy.
London, Butterworths. 1998, pp. 1496.
ISBN: 0 406 90200 3.
Bound volume of British tax cases 1997.
(B. 117.115)

Meussen, G.T.K.
Bedrijfswaarde.
Deventer, Kluwer.
Fiscale monografieën, No. 83. 1997, pp. 380.
ISBN: 90 200 1986 4.
This thesis deals with the concept of business valuation. The research is approached from various disciplines, accounting, civil law, fiscal law and business economics. In addition a comparison is made with the systems of Germany, France, Sweden, the United Kingdom and the United States. Finally an overview is given concerning harmonization possibilities concerning the definition of a business value concept.
(B. 117.064)

Thornhill, A.; Baxendale-Walker, P.
The law and taxation of remuneration trusts.
London, Key Haven Publications PLC., 7 Crescent Stables, 139 Upper Richmond Road, London SW15 2TN, United Kingdom. 1997, pp. 185. ISBN: 1 870070 93 3.
This book describes the legal and tax aspects of trusts set up to remunerate employees. These structures are distinct from employee share schemes and pension trusts which are only marginally covered. The book contains a model form of remuneration trust, discusses the related legal implications and covers the tax treatment of contributions, investments made by trust funds and trust distributions.
(B. 117.111)

Homer, A.; Burrows, R.
Tolley's Taxwise II, 1997-98. Value added tax, inheritance tax, taxation of trusts, tax planning.
Croydon, Tolley Publishing Company Ltd. 1997, pp. 500. ISBN: 1 86012 541 7.
The book offers practical explanations and guidance on how tax law applies in practice. It has 88 worked examples covering VAT, inheritance tax, taxation of trusts, and tax planning. This edition has been fully updated to include the relevant provisions from the Finance Act 1997 and the Finance (No. 2) Act 1997.
(B. 117.126A)

McKie, S.
Tolley's estate planning 1997/98.
Croydon, Tolley Publishing Company Ltd. 1997, pp. 507. GBP 44.95.
ISBN: 1 86012 522 0.
A comprehensive guide to practical taxation strategies. The book provides essential guidance on how to formulate a plan for the provision, holding and devolution of personal and family resources. This edition takes account of the changes made by the Finance Act 1997 and all other relevant provisions up to 1 August 1997.
(B. 117.231)

Coopers & Lybrand Foreign Exchange Tax Team.
Tolley's taxation of foreign exchange gains and losses. 3rd Edition.
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(B. 117.209)

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(B. 117.212)

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A, release 5
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releases 28-32
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USA

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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.

SEPTEMBER

Tax and Business Implications of the Currency Crisis in Asia, Amsterdam, the Netherlands, 21 September 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

Transfer Pricing '98, Café Royal, London, the United Kingdom, 21-22 September 1998 (English):

SMi Ltd., No.1, New Concordia Wharf, Mill Street, London SE1 2BB, the United Kingdom, Tel.: 44-171-252 2222, Fax: 41-171-252 2272.

Mergers & Acquisitions, Amsterdam, the Netherlands, 24-25 September 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

Taxation Strategies for Telecoms, Marble Arch Marriott, London, the United Kingdom, 28-30 September 1998 (English):

Vision in Business, 41 Whitcomb Street, London, the United Kingdom, Tel.: 44-171-839 8391, Fax: 44-171-839 3777, E-mail: booking@visibis1.demon.co.uk

OCTOBER

52nd IFA Annual Congress, London, the United Kingdom, 4-9 October 1998 (simultaneous translations into French, English, German and Spanish):

52nd IFA Annual Congress, Concorde Services Ltd, 10 Wendell Road, London W12 9RT, the United Kingdom, Tel.: 44-181-743 3106, Fax: 44-181-743 1010, E-mail:ifa@concorde-uk.com

Transfer Pricing and effective Tax Planning in China, Beijing Hilton, Beijing, China, 8-9 October 1998 (English):

IBC Asia Ltd, No. 1 Grange Road #08-02 Orchard Building, Singapore 239693, Tel.: 65-732-1970, Fax: 65-733-5087, E-mail: laynah@ibcasia.com.sg

XIXth Congress on Latin American Tax Law, Lisbon, Portugal, 11-16 October 1998:

Associaçao Fiscal Portuguesa, Secretariado das XIX Jornadas, Rua das Portas de Santo Antao, 89, 1150 Lisbon, Portugal, Tel.: 351-1346-7494, Fax: 351-1322-4051.

Application of Tax Treaties, Amsterdam, the Netherlands, 21-23 October 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

International Tax and Financial Planning Forum 1998, Hotel Occidental Miguel Angel, Madrid, Spain, 26-29 October 1998 (English and Spanish):

IBC Global Conferences Ltd, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-453 5479, Fax: 44-171-636 6858 (Attn. Dora Walsh), E-mail: cust.serv@ibcuk.co.uk

Transfer Pricing Audits, Amsterdam, the Netherlands, 30 October 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

NOVEMBER

Accounting & Tax for Derivatives, London, the United Kingdom, 3-6 November 1998 (English):

Hilary McCann, Managing Director of Public Programmes, Euromoney Training, Nestor House, Playhouse Yard, London EC4V 5EX, the United Kingdom, Tel.: 44-171-779 8753, Fax: 44-171-779 8693, E-mail: euromoneyt@dial.pipex.com

International Tax Aspects of VAT, Amsterdam, the Netherlands, 19-20 November 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

Ceny Transferowe w Polsce – Transfer Pricing, Hotel Bristol, Krakowskie Przedmiescie 42/44, Warsaw, Poland, 26-27 November 1998 and 26-27 January 1999 (English and Polish):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6913 (UK), 48-22-657 0401 (Polska), Fax: 44-171-878 6885 (UK), 48-22-657 0111 (Polska).

International Tax Planning Aspects of Doing Business with MERCOSUR, Amsterdam, the Netherlands, 27 November 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

DECEMBER

Double Taxation Relief: Practice, Theory and Planning, Amsterdam, the Netherlands, 10-11 December 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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Inland Revenue, International Division

The recently enacted 1998 Finance Act includes important provisions which modernize the UK transfer pricing rules. This article describes the main features of the new legislation and provides some background to the changes. It also describes the initiatives the Government is taking in the area of Advance Pricing Arrangements.

UK IMPUTATION, PAST, PRESENT AND FUTURE 429
Malcolm Gammie

From 1999 dividend taxation will change again in the United Kingdom. Has the United Kingdom found a lasting formula? This article tours the development of UK dividend taxation in an effort to find an answer.

BRITISH SOCIAL SECURITY AND TAXES: STRUCTURING THEIR INTERACTIONS 440
Dr David Williams

The current form of social security in the United Kingdom was launched 50 years ago in July 1948. It followed in many details the cradle-to-grave model set out in the famous Beveridge Report. In 1998, the new government has raised fundamental questions about both how it should be funded and what it should provide. Most notably, the task of collecting compulsory social security contributions is being transferred from the Department of Social Security to the Inland Revenue. Dr Williams analyses the inevitable interactions between tax and social security.

SOME ASPECTS OF UNITED KINGDOM DOUBLE TAXATION RELIEF 445
Philip Baker

Like most countries which provide relief from international double taxation wholly or in part by the credit method, the credit given in the United Kingdom is an "ordinary" or "normal" credit. That is, the credit is limited to a maximum, which is the amount of UK tax attributable to the income which has been subjected to foreign tax. Mr Baker examines the computation of the quantum of the relief for foreign tax in light of the decision in *Yates v. GCA International Limited*.

RECENT TAX TREATY DEVELOPMENTS IN THE UNITED KINGDOM 455
Jonathan S. Schwarz

The United Kingdom is now at the forefront in terms of treaty networks. In December 1996, the United Kingdom became the country with more bilateral treaties than any other in the world, having more than 100 in force. The result is that the United Kingdom now has comprehensive coverage in relation to industrialized countries with very extensive coverage in Eastern Europe and the developing world. The author outlines certain aspects of the UK's current treaty policy.

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THE UNITED KINGDOM AS AN INTERNATIONAL HOLDING COMPANY LOCATION 462
Eric Tomsett

Since 1 July 1994 when the Advance Corporation Tax problem was mitigated through the introduction of foreign income dividends and international headquarters companies the UK's position as a holding company location has strengthened. Mr Tomsett explains why the absence of any withholding tax on dividends in the United Kingdom and the opportunities to give a UK holding company real substance by combining it with the headquarters of European operations has meant that the United Kingdom can offer opportunities for holding companies absent in the more traditional European holding company locations such as the Netherlands and Luxembourg.

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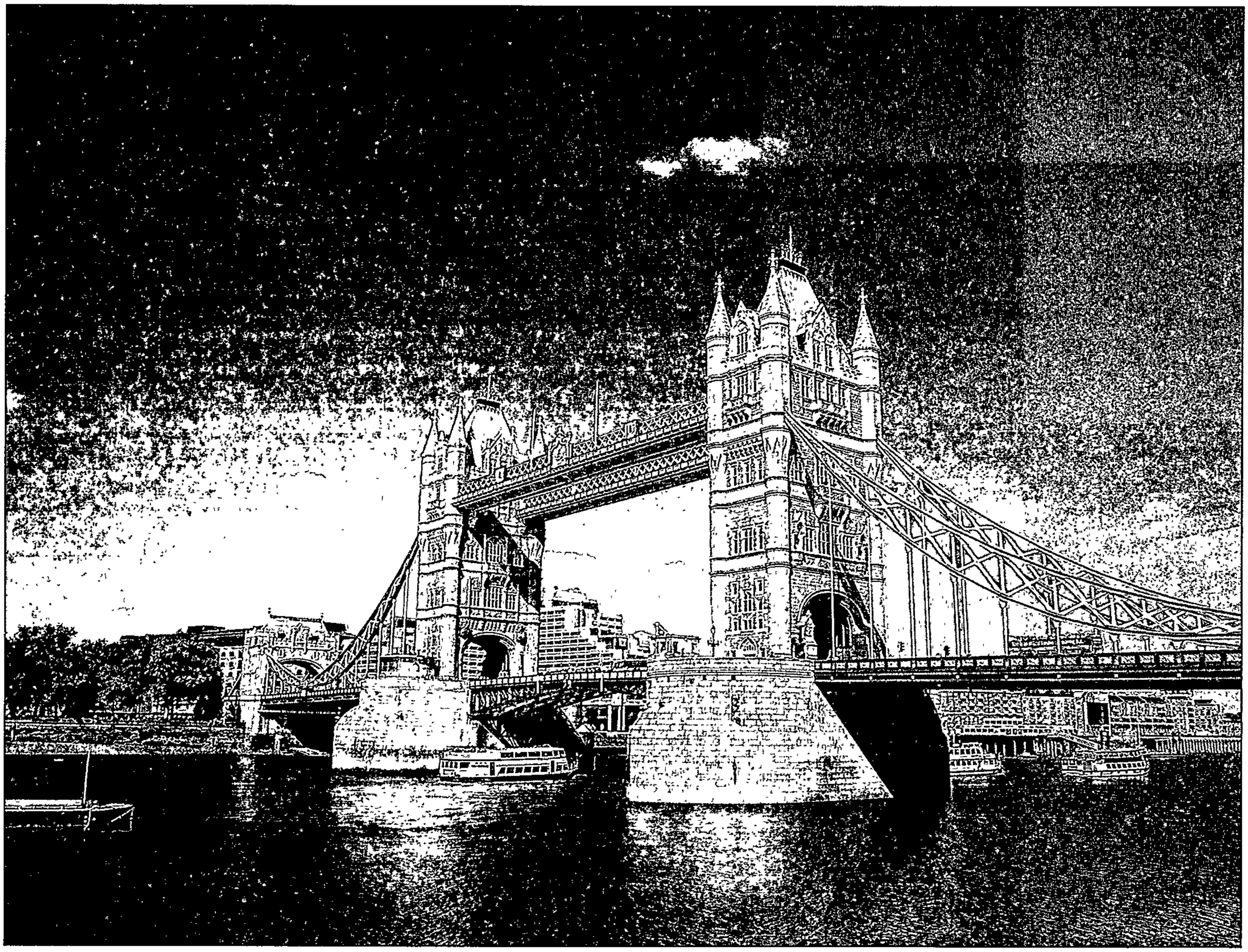
Introduction

THE 52ND IFA CONGRESS – LONDON 1998

Prof. Sven-Olof Lodin



This year IFA will have its annual congress in a well-known and familiar IFA city, London. Three earlier congresses have been arranged in London by the British IFA branch. This means that most IFA members are well acquainted with London and with the British IFA branch as congress organizer. Our experiences of London with all its charm as a congress location, of the excellent organization of the London Congresses and of the hospitality of our British IFA colleagues make me believe that this year's congress will be very well attended.

The great number of participants expected has led to the decision to split the Cultural Evening as well as the Gala Evening between different venues. Our experience tells us that the special IFA atmosphere nevertheless will still remain.

The London Congress will otherwise in many respects follow in the footsteps of earlier London Congresses, for example by going back to the classical timetable for the scientific programme, which means sessions from 9.30 to 17.00 with a lunch break.

But the London Congress will also in at least one sense be IFA's most modern congress ever. Parallel with the IFA Congress in London a Ministerial Conference on the general problems of electronic commerce will be held in Ottawa, Canada. The IFA seminar, Seminar B, on the tax problems involved in electronic trade will not only discuss the tax problems caused by modern information technology and Internet trade, it will also experiment with this technology. During the seminar the most modern electronic technique will be used in arranging a transatlantic video conference link

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between the OECD panel in Ottawa and the IFA panel in London for a joint transatlantic discussion of the tax problems in the area of electronic trade. We hope that the technique will work.

This seminar is remarkable also from another point of view. The joint seminar with the Ottawa Conference also shows the increasing importance of IFA as a discussion partner to international government bodies on international tax issues. The seminar discussion will to a large extent be based on the findings of the IFA Research Project on Internet and International Taxation, carried out by Professor Richard Doernberg, USA and Professor Luc Hinnekens, Belgium. We hope to be able to publish the final report later this year.

Seminar C on "24 hour global trading" also deals with a phenomenon made possible by modern information technology. The seminar will seek to identify and consider the tax issues which an organization conducting business in the international financial markets will need to address in practice.

Three years ago the first chapters of the OECD Guidelines on Transfer Pricing were published. No issue within the field of international taxation has been subject to so much discussion and debate as transfer pricing between related companies. After three years of application of the new OECD Guidelines Seminar D offers an opportunity to discuss the usefulness of the guidelines on the basis of concrete experiences. To what extent have the Guidelines been able to resolve the transfer pricing issues for the tax authorities and for the business sector?

In all, the London Congress offers seven seminars, some also of the more classical type. Seminar A will discuss "the OECD Model Convention – 1998 and beyond". As usual the panel consists of OECD officials and IFA members with Professor Klaus Vogel, Germany, as chairman.

Triangular treaty problems are not a new issue for IFA but the subject contains many questions that still need discussion. Seminar E will discuss the problems and existing solutions but will also look for new solutions.

The importance of international issues within the VAT area has increased. International services have become a more common feature and more countries have made services subject to VAT. Seminar G will discuss whether the existing VAT systems can cope with the growth in traditional cross-border services and whether the use of electronic technology may require new VAT rules.

Since the 1990 Congress in Stockholm one congress seminar, in London Seminar F, has been reserved for treating some recent development of special interest. At the London Congress the title of the seminar is "Recent international transactions of interest" and will treat the tax consequences of an international bond issue made by a big multinational company.

The two main subjects of the congress are:
- Tax treatment of corporate losses; and
- Practical issues in the application of double tax conventions.

Both subjects treat problems that are well known to everybody working in the field of international taxation. Still, the subjects contain problematic areas that need to be further analysed and discussed.

The first subject, "Tax treatment of corporate losses", has attracted 34 national reports. The subject treats both domestic and cross-border losses and losses of a single entity and losses within a group of companies. The subject deals especially with the various restrictions to the deductibility of losses that are applied in different countries, such as time restrictions, carry-back restrictions, basket limitations, and restrictions in connection with change of ownership. The subject also focuses on the policy reasons lying behind various existing restrictions.

The second subject, "Practical issues in the application of double tax conventions", deals with the practical aspects of applying double tax conventions. These questions are often overlooked when discussing the application of double tax treaties, as they normally are matters regulated in internal law. As international trade and business integrations grow and the number of double tax conventions increases, these practical questions have become more important. The general report and the discussion at the congress will to a great extent be based on the issues brought forward by the national reports, including both good practical solutions and problematic areas in the application of double tax conventions. Thirty national reports have been submitted to the congress.

As an experiment, the proceedings of the plenary sessions of the London Congress have been changed. There is a general feeling that during the recent congresses too much time has been devoted to discussing the details of the draft resolutions instead of discussing the subject. Moreover quite a few participants have questioned the value of the resolutions. The resolutions have also caused problems with regard to the participation from the public sector. For these reasons, as an experiment, no resolutions will be presented at the London Congress. Instead a summary of the discussions, a Précis, will be prepared, reflecting the views expressed in the discussion. The Précis will be presented to the General Assembly, but no vote will be taken. It will be interesting to see what the experience of this new model will be.

The very varied and interesting scientific programme together with an exciting social programme and finally the charm of London give promises of a successful congress. I am convinced that a great number of IFA members will draw the same conclusion and turn up in London in October. I give to all of those who will participate a warm welcome to London and a hearty thanks to our friends at the British Branch for all their efforts in organizing the congress. The London Congress will no doubt be a successful and memorable event.

IFA was founded in 1938. That means that our organization becomes 60 years old this year. This could of course be a cause for celebration. However, instead IFA has celebrated the even numbers of congresses. As many IFA members will recall the Geneva Congress 1996 was our 50th Congress, which also was celebrated as a Jubilee Congress. Although we will not officially celebrate our 60th birthday, the long and prosperous life of our organization is something to be proud of.

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SUBJECTS AND SEMINARS OF THE 1998 CONGRESS

SUBJECT I
The treatment of corporate losses
General Reporter: Prof. Aage Michelsen (Denmark)
Discussion Leader: Prof. Jacques Malherbe (Belgium)

SUBJECT II
Practical issues in the application of double tax conventions
General Reporter: Dr David W. Williams (United Kingdom)
Discussion Leader: Prof. Dr Michael Lang (Austria)

SEMINAR A
The OECD Model Convention – 1998 and beyond
Chairman: Prof. Dr Klaus Vogel (Germany)

SEMINAR B
Internet/I.T. communication issues
Chairman: Prof. Dr Kees van Raad (Netherlands)

SEMINAR C
24-hour global trading
Chairman: Geoffrey Pennels (United Kingdom)

SEMINAR D
Practical experience with the OECD transfer pricing guidelines
Chairman: Michel Taly (France)

SEMINAR E
Triangular treaty problems
Chairman: Dr John F. Avery Jones CBE (United Kingdom)

SEMINAR F
Recent international transactions of interest
Chairman: Edward Troup (United Kingdom)

SEMINAR G
VAT on cross-border services
Chairman: Prof. Dr Han Kogels (Netherlands)

TEMA I
Tratamiento impositivo de las pérdidas de empresas
Ponente General: Prof. Aage Michelsen (Dinamarca)
Presidente de Debates: Prof. Jacques Malherbe (Bélgica)

TEMA II
Aspectos prácticos en la aplicación de los convenios de doble imposición
Ponente General: Dr David W. Williams (Reino Unido)
Presidente de Debates: Prof. Dr Michael Lang (Austria)

SEMINARIO A
El Modelo de Convenio de la OCDE – 1998 y perspectivas futuras
Presidente: Prof. Dr Klaus Vogel (Alemania)

SEMINARIO B
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Presidente: Prof. Dr Kees van Raad (Países Bajos)

SEMINARIO C
El comercio global durante las 24 horas
Presidente: Geoffrey Pennels (Reino Unido)

SEMINARIO D
Experiencias acerca de las directrices de la OCDE sobre precios de transferencia
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SEMINARIO E
Problemas triangulares de los tratados
Presidente: Dr John F. Avery Jones CBE (Reino Unido)

SEMINARIO F
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Presidente: Edward Troup (Reino Unido)

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Modérateur: Prof. Jacques Malherbe (Belgique)

SUJET II
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Modérateur: Prof. Dr Michael Lang (Autriche)

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SEMINAIRE E
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SEMINAIRE F
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Vorsitzender: Prof. Dr Klaus Vogel (Deutschland)

SEMINAR B
Fragen von Internet und Informationstechnologie
Vorsitzender: Prof. Dr Kees van Raad (Niederlande)

SEMINAR C
24 Stunden Global Trading
Vorsitzender: Geoffrey Pennels (Vereinigtes Königreich)

SEMINAR D
Erfahrungen mit der praktischen Anwendung der OECD-Verrechnungspreisrichtlinie
Vorsitzender: Michel Taly (Frankreich)

SEMINAR E
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Vorsitzender: Dr John F. Avery Jones CBE (Vereinigtes Königreich)

SEMINAR F
Neueste internationale Transaktionen von Bedeutung
Vorsitzender: Edward Troup (Vereinigtes Königreich)

SEMINAR G
Mehrwertsteuer auf grenzüberschreitende Dienstleistungen
Vorsitzender: Prof. Dr Han Kogels (Niederlande)

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TRANSFER PRICING AND ADVANCE PRICING ARRANGEMENTS IN THE UNITED KINGDOM

A Current Perspective from Inland Revenue, International Division*

The recently enacted 1998 Finance Act includes important provisions which modernize the UK transfer pricing rules. These rules are contained in a new schedule to the Taxes Act 1988, Schedule 28AA, which will entirely replace the existing rules found at Section 770 of the Taxes Act for accounting periods ended on or after 1 July 1999.

This article describes the main features of the new legislation and provides some background to the changes. It also describes the initiatives the Government is taking in the area of Advance Pricing Arrangements.

International trade is of crucial importance to the United Kingdom. Relative to its gross domestic product, the United Kingdom has larger cross border flows of trade and investment than any other developed country and this economic activity has become increasingly concentrated in the hands of multinational groups. Transfer pricing is thus of great importance to the United Kingdom and it is essential that the UK rules are effective in a modern commercial environment. This is all the more important in the light of the general modernization of transfer pricing legislation throughout the developed world. It was in this context, and in the expectation of the advent of self-assessment for companies, that the Government announced in November 1995 that the Inland Revenue was to consult interested parties on the need to modernize the legislation and to bring it within the self-assessment framework.

The Inland Revenue carried out informal consultations with corporate taxpayers, tax practitioners and representative bodies during the first few months of 1996. A formal consultation document,[1] which included draft legislation, was published in October 1997 and this was accompanied by a series of presentations by the Inland Revenue and further extensive consultation. Over 50 written replies were received. The outcome of the consultation process was published in March 1998[2] together with the announcement that the Government intended to go ahead with the legislation. Respondents welcomed the opportunity for comment and a number of suggestions were made about ways in which the legislation could be improved, better targeted and made simpler and easier to comply with. Many of these were adopted in the final draft of the legislation and, as a result of concerns expressed during the consultation process, the Inland Revenue has also agreed to provide further guidance in three areas:

- The application of the new rules to financial transactions;
- Documentation requirements;
- The application of penalties in the area of transfer pricing.

It is expected that these will be published in *Tax Bulletin*[3] articles during October 1998.

The new rules apply mostly to cross border transactions between connected persons. In limited circumstances, the rules can apply to transactions within the United Kingdom. The scope of the legislation is largely unchanged, but the rules determining whether parties are connected for the purposes of the transfer pricing rules have been modified in a number of respects. The main changes involve joint ventures and situations where trusts are involved in a control chain. It is expected that these changes to the control provisions will affect only a very small proportion of transactions.

A fundamental policy objective of the new rules is to reaffirm the United Kingdom's commitment to OECD principles and to align the expression of the UK rules with that contained in the Associated Enterprises Article (9(1)) of the OECD Model Tax Convention. The drafting of the legislation is intended to reproduce the effect of that article in UK domestic law. For the vast majority of transactions, the arm's length principle will in practice be applied in exactly the same way as it is under the existing legislation.

A key feature of the new rules is that they are fully integrated into the UK self-assessment regime for companies, which will be introduced for accounting periods ended on or after 1 July 1999. This means that taxpayers will be required to self assess their liabilities and be obliged to apply the arm's length principle in making their returns. This represents a fundamental change to the existing responsibilities of taxpayers. Unlike most provisions of the Taxes Act, application of the existing transfer pricing legislation is effectively discretionary. Taxpayers are not required to apply the arm's length principle when filing their returns and the existing transfer pricing rules come into play only if an Inland Revenue officer makes a decision that it is appropriate to apply them. This must be effected by a "Board's Direction", a statutory procedure in which a senior official of the Inland Revenue acting on behalf of the Board directs that the rules should apply. So at present a return reflecting transactions not all of which satisfy the arm's length principle may nevertheless be a correct return for the purposes of the Taxes Act.

Under the new regime, taxpayers will be required to file returns in accordance with the arm's length principle and

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* Further information about the contents of this article can be obtained from the following officials at Inland Revenue, International Division: for details about the new transfer pricing legislation contact Colin Clavey, 0171 438 6911; for details about APAs contact Andrew Hickman, 0171 438 6916, or Peter Steeds, 0171 438 7914.

1. *Modernisation of the Transfer Pricing Legislation – A Consultative Document.* Inland Revenue, (October 1997).
2. *Modernisation of the Transfer Pricing Legislation – Outcome of Consultations.* Inland Revenue, (March 1998).
3. *Tax Bulletin* is an Inland Revenue publication for tax professionals.

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include any adjustment to their taxable profit in cases where transactions have not been on arm's length terms. Failure to do so where fraud or negligence is involved may result in a penalty in the same way as for any other incorrect return.

During the consultation period, taxpayers referred to the safeguards inherent in the Board's Direction process which they valued and which would disappear with the introduction of the new rules. The Government has responded to this by introducing a new statutory process under which a "Board's Approval" will be needed before any transfer pricing adjustment is made to a self-assessment other than with the taxpayer's agreement. Beyond that, internal administrative arrangements will provide for the review of cases at prescribed points by the Inland Revenue's International Division.

In the March 1998 Budget the Government also announced that the Inland Revenue would be consulting during the year with a view to introducing a statutory provision governing advance pricing arrangements (APAs). The remainder of this article sets out the background to that announcement.

The Inland Revenue currently participates in the APA process with other tax administrations under the authority of the Mutual Agreement Procedure (MAP) of Double Tax Treaties. (This process was described in *Tax Bulletin*, Issue 25, October 1996.) Whilst this has proved to be a workable basis it has several disadvantages that would be addressed through the introduction of a domestic provision. The principal disadvantage of the present situation is that although the MAP provides a mechanism for tax administrations to reach agreement between themselves through their competent authorities it does not allow the Inland Revenue to make agreements with taxpayers, to establish procedures for applications and review, or to secure compliance with such agreements. In practice this means that the United Kingdom is dependent on following procedures in the domestic law of treaty partners. Furthermore, it has difficulty in considering APAs with those administrations that have no domestic programme and is unable to consider unilateral agreements with UK taxpayers should circumstances make this desirable and worthwhile.

More generally, there has been a continuing growth in the volume and complexity of intra-group cross-border transactions which has led to a corresponding growth in the interest and sophistication of tax administrations in transfer pricing. It is acknowledged that taxpayers may want to seek some measure of advance comfort that their transfer pricing practices accord with the arm's length standard. The responses to the transfer pricing consultative document of October 1997 provided overwhelming support for the introduction of a domestic APA process and the Government decided to respond positively.

It is expected that a formal APA procedure will bring benefits to both the taxpayer and the tax administrations that are party to it. A bilateral or multilateral APA that establishes agreed parameters for transfer pricing of specified transactions according to the arm's length standard will ensure that the relevant profits or losses are taxed or relieved only once. Such an APA compresses and coordinates the separate audits of the participating administrations and effectively displaces any MAP which might otherwise have followed. The participating administrations may have different audit cycles so that in practice, without the coordination effected by an APA, audits of the same periods may be undertaken at widely differing times with a resulting delay in finalizing the position or in bringing forward matters for consideration under the MAP. The MAP process itself, whilst generally successful in eliminating double taxation, does not guarantee that profits will not remain doubly taxed. By contrast, an APA brings administrations to the table at the same time to discuss the same issues, and, if successful, will determine the transfer pricing of the transactions being considered in such a way that it will automatically prevent double taxation.

The Inland Revenue considers that the most appropriate cases for APA consideration would be those where, because of the volume, value or complexity of the cross-border transactions, it is likely that the administrations on both sides of the transactions would want to audit them, and where the difficulties inherent in determining how the transactions should be priced to accord with the arm's length standard in the particular case are such that there is a significant risk of double taxation. In cases where a taxpayer considers that there are genuine areas of uncertainty that might be examined and contested by tax administrations, an APA offers the taxpayer an opportunity to plan the audit effectively. The Inland Revenue is considering how it would ensure that only appropriate cases are dealt with under the APA process. Under the current regime APAs conducted under the authority of MAP have to meet the threshold test of "difficulties or doubts arising as to the interpretation or application" of a treaty, allowing concentration on cases where the risk of double taxation is apparent. Whilst it would be desirable to maintain some form of threshold test this must be considered in conjunction with the need for equality of taxpayer treatment.

Of course, an APA should not be undertaken lightly as it requires extensive preparation and is likely to be resource intensive. It is not therefore likely to be an appropriate approach for taxpayers the pricing of whose transactions under the arm's length principle can be accomplished in a relatively straightforward way. The Inland Revenue will be inviting taxpayers' comments on this issue as part of the consultation process. And it is not intended to exclude multinational taxpayers from, as now, seeking informal assurance from the Inland Revenue on particular aspects of their transfer pricing policy. In the Inland Revenue's experience multinational taxpayers do not constantly seek assurance regarding their transfer pricing practices. Many will not do so and may reasonably take the view that they have considered their compliance obligations, fulfilled them and need no further assurances.

Whilst it is envisaged that most APAs would be concluded on a bilateral or multilateral basis, there was support for unilateral APAs in response to the October 1997 consultative document and it is intended that that will be recognized. A unilateral UK agreement may be of limited value as it only determines the treatment of the UK side of transactions and

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could be disturbed by consideration of the transactions in the other jurisdiction. The United Kingdom fully supports the OECD's conclusion that wherever possible APAs should be concluded bilaterally or multilaterally. However there are circumstances where this may not be possible. It may be that the other end of a relevant transaction is in a territory with which the United Kingdom has no Double Tax treaty, or, whilst there is a treaty, the treaty partner may be unwilling to consider an APA. The time which would be required to conduct a bilateral APA may be an inhibiting factor, or attempts to reach agreement with a treaty partner may be unsuccessful. In such cases a unilateral agreement may be appropriate. However, such an agreement would not, of course, be binding on any tax administration other than the United Kingdom and it would still potentially be subject to the application of the MAP, so there would remain a risk that double taxation may not be eliminated.

It is too early to say what form the legislation will take. The Inland Revenue hopes to have a simple provision authorizing statutory agreements to be made that are binding on the parties in relation to transfer pricing. This would be accompanied by supporting administrative guidance that could easily be modified as experience grows. It is intended to offer a flexible process that could accommodate a wide variety of situations.

It is intended that an APA should interact positively with a transfer pricing audit given that one purpose of an APA is to coherently compress a series of audits and MAP discussions. Specifically it is envisaged that an APA may be a means of resolving existing transfer pricing audits by rolling back the principles of the APA to the earlier years to the extent that they are relevant and the circumstances appropriate. A somewhat different situation will arise where years prior to the period for which the APA application is made are not under enquiry, but the APA information demonstrates that a transfer pricing enquiry for those years is warranted. The Inland Revenue will not be prepared to accept that APA information cannot lead to a "discovery" and the reopening of earlier years since such an approach could be open to abuse. However, it may be prepared to permit a taxpayer to enter into discussions about a possible APA on an anonymized – but informed – footing, before requiring the taxpayer to reach a decision on whether to make a formal application.

The Inland Revenue does not believe that the potential exposure to penalties for fraud or negligence under the new rules should itself generate requests for APAs that would not otherwise have arisen. But it does recognize that penalties are an issue of concern based on the responses to the October 1997 consultative document. So, as indicated above, the Inland Revenue intends to issue guidance on how penalties will be applied in relation to transfer pricing. Such guidance should significantly reduce concerns over penalties. However, it has already indicated that a taxpayer who can demonstrate a reasonable attempt to comply with the terms of the legislation, but who has nevertheless failed to do so will not be subject to a penalty for fraud or neglect.

APAs will be confidential to the Inland Revenue and the taxpayer and so cannot have any precedent value. There are no plans to publish finalized APAs in any form. The process will be administered, as with the Inland Revenue's current participation in APAs, by the transfer pricing and competent authority specialists in its International Division, usually with the additional participation of the Inspector responsible for the taxpayer's affairs locally.

It is intended that the further consultation process relating to APAs will be initiated formally by publication of a consultative document during the autumn of 1998. The Revenue will be very pleased to hear the views of interested parties which will then be taken into account in proposing legislation in the 1999 Finance Bill.

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UK IMPUTATION, PAST, PRESENT AND FUTURE

Malcolm Gammie[1]

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I. INTRODUCTION

The story of corporate and dividend taxation in the United Kingdom over the last 50 or more years is a story of change. It reflects changing attitudes and political fortunes: the belief by some politicians that it is good to encourage companies to retain and invest their profits; the view of others that equity markets are the best judges of investment opportunities – that the tax system should encourage distribution and reinvestment through the market.

The outcome is predictable. Personal and corporate tax systems have distorted and continue to distort corporate choices between retention and distribution and between distribution in different forms.[2] And as dividend tax systems come and go, the questions remain – in an open economy how much do they really matter in determining investment and for companies' dividend decisions?[3]

From 1999 dividend taxation will change again in the United Kingdom. Has the United Kingdom found a lasting formula? This article tours the development of UK dividend taxation in an effort to find an answer. My starting point is the imputation system, its antecedents and its development over time.

II. THE UK IMPUTATION SYSTEM, PAST AND PRESENT

A. An outline of the basic system

1. Liability to pay advance corporation tax

A UK resident company must account to the Inland Revenue for advance corporation tax (ACT) whenever it pays a dividend.[4] This has been the rule since 6 April 1973[5] and it remains the rule until 6 April 1999.[6] There have always been some exceptions. A subsidiary may pay to its parent company a gross dividend – that is, without accounting for ACT – provided the parent and subsidiary companies have made a group income election.[7] A company that has received dividends (other than group income) from another UK company – known as franked investment income or "FII" – may use the credit that attaches to those dividends to discharge its own obligation to account for ACT.[8]

2. Offset of ACT against corporation tax

A company may deduct ACT from its corporation tax bill for the accounting period in which it pays the dividends that give rise to that ACT.[9] There is, however, a limit on the amount of ACT that a company can credit against its corporation tax for the period. This limit is the ACT that the company would pay on a dividend which, when aggregated with the ACT, equals the company's taxable profits for the period.[10]

If the actual ACT that the company pays on its dividends for the period exceeds this limit it is known as "surplus ACT".[11] The company does not lose the right to set surplus ACT against its corporation tax liabilities. It may claim to carry surplus ACT back up to six years against the corporation tax that it paid in earlier periods[12] and it can carry forward sur-

1. Malcolm Gammie is a UK correspondent for the *Bulletin*.
2. And the distortions have not always coincided with the intended effects of the system. In the 1970s many companies qualified for high depreciation allowances and stock relief and paid little corporation tax. Advance corporation tax (ACT) on dividends was the only tax they paid and thus represented a discouragement to distribution. The 1984 reform of corporation tax changed this but UK recession and the reduction of UK tax on foreign income due to foreign tax credits led many companies back to the position that ACT on dividends represented the major part of their UK tax payments. This created pressure from business to mitigate surplus ACT and led to the introduction of the foreign income dividend scheme in 1994, enabling companies to reclaim ACT on dividends paid out of taxed foreign income.
3. Despite the previous note, the UK imputation system was widely said to encourage over-distribution by UK companies. My experience suggests that the imputation system influenced (and continues to influence) the way in which public companies distribute their profits, e.g. as dividend, share repurchase or capital repayment. The evidence that it affects the absolute level of distribution by public companies seems rather less compelling, see Gammie, "The Future of UK Corporation Tax" in Head & Krever, *Company Tax Systems*, Australian Tax Research Foundation Conference Series No. 18, (Sydney, 1997). For evidence on the effects on dividends of the UK imputation system, see Bond, Chennells and Devereux, *Company Dividends and Taxes in the UK*, Fiscal Studies (1995) Vol. 16, No. 3, at 1-18.
4. Income and Corporation Taxes Act 1988 ("ICTA") Sec. 14(1). This rule applies to other forms of company distribution but I refer in this article only to dividends.
5. Finance Act 1972 Sec. 84(1).
6. Finance Act 1998 s. 31(1).
7. ICTA Sec. 247. The group income rules cease to apply to dividends paid after 5 April 1999, F(2)B 1998 Sch. 3 para. 18. After that, all dividends can be paid without accounting for ACT and without withholding. The group income provisions will continue to allow the payment of interest gross between group companies.
8. ICTA Sec. 241. The FII rules cease to apply in respect of dividends paid after 5 April 1999, F(2)B 1998 Sch. 3 para. 13.
9. ICTA Sec. 239(1).
10. ICTA Sec. 239(2). The limit is adapted in cases where foreign tax credits reduce the company's corporation tax bill. The adaptation ensures that foreign tax credits (which cannot be carried forward) are set against the tax bill first (rather than being wasted) so that the company can carry back or forward a larger amount of surplus ACT.
11. ICTA Sec. 239(3).
12. ICTA Sec. 239(3). The aggregate ACT that the company may deduct in earlier periods is subject to the same overall limit as applies in the current period.

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plus ACT indefinitely[13] until it earns profits sufficient to produce the corporation tax bill it needs to offset the surplus ACT.[14]

3. Some illustrative figures

Many readers will be familiar with the operation of these rules but it may help others if I illustrate the basic rules before going further. I assume a UK resident company, A Ltd, in the hypothetical years 19X1, 19X2 and 19X3. This allows me to divorce my illustration of the basic rules from the changing detail of the imputation system and changing tax rates. I assume a corporation tax rate of 35 per cent and an ACT rate of 25 per cent. A Ltd carries on a manufacturing activity in the United Kingdom. In its accounting period to 31 December 19X2 it generates profits of GBP 5,000,000. It pays in April and October dividends of GBP 1,250,000 and GBP 500,000 respectively. It has a strategic investment in the shares of B Ltd (not a subsidiary), from which it receives a dividend of GBP 40,000 in November of that year.

A Ltd pays ACT as follows:	(GBP)
April dividend	1,250,000
ACT @ 25%	312,500
ACT paid on 14.7.X2	312,500
October dividend	500,000
ACT @ 25%	125,000
B Ltd dividend	40,000
Tax credit	10,000
ACT due on 14.1.X3 (GBP)	125,000
Less tax credit	(10,000)
ACT paid on 14.1.X3	115,000
A Ltd settles its final tax bill for the year as follows	
Taxable profits	5,000,000
Corporation tax @ 35%	1,750,000
Less ACT paid	(427,500)
CT paid on 1.10.X3	1,322,500

Now I assume that A Ltd borrows for a major investment in 19X1 and 19X2. Its additional expenditure on capital equipment, the financing costs and an unanticipated downturn in business reduce its taxable profits for 19X2 to GBP 1,500,000. It nevertheless chooses to maintain its dividends in anticipation of a recovery in its business. It must still pay ACT as detailed above but the ACT that it can deduct is limited as follows:

Notional dividend	(GBP) 1,200,000
ACT @ 25%	300,000
Taxable profits	1,500,000
Thus it pays on 1.10.X3	
Taxable profits	1,500,000
Corporation tax @ 35%	525,000
Less ACT paid, restricted to:	(300,000)
CT paid on 1.10.X3	225,000
ACT paid	427,500
ACT offset	(300,000)
Surplus ACT	127,500

4. Entitlement to the tax credit

Hand-in-hand with the liability to account for ACT goes the tax credit that is afforded to shareholders on their dividends.[15] The current provision entitling shareholders to a dividend is in Section 231(1) ICTA. It reads as follows:

> where a company resident in the United Kingdom [pays a dividend] and the person receiving the [dividend] is another such company or a person resident in the United Kingdom, not being a company, the recipient of the [dividend] shall be entitled to a tax credit equal to such proportion of the amount or value of the [dividend] as corresponds to the rate of advance corporation tax in force for the financial year in which the [dividend is paid].

UK company dividends are not liable to corporation tax and do not form part of a company's taxable profits.[16] They are within the tax credit regime as FII, as B Ltd's dividend in my example illustrates. For other shareholders Section 20 ICTA imposes a charge to tax on dividends paid by UK resident companies under what is known as Schedule F.[17] Schedule F paragraph 1 states that dividends are income[18] and, under paragraph 2, where a person is entitled to a tax credit on a dividend, the measure of taxable income is the aggregate of the dividend and the tax credit.

13. There are anti-avoidance provisions to prevent the owners of a company with surplus ACT selling the company to another company which has corporation tax liabilities, enabling the surplus ACT to reduce the acquiring company's corporation tax bill, see ICTA Secs. 245, 245A and 245B. After 5 April 1999 no further ACT can arise but companies will not be able automatically to set existing surplus ACT against their future corporation tax bills. A system of 'shadow' ACT will operate to prevent companies recovering more surplus ACT carried forward than they would have recovered had the ACT system continued, see The Corporation Tax (Treatment of Unrelieved Surplus Advance Corporation Tax) Regulations 1998.

14. ICTA Sec. 239(4). The aggregate ACT that the company may deduct in later periods is subject to the same overall limit as applies in the current period.

15. "Advance corporation tax and the shareholder's tax credit form the core of the new system; they are the essential link between the company's corporation tax and the shareholder's own tax liability. In this way a single rate of 'imputation' can be applied to all distributions regardless of the effective rate at which the company is liable to tax." *Reform of Corporation Tax*, Cmnd 4955 (April 1972), para. 9.

16. ICTA Sec. 208. From 2 July 1997 share dealers have had to include UK company dividends in their taxable profits, ICTA Sec. 95 as amended by Sec. 24 F(2)A 1997. For dividends from non-UK resident companies, see the next two footnotes.

17. Dividends paid by non-UK resident companies are foreign source income and liable to tax under Sch. D Case V.

18. Different rules apply to determine whether a dividend paid by a non-UK resident company is an income receipt (taxed under Sch. D Case V) or a capital receipt (liable to capital gains tax).

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If I assume that UK individuals own A Ltd's entire issued share capital, the aggregate amount charged to income tax in the tax year 19X2/X3 is GBP 2,187,500. This represents A Ltd's dividend of GBP 1,750,000 plus GBP 427,500 ACT paid by A Ltd and GBP 10,000 ACT paid by B Ltd.

Shareholders other than UK resident companies may claim to set the tax credit against their liability to income tax on their dividends. Section 231(3) ICTA, which confers this right, is as follows:

> a person, not being a company resident in the United Kingdom, who is entitled to a tax credit in respect of a [dividend] may claim to have the credit set against the income tax chargeable ... on his total income for the year of assessment in which the [dividend is paid] and ... where the credit exceeds that income tax, to have the excess paid to him.

Where the rate of ACT is 25 per cent the tax credit is equal to tax at 20 per cent on the aggregate of the dividend and tax credit. Thus, on aggregate income of GBP 2,187,500, tax at 20 per cent is GBP 437,500, equal to the combined ACT paid by A Ltd and B Ltd. If A Ltd's shareholders are solely UK individuals liable to tax at the higher rate of 40 per cent, the income tax calculation would be as follows:

Total income (GBP)	2,187,500
Income tax @ 40%	875,000
Tax credit	(437,500)
Further income tax to pay	437,500

B. A brief historical digression

Having outlined the basic imputation system that entered into force in the United Kingdom on 6 April 1973, I digress briefly to explain how the United Kingdom arrived at this result.

1. Income and profits tax

In the beginning, companies paid income tax on their profits in the same way as individuals who chose to conduct their business as sole traders or in partnership. Companies deducted income tax from their dividends at a rate known as "the standard rate of income tax". As the company would pay its dividends from a taxed fund – that is, from profits that had borne income tax – the company could retain the standard rate tax on the dividend. Shareholders credited the tax deducted by the company against their own liability to income tax on the dividends and were entitled to reclaim the tax if it exceeded that liability.[19] This basic system of dividend taxation operated from the reintroduction of the income tax in 1842 through to 1965.[20]

Since 1915 governments have imposed various additional levies on corporate profits. From 1937 the government levied a National Defence Contribution on companies, which in 1947 it placed on a permanent basis as profits tax. Profits tax survived until 1965 and between 1947 and 1958 was levied at a lower rate on undistributed profits. From 1958 until its abolition in 1965 profits tax was charged at a single rate on distributed and undistributed profits. Throughout profits tax had a classical relationship with the personal income tax, that is no part of profits tax was creditable against personal tax liabilities on dividends.

2. Corporation tax

In 1965, corporation tax replaced income tax and profits tax. Since then the tax on corporate profits has been a separate tax from those – income tax, surtax and capital gains tax – on personal income and gains. Corporation tax adopts income and capital gains tax rules for measuring profits but is otherwise independent of those taxes. The 1965 corporation tax system emphasized this separation by adopting a classical relationship to the personal income tax. Companies continued to deduct income tax at the standard rate from their dividends. But as they no longer paid their dividends from a fund that had borne income tax, companies had to account in every case to the Inland Revenue for the income tax they deducted from dividends at source. Companies could not credit the tax deducted against their corporation tax liabilities and individuals paid income tax on dividends at their personal income tax rate with credit for the tax deducted at source by the company.

3. The 1971 Review

In 1971 the government announced that it would alleviate the economic double taxation of corporate profits implied by the classical system. The development of corporate taxation in the EEC was to be one of the factors in the government's choice of system. It put forward three options:[21]

- A split-rate system.
- An imputation system.
- A return to the pre-1965 arrangements.

The third option was never seriously on offer and the choice lay between a split-rate and an imputation system.[22]

Following a report by a Parliamentary Select Committee the government opted for the imputation system, despite an early preference for the split-rate system. The Select Committee put its choice in these terms:[23]

> The arguments in favour of the imputation system spring basically from this country's position as an international trader and investor. All whom Your Committee questioned agreed that the imputation system was preferable to the two-rate system as a basis for the renegotiation of double taxation agreements.

19. The same system was used for yearly interest paid by the company on its borrowings. Piroska Soos describes the origins of this system in *The Origins of Taxation at Source in England*, IBFD, Amsterdam (1997). Shareholders could only recover tax at the net UK rate in the case of dividends paid out of foreign profits that had borne foreign tax, see note 22 below.
20. The system works well while shareholders pay tax on their dividends at a single rate. Inevitably matters become more complex once individuals are subject to progressive rates of income tax.
21. *Reform of Corporation Tax*, Cmnd 4630 (March 1971).
22. Under the pre-1965 system, when a company paid dividends out of foreign income that attracted double tax relief, the rules restricted shareholders' ability to recover income tax deducted at source. If it were otherwise, the United Kingdom would repay tax that had been paid to a foreign Revenue authority. This was known as the net UK rate system. See *Memorandum on the Choice between Alternative Systems* submitted by the Board of Inland Revenue to the Select Committee on Corporation Tax, Session 1970–71, Minutes of Evidence, at 1.
23. Report from the Select Committee on Corporation Tax, Session 1970-71, para. 24.

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4. The choice between split-rate and imputation

A split-rate system of corporation tax charges tax at a lower rate on distributed profits. The government recoups the tax by taxing shareholders. In a domestic context, you can achieve an identical result whether you adopt a two-rate or an imputation system,[24] as the following example drawing on the previous figures illustrates:

	Imputation (GBP)
Profits	5,000,000
ACT @ 25%	427,500
Mainstream tax	1,322,500
Dividends	1,750,000
Tax Credit	437,500
Received by shareholders	1,750,000
Taxable income	2,187,500
Tax @ 40%	875,000
Less tax credit	(437,500)
Further tax to pay	437,500
Total tax suffered	2,187,500

	Split-rate (GBP)
Undistributed profits	2,862,500
Tax @ 35%	1,001,875
Distributed profits	2,137,500
Tax @ 15%	320,625
Dividends	2,187,500[25]
20% withholding tax (437,500–10,000)	427,500[26]
Received by shareholders	1,750,000
Taxable income	2,187,500
Tax @ 40%	875,000
Less tax withheld	(437,500)
Further tax to pay	437,500
Total tax suffered	2,187,500

When shareholders are abroad, the total tax a government can collect in the case of a split-rate system rests on its ability to maintain its dividend withholding tax. In the example, A Ltd ends up paying in each case GBP 1,322,500 on its final assessment to tax for the period. Under the split-rate system, however, this is the total corporation tax on undistributed and distributed profits that A Ltd suffers. With an imputation system A Ltd's corporation tax bill is GBP 1,750,000 with a credit for GBP 427,500 already paid on account. It is more expensive for a country adopting a split-rate system to have to agree a reciprocal reduction in dividend withholding taxes than for a treaty partner that adopts some other form of corporation tax.[27]

The government, however, had other issues in mind when, in 1971, it favoured a split-rate system. It noted that:[28]

> The [split-rate] system maintains a firm line of demarcation between the corporation tax liability of the company and the income tax liability of the shareholder in a way that the imputation system does not, for under the imputation system what is at one stage part of the company's corporation tax bill becomes in effect a payment on account of the shareholder's income tax.

The government perceived that it would become more difficult to maintain the integrity of ACT as a minimum tax payment than it would be to maintain a dividend withholding tax as a tax on shareholders' income.[29] This proved correct. What the government anticipated was the international surplus ACT problem that emerged strongly in the early 1990s.[30] Business lobbied Ministers intensely that they should not pay ACT on the distribution of foreign profits that had borne tax abroad. As ACT was not unambiguously a tax on shareholders' dividends, Ministers found it difficult politically to resist the lobbying.[31] The solution was to allow companies from 1994 to pay their foreign profits as foreign income dividends or "FIDs".[32] Companies were allowed to reclaim the ACT on FIDs but shareholders received no repayable tax credit on FIDs.[33]

In relation to the choice of system in 1972, however, the government continued:[34]

> this does not affect the reality of the matter: both the [split-rate] and the imputation systems substantially avoid the double taxation of distributed profits – the feature of the [classical] system which has tended to divorce the interests of the company and the shareholder.

In reaching its conclusion, what weighed heavily in the Select Committee's mind was the UK's relations with the United States. The Committee noted:[35]

> [The US] Government has hitherto been unwilling to negotiate other than agreements giving "mirror-image" rates of withholding tax. A country using a two-rate system would be disadvantaged if it concluded such a treaty with a country using the type of system

24. "In many respects these two systems, though different in form, are in substance alike ... Under either system, therefore, the company would pay (whether corporation tax alone or corporation tax plus income tax on distributions) at effectively the same rate on the whole of its profits. Similarly, under either system the shareholder would receive a dividend effectively net of income tax, which in appropriate cases could be reclaimed." *Reform of Corporation Tax*, Cmnd 4630 (March 1971), para. 7.
25. This comprises the GBP 50,000 dividend from B Ltd which A Ltd passes on to its shareholders plus GBP 2,137,500 distributed from A Ltd's own profits.
26. A Ltd need only account for GBP 427,500. B Ltd will have accounted for the balance of GBP 10,000 when paying its dividend of GBP 50,000.
27. Other than a dividend deduction system, which can be regarded as a split-rate system with a zero rate of corporation tax on distributed profits.
28. *Reform of Corporation Tax*, Cmnd 4630 (March 1971), para. 9.
29. *Memorandum on the Choice between Alternative Systems* submitted by the Board of Inland Revenue to the Select Committee on Corporation Tax, Session 1970–71, Minutes of Evidence, at 4, para. 13.
30. For some companies with large overseas operations, international surplus ACT emerged almost immediately in 1973. For most companies, however, the surplus ACT problem in the 1970s and early 1980s was a domestic issue that arose from insufficient UK taxable profits due to high domestic tax reliefs. Surplus ACT became an international problem of the late 1980s and 1990s as the proportion of corporate profits comprising foreign income not liable to UK tax due to foreign tax credits increased.
31. Accounting rules, which require a company to write off irrecoverable surplus ACT against profits, compound the problem.
32. One might suppose that there was quiet satisfaction within the Inland Revenue that its prediction was proved correct. The FIDs system raised similar issues to those that led the government in 1971 to reject the net UK rate system, see *Memorandum on the Choice between Alternative Systems* submitted by the Board of Inland Revenue to the Select Committee on Corporation Tax, Session 1970–71.
33. As a result companies paying FIDs before July 1997 usually grossed up the payment for the lost tax credit. More companies have paid FIDs since 2 July 1997, as tax exempt pension funds can no longer recover the tax credit on dividends. The funds are indifferent between ordinary dividends and FIDs and companies can more freely pay FIDs as part of their surplus ACT planning. The FIDs system is abolished from 6 April 1999. Given the points made in the previous note, one may imagine that the Inland Revenue was happy to see an early end to the FIDs system.
34. *Reform of Corporation Tax*, Cmnd 4630 (March 1971), para. 9.
35. Report from the Select Committee on Corporation Tax, Session 1970-71, para. 13.

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> which obtains in the United States. The Federal German Republic when it adopted the two-rate system sought therefore to conclude agreements balanced in their fiscal effect rather than "mirror-image" in form. They did so successfully with many countries but not with the United States ... There can be no assurance that this country would succeed where Germany failed.

The essential similarity of split-rate and imputation systems means that there is no mirror image when you adopt an imputation system that has no withholding tax with which to negotiate. What you have done, however, is to collect the tax from the company before distribution. The difference is in the negotiating position – the difference between what you give back and what you seek to reclaim. As John Chown stated in evidence to the Committee:[36]

> if you adopt the imputation system, it is to the advantage of the other country to rush the negotiations and if you adopt the two-rate system it is to their advantage to sit on their hands, and you are negotiating from weakness instead of from strength.

The UK government in 1972 accordingly accepted the Select Committee's view and chose an imputation system. A split-rate system imposes a minimum corporate tax liability on profits and the imputation maintained this feature by limiting the amount of ACT that a company is entitled to deduct from its mainstream tax bill. In doing so it followed the position of income tax and profits tax.[37] Meanwhile, the obligation to pay ACT on dividends secured for the Treasury a continuing year-on-year positive cash flow from dividend payments.[38]

C. Taxing foreign shareholders

1. The denial of the tax credit

On a consistent basis with the choice of imputation rather than a split-rate system, the tax credit on dividends only extends automatically to UK resident persons.[39] There is no dividend withholding tax as such but the United Kingdom does not hand back ACT by offering to repay the tax credit to non-resident shareholders. Such shareholders are still in receipt of UK income charged under Schedule F but they are not liable to be assessed at the basic rate on their dividends.[40]

Foreign corporate shareholders are only liable to tax at the basic (now the lower) rate of tax and therefore have no further liability on their UK dividends. Foreign individuals could be liable to income tax at higher rates but in practice this liability was not usually pursued. In neither case, however, is there an automatic entitlement to a tax credit.[41] UK tax treaty negotiators were however granted the power to confer the tax credit on non-resident persons in agreeing a bilateral tax treaty.[42]

2. The 1975 United Kingdom–United States Double Taxation Convention

This power was first exercised in renegotiating the United Kingdom–United States treaty, which in 1975 established what has come to be regarded as the standard dividend article for UK treaties under the imputation system.[43] US portfolio investors in UK shares were granted the tax credit subject to a deduction of 15 per cent of the dividend and tax credit. Direct investors – those with at least 10 per cent of the voting stock – were granted half the tax credit subject to a deduction of 5 per cent of the dividend and half the tax credit. Based on my previous figures, this produces the following results:

	US Portfolio Investors (GBP)
Profits	5,000,000
ACT @ 25%	427,500
Mainstream tax	1,322,500
Dividends	1,750,000
Tax Credit	437,500
Total	2,187,500
15% deduction	(328,125)
Net payment from UK	1,859,375

	US Direct Investors (GBP)
Profits	5,000,000
ACT @ 25%	427,500
Mainstream tax	1,322,500
Dividends	1,750,000
Half tax credit	218,750
Total	1,968,750
5% deduction	(98,438)
Net payment from UK	1,870,312

The United States conceded similar reductions in its dividend withholding tax to 15 and 5 per cent respectively for UK portfolio and direct investors in the United States. The outcome for portfolio investors is no different to that under a split-rate system with a mirror-image reduction in the withholding tax to 15 per cent. By restricting the tax credit to half its normal amount the UK negotiators arrived at a 5 per cent mirror-image rate for direct investors. A similar outcome is

36. Minutes of Evidence, Question 257.
37. See the description of the Royal Commission on *The Taxation of Profits and Income*, Cmd 9474 (June 1955), Chapter 20, paras. 541–547.
38. The corporate tax rate was increased from 40 per cent under the classical system to 52 per cent under the imputation system. The delay in payment of mainstream corporation tax liabilities meant that ACT was an essential feature for maintaining the government's cash flow on moving from one system to the other. For the same reason, the abolition of ACT on 6 April 1999 is accompanied by the adoption of a regime requiring large companies to pay their estimated corporation tax bill in advance by instalments, see Finance Act 1998 s. 30.
39. FA 1972 Sec. 86(1), now ICTA Sec. 231(1).
40. FA 1972 Sec. 87(5), now ICTA Sec. 233(1). The basic rate replaced the standard rate of income tax in 1973/74 when income tax and surtax were combined into a unified system of income tax. The original language of FA 1972 Sec. 87(5) and of ICTA Sec. 233(1) referred to no assessment to income tax being made on the dividends. The statutory language has been changed so that Sec. 233(1) now treats the shareholder as having paid tax at the lower rate of income tax but states that no repayment of such tax may be made, see FA 1996 Sec. 122. This reflects the move in the personal tax system from Revenue assessment to self-assessment. Dividends became taxable at the lower rate rather than the basic rate of income tax in 1993/94.
41. Certain non-resident individuals who were entitled under other provisions to personal allowances against their UK income were also granted the tax credit, FA 1972 Sec. 98(1). From 1996/97 the entitlement to personal allowances and the tax credit was extended to nationals of those countries that are parties to the Agreement on the European Economic Area, see ICTA Sec. 278 as amended by FA 1996 Sec. 145.
42. ICTA 1970 Sec. 497(1) as amended by FA 1972 Sec. 98(2), now ICTA Sec. 788(3)(d).
43. It is no longer UK treaty policy to offer the tax credit in treaty negotiations. This new policy pre-dates the July 1997 changes to the imputation system. While the benefit of the tax credit is given under most treaties to portfolio shareholders, it only now extends to direct investors in the United Kingdom in nine cases.

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only possible under a split-rate with differential withholding tax rates.

3. The *Union Texas* Case

The Inland Revenue's interpretation of the dividend provisions of the United Kingdom–United States Double Taxation Convention[44] was challenged in *Union Texas Petroleum Corporation v. Critchley*.[45] The *Union Texas* case was concerned with the validity of the 5 per cent deduction under the direct investor provisions from the aggregate of the dividend and the half tax credit. Simplifying the detail somewhat, there were two basic arguments. The first was whether a payment equal to half the tax credit was a tax credit within Section 86 Finance Act 1972.[46] If the half tax credit was not a Section 86 tax credit, a US direct corporate investor would be entitled under the treaty to a payment equal to the half tax credit but would have no liability to UK tax.[47]

This argument failed. A half tax credit was still a tax credit.

The second argument proceeded on this basis. If a half tax credit was a tax credit the company was liable to UK income tax on the aggregate of the dividend and half tax credit. The treaty limited the tax to 5 per cent of that aggregate amount. There was, however, no authority under UK tax law to withhold tax from dividends.[48] This too was rejected. While there was no explicit power to withhold tax, a shareholder could claim repayment only of the excess of the tax credit over his liability to income tax.[49]

The Court of Appeal put the matter as follows:[50]

> The sense of [Article 10] is clear if the words "withheld" and "according to the laws of the United Kingdom" were omitted from the provision for deduction. That would leave standing, "subject to the deduction from such payment of an amount not exceeding 5 per cent of the aggregate of the amount or value of the dividend and the amount of the tax credit paid to such corporation." That is clearly, to my mind, what the deduction provision is aimed at.

Alternatively "withheld" can be construed as meaning "subject to the deduction to be withheld from such payment of an amount" etc., and the words "according to the laws of the United Kingdom" are to be construed as referring across to the Finance Act 1972 in general and in particular to Section 86(4) which shows how a tax credit under United Kingdom law is to be dealt with, that is to say outstanding tax chargeable on the taxpayer's income is to be set against the tax credit and only the excess is actually to be paid to the taxpayer. It may refer across also to the final wording in paragraph 2 of the new Schedule F ... which uses the words "equal to the aggregate of the amount or value of that distribution and the amount of that tax credit", and then proceeds to direct that "income tax under this Schedule shall accordingly be charged on that aggregate". Here, in (i) and (ii) of Article 10(2)(a) of the convention the deduction provisions set out the amount which the tax charged is, under the final words of Article 10(2), not to exceed."

III. THE UK IMPUTATION SYSTEM, THE FUTURE

A. The withdrawal of tax credit repayments

1. The 1997 changes

Section 231(3), which provides the authority for a shareholder to be repaid the tax credit,[51] benefited particularly tax exempt pension funds (including insurance companies in respect of their pensions business). Such funds hold more than half of the UK's quoted equity and their ability to be repaid the tax credit was of substantial value to them.[52] It provided an incentive for market arbitrage operations and for structuring transactions to transfer the tax credit from taxable to tax exempt shareholders.

From the outset legislation aimed to discourage such tax avoidance activity and to withdraw the benefit of the tax credit in blatant cases.[53] The 1997 changes resolve the matter finally by denying tax-exempt pension funds[54] and UK companies[55] the repayment of the tax credit.[56]

2. The 1999 changes

From 6 April 1999, further changes come into effect, as follows:

The tax credit on dividends reduces from 20 per cent to 10 per cent. As companies will no longer pay ACT on dividends, the tax credit is given without regard to the UK tax (if any) paid by the company.[57]

44. Double Taxation Relief (Taxes on Income) (The United States of America) Order 1980, SI 1980/568.
45. (1990) 63 TC 244.
46. Now ICTA Sec. 231(1).
47. See above FA 1972 Sec. 87(5), now ICTA Sec. 233(1). If Union Texas was not a person entitled to a tax credit, it could not be assessed to income tax at the basic rate and had no further liability to income tax.
48. The US–UK Treaty required the deduction to be made "according to the laws of the United Kingdom" and the taxpayer company argued that there were no relevant laws to permit deduction of the tax at source.
49. FA 1972 Sec. 86(4) now ICTA Sec. 231(3), set out previously. The taxpayer's main argument failed but it was successful in showing that the treaty required the half-tax credit to be grossed up at 5 per cent. The 5 per cent deduction was applied to the aggregate dividend and the grossed up half credit. The government reversed with retrospective effect this part of the court's decision, see FA 1989 Sec. 115.
50. (1990) 63 TC 244 per Dillon L.J. at 274.
51. See II.A.4. above.
52. The elimination of tax credit repayments netted the Exchequer some GBP 5 billion annually, although the Chancellor returned some GBP 3 billion of this through a reduction in the corporate tax rate from 33 to 31 per cent.
53. E.g. ICTA Secs. 235 and 703 and FA 1997 Sch. 7.
54. ICTA Sec. 231A in relation to pension funds with effect from 2 July 1997.
55. UK companies could reclaim the tax credit by claiming to set certain losses against their FII. This ceased for accounting periods beginning on or after 2 July 1997, F(2)A 1997 Sec. 20(1).
56. The new Labour Government made the change to remove what they saw as an incentive for companies to distribute rather than retain profits, thereby affecting investment. At the same time they reduced the corporation tax rate from 33 to 31 per cent.
57. Thus the rate of tax credit no longer corresponds to the rate of ACT. Instead there is a separate tax credit fraction which applies to dividends and which from 6 April 1999 is one ninth.

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There are special rates of income tax on dividends of 10 per cent and 32.5 per cent.[58] This reduction in the tax rates on dividends ensures that UK individuals face the same post-tax result on their dividends with a 10 per cent tax credit as they did with a 20 per cent tax credit and higher personal tax rates.[59]

As a general principle, no shareholder may reclaim any part of the tax credit.[60] The only exceptions are foreign shareholders who benefit from a treaty that allows repayment of the tax credit and, for five years, individuals in respect of shares held within an individual savings account.[61]

Large companies will pay corporation tax by regular instalments rather than by ACT instalments that depend upon their dividend payments.[62]

3. Taxation of foreign investors from April 1999

As the government's policy objective is to deny repayment of the tax credit entirely, it has had to address how it deals with inward investors who are entitled to repayment under a treaty. US considerations dominated the UK's choice of corporation tax system in 1971 and US considerations have dominated also the choices that have been made for 1999. The government thought it impossible just to abolish the tax credit. If it did so, the tax credit provisions of existing bilateral treaty dividend articles would cease to apply. The default provisions of dividend articles would take effect. In the case of UK direct investment into the United States the result would be an increase in the withholding tax rate on US dividends from 5 to 15 per cent.[63] At the same time, UK banks have issued in the US market significant amounts of Tier 1 preference share capital. The return on this capital is geared to the amount of the tax credit. The abolition of the tax credit would have raised the cost of this capital to UK banks.

The reduction in the rate of tax credit from 20 to 10 per cent ensures that portfolio investors under the standard UK treaty article receive no tax credit repayment. A dividend of 90 with a tax credit of 10, leads to a 15 liability on the aggregate of 100. The Act, however, restricts the UK liability to 10.[64] Direct investors still qualify for a relatively small repayment, as the following example illustrates:

	US Portfolio Investors (GBP)
Dividends	1,750,000
Tax Credit	194,444
Total	1,944,444
15% deduction of 291,667 limited to	(194,444)
Net payment from UK	1,750,000

	US Direct Investors (GBP)
Dividends	1,750,000
Half tax credit	97,222
Total	1,847,222
5% deduction	(92,361)
Dividends	1,750,000
plus tax credit repaid	4,861

B. The EC Parent-Subsidiary Directive

1. The abolition of withholding taxes

In this way, the UK government hopes to retain for UK investors overseas the benefit of lower dividend withholding taxes while denying the reciprocal benefit of the tax credit payment where a foreign shareholder remains entitled to one under a treaty.[65] The reduced tax credit mimics for foreign shareholders the virtual abolition of the tax credit and solves a trans-Atlantic problem. But within Europe its success depends upon the validity of the Inland Revenue's view that the 5 per cent reduction in the tax credit is permitted under the EC Parent-Subsidiary Directive.[66] Here lies in my last example the difference for an EC parent company between a repayment of GBP 4,861 and GBP 97,222.

Several commentators have written elsewhere on this issue[67] and I will not repeat the entire analysis. The Inland Revenue, necessarily, remains of the view that the Directive authorizes the 5 per cent deduction.[68] The received wisdom within the UK tax community has been to accept that view. But the substantive equivalence of split-rate and imputation systems should at least raise doubts about this conclusion. The two systems may offer different negotiating positions in bilateral negotiations. Taking the example in II.B.4. above, however,

58. This applies both to UK company dividends under Sch. F and foreign company dividends under Sch. D Case V.
59. A dividend of 80 plus a 20 tax credit gives income of 100 and a tax liability at 40 per cent of 40. The net receipt is 60. A dividend of 80 plus a tax credit of 8.89 produces income of 88.89 and a tax liability at 32.5 per cent of 28.89. The net receipt remains 60. This ensures that the government does not breach its pre-election promise not to raise personal tax rates.
60. F(2)A 1997 Sec. 30.
61. Finance Act 1998 Sec. 76.
62. Finance Act 1998 Sec. 30.
63. See Art. 10(1) of the UK–US treaty. The aggregate US corporate and withholding taxes would exceed the UK corporation tax, giving rise to excess foreign tax credits. Inward investment to the United Kingdom accounts for around two thirds of repayments the United Kingdom makes of tax credits.
64. F(2)A 1997 Sec. 30(10).
65. Governments are as adept at tax planning as anyone. The reduction in the value of the tax credit has been an on-going process since 1973 when the corporation tax rate was 52 per cent and the imputation rate was three-sevenths corresponding to a basic rate of 30 per cent. Previously, however, reductions in the tax credit have been associated with real reductions in personal tax rates on dividends. It is fair to note that the main UK corporation tax rate has reduced from 52 per cent when imputation was introduced in 1973 to 33 per cent for the financial year ending 31 March 1997 and to 30 per cent for the financial year beginning 1 April 1999.
66. Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, 90/435/EEC. The question currently arises under the UK's treaties with Belgium, Italy, Luxembourg, Netherlands and Sweden.
67. See e.g. de Hosson, "The Parent-Subsidiary Directive", *Intertax* 1990/10, at 414–437; McGregor, "Implementation of the EC Parent-Subsidiary Directive in the various Member States", 46 *Bulletin for International Fiscal Documentation*, 7 (1992), at 340; Graham, "The EC Parent-Subsidiary Directive and UK Advance Corporation Tax: Abuse by the Tax Authorities?" 32 *European Taxation*, 10 (1992), at 353-355; Raby, "National Implementation of the Parent-Subsidiary Directive: Some Problems and Opportunities Identified", *EC Tax Review*, 1992/4, at 216-223; Oliver, "Withholding tax and tax credits, with some reflections on Union Texas", [1991] *British Tax Review* at 245-247; Dietz, "ACT, Dividends and UK Withholding Tax: We Are Not Amused", 51 *Bulletin for International Fiscal Documentation*, 5 (1997), at 224-228.
68. See Inland Revenue, *EC Direct Tax Measures, A Consultative Document*, December 1991, at 21, para. 3.5.

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can a single market Directive have intended that there be a different outcome between a Member State that adopts the imputation approach and another that adopts the split-rate system? The *mechanisms* of different corporate tax systems ought not to affect the substantive outcome sought by the Directive.

2. What is a withholding tax?

Article 5 states quite simply that:

> 1. Profits which a subsidiary distributes to its parent company shall "be exempt from withholding tax".

Article 5 is both unconditional and sufficiently precise to have direct effect in Member States.[69] The Directive does not define the term "withholding tax". The Advocate General set out the commonly understood meaning of a withholding tax in his opinion in *Denkavit*. He referred to it as a tax "collected at source by the paying company on behalf of the tax authorities" and the arguments of the German and Greek Governments in that case focused on the classical form of a withholding tax as an obligation on the payer to deduct tax when making payment.[70] This was understandable given the issue in that case.

But it seems improbable that the Directive's use of the term "withholding tax"[71] should be limited in this way. Union Texas effectively argued for a restricted meaning of the term in the context of the United Kingdom–United States treaty and the Court of Appeal disposed of its argument with little difficulty.[72] In the case of the Directive, the restriction of the term "withholding tax" to tax collected by the payer through deduction from a dividend payment would imply that Member States remain free to tax dividends by direct assessment on the parent company but cannot do so by withholding.[73] But these are just different methods of collecting tax from shareholders. The objective of the Directive is to eliminate a substantive tax liability on the parent company, rather than just to restrict Member States' options for collecting tax.[74]

Article 4 of the Directive offers confirmation of this. It allows the parent company's state to tax distributed profits with credit for corporation tax borne by the subsidiary and those withholding taxes authorized by the Directive.[75] If the source state were allowed to impose tax by direct assessment on the distribution of the subsidiary's profits you would expect Article 4 to provide a credit for such tax. The assumption must be, however, that no such tax is permitted. Only those taxes for which credit is given remain.[76]

This conclusion receives support from the Explanatory Memorandum to the original 1969 proposal for a Directive.[77] This noted that:[78]

> profits which have already been taxed in the hands of the subsidiary are, upon distribution to the parent company, once more subjected to tax in the hands of the latter. The economic double taxation which results therefrom constitutes a fundamental obstacle to this form of concentration.

The Commission stated as a fundamental consideration the need to avoid economic double taxation and "thus to exempt profits which a parent company receives from its subsidiaries, from corporation tax in its hands". Given that exemption, the removal of withholding taxes at the subsidiary level followed because "the withholding tax is normally only an advance payment of tax, and there is no need to require such an advance payment where the recipient of the income is exempted from tax on such income."[79]

This suggests that the Directive is aimed at any tax arising by reference to distribution, irrespective of the collection mechanism. And the simple words of Article 5(1) support that view. The Article does not focus on the payment of dividends.[80] It speaks of the "profits which a subsidiary distributes to its parent company."[81] In other words, the Directive prohibits tax charged by reference to profits that the subsidiary distributes to its parent company.[82] Profits as such

69. *Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v. Bundesamt für Finanzen* (Joined cases C–283/94, c–291/94 and C–292/94) [1996] STC 1445. See the Advocate General's opinion at 1458, para. 51 and the Court's decision at 1466, para. 39. I refer hereafter to the case merely as *Denkavit*.
70. Advocate General's opinion, paras. 7, 30 and 32.
71. "Retenue à la source".
72. See II.C.2. above.
73. De Hosson in *Intertax* 1990/10 at 434 provides an example by reference to Dutch tax provisions.
74. The Directive is not limited to the elimination of second tier taxes imposed by a source country on subsidiary profits, as the derogations in favour of Germany and Greece illustrate. This is important in relation to the tax credit, which by definition represents the corporate tax imposed on the subsidiary's profits.
75. Namely, those permitted to Germany, Greece and Portugal. The derogations for Germany and Greece recognized the split-rate and dividend deduction systems operating in those countries, see the Preamble and Art. 5(2) to 5(4) Portugal was allowed to retain a withholding tax for budgetary reasons.
76. Where a parent company is denied a tax credit under an imputation system, the tax representing the credit qualifies as the subsidiary's corporation tax. Income tax imposed on the parent company by reference to the dividend and tax credit does not fit into Art. 4. See also note 85 below regarding surplus ACT.
77. Proposal for a Council Directive (with explanatory memorandum) concerning the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, submitted by the Commission to the Council on 16 January 1969 (COM(69) 6 final). While the detail of the final Directive differs in many respects from that of the draft Directive, the basic exemption from withholding taxes is unchanged, as befits what was the central purpose of the Directive.
78. Explanatory Memorandum para. 2.
79. Explanatory Memorandum paras. 5(a), & (b). The Commission's focus is not on eliminating economic double taxation as such as eliminating any extra tier of tax that may arise between parent and subsidiary, taking account of the further tax that may arise on further distribution by the parent company to its shareholders.
80. Contrast the terminology of the Art. 10 of the OECD Model Treaty. The Model Treaty does not refer to withholding taxes as such, suggesting that there is no accepted technical meaning to that expression.
81. "Les bénéfices distribués".
82. Thus, Art. 6 of the Directive also prohibits the parent company's state from levying tax on the distribution by the subsidiary. This does not prevent their inclusion as part of the parent company's profits (subject to credit) or the imposition of tax on their distribution by the parent company (unless that also falls within Art. 5(1)).

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are not exempt from tax. The source country may subject profits to corporation tax. Profits may not, however, be subject to a tax on their distribution. The term "withholding tax" distinguishes a direct tax on profits in the form of corporation tax from a tax imposed on profits by reference to their distribution.[83]

3. ACT

Article 7(1) supports this meaning. It states that the term:

> shall not cover an advance payment or prepayment (précompte) of corporation tax to the Member State of the subsidiary which is made in connection with the distribution of profits to its parent company.

A first point to note is that ACT is not a deduction or withholding from the dividend in the sense referred to in *Denkavit*. It is a liability to pay something in addition to the dividend.[84] Article 7(1) also recognizes that the characterization of the payment as source country corporation tax does not prevent it being a withholding tax within the Directive. It is a liability to tax that arises by reference to profits that the subsidiary distributes to its parent company. As such it is, in the sense I have explained, a withholding tax within Article 5(1). Article 7(1) ensures that the Directive does not affect a mechanism for collecting corporation tax that the United Kingdom remains entitled to charge, as contrasted with a tax charged by reference to profits that the subsidiary distributes to its parent company, which the Directive prohibits.[85]

4. The tax credit

Article 7(1) suggests that those who drafted the Directive thought that ACT would be a withholding tax but for Article 7(1). But the essential feature of an imputation system is that it gives a credit to the shareholder for the source country's corporation tax when a company distributes profits. The credit does not represent a second charge to tax on profits – it represents credit for corporation tax on the subsidiary's profits. But in that sense neither is the withholding tax under a split-rate or dividend deduction system a second tax charge on the profits. Put another way, the withholding tax under a split-rate system is equivalent to the corporation tax foregone by the source country.

As the choices made by the United Kingdom in 1972 illustrate, the credit is equivalent to tax withheld at source under a split-rate system. Like ACT the credit is not a deduction or withholding from the dividend and it represents tax imposed by the source state by reference to profits distributed to a parent company.[86] And as the UK government noted in 1971, "under the imputation system what is at one stage part of the company's corporation tax bill becomes in effect a payment on account of the shareholder's income tax."[87]

These observations could lead to the conclusion that Article 5 obliges an imputation country to repay its imputation credit (representing its corporation tax) to EC parent companies. Thus Hoechst AG could support its claim to the credit by reference to the Directive rather than the non-discrimination provisions of the UK–Germany treaty and the EC Treaty. And UK parent companies might claim to be repaid the German or French imputation credit. Article 7(1) entitles the United Kingdom to continue to charge ACT on a subsidiary's dividends[88] but without more the parent company could claim the mirror image of that tax – the tax credit.

Article 7(2) avoids that outcome for imputation countries by providing that:

> This 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 recipients of dividends.

In other words, the Directive does not affect domestic rules that determine when a shareholder is entitled to the tax credit and in particular can claim payment of it.[89] It authorizes the UK's denial of its tax credit to non-resident shareholders and allows it to restrict the tax credit to one half of the normal credit in the case of direct investors. It does not, however, derogate from the exemption from tax in Article 5.

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83. The broadest formulation of the term "withholding tax" could encompass corporation tax paid on the subsidiary's profits. A principal reason for taxing company profits is to act as a tax at source or withholding tax on the shareholders' income. This is particularly important in an international context where corporation tax on its domestic enterprises may be a country's only way of collecting tax on inward investment. The use of the term "withholding" (rather than just saying that distributed profits are exempt from tax) makes clear that Art. 5 is aiming at taxes arising by reference to the profits which the subsidiary distributes rather than requiring the source state to refund corporation tax charged by direct assessment on the profit pool from which the distribution comes. For the same sense of the term as used in the UK's unilateral relief see Sec. 790(5)(c)(i) ICTA, which refers to overseas tax charged on a dividend which represents tax that would not have been borne by the company or its shareholders but for the payment of a dividend.

84. It is a withholding tax in the sense of being a liability that falls on the subsidiary as payer rather than the parent company as recipient. For the reasons already given, I consider that the exemption under Art. 5 is not limited to taxes imposed on the payer rather than by direct assessment on the recipient.

85. There are arguments that surplus ACT arising on the distribution of profits derived from European subsidiaries is not within Art. 7(1) See Graham, "The EC Parent-Subsidiary Directive and UK Advance Corporation Tax: Abuse by the Tax Authorities?" 32 *European Taxation*, 10 (1992), at 353-355. These arguments turn on being able to say that the payment has a different character where the dividend comprises profits covered by foreign tax credits so that there is no domestic corporation tax liability. The FIDs scheme lends support to this view as a practical illustration of how ACT can be refunded in such cases to avoid the withholding nature of ACT. Consider the case of Austria and the Netherlands in *Denkavit* as illustrations of how practical solutions to issues may be relevant to the interpretation and application of the Directive.

86. This analysis does not depend so much upon the payment of ACT as on the liability to tax that arises on the shareholder when the profits are distributed. The analysis does not change when ACT disappears after 5 April 1999.

87. *Reform of Corporation Tax*, Cmnd 4630 (March 1971), para. 9, see II.B.3. above. This becomes explicit when, as under the UK system, the distribution of the profits triggers an obligation to account for corporation tax but ACT is not a necessary feature of imputation systems; see the previous note.

88. Although the inability of a UK subsidiary and the foreign parent company to receive dividends gross under a group income election (see II.A.1. above) may infringe the non-discrimination provisions of the EC Treaty, see Gammie & Brannan, "EC Law Strikes at the UK Corporation Tax – The Death Knell of UK Imputation?" *Intertax* 1995/8–9, at 389-405.

89. There is no reason why a Directive designed to eliminate economic double taxation should affect the application of domestic provisions (i.e. change the way in which they apply) designed with the same objective in mind, except by extending the domestic provisions in ways that were not intended. If the tax credit is equivalent to but is not a withholding tax, the Directive would not affect the application of domestic provisions at all. That could support the Revenue view that the only application to which Art. 7(2) can refer is to a domestic or treaty-based tax charge as part of the tax credit provisions. But Art. 7(2) does not say (as Art. 7(1) does for ACT) that a tax credit is not a withholding tax and you would expect a derogation from Art. 5 entitling a Member State to levy a withholding tax (as contrasted with not extending the credit) to be conferred rather more explicitly.

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In allowing countries to deny the benefit of the tax credit the Directive appears to distinguish split-rate from imputation systems. And there is a fine line between denying the tax credit and taxing the dividend with the tax credit. The reason why there is a line, however, is because a split-rate system incorporates a minimum corporate tax rate, which the Directive does not disturb.[90] But an imputation system does not explicitly incorporate that feature.[91] You can only infer the minimum corporation tax charge from the domestic provisions relating to the tax credit. As a result, the Directive deals with split-rate and imputation systems differently to preserve the minimum corporation tax charge on the subsidiary's profits. It does not authorize the levying of tax by reference to the distribution of profits to the parent company.[92]

Thus, Article 7(2) ensures that the exemption under Article 5 of profits from withholding tax does not extend the occasions on which a country must relieve economic double taxation, including the payment of the tax credit, beyond those contemplated by its domestic or treaty-based provisions. As such Article 7(2) complements Article 7(1). A subsidiary company cannot rely upon Article 5 to avoid payment of corporation tax when making a distribution nor can the parent company reclaim the corporation tax represented by the tax credit. It must continue to rely on domestic or treaty-based provisions for its entitlement to and payment of the tax credit.

5. The treaty deduction

The Inland Revenue's position relies on Article 7(2) not merely to deny an automatic entitlement to the tax credit but to justify taxing the dividend and tax credit.[93] This is on the basis that you must apply the entire treaty article — both conferring entitlement to the credit and authorizing its reduction, or allowing abatement in the tax credit entitlement.[94] And this is notwithstanding the specific exemption in Article 5 and the absence of an explicit saving for the UK position.[95] But this reads more into Article 7(2) than can be justified once you read Article 7(2) with Article 7(1) and take account of the source country's right to levy a minimum corporate tax on the subsidiary's profits.

Section 231(3) of ICTA simply states that a person who is entitled to a tax credit may set the credit against his liability to income tax for the year and be repaid the excess of the tax credit over that liability.[96] This wording has its counterpart in the standard UK treaty article, which refers to tax being charged according to the laws of the United Kingdom[97] and the excess of the credit over the liability to UK tax being paid to the shareholder.[98] As the parent company can have no liability to tax on the distribution of its subsidiary's profits, it may make a repayment claim (as any other non-taxable shareholder may do) for the full half tax credit.

From 6 April 1999 Section 231(3) will no longer permit UK resident shareholders to claim repayment of the credit. This does not, however, affect the entitlement of a non-resident person to claim repayment under a treaty provision.[99]

IV. CONCLUSION

The trend within Europe is increasingly away from imputation systems and towards the adoption of the dual income systems that have developed in the Scandinavian countries.[100] This reflects the difficulty of maintaining imputation within a single market. In this sense these changes in UK dividend taxation are consistent with the trend.[101] Nevertheless, the circuitous route that the United Kingdom has adopted for abolishing entitlement to the tax credit while leaving intact existing treaty arrangements, in my view ensures that 1999 does not mark the end of changes in UK dividend taxation.

At a domestic level it is difficult to believe that the special rates of tax for dividend income can remain in place long-

90. But as previously noted the Directive applies even when the minimum corporate tax rate on distributed profits is zero, i.e. a dividend deduction system operates as in Greece when the Directive was entered into.
91. Thus the German system gives credit for the entire corporate income tax, as has also been the case with the French imputation credit.
92. Once the source state has agreed under domestic provisions to extend the benefit of the tax credit to the parent company, any tax charge by reference to the distributed profits and tax credit is equivalent to the withholding tax under a split-rate system. This is consistent with Art. 4 of the Directive, see *supra* note 76.
93. Inland Revenue, *EC Direct Tax Measures, A Consultative Document*, December 1991, at 21, para. 3.5. *Denkavit* illustrates that general agreement among Member States on the meaning of the Directive does not suffice to justify a particular interpretation, especially where there are practical answers to the issue, in this case the retention by the United Kingdom of half the tax credit in the case of a direct investor.
94. See also *supra* note 89. The language of the UK–US Treaty better supports this view as it combines entitlement to the half tax credit and the 5 per cent deduction in a single provision, Art. 10(2)(a)(i). Subsequent treaties track more explicitly the language of ICTA Sec. 231(3), granting entitlement to the credit and imposing a charge to UK tax.
95. *Denkavit* illustrates the importance of the Art. 5 exemption. Parallels can be drawn with the absolute right to deduct input tax under the Sixth VAT Directive and the reluctance of the ECJ to allow any derogation from that principle: "The right of deduction provided for in art 17 et seq of the Sixth Directive is an integral part of the VAT scheme and in principle may not be limited ... Any limitation on the right of deduction affects the level of the tax burden and must be applied in a similar manner in all the member states. Consequently, derogations are permitted only in the cases expressly provided for in the directive." *BP Supergas Anonimos Etairia Geniki Emporiki-Viomichaniki kai Antiprossopeion v. Greece* (Case C-62/93) [1995] ECR I-1907 at 1914.
96. See II.A.4. above.
97. F(2)A 1997 Sec. 30(10) (limiting the deduction to an amount not exceeding the credit conferred on the shareholder) recognizes that tax may be charged or deducted although it also refers to the possibility of a reduction (rather than tax or deduction) in the amount of the tax credit. See Hughes, "Recent Changes to the UK Tax Credit Regime, the Abolition of ACT and Certain Related Matters", 52 *Bulletin for Fiscal Documentation*, 1 (1998) at 19-23.
98. This is the case in each of the Belgian, Dutch, Italian, Luxembourg and Swedish Treaties. The language in this respect differs from that used in the UK–US Treaty and in issue in the *Union Texas* case.
99. F(2)A 1997 Sec. 30(9). As previously noted, from 6 April 1999 the tax credit is unrelated to any corporation tax paid by the subsidiary. On balance this does not appear significantly to affect the arguments either way.
100. Ultimately the trend may prove to be towards exemption of dividends from tax altogether. In that sense the dual income systems may merely be a stage in the process of reducing dividend tax rates from a low single rate to zero, leaving any tax to be collected at the corporate level.
101. Even though not justified by the government on that basis.

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term. Internationally, the key to a cleaner abolition of the tax credit will be found in the renegotiation of existing treaties to replace the tax credit provisions of dividend articles.[102]

The principal difficulty in renegotiation is likely to lie across the Atlantic. The UK's freedom to resolve that issue in its own timescale and to its own agenda may depend upon how quickly it takes to resolve challenges under the Directive to the current and future arrangements for the tax credit.

102. The United Kingdom has, for example, already renegotiated the dividend article in its treaties with Denmark and Finland to eliminate entitlement to the tax credit. This raises the question whether the United Kingdom can withdraw the benefit of the tax credit selectively from parent companies in this manner rather than by altering its dividend tax system to affect all shareholders. This point has overtones of the most favoured nation arguments that some regard as resolved by the recent decision in *Gilly v. Directeur des Services Fiscaux du Bas-Rhin* (Case C-336/96), see Maugham, "Direct Taxation in the Community after Gilly", *Tax Journal*, (29 June 1998), at 15.

Conference Diary

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

OCTOBER

52nd IFA Annual Congress, London, the United Kingdom, 4-9 October 1998 (simultaneous translations into French, English, German and Spanish):

52nd IFA Annual Congress, Concorde Services Ltd, 10 Wendell Road, London W12 9RT, the United Kingdom, Tel.: 44-181-743 3106, Fax: 44-181-743 1010, E-mail:ifa@concorde-uk.com

Transfer Pricing and effective Tax Planning in China, Beijing Hilton, Beijing, China, 8-9 October 1998 (English):

*IBC Asia Ltd, No. 1 Grange Road #08-02 Orchard Building, Singapore 239693, Tel.: 65-732-1970, Fax: 65-733-5087, E-mail: laynah@ibcasia.com.sg*XIXth Congress on Latin American Tax Law, Lisbon, Portugal, 11-16 October 1998:

Associaçao Fiscal Portuguesa, Secretariado das XIX Jornadas, Rua das Portas de Santo Antao, 89, 1150 Lisbon, Portugal, Tel.: 351-1346-7494, Fax: 351-1322-4051.

Application of Tax Treaties, Amsterdam, the Netherlands, 21-23 October 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

International Tax and Financial Planning Forum 1998, Hotel Occidental Miguel Angel, Madrid, Spain, 26-29 October 1998 (English and Spanish):

IBC Global Conferences Ltd, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-453 5479, Fax: 44-171-636 6858 (Attn. Dora Walsh), E-mail: cust.serv@ibcuk.co.uk

Transfer Pricing Audits, Amsterdam, the Netherlands, 30 October 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

NOVEMBER

Accounting & Tax for Derivatives, London, the United Kingdom, 3-6 November 1998 (English):

Hilary McCann, Managing Director of Public Programmes, Euromoney Training, Nestor House, Playhouse Yard, London EC4V 5EX, the United Kingdom, Tel.: 44-171-779 8753, Fax: 44-171-779 8693, E-mail: euromoneyt@dial.pipex.com

The Taxation of Commercial Property, The Forum Hotel, London, the United Kingdom, 10 November 1998 (English):

Customer Service Manager, IIR Ltd., 6th Floor, 29 Bressenden Place, London SWIE 5DR, the United Kindom, Tel.: 44-171-850 5055, Fax: 44-171-850 5056.

International Tax Aspects of VAT, Amsterdam, the Netherlands, 19-20 November 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

Taxation for International Companies in Russia and the CIS, the Marriott Hotel, Vienna, Austria, 23-24 November 1998 (English):

Business Seminars International Ltd, Sussex House, High Street, Battle, East Sussex, TN33 OAL, the United Kingdom, Tel.: 44-171-490 3774, Fax: 44-1424-77 3334, E-mail:communications@bsisussex.co.uk

Tax Planning and the Euro, 86 Park Lane, Grosvenor House, London W1A, the United Kingdom, 24 November 1998 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

Taxation in Central and Eastern Europe, the Marriott Hotel, Vienna, Austria, 25 November 1998 (English):

Business Seminars International Ltd, Sussex House, High Street, Battle, East Sussex, TN33 OAL, the United Kingdom, Tel.: 44-171-490 3774, Fax: 44-1424-77 3334, E-mail:communications@bsisussex.co.uk

Offshore Tax Planning for Central & Eastern Europe and Russia/CIS, The ANA Grand Hotel, Vienna, Austria, 26-27 November 1998 (English):

Business Seminars International Ltd, Sussex House, High Street, Battle, East Sussex, TN33 OAL, the United Kingdom, Tel.: 44-171-490 3774, Fax: 44-1424-77 3334, E-mail:communications@bsisussex.co.uk

Ceny Transferowe w Polsce – Transfer Pricing, Hotel Bristol, Krakowskie Przedmiescie 42/44, Warsaw, Poland, 26-27 November 1998 and 26-27 January 1999 (English and Polish):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6913 (UK), 48-22-657 0401 (Polska), Fax: 44-171-878 6885 (UK), 48-22-657 0111 (Polska).

International Tax Planning Aspects of Doing Business with MERCOSUR, Amsterdam, the Netherlands, 27 November 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

School of Transfer Pricing, The Hampshire Hotel, London WC2, the United Kingdom, 30 November & 1 December 1998 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

DECEMBER

Double Taxation Relief: Practice, Theory and Planning, Amsterdam, the Netherlands, 10-11 December 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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BRITISH SOCIAL SECURITY AND TAXES: STRUCTURING THEIR INTERACTIONS

Dr David Williams

Dr **David Williams** is the general reporter for Subject II at the 1998 IFA Congress. Until earlier this year he was the Professor of International Tax Law at the Centre for Commercial Law Studies, Queen Mary and Westfield College, University of London. He now holds a visiting post there, and is a social security specialist. The views expressed here are personal and have no official status.

"And since to look at things in bloom,
Fifty springs are little room,
About the woodlands I will go,
To see the cherry hung with snow."

(A.E. Housman, A Shropshire Lad, ii)

The current form of social security in the United Kingdom was launched 50 years ago in July 1948. It followed in many details the cradle-to-grave model set out in the famous Beveridge Report. In 1998, the new government has raised fundamental questions about both how it should be funded and what it should provide. Most notably, the task of collecting compulsory social security contributions is being transferred from the Department of Social Security to the Inland Revenue. This is one aspect of the inevitable interactions between tax and social security.

I. INTRODUCTION

In 1948, Britain adopted a series of measures that followed the famous Beveridge Report.[1] These had the aim of making provision for all from cradle to grave. 1998 sees the 50th anniversary of the general social security system funded by specific national insurance (NI) contributions, along with the 50th anniversary of the universal free national health service, and the safety-net national assistance scheme (now called income support). It also sees a growing realization that the 1948 system cannot be sustained to 2048, and that major changes must occur.[2]

The social security budget alone has risen since 1949 from 14 per cent of government spending to a predicted level of over one-third of government spending in 1999. Total spending of all forms, including education, health, social welfare, and housing, is now significantly more than half of all public spending. In particular, the dependency ratio of pensioners to those of working age has shifted from about 1:4.5 in 1949 to 1:3.4 now and will be about 1:2.5 in 2048.[3] The debate about the shape of the necessary reforms also poses fundamental questions about how future social benefits should be financed, and how they should be delivered to their recipients.

In common with its northern hemisphere neighbours, Britain provides its citizens with a wide range of social benefits. These include state pensions for the retired and survivors, contributory and non-contributory benefits for the sick and disabled, universal help for families and young people, help for those injured at work, and help for the unemployed and others with no or low incomes. In addition, it provides a free health service and education for all from 5 to 16, and subsidizes the housing costs of over 4.7 million households.

How should the cost of these social benefits be funded? Should it be from earmarked premiums or contributions, and if so, who should pay them and on what basis? Should they be funded from general taxation, or regional taxes or levies? Or should the premiums and contributions, although compulsory, not be regarded as taxes at all? There are, of course, several answers to that question, any one of which may be regarded as the "right" answer. Britain is no exception in having no clear national view about what that "right" answer is.

The difficulty in answering the question about funding is compounded by another difficulty. What is the difference between a tax benefit and a social security benefit? This problem is also posed by recent British developments. In particular, the Chancellor of the Exchequer announced in the 1998 Budget that help for low paid working families was being transferred from a social security benefit called family credit (FC) to a tax benefit called working families tax credit (WFTC). Why? What is the difference?

II. NO ONE BRITISH ANSWER

The central assumption of the Beveridge Report was of "benefit in return for contributions, rather than free allowances from the state". However, the 1948 scheme continued the previous tripartite funding of most cash benefits: employer, employee and state. In recent years, other approaches to the problem of meeting the growing cost of benefits have had some influence. One is that pensions and other contributory benefits should be entirely funded by employers and employees, and not by the state. The subsidy to contributory benefits funded from the general taxation was withdrawn some years

1. The key elements were, however, not new. Social insurance was first adopted at national level in Britain by the National Insurance Act 1911. For an outline history, see the report noted at note 2.
2. The problems of our social security system were reviewed generally in a recent government report, *New ambitions for our country: A NEW CONTRACT FOR WELFARE, Command Paper Cm 3805*, March 1998.
3. The figures in this article are all drawn from the government report noted at *supra* note 2, which itself draws on figures published in the annual volumes of Social Security Statistics and the Government Financial Report that accompanies the annual Budget Statement.

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ago, causing a rise in contributions. But it has since been partly reinstated.

A second approach is that the state should withdraw from the arrangements to fund and pay social security benefits. Its role should be that of the regulator, not the provider. This has occurred with the transfer of the burden of paying sick pay for short term illness from the state to employers (who are required to fund and pay statutory sick pay). The third approach is that keeping the social security and personal tax systems separate is inefficient, and that they should where appropriate be merged. In particular, the distinction between "taxes" and "contributions" should be ignored.

III. MERGING THE TAX COLLECTORS

To the surprise of some commentators, it was announced this year that income tax and social security contributions are to be brought together at the point of imposition. In this 1998 Budget,[4] the Chancellor of the Exchequer announced that "My right honourable friend the Secretary of State for Social Security and I have agreed that the Contributions Agency will be transferred to the Inland Revenue with effect from April 1999. This is a government which does not simply talk about [reducing] the costs of bureaucracy and red tape but takes the decisive action necessary to achieve it".[5]

The Contributions Agency is the executive agency of the Department of Social Security (DSS) responsible for imposing and collecting contributions,[6] with the DSS maintaining an overall policy responsibility for both contributions and benefits. Throughout, a separate government department, the Inland Revenue (Revenue) has been responsible for collecting income tax. Since 1975, all contributions paid by employees and their employers, and the main contributions paid by the self-employed, have been earnings-related.[7] From that year the Revenue started to act as agent for the DSS in collecting some NI contributions. The effect of the merger will be to end that dual responsibility and to bring together the two agencies responsible for collecting tax and contributions from employers.[8]

The merger will complete a unification of collection procedures for PAYE income tax payments and NI contributions. Behind the unification lies a series of legislative and administrative changes to align the powers to administer, collect, and enforce payments, including penalty provisions and other procedural matters. From an employer's point of view, this will be a significant gain. One tax return will be needed for one set of officials rather than, as at present, separate returns to separate sets of officials with differing information requirements and enforcement powers.

IV. MOVING TO COMMON DEFINITIONS

The merger does not, however, result in the two levies having an identical basis. When NI contributions became earnings-related in 1975, no attempt was made to align the income base for contributions with that for income tax. In particular, a policy decision was taken not to apply contributions to benefits in kind.[9] At that time, the differences caused limited concern. This was partly because the contribution rates were low, and partly because they were capped so that they applied only to income up to a cap of about 1.5 times average earnings. Later, while the rates of income tax were dropping, the contribution rates were increased, and the cap was removed from the employer's contribution.[10]

The result of the increased impact of contribution liability, especially on those with high rates of pay, was a growth in planning to avoid and reduce NI contributions. A spiral started of more complex remuneration packages matched by more complex NI contribution liability law and more rigorous enforcement. In particular, use was made of "cashable" benefits in kind, such as investments in commodities, jewellery or rare wines, and targeted measures to prevent these forms of avoidance.

Over the last 20 years, dozens of differences emerged between the income tax treatment of non-cash benefits and the NI contribution treatment. While the two sides disputed who was responsible for the growing disparity and complexity, the result was increased sophistication both in liability rules and the problems of applying them to individual remuneration packages. The results of the opportunity to avoid were a loss of contribution income, a growth in compliance costs and, as anti-avoidance measures were put in place, a loss of certainty.

Another response to the pressure of contributions was a move towards self-employment. This is in part because the contributions payable by the self-employed in Britain are significantly lower than those payable by employees and their employers. In particular, there is a cap on earnings-related contributions by the self-employer but not, as noted above, for employers. The growing cost of NI contributions has rein-

4. Budget Speech by Gordon Brown, Chancellor of the Exchequer, 17 March 1998.
5. The transfer will require primary legislation which has not yet been published. This article is therefore based on government announcements.
6. These are usually referred to as National Insurance (or NI) contributions. They are imposed under the Social Security Contributions and Benefits Act 1992, with procedure provided under the Social Security Administration Act 1992.
7. Before then, the main contributions were flat-rate, and the income levels of employees were largely irrelevant to liability to contribute. The contributions were paid by the sale of revenue stamps that had to be stuck on a contribution card by or for anyone in work.
8. Almost all income tax on earnings (technically called emoluments, and charged to income tax under Schedule E) is collected by employers from their employees by deduction from earnings under the PAYE (Pay As You Earn) system. An adapted form of the PAYE system applies to the Class 1 NI contributions payable by employees and their employers on their cash earnings. Employers are also responsible for paying the Class 1A NI contributions on the value of company cars and Class 1B NI contributions due on sums covered by "PAYE settlements" – that is, sums agreed by employers and the IRC in respect of some non-cash benefits.
9. The United Kingdom is of course unusual in basing its NI contributions on a narrower income base than its income tax. The difference has been accentuated since 1973 partly because of the fiscal advantages of payments in kind. These apply alike to high earners (or, rather, their employers) and low paid earners.
10. The standard rate for employees has risen from 5.5 per cent of gross pay (with no permitted deductions) in 1975 to 10 per cent in 1999, and that for employers from 8.5 per cent to 12.2 per cent. During that time, the basic rate of income tax has dropped from 35 per cent to 23 per cent.

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forced other moves, such as down-sizing of firms and the availability of information technology, towards increased use of consultants, single member companies, and sub-contractors rather than employees.

The law dealing with the distinction between employment and self-employment is inevitably complex and may lead to different interpretations. One result was that different views were taken by the Revenue and the DSS about whether individuals were employees or self-employed. This added further to the compliance costs of employers.

In recent years, government has sought to reduce those differences and costs. A series of amendments to both income tax and NI contribution laws have removed several differences. Informal practices have been aligned. Minor differences with no significant policy justification have been targeted for removal. For example, different rules for claiming deductions for expenses or dealing with the value of certain benefits have been aligned. The process has been accelerated by the transfer of the British income tax system from being administered as an assessed tax to being a self-assessed tax. This put a premium on certainty and consistency.

The merger will remove other differences. The different interpretations of the status of employment will end, as one office will be taking the decision for both purposes. Audit policy and visits will become common to the two levies. Further, the approach to both enforcement and appeals will become common. This is likely to remove another unintended difference between the two levies, namely different appeal systems to deal with disputes about interpretation and application of the two laws. The result is likely to be considerable convergence in practice between NI contributions paid by employees and their employers, and the PAYE collection of income tax on employees.

A full merger of contributions and income tax, or a merger in all but name as in the Netherlands, is unlikely in the immediate future. Although it was recently recommended for consideration to government,[11] there is strong resistance in particular to the imposition of NI contribution liability on benefits in kind and other payments such as pension contributions. There is also political resistance to the public acceptance of a two-part basic rate of income tax for employees of 33 per cent on the employee with a further 10 per cent or more on the employer – although that is already in effect by other names. A higher basic rate of income tax is still seen by many electors and those they elected as unacceptable. The aim of successive governments has been the continued reduction in the basic rate of income tax.[12]

V. WHO SHOULD PAY?

The government has yet to decide on another aspect of the reforms announced in the 1998 Budget. A significant difference between income tax and Class 1 NI contributions is that income tax becomes payable at a higher earnings threshold than contributions. In 1998 this is GBP 81 a week rather than GBP 65. Over a million employees pay contributions but not income tax. The government would like to see them all removed from the scope of contributions and the thresholds unified. But removing people from contribution liability also removes their entitlement to statutory sick pay, the jobseeker's allowance for the unemployed, incapacity benefit for the long term sick and state retirement and survivors' pensions. While they would be entitled to payments of income support (the safety net benefit), this would sharply increase those with no earned rights to social security benefits. There is also a major cost to be met. For the time being, contributions payable by employers will start at the higher weekly figure, while those paid by employees remain based on the lower figure.

A further problem actively under consideration is how to fund pensions in the long term. British social security contributions have been kept lower than those in neighbouring states such as France and Germany partly because costs such as benefits for the disabled are met from general taxation, but also partly because pensions are less generous. But the value of the British state pension is slowly being eroded as wage inflation outstrips price inflation. This is because pensions are adjusted annually to reflect price increases not wage increases. Within the lifetime of many younger workers, the state pension, on current plans, will be worth less than 10 per cent of average earnings.[13] If the prudent aim is a pension of 50 per cent of earnings, then significant extra pension provision is needed.

Experts advise that measures need to be taken to encourage – or to compel – payments to other pensions, or to upgrade the state pension or safety net provision. There are several million people who do not belong to occupational or private pension schemes. Employers are not required to run a pension scheme, and employees are not required to belong to it if one is run. However, employees and their employers must then contribute to the state earnings related pension scheme (SERPS). In the longer term, SERPS will decline in value, and its coverage has narrowed. The self-employed may make their own arrangements, but are not compelled to do so. A further rise in pensioner inequality therefore seems likely.[14] Should the state provide for the non-pensioned or under-pensioned when they are no longer able to do so themselves, or should they be compelled to provide for themselves now, or should they be allowed, as we say in English, "to make their beds and lie in them"?

Government is currently contemplating these important issues. One outcome may be compulsion to pay for additional pensions, but not through the state system. Another may be to compel the division of pension rights between both partners of a former marriage. This raises the question whether a compulsory pension contribution is a tax, or not?

11. By the Taylor Report, a report prepared for the Chancellor by Martin Taylor of Barclays Bank, and published at the same time as the 1998 Budget.
12. This aim was stated (again) in the 1998 Budget.
13. The basic pension for a man on median earnings was about 25 per cent of average earnings in 1984, but declines to under 10 per cent by 2044 on current predictions. See the first report of the Pensions Provision Group established as part of the government's Pensions Review in 1997.
14. This is one of the conclusions of the Pension Provision Group – see *supra* note 13.

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Whichever answer is given, another question is whether we should maintain the major tax subsidy that has, in the past, supported those who take out pension or life assurance schemes. Government estimates show that more than GBP 30 billion a year is being paid in contributions to pensions by employees and employers, but that a further GBP 13 billion is added to this by tax relief on pension contributions and GBP 7 billion in a subsidy to private pension schemes paid from the National Insurance Fund (as a relief against NI contributions).

In addition to the full relief from tax of pension contributions to approved pensions, the funds themselves pay no tax. Under the British ACT (advance corporation tax) system, funds also received a refund for the tax credit paid with a dividend. Another announcement confirmed in 1998 was the abolition of the British ACT system. On 2 July 1997 retirement funds lost their right to a refund of the tax credit. This will reduce sharply the net return of pension funds from equity investments, and will reduce the tax subsidy of those funds accordingly. The British system also exempts some part of the pension itself from tax.[15] The extent to which this exemption, and the full exemption of pension contributions, will be maintained has been questioned by some, but no further measures to disentangle pension payments and tax support have been announced.

VI. INTERACTIONS BETWEEN BENEFITS AND TAX

The Labour government also announced another radical measure in the 1998 Budget – the abolition of a series of work-related social security benefits and their transfer to the income tax system.

The non-contributory and means-tested benefits are to be abolished. These are the family credit noted above and disability working allowance (DWA). FC is paid to many low paid workers with children if the worker's income is less than a set weekly level. DWA is a similar addition to low pay for those unable to take a full part in the job market because of severe disability.

These will be replaced by tax credits delivered by employers through the pay packet. The first of these schemes, the working families tax credit (WFTC), is announced for October 1999. Its initial target is 1.2 million low paid families, a significant rise from the number now receiving FC. A family with children will be able to claim WFTC if the earnings of the family are below a weekly threshold. In effect, they will receive a maximum weekly benefit which is withdrawn at a 55 per cent marginal rate as earnings rise above the minimum figure. A similar scheme can then be considered for the working disabled.

WFTC is seen as having a number of advantages compared with FC. It will be paid through the pay packet, and so will be seen as supporting the working parent as against the non-working parent.[16] It will be paid as an offset against PAYE, so delivery is by tax rebate rather than a separate system. It will, as with sick pay, reduce the role of the state to regulator rather than direct provider. This cuts public administrative costs (though there will be some burden on employers). It is likely that take-up by intended beneficiaries will be significantly better than that of FC because of problems such as lack of knowledge of the benefit. It should also increase the accuracy of delivery of the benefit while reducing the scope for fraud, so making the overall delivery more efficient. And it does so at the same time as reducing overall public expenditure.[17]

In practice the credit will work alongside another government measure, the minimum wage, to provide a safety net to all low paid families.[18] The minimum wage will prevent employers shifting the burden of paying the low paid on to the WFTC by reducing weekly pay in the knowledge that the state will make up the reduction through the WFTC. Both will be reinforced by the decision to reduce NI contributions payable for and by the low paid.

VII. REDUCING EXCESSIVE MARGINAL TAX RATES

The joint effect of these, and other measures, has another target: the poverty and unemployment traps. More formally, the problem is that of an excessive net marginal tax rate caused by the full set of income-based taxes and benefits interacting. This happens as income rises, or as welfare benefits are replaced by earned income. For example, the starting rate of income tax is 20 per cent, and the employee's NI contribution rate on those earnings is 10 per cent. But as income rises, so the employee loses housing benefit and FC at 70 per cent of net income. On a GBP 10 rise, the earner loses GBP 3.30 directly, and a further GBP 4.70 in benefit reduction. If other benefits, such as free medicines, are lost, the earner is a net loser.

The income tax, contribution and benefits systems are being reviewed together to remove disincentives to work. The traps are caused, as illustrated, by the interaction of increasing rates of taxes along with the withdrawal of benefits. All states with complex tax and social security systems have these traps. They frequently result in imposing the highest marginal rates of tax on the lowest paid. Several past reforms have been targeted on reducing the earnings trap, and it is rare in Britain for the low paid to face marginal rates of over 100 per cent. But the government still noted in 1998 that almost one in seven people that moved from welfare to work said they were worse off financially in work than unem-

15. This gives some aspects of pensions the "triple E treatment" – exemption for contributions, fund income and benefits.
16. This is part of the "welfare to work" aim of the government. The government is acutely aware that nearly 3 million children are currently growing up in workless households, and that this figure has increased sharply in recent years.
17. This is because the tax expenditure of WFTC is not counted as full public expenditure, while the present actual cost of FC will cease to be recorded as a cost. This is so although the real cost of WFTC is likely to be greater than FC. Other details, such as for example whether WFTC counts as income for NI contribution purposes, and whether there is a claw-back if there is a sharp increase in the income of a working family during a tax year, have yet to be announced.
18. At the time of writing, the legislation to impose a minimum wage has been adopted by Parliament, but the rate(s) had not been set.

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ployed. Systems elsewhere often interact to produce what are, in effect, cash incentives not to work. By contrast, the 1998 measures will further reduce the marginal rate for many working poor.

VIII. AN INTEGRATED FUTURE?

This brief review shows that much active consideration is being given in Britain to the interaction of tax and social security systems, and to the interaction of both with private pension provision. Thanks in part both to British demographic trends, and decisions of previous governments, we do not face a pensions funding crisis.[19] But we will need to reach important decisions about the long term funding of the costs of living longer. In the short term, recent measures have removed some of the barriers both to the low paid being in work rather than on benefit and the burden on employers of employing the low paid.

Integrating these systems in a way that ensures not only "welfare to work", but also "welfare after work" and "welfare to those who cannot work" will continue to challenge the ingenuity of all those involved.

19. British pensions funds are the largest anywhere in the world outside the United States of America. The Pension Provision Group estimated that about GBP 750 billion was invested in pension funds in Britain in 1995, and that 45 per cent of pension rights were funded (most of the others being public sector). It leaves Britain in a significantly stronger position than states with unfunded systems.

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SOME ASPECTS OF UNITED KINGDOM DOUBLE TAXATION RELIEF

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I. INTRODUCTION

Consider the following scenario.

A company resident in the United Kingdom earns 100 in royalties from a foreign country. The foreign country imposes a withholding tax at 25 per cent on the royalties. The United Kingdom company receives 75 net of withholding tax.

The royalties are included in the computation of taxable profits of the company for UK corporation tax purposes. Assume that the total income of the company, including the royalties, is 1000, and allowable expenses are 600. This gives a taxable profit of 400, which would be subject to corporation tax. Ignoring foreign tax credit for the moment, if corporation tax were at 30 per cent,[1] then the UK corporation tax liability would be 120.

The question is: how much foreign tax credit should the company be entitled to set against its liability to tax in the United Kingdom? Should it be:

25; or
12;.or
10;[2] or
another figure (between 0 and 25?)[3]

Looking at this question entirely unembarrassed by the wording of relevant legislation or any case law, there is much to be said in favour of the answer 25, at least from the taxpaying company's point of view. If the amount of foreign tax credit is 25, then the company's total tax liability for that year would be 120 (25 in foreign tax, and 95 UK corporation tax after allowing for the foreign tax credit). This is the same total amount of tax as the company would have had to pay if the 100 of royalties had been earned in the United Kingdom.[4]

Thus, if the amount of foreign tax credit were 25, this would achieve the magical result of capital export neutrality: the same overall tax burden would have arisen whether the income had a domestic or foreign source.

By contrast, if the amount of foreign tax credit were 12 – which is the most likely alternative candidate (for reasons discussed further below) – then the total tax suffered by the company would have been 133 (25 of foreign tax, plus 108 of UK corporation tax).[5] A higher overall tax burden would have been suffered because of the fact that part of the company's income derived from overseas and was taxed on the gross amount in the foreign country.

Looked at from the point of view of the United Kingdom fisc, however, the result appears rather different, and rather less attractive. If the amount of foreign tax credit is 25, then the total tax collection is divided so as to give 95 to the United Kingdom, and 25 to the foreign country. This is the case, even though nine-tenths of the company's profits derive from the United Kingdom, and only one tenth derives from abroad. Giving foreign tax credit at 25 in these circumstances shifts the benefit of tax collection significantly to the foreign fisc (and provides, at least in principle, an incentive for the foreign government to tax the gross amount of the payment at a not insignificant rate).

II. THE ISSUE: CALCULATING THE LIMIT ON FOREIGN TAX CREDIT

The issue that is illustrated by this scenario is a fundamental issue concerned with the operation of foreign tax credit. The issue is how one computes the limit on foreign tax credit.

Like most countries which provide relief from international double taxation wholly or in part by the credit method, the credit given in the United Kingdom is an "ordinary" or "normal" credit. That is, the credit is limited to a maximum, which is the amount of UK tax attributable to[6] the income which has been subjected to foreign tax.[7] In the scenario given here, the amount of income subjected to foreign tax is

1. Which is the general rate of corporation tax for the year beginning the 1 April 1999.
2. This would be the figure if one allowed as credit the amount of foreign tax on the "doubly taxed income". Here, 40 of profit is taxed both in the foreign country and in the United Kingdom (one tenth of turnover is from overseas, so one tenth of the profit may be apportioned to the foreign source). Foreign tax is imposed at 25 per cent, therefore the foreign tax on the doubly taxed income would be 10. This would be the result, in effect, if the 100 of royalties were derived by a permanent establishment in the foreign country, which bore a proportionate amount of expenses, thus generating a taxable profit of 40 taxable at 25 per cent. It appears that, at present, no one in the United Kingdom is contending for this result.
3. Clearly, in the absence of tax sparing, the foreign tax credit cannot exceed the amount of foreign tax imposed which is 25.
4. The company's taxable profit would still have been 400 and UK corporation tax on that at 30 per cent would have been 120.
5. 120 of corporation tax, minus 12 foreign tax credit.
6. Using a neutral term – it is the issue of how one attributes the UK tax which is at issue.
7. The Commentary to Art. 23 of the OECD Model, at para. 16, explains an ordinary credit as follows:
The deduction given by State R for the tax paid in the other State is restricted to that part of its own tax which is appropriate to the income which may be taxed in the other State: this method is called "ordinary credit".

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100. Applying the UK corporation tax rate of 30 per cent to this amount would give a limit to the tax credit of 30. However, the 100 of foreign income becomes part of a computation of trading profits in the United Kingdom. Because of expenses, the 100 of foreign income generates only 40 of profits taxable in the United Kingdom. The UK corporation tax on this amount is only 12. The issue is whether the "ordinary tax credit" limitation restricts the foreign tax credit to a maximum of 30 or to 12.

In a narrow sense, the issue is whether one computes the limit on foreign tax credit by reference to the gross amount of foreign source income, or to the net amount (after setting expenses and other deductions against that gross receipt). In the broader sense, the issue is whether in computing the limit on foreign tax credit one uses the foreign, source country's measure of taxable income (and applies to that the UK rate of tax) or whether one applies the UK measure of taxable income.[8]

This issue has been cropping up recently in a wide range of situations in the United Kingdom. Many of these situations have this in common: they involve the scenario where income is earned from overseas and is subject to tax imposed in the foreign country on the gross amount of the income; the foreign source income is then included in a United Kingdom computation of taxable profits of the worldwide trade of the UK-resident taxpayer.[9]

The situation is most commonly found where interest, royalties or technical service fees are earned from overseas (where they are taxed on the gross amount), but the interest, royalties or fees are included in a computation of the taxable profits of a worldwide trade for UK corporation tax purposes. The problem arises, in particular, for UK resident banks, insurance companies or companies exploiting industrial and intellectual property or technical skills and knowledge.

The issue is of significant importance to UK-resident companies deriving income from overseas. It is encountered regularly by such companies when they come to compute their foreign tax credit.

The issue is not, however, unique to the United Kingdom. It arises in many other countries where a computation of foreign tax credit is necessary.[10]

The issue is one upon which the United Kingdom Inland Revenue has changed its approach in recent years. The former approach was to accept claims for foreign tax credit subject to a limit computed by reference to the foreign country's measure of income. The current approach is to require the limitation on foreign tax credit to be computed by reference to foreign source income computed as for UK corporation tax purposes.

This change of approach is reflected in a number of statements in the Inland Revenue Manuals.[11] The Double Taxation Relief Manual[12] expresses the change – with respect to foreign branch profits – as follows:

> ...The approach is that, ..., the foreign tax on the foreign tax measure of the branch profits for a particular period is credited against, and up to the amount of, *United Kingdom tax on the United Kingdom tax measure* of the profits for the same period ...
>
> In the past we have accepted a different approach to the branch profit measure by taking the foreign commercial measure, ..., and applying the appropriate United Kingdom tax rate to that figure ... Adoption of the foreign commercial measure approach has only been accepted where it has been applied consistently. Following the decision in *Yates v. GCA International Limited* (64 TC 37) new cases based on the foreign commercial measure should not be accepted, although existing cases should not be disturbed. (emphasis added)

There are a number of other statements in the Revenue Manuals indicating a change of approach.[13]

What is rather intriguing is that certain legislation has been enacted in the recent past which proceeds on the assumption that the foreign measure of income may be employed. An example of this relates to the computation of the limit on foreign tax credit on interest on overseas loans, which was originally enacted in 1987.[14] This legislation limits the amount of foreign tax credit, and requires that the lender's financial expenditure is to be taken into account in computing the limit of foreign tax credit: underlying this legislation is the assumption that, absent these provisions, the limit of foreign tax credit might be computed by reference to the gross amount of interest.[15]

The reason generally given for the change in approach by the Inland Revenue is the decision in *Yates v. GCA International Limited*.[16] That case is discussed in greater detail below.

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8. Thus if the credit is for tax on the profits of a permanent establishment, the limit is computed by reference to the foreign measure of those profits.
9. Normally, a computation of worldwide profits on a Sch. D, Case I basis.
10. For a recent, German example, see Bundesfinanzhof, 9 April 1997, IR 178/1994, (1997) BStBl II, 657. This case is also printed, with a translation, in (1997) 1 *Offshore Financial Law Reports* at 843. In that case the taxpayer company carried on insurance business and held a portfolio of shares issued by companies resident in a number of other countries. Tax was withheld on dividends from those companies on the gross amount. Under the double taxation conventions with those countries, Germany provided relief from double taxation on dividends by the credit method. In computing double taxation relief, the company sought to credit the foreign tax withheld on the gross amount of the dividends. The German Tax Office disagreed, however, and argued that the tax credit should be computed by reference to a net amount, after deducting "economically attributable business expenditure". This significantly reduced the available foreign tax credit. The Bundesfinanzhof upheld the Tax Office in part, remitting the case to the Hessen Tax Court for further findings of fact. In essence, the Bundesfinanzhof held that the foreign tax credit should be computed by reference to the net amount, provided that the deductions were those incurred in producing the foreign source income.
11. These Manuals were originally produced as internal guidance for Inland Revenue staff. In recent years, the Manuals have been made publicly available. Several of the Manuals are extremely well written and interesting. For those persons interested in international taxation, the Double Taxation Relief Manual and the International Tax Handbook are especially good reads.
12. At para. 878.
13. See, for example, the Life Assurance Manual, para. 14.26, the Banking Manual, para. 8.16, and the Double Taxation Relief Manual at paras. 876 and 1451.
14. The legislation is now found in Sec. 798 of the Income and Corporation Taxes Act 1988, which was originally enacted as Sec. 65 of the Finance Act 1982 and Sec. 67 of the Finance (No.2) Act 1987.
15. What is a little intriguing is that these provisions have recently been re-enacted with substantial amendments by sections 103-106 of the Finance Act 1998. It is relevant to point out, however, that the enactment and amendment of the legislation was largely due to the development of a number of techniques for avoiding the previous legislation, and the desire to extend the previous legislation to exclude these techniques.
16. (1991) 64 TC 37; [1991] STC 157. This is not the only case cited as the reason for the change; reference has also been made to *George Wimpey International Limited v. Rolfe* 62 TC 597, though that case is not directly relevant to this issue.

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Before doing that, however, some discussion of the background to the history and basis for double taxation relief in the United Kingdom is necessary.[17]

III. BACKGROUND: A MODEST HISTORY OF UK DOUBLE TAXATION RELIEF[18]

Issues of relief from international double taxation seem first to have arisen in the United Kingdom in the context of estate duty. This led to the enactment of the first provision for relief from double imposition of estate duty within the British Empire.[19] This provision operated by granting a credit for the overseas estate duty against the UK duty on the estate. This also led, incidentally, to the first United Kingdom double taxation convention, with respect to succession and legacy duty, with the Canton of Vaud.[20]

Issues of double income taxation were not prominent until 1914. Not only were tax rates on income low, but foreign source income was generally taxable, if at all, only on a remittance basis. This changed in 1914, both with respect to the rates of tax and with respect to the basis of taxation.[21] During the First World War, representations were made to the UK Government about the impact of double taxation on income. This led to the introduction of a purely temporary measure of double taxation relief in 1916[22] under which, in effect, credit was granted for any "colonial" income tax, but subject to the restriction that the amount of UK income tax should not fall below 17.5 per cent.[23] That measure of relief was expressed to be for the current income tax year only, though it was extended in 1918.[24]

The question of double income taxation received a full discussion in the context of the Royal Commission on the Income Tax, which reported in March 1920.[25] The recommendations of that Commission on international taxation were accepted and formed the basis for the United Kingdom's approach to double taxation for over 25 years.

The Commission made a number of recommendations of principle. In particular, it drew a sharp distinction between double income taxation within the British Empire and with foreign countries. Within the Empire, the Commission concluded that there were a number of considerations which made the removal of double taxation an urgent necessity: "the sharing of common burdens, the common interest in the well-being of every part of the Empire, and the desire for free circulation of capital within the Empire".[26] With respect to foreign states, however, these elements were lacking. As a result, the Commission recommended that measures for relief from double income taxation within the Empire should be enacted, and this recommendation was acted upon.

With regard to foreign states, however, the Commission recommended that the only solution was reciprocal arrangements between the government of the United Kingdom and the government of each foreign state, and that such arrangements would only be practicable by means of a series of conferences, possibly under the auspices of the League of Nations. Pending such arrangements, the Royal Commission did not recommend any changes to the existing position as to double taxation with respect to foreign states.

Two consequences flowed from the Royal Commission. First, the United Kingdom enacted domestic law provisions for "dominion income tax relief".[27] The relief operated by reference to the rate of United Kingdom tax and the dominion rate of tax. If the dominion rate of tax did not exceed one half of the appropriate rate of United Kingdom tax then the rate applicable in the United Kingdom was reduced by the dominion rate of tax. If the dominion rate exceeded this limit, then United Kingdom tax was reduced to one-half of its normal rate. Since the relief operated by reference to the rate of tax, the issue of a limitation of foreign tax credit and the different bases for computation of the taxable amounts in the two countries did not arise.

The second consequence of the Royal Commission's recommendations was that, in practice, the United Kingdom did not enter in to any comprehensive double taxation conventions[28] providing for credit relief during the inter-war period. An agreement was entered into with the Irish Free State on 14 April 1926.[29] That agreement was in atypical form, providing in part for exemption for certain categories of income and extending dominion income tax relief to the Irish income tax. In addition, the United Kingdom entered in to a number of limited agreements relating to agency profits, shipping profits and, latterly, profits from aircraft operations, which provided for reciprocal exemption from tax.

An effective consequence of the acceptance of the recommendations of the Royal Commission was that relief from double income taxation by an ordinary tax credit was not a feature of the UK tax system prior to the Second World War.

17. Those readers who have grown up with unilateral and treaty relief, the "credit code" and the limitation of foreign tax credit in the United Kingdom – along with "Goldilocks and the Three HINWIs" and "Snow White and the Seven Non-domiciled Individuals of Diminished Stature" – may prefer to miss these background sections.
18. On this see R. Willis; "Great Britain's Part in the Development of Double Taxation Relief" [1965] *BTR* at 270.
19. Sec. 20 of the Finance Act 1894.
20. The Convention was agreed by a declaration of 1872. For those who have time and inclination, there is an extremely interesting file in the Inland Revenue records at the Public Records Office in Kew dealing with the termination of this Convention (file reference: IR40/13302). The file starts with a letter from the Swiss Embassy in 1928 relating to a British lady who had died domiciled in Vaud. It is followed by a proposal from the Swiss in 1949 to update the Convention, which prompts a response from the Secretary (Taxation) at the Treasury that he was previously unaware of the existence of the Agreement. The Agreement was terminated in the United Kingdom by an Exchange of Notes of 24 December 1957.
21. Sec. 5 of the Finance Act 1914.
22. Sec. 43 of the Finance Act 1916.
23. Three shillings and six pence in the pound, for those who remember that sort of thing.
24. By Sec. 22 of the Finance Act 1918.
25. The "Colwyn Commission, Cmd. 615 of 11 March 1920; double taxation is dealt with at paras. 67-83 of that Report, and in Appendix 1, at 168 to 173.
26. Para. 79 of the Report.
27. Sec. 27 of the Finance Act 1920.
28. UK legislation uses the general term "arrangement" for all forms of double taxation agreement or convention. This article employs the term now more widely used – double taxation convention.
29. The agreement is set out in Sch. 2 to the Finance Act 1926 of the United Kingdom.

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The first legislative provisions for relief by foreign tax credit were enacted after the conclusion of a double taxation convention between the United Kingdom and the United States on the 16 April 1945. At the time that this convention was signed, UK domestic legislation made no provision for computing the foreign tax credit. Such legislation was enacted in the autumn Finance Act in 1945.[30] This legislation first introduced what is known as the "Credit Code" of rules for computing the amount of foreign tax credit.

The legislation originally enacted in 1945 – which applied to income tax and excess profits tax or (national defence contribution) – has been subject to numerous amendments. In particular, the provisions were amended and re-enacted in 1947[31] and there were significant amendments in 1972 (consequent upon the introduction of the imputation system of corporate and individual income tax integration).[32] Certain of these amendments are referred to below.

The current Credit Code is found in Sections 792 to 806 of the Income and Corporation Taxes Act 1988. Despite the amendments over the years, it is still possible to trace a number of the provisions of the current Credit Code directly back to provisions of the first Credit Code in 1945.

The 1945 Credit Code was enacted as a consequence of the conclusion of the double taxation convention between the United Kingdom and the United States. Though the United Kingdom began actively negotiating double taxation conventions after the Second World War, by the end of the 1940s the United Kingdom still lacked conventions with a number of its major trading partners. For that reason, in 1950 the United Kingdom adopted legislation providing for unilateral double taxation relief.[33] This was the first provision for unilateral relief with regard to non-Commonwealth countries.[34]

The new unilateral relief tied in with the existing Credit Code in the following way. The Credit Code had originally been enacted on the basis that there was a double taxation convention with the foreign country concerned, and that an article in that convention established a right to credit for the foreign tax. The Credit Code then provided the method for computing that foreign tax credit. Unilateral relief was made to fit in to this scheme by operating as if there were a convention in force with the other country concerned. The terms of that notional convention were set out in the 1950 legislation[35] and that legislation made provision for the United Kingdom to grant a foreign tax credit. The Credit Code then operated – just as it would if there were an actual convention with the country concerned – to provide computational rules. Thus the Credit Code operates both for unilateral relief and for treaty relief.[36]

The operation of both treaty relief and unilateral relief under the Credit Code is discussed more fully next.

IV. BACKGROUND: ENTITLEMENT TO DOUBLE TAXATION RELIEF AND THE OPERATION OF THE CREDIT CODE

There is no entitlement to credit for foreign tax under UK law unless it is expressly provided for. Foreign tax may be deductible, for example, in computing the profits of a worldwide trade.[37] It may also be that foreign tax is deductible de facto where the UK resident's entitlement to foreign source income is only to the net of tax payment.[38] Relief by deduction of foreign tax is, of course, less attractive than relief by credit against the UK tax liability.

In the case of treaty relief – where there is a double taxation convention in force between the United Kingdom and the foreign country concerned – the entitlement to foreign tax credit arises under the "elimination of double taxation" article of the convention. These articles now follow a standard format,[39] an example of which would be as follows:[40]

> (1)(a) Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (which shall not affect the general principle hereof) and subject to sub-paragraph (b) of this paragraph,[41] [foreign country] tax payable under the laws of [foreign country] and in accordance with this Agreement, whether directly or by deduction, on profits, income or chargeable gains from sources within [the foreign country] shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the [foreign country] tax is computed.

The provisions of the double taxation convention need to be given effect in UK domestic law.[42] This is achieved by Section 788 of the Income and Corporation Taxes Act 1988, the relevant provisions of which are as follows:

30. Secs. 51 to 56 and Sch. 7 of the Finance (No. 2) Act 1945. This legislation first introduced what is generally known as the "Credit Code" which sets out the UK domestic rules for the computation of foreign tax credit.
31. Sec. 66 and Sch. 9 of the Finance Act 1947.
32. In particular, Sec. 100 of the Finance Act 1972.
33. Sec. 36 and Sch. 6 of the Finance Act 1950. For a discussion of unilateral relief, see (1981) 66B *Cahiers de Droit Fiscal International*, especially the United Kingdom report (by Harvey McGregor QC).
34. Initially, a difference was made in the ceiling of the relief between Commonwealth and non-Commonwealth countries, but this was subsequently removed.
35. And are now found in Sec. 790 of the Income and Corporation Taxes Act 1988.
36. A point which is particularly relevant, given that the major case on this area – *Yates v. GCA* – (which is discussed further below) was a case on unilateral relief.
37. See *Harrods (Buenos Aires) Limited v. Taylor-Gooby* (1964) 41 TC 450 where Argentinean substitute tax was held to have been incurred wholly and exclusively for the purposes of the taxpayer company's trade overseas. Most foreign taxes are not deductible under this principle since they are not incurred for the purposes of the trade, but rather are a tax imposed on the profits of the trade after that profit has been computed. For this reason, Sec. 811 of the Income and Corporation Taxes Act 1988 provides for relief by deduction of foreign tax where credit is not claimed or not available.
38. This is rather more contentious, and I am not aware of any case law on the subject. In principle, however, it seems to me to be correct if, under a contract for the payment of, for example, royalties the UK recipient is entitled only to a net royalty (after deduction of withholding tax) that UK tax can only be imposed on such sum as the UK taxpayer is entitled to – that is a net sum, after deduction of the foreign tax.
39. Which is significantly different from the format of Art. 23B of the OECD Model.
40. Based upon the United Kingdom–Singapore DTC of 12 February 1997.
41. Sub-paragraph (b) deals with underlying tax credit on dividends.
42. The United Kingdom adopts a "dualist" approach to public international law: treaties to which the United Kingdom is a party do not automatically take effect in UK domestic law, but require incorporation by domestic legislation.

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(3) Subject to the provisions of this Part, the arrangements[43] shall, notwithstanding anything in any enactment, have effect in relation to income tax and corporation tax in so far as they provide:

(a) for relief from income tax, or from corporation tax in respect of the income or chargeable gains; ...

(4) The provisions of Chapter II of this Part [the Credit Code] shall apply where arrangements which have effect by virtue of this section provide that tax payable under the laws of the territory concerned shall be allowed as a credit against tax payable in the United Kingdom.

Thus, in the case of treaty relief, the combined effect of the "elimination of double taxation" article in the convention and Section 788 brings in to play the operation of the Credit Code.

Where unilateral relief applies, the terms of the notional double taxation convention are contained in Section 790 of the Income and Corporation Taxes Act 1988. The relevant provisions of that section are as follows:

(3) Unilateral relief shall be such relief as would fall to be given under Chapter II of this Part [the Credit Code] if arrangements with the government of the territory in question containing the provisions specified in subsections (4) to (10) below were in force by virtue of Section 788 ...

(4) Credit for tax paid under the law of the territory outside the United Kingdom and computed by reference to income arising or any chargeable gains accruing in that territory shall be allowed against any United Kingdom income tax or corporation tax computed by reference to that income or gain ...

Thus, again, in the case of unilateral relief the terms of the Credit Code are brought in to play by the operation of the notional convention, the terms of which are set out in Section 790.

The terms of the Credit Code are now found in Sections 792 to 806 of the Income and Corporation Taxes Act 1988. The Code merits discussion in detail;[44] for our purposes, however, only two sections need to be quoted in full.

First, Section 793 gives effect to the credit:

(1) Subject to the provisions of this Chapter, where under any arrangements credit is to be allowed against any of the United Kingdom taxes chargeable in respect of any income or chargeable gain, the amount of the United Kingdom taxes so chargeable shall be reduced by the amount of the credit.

The second provision from the Credit Code which needs to be quoted is the limit on credit for corporation tax. There is a separate provision dealing with limit on credit for income tax which is worded somewhat differently than the limit for corporation tax.[45] The relevant provisions of the limit on credit for corporation tax are as follows:

(1) The amount of the credit for foreign tax which under any arrangements is to be allowed against corporation tax in respect of any income or chargeable gain ("the relevant income or chargeable gain") shall not exceed the corporation tax attributable to the relevant income or gain, determined in accordance with subsections (2) and (3) below.

(2) Subject to subsection (3) below, the amount of corporation tax attributable to the relevant income or gain shall be treated as equal to such proportion of the amount of that income or gain as corresponds to the rate of corporation tax payable by the company (before any credit under this Part) on its income or chargeable gains for the accounting period in which the income arises or the gain accrues ("the relevant accounting period").

(3) Where in the relevant accounting period there is any deduction to be made for charges on income, expenses of management or other amounts which can be deducted from or set against or treated as reducing profits of more than one description:

(a) the company may for the purposes of this section allocate the deduction in such amounts and to such of its profits for that period as it thinks fit; and

(b) the amount of the relevant income or gain shall be treated for the purposes of subsection (2) above as reduced or, as the case may be, extinguished by so much (if any) of the deduction as is allocated to it.

It is relevant to the discussion below to know that subsections (2) and (3) were inserted into the Credit Code when amendments were made in 1972 consequent upon the adoption of the imputation system of individual and corporate tax integration.[46] Previous to this amendment, the precursor of Section 797[47] was admirably brief:

The amount of the credit for foreign tax which, under any arrangement, is to be allowed against corporation tax in respect of any income shall not exceed the corporation tax attributable to that income.

That provision, in its elegant simplicity, can be traced right back to the earliest provisions of the Credit Code in 1945.[48]

It is around the operation of the limit on foreign tax credit for corporation tax – and Section 797 in particular – that much of the discussion revolves about computing the limit on foreign tax credit. One issue in that discussion is whether the various amendments since the limit was first introduced in the Credit Code have changed the computation of that limit from computation by reference to the foreign measure of taxable income to the UK measure.

The computation of the amount of foreign tax credit was one of the issues in the case of *Yates v. GCA International Limited*. It is to a discussion of that case that we can now turn.

43. As already noted, the UK legislation uses the term "arrangement" to apply to all double taxation conventions, however labelled.

44. Sadly, there is not space for such a discussion here. For a very good analysis of UK double taxation relief, see Rodney Taylor; *Tolley's Double Taxation Relief* (Tolley Publishing, Croydon, England, 1996: ISBN 1 86012 311/2).

45. The limit on credit for income tax is contained in Sec. 796. The text of Sec. 796 is as follows:
(1) The amount of the credit for foreign tax which, under any arrangements, is to be allowed to a person against income tax for any year of assessment shall not exceed the difference between the amounts of income tax which would be borne by him for the year (no credit being allowed for foreign tax but allowing for the making of any other income tax reduction under the Income Tax Act) –
(a) if he were charged to tax on his total income for the year, computed in accordance with Sec. 795; and
(b) if he were charged to tax on the same income, computed in the same way, but excluding the income in respect of which the credit is to be allowed.

46. See Sec. 100(4) and (5) of the Finance Act 1972. One may well wonder why the introduction of the imputation system required changes to the method of computing the foreign tax credit. This issue is discussed further below.

47. Sec. 505 of the Income and Corporation Taxes Act 1970.

48. Para. 6 of the 7th Sch. to the Finance (No. 2) Act 1945, which dealt with excess profits tax, and provided as follows:
The amount of the credit to be allowed against excess profits tax for foreign excess profits tax on any profits shall not exceed the excess profits tax attributable to those profits.

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V. WHAT DID *YATES V. GCA*[49] DECIDE[50]

There is a matter of some significance to explain before looking at the facts and analysis of this case, particularly for those for whom the English legal system is foreign territory. The case was originally decided by a Special Commissioner[51] sitting by himself, and was then taken on appeal to the High Court.[52] The issue of the computation of the quantum of foreign tax credit was not argued before the High Court, only before the Special Commissioner. The case is reported at the High Court level[53] and the Special Commissioner's determination is appended to the High Court judgment. Thus, though the issue of computation was not decided at the High Court level, one can see how it was decided at the Special Commissioner's level from the reports of the High Court judgment.

Gentle readers who come from countries other than the United Kingdom may be somewhat surprised to find that a significant change in practice with regard to the computation of foreign tax credit has been based on a single decision of a Special Commissioner sitting alone on a point which was not considered when the case in question went on appeal to the High Court.[54]

The basic facts of *Yates v. GCA* can be shortly stated. GCA International Limited was a UK resident company which carried on business as petroleum and natural gas consultants. In 1979 it entered into a contract with a Venezuelan company to carry out a technical study on three oil fields in Venezuela. Under the contract, GCA was to receive a total payment of USD 209,300. Part of the work on the contract was to be carried out in England, and part in Venezuela. The contract expressly broke down the consideration in to a figure of USD 161,000 for work performed in the United Kingdom and USD 48,300 for work performed in Venezuela.

Under the Venezuelan Tax Code, the payer was required to deduct and withhold tax – generally at a rate of 30 per cent – on 90 per cent of the gross receipts paid to GCA. This 90 per cent of the gross receipts was deemed to be GCA's net profit from the contract. Venezuelan tax was withheld on the entire consideration paid to GCA both for work in Venezuela and in the United Kingdom. The Venezuelan tax withheld amounted to a total of GBP 22,353.

At the time, there was no comprehensive double taxation convention in force with Venezuela.[55] GCA claimed unilateral double taxation relief by way of credit against its United Kingdom corporation tax liability for its accounting period ended 31 December 1979.

Various further figures which relate to the case will be mentioned below. However, it is interesting to note that the company's commercial profit before tax for the accounting period ending 31 December 1979 was GBP 25,577, and its taxable profits for UK corporation tax purposes (after adding back certain non-allowable deductions, such as depreciation) was GBP 40,995. Corporation tax on this figure at the then current rate of 52 per cent would have amounted to GBP 21,317 – if full credit had been granted for the entire amount of Venezuelan tax, then no UK corporation tax liability would have remained.

The company's tax inspector refused the claim to unilateral relief in its entirety, and the company appealed to the Special Commissioner.

There were three issues before the Special Commissioner:

- Whether the Venezuelan tax corresponded to United Kingdom corporation tax, this being a basic requirement of unilateral double taxation relief?
- Whether the Venezuelan tax was imposed on "income arising in" Venezuela (and if so how much of that income was so arising)? Again, this is a requirement of unilateral relief contained in Section 790(4) of the Income and Corporation Taxes Act 1988; and
- What was the quantum of the foreign tax credit?

It is only the third issue that is of interest to us here.

For the record, the Special Commissioner held that the Venezuelan tax corresponded to UK corporation tax, but that only part of the tax was tax on income arising in Venezuela. So far as the amount arising in Venezuela was concerned, the Special Commissioner adopted the apportionment contained in the contract with the Venezuelan company, and held that USD 48,300 was for work done in Venezuela (and, hence, arose in that country) while the remaining USD 161,000 was for work performed in the United Kingdom.[56]

Again for the record, the Inland Revenue appealed against the first of these findings, and the taxpayer cross-appealed against the second (arguing that the entire consideration under the contract should be regarded as income arising in Venezuela). Scott J. in the High Court upheld the Special Commissioner on both points.

49. I have been greatly assisted in preparing this section of this article by discussions both with Michael Flesch QC – who appeared for the taxpayer in the High Court – and Ian Richards who appeared both before the Special Commissioner and the High Court. There is an excellent analysis of all of the issues in the Yates case by JDB Oliver; "Unilateral Relief: The Issues in *Yates v. GCA*" [1993] *BTR* at 201.

50. May I at this point welcome back those for whom the history of UK double taxation relief and the Credit Code are second nature.

51. In effect, a specialist tax judge.

52. In fact, both parties appealed against elements of the Special Commissioner's determination.

53. Both in Tax Cases – 64 TC 37 – and in Simons Tax Cases – [1991] STC 157. The Inland Revenue have also cited the case of *George Wimpey International Limited v. Rolfe* as authority for the change in approach. Though that case is not inconsistent with *GCA*, it would of itself not provide authority for the new approach.

54. In fact, one can go a little bit further than that – the decision of the Special Commissioner on this point occupies only two pages in the Tax Cases report and, if one excludes quotation from legislation and from judicial authority, it stretches to little more than 20 lines of text.

55. A convention of the 11 March 1996 has now been concluded between the United Kingdom and Venezuela.

56. So that Venezuelan tax that related to income arising in the United Kingdom would not be allowable for credit.

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The third issue of the quantum of foreign tax credit was decided only at the level of the Special Commissioner, and was not an issue in the case before the High Court.[57]

So far as the quantum of foreign tax credit was concerned, it will be recalled that the amount of Venezuelan tax withheld by the payer was equal to GBP 22,353. Of this, the Special Commissioner held that only GBP 571 was available for credit against the company's UK corporation tax liability.[58] The interesting issue is how the Special Commissioner reached this conclusion.

The solicitor acting for the Inland Revenue presented his argument on this point on two alternative bases. The first basis relied upon the provisions of the limit to foreign tax credit for corporation tax now contained in Section 797 of the Income and Corporation Taxes Act 1988.[59] In his contention, this required the credit to be limited so that it did not exceed a figure produced by applying the rate of corporation tax to the amount (as measured for UK corporation tax purposes) of the income upon which the foreign tax eligible for credit relief was levied.

The alternative basis relied upon what is now Section 790(4) of the Income and Corporation Taxes Act 1988[60] which is the provision of the notional double taxation convention under which the entitlement to foreign tax credit arises in the case of unilateral relief. Under this argument, credit for foreign tax would be allowable only against UK corporation tax computed by reference to the same income by reference to which the foreign tax eligible for credit relief was computed.

Both of the approaches propounded by the solicitor for the Inland Revenue reached the same result – that is GBP 571. Both approaches required that one started with the taxable income *as computed for UK corporation tax purposes:* that is, the net income of the company for the accounting period in question, after having set against that income the expenses allowed under UK tax law.

In effect, both approaches taken by the Inland Revenue began by seeking to determine how much of the UK taxable profits of GBP 40,995 was attributable to the work performed in Venezuela. In the absence of more detailed information about expenses, the Revenue's approach was to take this profit figure, and to allocate it to Venezuela on a basis proportional to the turnover derived from Venezuela.

Total turnover of the company for the accounting period in question was GBP 839,498. Of this turnover, USD 48,300 (which translated into GBP 22,464) was for work performed in Venezuela.[61] Thus approximately 2.675 per cent of the turnover for that year derived from work performed in Venezuela. Applying this proportion to the UK taxable profit, GBP 1,097 of the UK taxable profit arose from the work performed in Venezuela. Applying the UK corporation tax rate of 52 per cent to this figure produces the maximum amount of foreign tax credit of GBP 571.

Both arguments of the Revenue reached the same financial result, though starting from different bases in law. What is somewhat surprising is that the Special Commissioner preferred the second of the Revenue's arguments to the first.

The first argument, it is to be recalled, was based upon the limits on credit for corporation tax provision, now found in Section 797. The Special Commissioner preferred the argument, however, which derived from the provision which actually creates the right to a foreign tax credit (that is Section 790(4) – which creates the right to unilateral relief). The Special Commissioner's reasons for preferring the second argument are not entirely apparent. They relate primarily to an amendment to the wording of Section 790(4) which originally read "credit for tax paid under the law of the territory outside the United Kingdom *in respect of* income arising in that territory shall be allowed against United Kingdom income tax or profits tax *chargeable in respect of* that income".[62] The words in italics were changed in 1967[63] to read "computed by reference to". It is hard to see how this change could have been intended to create a limitation on the amount of foreign tax credit.

What is particularly difficult to accept about the decision of the Special Commissioner is that Section 790 – which is the section which creates the right to a foreign tax credit – also operates as a limit on the amount of that credit.[64] If there is an argument for the Revenue's view on this matter, it would seem that the first argument, based on Section 797, has the greater chance of success.

Sadly, the issue of the computation of the limit to foreign tax credit was not taken when the case went on appeal to the High Court. At present, the statements of the Special Commissioner remain the only judicial authority on this point.

One thing is clear from the decision of the Special Commissioner. He accepted an approach to the computation of the

57. Some of the background to the appeal is of interest here. It is understood that the taxpayer company was not itself minded to take an appeal against the decision of the Special Commissioner. However, the Inland Revenue were very concerned to have a reported judgment on the first issue of a corresponding tax, in particular. The Inland Revenue funded Counsel to appear to argue the case from the point of view of the taxpayer. Since the primary purpose of the Inland Revenue was to obtain clarification of the point concerning corresponding foreign tax, that formed the central issue of the appeal, with the second issue of the source of income being taken along with it. It was decided not to argue the issue of quantum before the High Court. In practice, it now appears that the decision on the question of quantum has had a more significant, broader impact than either of the two issues which were taken before the High Court.

58. The point will be made again later, but it is worth noting at this point that the company would have suffered a total tax burden in the relevant accounting period of GBP 43,099 (52 per cent UK corporation tax on a taxable profit of GBP 40,995, less GBP 571 foreign tax credit, plus Venezuelan tax of GBP 22,353); this in an accounting period when the group's commercial profits were GBP 25,577. The company could have elected against any credit under s. 811 ICTA 1988, in which event the UK tax would have been GBP 9,694 and the total tax (UK and Venezuelan) GBP 32,047. I am indebted to Mike Waters of the Inland Revenue, International Division for pointing this out.

59. But at the time contained in the combined provisions of Sec. 505 of the Income and Corporation Taxes Act 1970 and the Finance Act 1972, Sec. 100.

60. But which was at the time Sec. 498(3) of the Income and Corporation Taxes Act 1970.

61. USD 209,300 (which translated as GBP 97,345) was the total payment under the contact with the Venezuelan company, and, applying the attribution of income in the contract, USD 48,300 (which translated into GBP 22,464) was for work performed in Venezuela.

62. See para. 1 of the Seventeenth Sch. to the Finance Act 1952.

63: By Sec. 36 of the Finance Act 1967.

64. It also has as a consequence that the rule may be different for treaty relief – as opposed to unilateral relief – where the wording of the relevant article may differ from Sec. 790(4).

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foreign tax credit which began from the chargeable profit of the company as computed for UK corporation tax purposes. Thus, the limit was applied to the net amount of income of the company, computed under UK principles, and not to the gross amount of income to which the Venezuelan tax rate had been applied. It is this element of the decision that has led to the change of approach and the consequences mentioned earlier.

In the final part of this article, I discuss which of these approaches is correct.

VI. THE ARGUMENTS FOR AND AGAINST COMPUTING FOREIGN TAX CREDIT BY REFERENCE TO THE FOREIGN MEASURE OF INCOME OR THE UK MEASURE

Leaving aside *Yates v. GCA*, and the authority that it has, the strongest textual argument in favour of computing the limit on foreign tax credit by reference to the UK measure is Section 797 of the Income and Corporation Taxes Act 1988. Subsections (1) and (2) of that section[65] can be regarded as neutral on this point. However, subsection (3) deals with the allocation of certain deductions when calculating the limit on foreign tax credit. The deductions concerned are those which are set against total income, after the amount of taxable profits has been computed. In that respect, they do not bear directly on the question of whether it is the gross income or the net profit. However, if it is not the UK measure of chargeable income which is used as the basis for computing the limitation, then why should there be any reference at all to the allocation of deductions to different categories of income? If the limit on credit is to be computed by applying the UK corporation tax rate to the foreign measure of income, then such deductions are surely irrelevant.

There is some strength to this argument, even though it was not the argument accepted by the Special Commissioner in the *GCA* case. However, it has as an implication that the law may have been changed when Section 797(3) was added in 1972. It is to be recalled that this was added at a time when the imputation system was introduced.

Something of a light on this issue can be thrown by reference to two historical documents relating to Section 797.

The first of the documents concerned the amendment which was made in 1972 and which led to what is now Section 797(3). This change of law followed the publication of a Government Green Paper[66] and a White Paper[67] which contained notes to the proposed legislation. A general introduction to that White Paper explains the new provisions relating to international matters as follows:

> The new corporation tax has been so devised as to give as generous treatment as possible, within the framework of the tax, to trading income from overseas. For double taxation relief purposes any deductions from corporation tax profits will be set against domestic profits in priority to overseas profits (Clause 95(5))[68] and advance corporation tax will be apportioned against the corporation tax on domestic income in priority to that on overseas income (Clause 95(6)).[69] ... In consequence as much UK tax as possible will be attributed to the foreign profits and the scope for tax credit relief maximised.

There is certainly nothing in this explanation of the proposed legislation which suggests an intention to introduce a fundamental change to the way in which foreign tax credit was to be computed. Quite the contrary, this suggests that the proposals were intended to ensure the maximum utilization of foreign tax credit.

One other historical source suggests, however, that from the outset the intention was to compute the limit of foreign tax credit by reference to the net amount of profits, computed on UK taxation principles.

It will be recalled that the origins of the Credit Code lie in legislation introduced in 1945. The Notes to Clauses[70] to the autumn Finance Bill in 1945[71] (which originally introduced the limit on foreign tax credit for income tax)[72] contain the following statement:[73]

> 7. The limit of credit is measured by the effective rate on the foreign income *as computed for United Kingdom tax purposes*,[74] regardless of the amount of the assessment in the foreign country. Suppose the trader's United States profits are assessed at GBP 1,000 in the United States, tax (at 40 per cent) GBP 400; and suppose that the United Kingdom measure of the same profits is GBP 900 tax (at 9 shillings)[75] GBP 405; then the whole of United States tax is allowed as credit and only GBP 5 is paid in the United Kingdom. This gives a fairer result to the trader than the rule for Dominion Income Tax relief, under which the relief is always calculated on the lower of the two assessments at the lower of the two rates; i.e. the relief in the example given would be only GBP 900 at 40 per cent equals GBP 360.

What this statement indicates is that those who prepared the original Credit Code were alive to the issue of the different bases for computing profits for purposes of the limit on credit. The example given clearly relates to the computation of the limit by reference to the net amount of profits, and specifically refers to the profits as computed for United Kingdom tax purposes.[76]

65. Quoted above.
66. Reform of Corporation Tax, March 1971, Cmnd. 4630.
67. Reform of Corporation Tax, April 1972, Cmnd. 4955.
68. Which eventually became Sec. 797(3), with amendment from the original draft.
69. Which eventually became Sec. 797(4) ICTA 1988.
70. The Notes to Clauses are guidance notes prepared within the Government indicating the intention behind the proposed legislation. In earlier years, these Notes to Clauses were made available only to Government Ministers and to others involved in the Parliamentary process. In recent years, the Notes have been made publicly available. The Notes to Clauses for earlier years, before they were made available to the public, can be consulted at the Public Records Office, where they are part of the bound volumes of Parliamentary material relating to each year's Finance Bill. These are catalogued under the reference IR 63.
71. Public Records Office, IR 63/174 at 190.
72. Para. (4) of Sch. 7 to the Finance (No.2) Bill 1945.
73. Para. 6 of Sch. 7 to the 1945 legislation introduced the limit of foreign tax credit for excess profits tax, which subsequently became the limit now found in Sec. 797(1) of the Income and Corporation Taxes Act 1988. The Notes to Clauses state that para. 7 was intended to achieve the same result as the limit on credit for income tax. Thus, the example quoted would also have been intended to apply to excess profits tax (and to corporation tax subsequently imposed).
74. The italics are in the original.
75. Now 45p – or 45 per cent.
76. Under present law these Notes to Clauses are not material which could presently be relied upon in argument in court as an aid to interpretation of legislation: see *Pepper v. Hart* [1992] STC 898 and the limited category of materials discussed there.

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What also appears from the example, however, is that the draftsmen did not make specific reference to the issue touched on in the scenario at the start of this article: where foreign tax is imposed on the gross amount of income, but the income then becomes part of a UK computation of trading profits.

Looking more broadly than UK domestic material, the issue of computing the limit of an ordinary foreign tax credit is touched on in the Commentary to Article 23 of the OECD Model. The discussion supports a view of the limit based on the net profit figure, but does not directly address the issue of the foreign measure of profits. The Commentary makes a number of significant points:

> 62. According to the provisions of the second sentence of paragraph 1 of Article 23B, the deduction which the State of residence (R) is to allow is restricted to that part of the income tax which is appropriate to the income derived from the State S, or E (so-called 'maximum deduction'). Such maximum deduction may be computed either by apportioning the total tax on total income according to the ratio between the income for which credit is to be given and the total income, or by applying the tax rate for total income to the income for which credit is to be given[77] ...
>
> 63. The maximum deduction is normally computed as the tax on net income, i.e. on the income from State E (or S) less allowable deductions (specified or proportional) connected with such income ... For such reason, the maximum deduction in many cases may be lower than the tax effectively paid in State E (or S) ... This problem could be solved by using the full credit method in State R ...

The Commentary does not specifically address the issue considered in the scenario at the start of this article. Nor is the Commentary of direct relevance to the interpretation of the UK's conventions since those conventions employ a form of words quite different from the OECD Model. However, it is interesting to note that the Commentary makes reference to the issue, and that full (i.e. unlimited) credit may be necessary to ensure that international double taxation is adequately relieved.

Turning to the arguments in favour of computing the limit on foreign tax credit by reference to the income as computed for foreign tax purposes.

The first, textual argument goes back to the basis upon which a foreign tax credit is provided. The starting point is the "elimination of double taxation" article in the relevant convention, or Section 790 of the Income and Corporation Taxes Act 1988 in the case of unilateral relief. The standard treaty provision provides that "tax payable under the laws of [foreign country] on profits, income or chargeable gains ... shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the [foreign country] tax is computed." Thus the starting point for the claim to credit is the profits, income or chargeable gains by reference to which the foreign tax has been computed. Prima facie, this refers to the amount of profits, or income, or chargeable gains computed according to the foreign tax rules.

This reference to "the same profits, income or chargeable gains" flows through to the Credit Code which gives effect to the promise of a foreign tax credit in the convention or the unilateral relief. Thus the "relevant income or gains" in Section 797 ought also to mean the income or gain computed for purposes of the foreign tax. The limit of foreign tax credit is then found by applying the rate of corporation tax to the foreign measure of income or gains. This is consistent with the wording of Section 797(2). In fact, the reference in that subsection to the rate of corporation tax seems a rather clumsy formulation if the limit is the amount of corporation tax on the UK measure of profits.

A second argument is based upon the evidence of Parliament's intention during the years since the Credit Code was originally enacted. Whatever may have been the intention of Parliament when the Credit Code was enacted, it has subsequently enacted several pieces of legislation on the assumption that the basis for computing the limit of foreign tax credit would not otherwise be based on the UK measure of taxable profits. The example of Section 798 of the Income and Corporation Taxes Act 1988 is mentioned above.

A third argument takes one back to the rationale of double taxation relief. As shown by the example at the outset of this article, if foreign tax credit were granted on the basis that the limitation applies to the income as computed for foreign tax purposes – in this case, the gross amount of income – then (so long as the foreign tax rate is lower than the UK rate) capital export neutrality would be achieved. By contrast, applying the approach taken in the *GCA* case to the facts of that scenario, the limit of foreign tax credit would produce a maximum amount of credit of 12. The overall tax resulting – both UK corporation tax and foreign tax – would then be 133; a higher amount than if all the income arose from sources in the United Kingdom. The OECD Committee on Fiscal Affairs recognises this by suggesting a full credit where international double taxation would not otherwise be fully relieved.

The dangers of computing the limit on tax credit by reference to the UK measure of income can be seen in the *GCA* case itself. In that case, the company would have paid a final UK corporation tax liability of GBP 20,746[78] on top of the Venezuelan tax of GBP 22,353. This resulted in a total tax burden on the company for that year – UK corporation tax and Venezuelan tax – of GBP 43,099, when the facts of the case indicate that the company had a commercial profit in that year of only GBP 25,577. In effect, the limitation on foreign tax credit resulted in the company suffering a commercial loss for the year because of the fact that it derived a part of its income from overseas.

Underlying this argument is a consideration of the objectives of double taxation relief and the rationale for the ordinary tax

77. These alternative approaches have similarity to the alternatives presented by the solicitor for the Inland Revenue in the *GCA* case. Para. 13 of the Commentary to Art. 11 of the OECD Model considers the situation where tax on interest is imposed in the country of source on the gross amount, but the interest is then included in the country of residence in a net computation of taxable income. The paragraph points out that surplus foreign tax is likely to result, though it does not directly discuss the issue of the foreign or domestic measure of income. I am indebted to Mike Waters of the Inland Revenue, International Division, for drawing my attention to this paragraph.

78. The company's taxable profit for UK purposes for the accounting period in question was GBP 40,995. Tax at 52 per cent would result in GBP 21,317, against which only GBP 571.00 of foreign tax credit could be set.

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credit limitation. The purpose of double taxation relief is as part of the mechanism to ensure that international trade and investment is not deterred by double taxation. The ordinary tax credit limitation serves to protect the State granting relief from having its tax receipts from domestic-source income undermined by high levels of foreign tax credit. There is clearly a conflict between these objectives in the scenario discussed at the opening of this article.[79]

By computing the limit on tax credit by reference to the foreign measure of income, however, the State granting relief is not left totally unprotected. If the foreign rate of tax exceeds the domestic tax rate, relief is still limited to the level of the domestic tax rate.[80] Thus there is protection against excessive levels of tax on the foreign measure of income.

A final argument in favour of applying the foreign measure of income to compute the limitation of foreign tax credit is simplicity. The foreign measure of income will be known: it would have been known in order to calculate the amount of foreign tax (whether it is a gross amount or a net profit in the foreign country). By contrast, if the limit on foreign tax credit is to be computed by reference to the UK measure of profits, then a separate computation would usually be needed to calculate these profits.

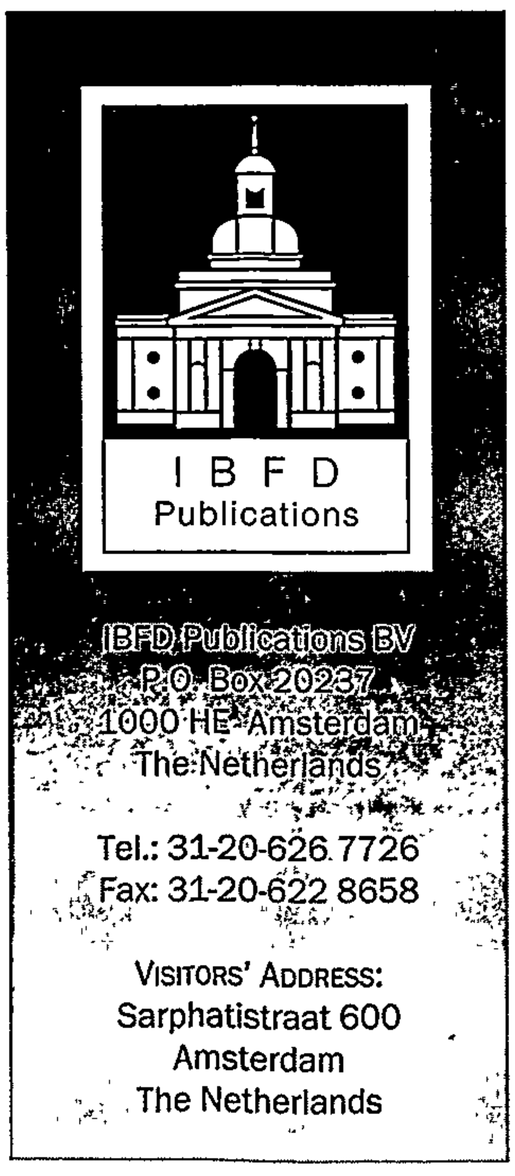
A particular difficulty here will be the question of deciding how one attributes expenses to the foreign income. In the *GCA* case expenses were, in effect, attributed proportionately to the foreign source income and the UK source income by starting with the UK corporation tax measure of profits and attributing this on the basis of turnover. In other circumstances, a direct attribution of expenses may be necessary and may be extremely difficult.[81]

VII. CONCLUSION

At the time of the recent UK Budget on 17 March 1998, the Inland Revenue announced a review of double taxation relief for companies. It is understood that no particular matter has prompted this review; it is simply that the Credit Code has been in existence for over 50 years without a thorough review. It seems likely, however, that one of the factors which has prompted the review has been the decision in the *GCA* case and the change of approach by the Inland Revenue. The consequences of this change are being felt by many UK companies with foreign source income.

One issue which unquestionably must be tackled by the review is whether the limitation on foreign tax credit should be computed by reference to the income as computed for UK corporation tax purposes or the foreign measure of income. At present, it is less than entirely clear which of these approaches is correct under existing legislation. If the review confirms the approach taken in *Yates v. GCA* then an answer needs to be proffered to those – such as GCA itself – for whom the operation of the limit on foreign tax credit would otherwise render foreign operations uncommercial.

79. Perhaps one of the only complete solutions to this issue is the inclusion of double taxation conventions which deal with all categories of income and which limit the rate of tax on gross income to a more modest level.
80. In the scenario discussed, if the foreign tax rate had been 40 per cent, the limit to credit would have been found by applying the UK corporation tax rate to the foreign measure of income – i.e. still 30.
81. This difficulty is, in effect, recognized by the Inland Revenue in the Double Taxation Relief Manual at para. 886 which deals with the attribution of an appropriate amount of expenses.



SURVEY OF THE IMPLEMENTATION OF THE EC CORPORATE TAX DIRECTIVES

Unprecedented exposure of the flawed tax policy of the Member States

The two most important Directives on corporate taxation – the Merger Directive (90/434/EEC) and the Parent-Subsidiary Directive (90/435/EEC) – both came into force on 1 January 1992, and yet, years later, it remains clear that most Member States have still not implemented the Directives correctly. In some cases, indeed, non-implementation of the Directives has been deliberate. This comprehensive survey details the nature and degree of the twelve "older" Member States' response to the Directives (the report was written prior to Austria, Finland and Sweden's accession to the Union), and reaches the conclusion that all twelve fall some way short of full implementation. Carried out with financial support granted by the EC, this is clearly essential reading for all tax professionals, financial advisors and business people operating or intending to operate in Europe.

The survey is divided into two sections, examining each Directive in turn. Each comprises a detailed analysis of the Directive itself, examining its scope and omissions, followed by a series of country-by-country analyses, including detailed references to relevant national legislation. Each country analysis concludes with an article-by-article summary of aspects of national law in conflict with the provisions of the Directive.

This report is by far the most complete and thorough ever written on the subject. Through a strict and systematic approach, the report highlights the aspects of Member States' national taxation policy and legislation which are in direct contradiction with the EC Directives. The practicality of European tax harmonization is exposed as being, for all intents and purposes, non-existent.

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RECENT TAX TREATY DEVELOPMENTS IN THE UNITED KINGDOM

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I. INTRODUCTION

The United Kingdom is now at the forefront in terms of treaty networks. In December 1996, the United Kingdom became the country with more bilateral treaties than any other in the world, having more than 100 in force. The result is that the United Kingdom now has comprehensive coverage in relation to industrialized countries with very extensive coverage in Eastern Europe and the developing world. While most negotiations have led to the conclusion of treaties, there are still problem areas. For example, insoluble differences with Brazil mean that there is unlikely to be any progress on conclusion of a treaty at present.[1] On the other hand, now that so many countries have treaties with the United Kingdom, negotiations are even turning to countries that have no income tax such as the United Arab Emirates.

Much treaty activity at present is focused on updating and revising treaties. Revised treaties with the Falkland Islands,[2] Lesotho,[3] Malaysia[4] and Singapore[5] have entered into force in 1997 for example. Negotiations are now to concentrate on updating treaties with European partners, particularly France, Germany, the Netherlands and Ireland.

Since the transfer of Hong Kong to China, an air transportation agreement has been concluded. This is unusual in that its provisions are not contained in a tax treaty, but are included in a more general Air Services Agreement.

The Inland Revenue have announced an ambitious plan of treaty negotiations and renegotiations. In addition, they have given some indications as to their position on several issues. The key elements of Inland Revenue policy[6] on treaties are as follows:

1. The benefit of repayment of the dividend tax credit to qualified treaty residents will be withdrawn where possible in future negotiations. Exceptions to this will apply only where the other contracting state offers similar benefits or where this is traded for other treaty benefits. Generally, a reciprocal approach will be taken.
2. Although the Inland Revenue does not intend to introduce a general limitation of benefits provision, they will not agree to any treaties that do not contain their now standard limitation of benefits wording which has appeared in recent treaties relating to dividends, interest, royalties and "other income".
3. The Inland Revenue will insist on their now standard wording which will entitle the United Kingdom to tax UK resident partners of foreign partnerships on their share of partnership income.
4. The Inland Revenue will withdraw tax sparing relief other than in exceptional circumstances and subject to strict limits.

Since treaties are the product of negotiations, these results are not always achieved. For example, the new treaty with Singapore continues to provide for tax sparing. Tax sparing[7] is also found in the new treaties with Lesotho,[8] Argentina[9] and China[10] for example. The question as to which are developing countries and therefore deserve tax sparing is hardly clear these days. The fall back position of the Inland Revenue is that where tax sparing is agreed, it will be subject to time limits and will be focused on infrastructure projects. Generally the balance of the treaty must be acceptable if tax sparing is included.

Repayment of tax credits is generally not provided in recent treaties that the United Kingdom has signed. An interesting development in this area is in relation to the treaty with Finland. Finland does operate an imputation system and previously the treaty permitted repayment of tax credits on dividends flowing in both directions between the two countries. The withdrawal of tax credit repayments in the recent protocol with Finland[11] was justified on the basis that the treaty provisions were becoming extremely complicated and that the flow of investments was such that both parties felt that it was not worth the trouble.[12]

The Revenue have had a high success rate in including their limitation of benefits wording.[13] Although this has been at the insistence of the United Kingdom, the application of these provisions by treaty partners will need close monitoring to see how well the UK Treaty network operates for UK companies operating overseas.

1. Inland Revenue Press Release 28 April 1998. The Press Release sets out the current programme of the Inland Revenue for treaty negotiations.
2. SI 1997/2985.
3. SI 1997/2986.
4. SI 1997/2987.
5. SI 1997/2988.
6. As explained by John Brice, Inland Revenue International Division, at a meeting of the IFA British Branch in April 1997.
7. Art. 23(4).
8. Art. 23(4).
9. Art. 23(4).
10. Art. 23(3).
11. SI 1996/3166, Art. 4.
12. See *supra* note 5.
13. The pattern is now generally: "The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the [debt claim/rights] in respect of which the [royalties/interest/other income] are paid to take advantage of this Article by means of that creation or assignment".

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A. Treaties with EU Member States

Although the United Kingdom generally uses the OECD Model Convention as its starting point, in the treaty negotiations several patterns may now be discerned as shown by recent treaties. Protocols to the UK treaties with Denmark[14] and Finland[15] respectively indicate the impact of European law and may give an indication of the direction that other European treaty negotiations are likely to take.

For example, in the protocol to the Danish Treaty, the previous dividend Article was replaced in its entirety.[16] A general rate of withholding of 15 per cent on the gross amount of dividends is permitted. This is however made subject to the provisions of the Parent-Subsidiary Directive. Dividends are exempt from tax if the beneficial owner of the dividend is a company which holds at least 25 per cent of the issued share capital of the company paying the dividends. Entitlement to repayment of the tax credit in respect of dividends paid by a UK company is no longer extended to Danish companies.

Likewise, the rules relating to the elimination of double taxation in that protocol reflect not only recent developments in both contracting states, but also take into account the Parent-Subsidiary Directive.

Generally, Danish residents will be entitled to a credit for income which may be taxed in the United Kingdom. This continues the existing practice. However, in the case of dividends paid by UK companies to a Danish resident which holds at least 25 per cent of the issued share capital, the dividend is exempt. This exemption only applies to the extent that the profit out of which the dividends are paid has been subject to corporation tax in the United Kingdom or to any other tax in the United Kingdom or elsewhere which is comparable to Danish tax; or the dividends paid by the company which is a resident of the United Kingdom represent dividends received in respect of shares in a company which is a resident in a third state, which would have been exempt from Danish tax if those shares or rights were held directly by the company which is a resident of Denmark.

An exchange of notes between the contracting states confirms that by continuing to use the criterion of a holding of voting power with respect to the operation of the foreign tax credit in the United Kingdom on dividends received by a UK parent from a Danish subsidiary, the contracting states are exercising the option provided in Article 3(2) of the Parent-Subsidiary Directive to derogate from Article 3(1) by replacing the criterion of a holding in the capital of a company of another Member State by that of a holding of voting rights.

The protocol to the Finland–United Kingdom Treaty[17] adopts a 10 per cent rule based on ownership of voting power for allowing credit for underlying tax paid by a Finnish company on dividends received by a UK corporate shareholder. Again, an exchange of notes between the contracting states confirms the exercise of the option under Article 3(2) of the Parent-Subsidiary Directive to adopt the voting rights criterion.

Apart from minor protocols signed with Austria and Spain, these are the first agreements that the United Kingdom has concluded with another EU Member State since the introduction of the Parent-Subsidiary Directive, the Mergers Directive and the Arbitration Convention in 1992.

Tax treaties are subject to the same tests as the domestic law of Member States in determining whether they comply with European law. Other provisions of the protocols with Denmark[18] and Finland[19] particularly relating to cross-border pension payments have also been amended in ways that appear to attempt to comply with European Court of Justice decisions, particularly *Wielockx v. Inspecteur der Directe Belastingen*.[20]

The previous treaty with Denmark contained a much criticized limitation of benefit provision. Under the so-called "look-through" principle, treaty benefits on dividends, interest and royalties were denied if the Danish recipient of income was a company in turn owned by persons who would not themselves qualify for benefits. This look-through approach to limitation of benefits is likely contrary to European law and was liable to be struck down by the European Court of Justice. Similar provisions remain in the Netherlands treaty in relation to dividends.

B. Treaties with developing countries

Treaties with developing countries increasingly reflect the impact of the United Nations Model Treaty between developing and developed countries. Thus, a number of recent treaties[21] will permit a permanent establishment to be constituted where a building site construction assembly or installation project continues for more than six months. The OECD version applies a twelve-month test.

Another influence of the UN Model is to be found in the treatment of management and technical service fees. The Lesotho Agreement[22] provides for a minimum tax of 10 per cent on the gross amount of management and technical fees in the absence of a permanent establishment. Where such fees are attributable to a permanent establishment, then the business profits provisions apply. A similar approach is taken in the Malaysia Agreement,[23] although the rate of tax is 8 per cent.

Other features of recent treaties with developing countries indicate a tendency towards broadening the scope of permanent establishment generally. For example, the Argentina Agreement[24] provides that the furnishing of services through employees or other personnel engaged by the enterprise will constitute a permanent establishment where such services continue in respect of the same or a connected project within

14. SI 1996/3165.
15. SI 1996/3166.
16. Art. 10.
17. Art. 11.
18. Art. 18.
19. Art. 19.
20. (Case C-80/94) [1995] STC 876.
21. See for example Argentina: Art. 5(3)(a), Falkland Islands: Art. 5(3), Lesotho: Art. 5(3), Malaysia: Art. 5(2)(h), Singapore: Art. 5(3).
22. Art. 13.
23. Art. 13.
24. Art. 5(3)(b).

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a country for periods aggregating more than six months in any twelve-month period.

C. Most-favoured nation status

The recent treaty with Latvia[25] contains a most-favoured nation clause. The rate of withholding tax in Latvia may be lowered on payments made to UK residents if Latvia agrees to a rate with any other OECD country that was lower than the rate negotiated with the United Kingdom. A protocol to the Kazakhstan treaty introduces the same principle in relation to branch profits tax. Such provisions are unusual in UK treaty practice.

II. OUTWARD-BOUND TRANSACTIONS

Tax treaties fulfil two roles for UK based businesses. Firstly, they reduce or eliminate foreign taxes. Secondly, they provide for UK relief for foreign tax paid in the form usually of a credit.

A. Legislative developments

A number of treaties provide for UK resident companies to obtain credit for the underlying tax payable by a non-resident company on the profits out of which the dividend is paid. Most treaties make the availability of the credit subject to the provisions of United Kingdom law. The effect of this wording is to import generally the domestic rules applicable to the determination of the credit.

UK companies are taxed on dividends received from an overseas company. By treaty or domestic law, such a company can claim relief from foreign tax deducted from the dividend. If the company controls at least 10 per cent of the voting power in the overseas company, it can also claim relief for underlying tax. This is tax which the overseas company has paid on its profits out of which it pays the dividend.

The UK company can also claim relief for underlying tax paid by other companies in the chain where the 10 per cent control test is met at each stage in the chain and dividends are paid by one company to another.

Measures, announced in the November 1996 Budget, were aimed at artificial schemes involving overseas companies to reduce UK tax bills. In the Inland Revenue Budget Press Release, they indicated that UK companies could claim credit to reduce UK corporation tax on foreign tax paid by an unconnected overseas company.

The scheme that the Inland Revenue expressed concern about involved UK based groups acquiring for a specified period a stream of highly taxed foreign income. This included dividends paid by a previously unconnected company out of its highly taxed profits. This is then mixed with other income on which much less tax, if any, has been paid. The separate sources of income are used to fund payment of a dividend to a UK company. Relief is then claimed in the United Kingdom for all the underlying tax.

The tax that has been bought in with the acquired income in effect shelters from UK tax the lowly taxed income that has been brought into the United Kingdom as part of a dividend. This scheme provides for the UK company to share the benefit of the relief given by the UK exchequer with the company from which the stream of highly taxed income was bought.

As a result, legislation was introduced,[26] which restricts relief for underlying tax in respect of dividends paid by overseas companies where there is a scheme, the purpose or one of the main purposes of which is to obtain relief for an amount of underlying tax.

In common with other anti-avoidance provisions, the new section is very widely drafted. An avoidance scheme comprises two elements.

Firstly, it must have as its purpose or one of its main purposes to have an amount of underlying tax taken into account by way of credit.

Secondly, the parties to it must include both the UK company, a company related to that company or a person connected with the UK company and a person who is not under the control of the UK company at any time prior to the scheme or arrangement.

Concerns have been expressed about the potential scope of application of the provision. The Inland Revenue gave some guidance as to how it will interpret this provision.[27] The interpretation is of limited value. They have indicated that they would not regard the acquisition of a shelf-company as being under the control of anyone else because it was owned by a formation agent prior to its acquisition. They are less equivocal in relation to other transactions. For example, they indicate that they accept that a company is not caught if the company was under the control of the UK company before a scheme was entered into. Even then, they will not necessarily adopt that approach where the UK company ceased to control the foreign company and thereafter acquired an interest as part of an avoidance scheme.

Similarly, the introduction of a new mixer company would not itself trigger the new legislation, assuming that it does not form part of an avoidance scheme within the section. They indicate that each case must be examined on its own facts and that they will reassess the position if new schemes come to light which are designed to circumvent the section. Any new or revised approach will be published and the Inland Revenue will give guidance on cases where there is concern that a bona fide commercial acquisition might lead to a restriction of relief under the new rules.

In practice, advisors will have to consider the application of this rule in every acquisition involving foreign target companies.

Further limitations to the foreign tax credit for financial institutions were announced in the Budget on 17 March 1998.

25. Treaty not yet in force.
26. Finance Act 1997 Sec. 90; now contained in Taxes Act 1988 Sec. 801A.
27. *Inland Revenue Tax Bulletin*, (June 1997).

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Banks and other financial traders have been restricted in the foreign tax they are entitled to credit to their profit margin on a foreign loan.[28] The issue arises in the context of foreign withholding taxes imposed on a gross basis, whereas the UK taxpayer is only liable to tax on a net basis.

In order to minimize the effect of these rules, some taxpayers have arranged to return interest income on foreign loans in the form of dividends. Where the loan is made by a foreign subsidiary and profits on the loan are paid out as dividends, credit for underlying tax has enabled UK institutions to obtain the full benefit of the foreign tax credit usually in excess of tax on the profits in relation to the transaction. The new rules are essentially designed to ensure that banks and financial traders cannot avoid the limitation on the foreign tax credit by booking the loan through an associate resident outside the United Kingdom,[29] so that income is received in a form other than interest. New rules also extend these principles to foreign tax spared by treaty.[30]

B. Foreign mergers

The Inland Revenue have recently indicated a more positive approach in relation to claims for underlying relief in the context of pre-merger profits. Relief is allowed for underlying tax paid at lower levels in a chain of companies.[31] Relief is allowed for underlying tax paid by a company which pays a dividend to the company above it in the chain. The 10 per cent control test must be satisfied for each link in the chain. However, both treaties and domestic law require that the tax be paid by the same company which pays the dividend if relief for underlying tax is to be allowed.

That condition may not be satisfied if a foreign company earns profits and pays tax on them and thereafter merges with an overseas company in such a way that the first company ceases to exist and its undistributed profits are taken over by the second company. Some of the difficulties arise, because this form of merger is unknown under English company law. It is common in both Canada and the United States.

If the surviving company then pays a dividend to a UK company out of profits earned by the predecessor company, relief for underlying tax may not be available.

The Inland Revenue have indicated that they have considered the effect of a merger of this kind governed by the laws of New Jersey in the United States.[32] The Inland Revenue agreed that tax paid for the merger by the predecessor company on profits that were distributed after the merger by the successor company could be regarded as tax paid by the successor for the purposes of a claim to relief for underlying tax.

This approach will be particularly helpful in countries such as Canada that do not recognize any form of group relief or consolidation and where post-acquisition mergers are therefore more common.

C. Hybrid entities

The question of availability of the foreign tax credit has been controversial over the last year or so in a number of areas.[33] One such area is in relation to hybrid entities. This term refers generally to entities that are treated as a company in one jurisdiction and a partnership or some other fiscally transparent entity in another. It has come up particularly in the context of limited liability companies which may be formed in a number of states in the United States and increasingly in tax haven jurisdictions.

The matter has been considered by the Inland Revenue.[34] Although in the United States, federal income tax is charged on the profits of an LLC on its members, rather than the entity itself, the United Kingdom has taken a view that those LLCs it has examined should be treated as companies and not as fiscally transparent. As a result, a UK member of a US LLC will be taxed by reference to distributions of profits made and not by reference to the income of the LLC as it arises. If tax is paid in the United States on the profits of the LLC, that tax is regarded as underlying tax and is creditable in the hands of a member which is a UK resident company controlling at least 10 per cent of the voting power of the LLC. These views are not exhaustive of the issue, nor necessarily correct in all cases.

Fiscally transparent entities form a significant part of US tax strategy today and UK participants in a US venture will need to be careful to avoid unintended UK tax consequences flowing from investment in such entities.

The question of fiscal transparency in the context of the foreign tax credit and treaty relief was brought to the fore in the recent High Court decision of *Memec Plc v. IRC*.[35] In that case, a UK company (plc) held either directly or indirectly through four wholly-owned 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–United Kingdom Treaty.

In 1995, GmbH entered into a silent partnership under German law whereby Plc was the silent partner. Plc 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. Under German law, a silent partnership has no separate legal personality.

28. Taxes Act 1988 Sec. 798.
29. Taxes Act 1988 Sec. 803.
30. Taxes Act 1988 Sec. 798A.
31. Taxes Act 1988 Sec. 801(2) & (3).
32. *Inland Revenue Tax Bulletin*, (October 1997).
33. 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.
34. *Inland Revenue Tax Bulletin*, (June 1997).
35. [1996] STC 1336 (ChD).

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The question arose as to whether Plc was entitled to credit in respect of the German trade tax (*Gewerbesteuer*) suffered by the subsidiary on profits paid by the subsidiary to GmbH and in which profits, Plc took a share by virtue of the silent partnership agreement.

Creditability of the tax involved consideration of three issues:

Transparency of the partnership

The Court concluded that the silent partnership was not transparent. In this case, Plc received a share of partnership profits as a separate source of income replacing the dividends received. The amount was determined by reference to the dividends, rather than the dividends themselves. As a result, Plc could not qualify directly for treaty relief by way of credit for the trade tax under Article XVII(1)(a) & (b) of the Treaty.

"Dividends" for treaty purposes

The taxpayer, however, further argued that Plc ought to be entitled to credit for underlying tax under Article XVII(1) of the Treaty. Credit for underlying tax suffered by the German company is allowed if the recipient shareholder controls 25 per cent of the votes in the German company. The credit would extend to the trade tax suffered by the German company itself. It would not permit credit for trade tax suffered by a German subsidiary of a German company paying a dividend to a UK company. It is perhaps for this reason that the new structure was introduced.

Article VI of the Treaty contains the definition of dividends for the purpose of that Article. This includes income derived by a sleeping partner from its participation as such. The Inland Revenue argued that this definition was for the purpose of that Article only. This was disputed by the taxpayer who argued that the definition should be applicable to the tax credit provisions. This view was upheld by the Court. Thus, for treaty purposes dividends included distributions of silent partnership profits.

"Dividends" under domestic law

However, in order to succeed, the taxpayer had to satisfy a third criterion, namely the distribution should be treated as a dividend under domestic law. It was noted that there is no special definition of dividend in the foreign tax credit provisions of Taxes Act 1988. The Court accepted the Inland Revenue argument that Sections 790(6) and 801(1) &(2) refer narrowly to the profit distributions made by companies. Since the foreign tax credit provisions are made subject to the rules of domestic law, the claim failed.

The Court of Appeal upheld the High Court decision.[36] The Court of Appeal concluded that by contrast to an English or a Scottish partnership, no business was carried on in common between the German company and the UK parent as silent partner, with a view to profit. The silent partner was in the position of a purchaser, who for a consideration consisting of the capital contribution purchased the right to income of a fluctuating amount calculated as a share of the annual profits of the business.

The Court of Appeal also noted that the treaty recognized Germany's right to withhold tax on silent partnership distributions and to ensure that they would not be treated as business profits. Credit was to be given by the United Kingdom for such withholding tax. However, the treaty was carefully drafted to ensure that the reference to dividend in relation to the underlying credit did not include the share of profits from a silent partnership. There was, thus, no intention to extend the meaning of the word "dividend" for treaty purposes beyond its ordinary significance in UK domestic law.

D. Controlled foreign companies and treaties

Another recent decision that has an important impact on outward bound transactions is that of the Court of Appeal in *Bricom Holdings v. IRC*.[37] In that case, the Court of Appeal concluded that the Netherlands–United Kingdom Treaty did not prevent the application of UK controlled foreign company rules.

Bricom Limited was resident in the United Kingdom. It owned 100 per cent of the shares of a Netherlands company which carried on business through a branch in Singapore. The business was sold and the proceeds of the sale were lent to group companies in the United Kingdom. In three accounting periods, the Netherlands company received interest from a UK resident company.

Article 11 of the Netherlands–United Kingdom Treaty excludes from UK tax interest arising in the United Kingdom which is derived and beneficially owned by a resident of the Netherlands.

The Inland Revenue served notices on Bricom that the CFC rules applied to it on the basis that the Netherlands company was resident outside the United Kingdom controlled by persons resident in the United Kingdom and subject to a lower level of taxation in the territory in which it was resident.

The Court of Appeal concluded that the treaty did not apply to the CFC charge on the basis that the CFC charge was a wholly notional sum computed by reference to the Netherlands company's chargeable profits less creditable tax. The notional sum did not include an interest component and therefore treaty provisions exempting interest from UK tax were not available.

The Inland Revenue argued that the treaty could not apply to the CFC charge on the basis that the charge was not corporation tax. This view was upheld by the Special Commissioners. The Court of Appeal did not consider this issue on the basis that it was unnecessary for their decision in favour of the Inland Revenue.

The Special Commissioners did however incline to the view that the CFC charge was likely to be "substantially similar" to corporation tax and therefore within the scope of the treaty. This raised an important issue in relation to the manner in

36. [1998] STC 754.
37. [1996] STC [SCD] and [1997] STC 1179 [CA]. See also Jonathan Schwarz "Controlled Foreign Companies and Tax Treaties"– 51 *Bulletin for International Fiscal Documentation*, 12 (1997), at 553.

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which treaties are incorporated into domestic law. The Inland Revenue argued that Taxes Act 1988 Section 788(3) which brings treaties into UK domestic law only makes provisions for relief on income tax or corporation tax. It does not incorporate "substantially similar" taxes. The argument of the Inland Revenue on this point is a curious one, because it means that they are arguing that the enacting legislation is deficient in that it does not fully implement UK treaty obligations into UK domestic law.

On appeal, Millett LJ declined to address this issue, but simply noted that treaties have no direct effect in English law and are given effect by the relevant provisions of Taxes Act 1988, namely Section 788. As a result, this particular issue appears to remain unresolved.

III. INWARD-BOUND TRANSACTIONS

A. Hybrid entities

The treatment of hybrid entities on inward-bound transactions is an issue that has attracted as much attention as it has on outward-bound transactions. Benefits under the United Kingdom–United States Treaty have been denied to limited liability companies formed in the United States by the Revenue. Applications for treaty clearances in respect of dividends, interest and royalty payments were not being processed by the Inland Revenue for some time. The Inland Revenue response[38] was that strictly speaking, LLCs were not residents of the United States for the purposes of the treaty. They take the view that an LLC cannot be said to be a resident in the United States within the terms of the treaty, as it is not a US corporation nor is it a person resident in the United States for the purposes of US tax.

As a matter of practice, the Inland Revenue are prepared to accept treaty claims for relief from UK tax, but only to the extent that the income in question is subject to US tax in the hands of those members of the LLC, who are resident in the United States.

In my view, this statement is very unsatisfactory in a number of respects. Firstly, there is some inconsistency between the way that outward-bound and inward-bound transactions are treated. For outward-bound investment, LLCs are treated as entities for UK purposes, but not for inward-bound transactions. Secondly, the statement that an LLC is not a resident for purposes of the treaty is incorrect. In my view, it may qualify as a US corporation under Article 3(1)(b)(I) of the Treaty.

Other examples of hybrid entities include the French *société en nom collectif* (SNC) which is treated as transparent for French tax purposes but which has a corporate character.

B. Foreign employees on secondment

Until June 1995, the Inland Revenue generally accepted in the context of Article 15 of the OECD Model that where an employee on a short secondment to the United Kingdom continued to be paid by an overseas employer, no UK tax would be due on employment income if there was no contract of employment with a UK company and the employee's remuneration was not paid by or on behalf of a UK employer. In June 1997, it announced that the United Kingdom would follow the approach contained in the Commentary to the OECD Model Convention. In other words, where the remuneration is paid by a non-resident but the cost of the remuneration is borne by "an economic employer" in the United Kingdom, UK tax on employment income would be due.

An economic employer for this purpose is a UK company or branch in whose business the employee works and which obtains the benefit of the work undertaken if it bears the cost of the remuneration.

In reply to a question in Parliament on the United Kingdom–Argentina Treaty, the Financial Secretary to the Treasury clarified that these rules would not apply to short term business visitors. An employee may fall to be treated as a short term visitor where the employee concerned is in the United Kingdom for less than 60 days in a tax year and the period does not form part of a more substantial period when the taxpayer is present in the United Kingdom.

C. European issues

The European Court of Justice has been active in recent years in striking down both legislation and practices that are discriminatory.[39] Generally, instances of discrimination are raised by taxpayers. An interesting example of the elimination of potential difficulties in this regard has appeared in the context of interest payments made to Irish financial institutions.

The Inland Revenue Double Taxation Relief Manual referred to a practice to allow UK residents to pay interest gross to financial institutions in the Irish Republic without the institutions concerned making a claim pursuant to the Ireland–United Kingdom Treaty. This practice was discontinued from 1 May 1997.

The announcement[40] indicated that interest must be deducted and accounted for under Taxes Act 1988 Section 349(2), unless FICO International has given clearance pursuant to a treaty claim.

Transitional provisions are made for existing loans. The effect of this is to place Irish resident institutions in the same position as residents of other treaty countries. No explanation for this was given, but it must be expected that the Inland Revenue feared that by allowing this practice to continue, it would be viewed as discriminatory by institutions in other EU Member States, who might then seek to attack the UK system for administering treaty relief claims on that basis.

38. *Inland Revenue Tax Bulletin*, (August 1997).
39. This has been the subject of considerable analysis and does not form part of the Article. On treaties specifically, see for example Gassner at al., *Tax Treaties and EC Law* – Kluwer Law International (1997).
40. *Inland Revenue Tax Bulletin*, (June 1997).

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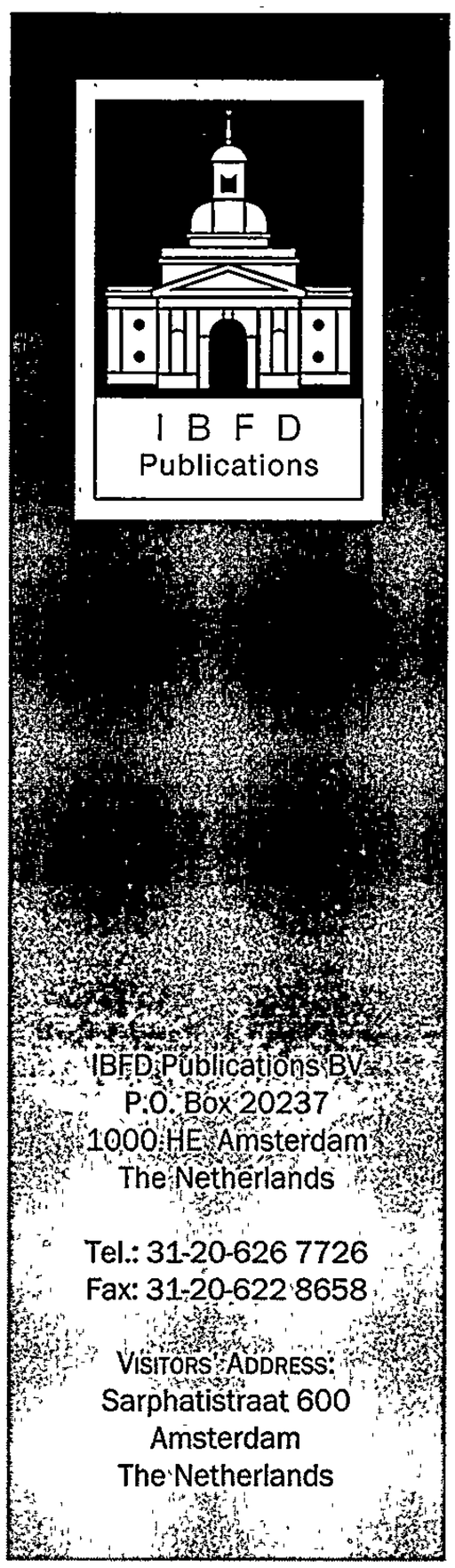
IV. TREATIES AND SELF-ASSESSMENT

The move to self-assessment has resulted in a number of changes in the manner in which treaties are administered. For the first time, issues relating to treaties appear in self-assessment returns and the related forms. In certain circumstances, claims for relief are still required to be made. These are notably where tax is deducted at source, particularly in relation to interest and royalties and other annual payments. Similar issues apply in relation to dividends. In other areas, such as in determining the existence of a permanent establishment taxpayers will generally form their own conclusions as to whether they are liable to account for UK tax and to return their results accordingly.[41]

V. CONCLUSION

While the UK treaty network continues to spread and be updated, the UK tax system is undergoing a fundamental process of modernization. As part of this process, a review was announced of the system of double taxation relief for companies, as part of the tax reforms proposed in the Budget statement of 17 March 1998. The Inland Revenue Press Release indicates that the consultation process will involve a review of the functioning and fairness of the existing system, its effectiveness in meeting the objectives of the relief and business compliance costs. Regard will be had to the overall cost of the relief. The statement indicates that in the 1997-98 year, 5.3 billion of double taxation relief will be given against income tax and corporation tax. Although the review relates to companies, it is envisaged that the principles emerging from the review might ultimately feed through into changes to the system for individuals. As with other areas of taxation in the United Kingdom, the approach to double taxation may well be undergoing fundamental change.

41. For a detailed analysis, see Jonathan Schwarz in *Cahiers de Droit Fiscal International Volume LXXXIIIb* "Practical Issues in the Application of Double Taxation Conventions", United Kingdom National Report at 703.



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THE UNITED KINGDOM AS AN INTERNATIONAL HOLDING COMPANY LOCATION

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I. THE EMERGENCE OF THE UNITED KINGDOM AS HOLDING COMPANY LOCATION

Prior to 1994 the United Kingdom was rarely one of the territories which came to mind when considering an optimum location for a European holding company. The absence of any kind of participation exemption for dividends and capital gains and the burden of advance corporation tax (ACT) on dividends meant that the opportunity to achieve a substantially tax-free flow through of profits, which is the essential feature of a good holding company location, was rarely available.

From 1994 the position changed substantially. Falling UK corporate tax rates meant that the United Kingdom's system of foreign tax credit relief could often achieve the same nil tax result as a participation exemption on dividends received and from 1 July 1994 the ACT problem was at last addressed by the introduction of foreign income dividends (FIDs) and international headquarters companies.

The absence of any withholding tax on dividends in the United Kingdom and the opportunities to give a UK holding company real substance by combining it with the headquarters of European operations has meant that the United Kingdom can offer opportunities for holding companies absent in the more traditional European holding company locations such as the Netherlands and Luxembourg.

II. HOW TAXATION ON DIVIDEND INCOME CAN BE AVOIDED

The UK tax system never exempts UK resident companies from corporation tax on foreign source dividend income. The opportunity to avoid UK taxation is, however, available through an extensive system of foreign tax credit relief. Where a UK company owns, directly or indirectly, 10 per cent or more of the voting power in a foreign company it will be entitled to foreign tax credit relief in respect of dividends received for both foreign income taxes directly charged on the dividend (e.g. withholding taxes) and for the appropriate proportion of the foreign underlying corporate tax on the profits out of which the dividend was paid. As the current full rate of UK corporation tax is only 31 per cent and reduces still further to 30 per cent from 1 April 1999, provided that the combined rate of foreign withholding tax (if any) and foreign underlying corporate tax in the company paying the dividend is at least equal to this UK corporation tax rate, no UK corporation tax will actually be payable on the dividend income. Unlike the participation exemptions of many other European countries, there is no minimum holding period required before full foreign tax credit relief can be claimed. As soon as the UK holding company has beneficial ownership of the foreign participation, foreign tax credit relief will be available in respect of dividends paid.

The United Kingdom's system of foreign tax credit relief fully satisfied the requirements of the EC Parent-Subsidiary Company Directive so that no new regime needed to be established in the United Kingdom in order to implement that Directive.

Another particular advantage of the UK system of foreign tax credit relief is that the relief extends through an unlimited number of "tiers" of foreign companies through which the dividend is derived. Provided that there is at least a 10 per cent direct or indirect interest in the voting power at each tier in the chain of companies, the full relief for the foreign underlying and withholding taxes suffered will be available when the dividend is paid through to the United Kingdom. There is no requirement for the UK holding company itself to own at least a 10 per cent interest in the lower tier foreign "subsidiaries" so that the actual proportionate interest of the UK holding company in the lower tier subsidiaries in a multi-tier structure may be proportionately very low, but it will still qualify for full foreign tax credit relief on dividends flowing through the structure provided that the minimum 10 per cent interest applies at each tier in the chain.

The availability of foreign tax credit relief is not confined to countries with which the United Kingdom has concluded a double taxation treaty, but is available unilaterally in respect of dividends from any foreign country, provided that an income tax is charged on the profits earned.

The entitlement to foreign tax credit relief through unlimited tiers of companies and the availability of the relief unilaterally to all foreign countries imposing income taxes means that the UK foreign tax credit relief system is one of the most extensive available.

III. USING A MIXER COMPANY WITH A UK HOLDING COMPANY

There is, however, one unpleasant feature of the UK foreign tax credit relief system. This is that it is calculated on a source by source basis, rather than on an overall averaging

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system as applies in many other territories, such as the United States (although important restrictions have been introduced on this system in the United States).

What this means in practice is that each dividend received by a UK holding company from a foreign participation will be subject to a separate foreign tax credit relief calculation. For example, if a UK company has subsidiaries in both Germany and in the Dublin Docks International Financial Services Centre in Ireland, German taxes may have been suffered on dividends from the German participation at effective rates of up to 44 per cent or more. A dividend from the Irish company will, however, normally only have suffered a 10 per cent tax rate. In these circumstances the dividend from the Irish company will be subject to a further 21 per cent UK corporate income tax, whereas the German dividend will not give rise to a UK tax liability owing to the foreign tax credit relief available, but the large excess foreign tax credit on the German dividend will be wasted as it is not permitted to carry this credit over against any other source of income or to carry it forward or back against future or previous dividends from the same German company.

This problem has often been overcome by the use of a second foreign holding company underneath the UK holding company to own the foreign participations and to act as "mixer" for the dividends. In these circumstances a dividend paid by the foreign holding company back to the UK holding company out of profits derived from participations in a number of different foreign territories, will effectively average the foreign tax rate suffered so that the disadvantage of excess foreign tax credits on a dividend from one foreign country whilst tax is paid on a dividend from another will be removed.

The use of such foreign mixer companies by UK companies has always been controversial. Up to 1997 there were no provisions of UK tax law under which such arrangements could be challenged as long as the foreign mixer company was genuinely foreign rather than UK resident by virtue of management and control outside of the United Kingdom. The UK Inland Revenue were, however, known to have concerns about such arrangements.

In 1997 an anti-avoidance provision was introduced in Section 90 of the Finance Act 1997 to counteract particular mixing schemes under which UK groups acquired for a specified period a stream of highly taxed foreign income, such as dividends paid by a previously unconnected company out of highly taxed profits, in order to avoid UK taxation through utilization of foreign tax credits. Such schemes typically involved mixing the highly taxed income in a foreign company with income which had suffered only a low or nil rate of tax. These separate sources of income were then used to fund a dividend payment to a UK resident company so that foreign tax credit relief for underlying tax was available to effectively shelter the lowly taxed income from UK corporation tax. Under such schemes the UK company normally shared the benefit of the foreign tax credit relief available through the fixing of the price paid for the company giving the stream of highly taxed income.

The anti-avoidance provisions introduced by Section 90, however, extended considerably beyond the bought-in foreign tax credit schemes which they were purported to be aimed at.

The new section applies to dividends paid on or after 26 November 1996 where:

- a UK resident company claims foreign tax credit relief for underlying tax in respect of a dividend from a non-UK resident company ("overseas company");
- the underlying tax includes foreign tax (called the "higher rate tax") payable at a rate in excess of "relievable rate"; and
- the whole or part of the higher rate tax will not have been included in the claim but for an "avoidance scheme".

The limitation on relief which is imposed is that the claim to relief is to be determined as if "the higher rate tax" had been at the "relievable rate".

Tax is regarded as "payable at a rate in excess of the relievable rate" where the amount of tax payable exceeds the tax which would have been paid on the relevant profits at the rate of corporation tax in force when the UK company received the dividend from the overseas company. This is referred to as the "relievable rate"[1] and will currently be 31 per cent.

"Relevant profits" are defined as the profits of the overseas company (or a company in which it has an interest) on which the underlying tax has been paid.

The legislation only applies where there is an "avoidance scheme". In order for there to be an "avoidance scheme" two conditions must be satisfied:

- a test relating to control between the parties involved; and
- a purpose test.

In order to satisfy the control test the parties to the scheme or arrangement must include:

(a) the UK resident company claiming the foreign tax credit relief, a company related to that company or a person connected with the UK resident company; and
(b) a person who is *not* under the control of the UK resident company claiming the foreign tax credit relief at any time before doing anything as a part of, or in pursuance of, the scheme or arrangements.

The purpose tests will only be satisfied if the scheme or arrangement has at its purpose, or one of its main purposes, to have an amount of underlying tax taken into account on a claim for foreign tax credit relief in the United Kingdom.

Considerable concern has arisen about the application of this new legislation to normal "mixer companies". Although the Inland Revenue statements relating to the new legislation highlight that it is aimed at "bought-in foreign tax credit" schemes, the wide scope of the purpose test and the definition of an "arrangement" together with the nature of the test relating to the parties to the scheme or arrangement not being under the control of the UK company claiming the foreign

1. "The relievable rate" is defined as the rate of corporation tax in force when the UK resident company received the dividend from the overseas company.

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tax credit relief, means that mixer company arrangements could come within the terms of the legislation in certain circumstances. This could, for example, be the case where the UK company claiming the foreign tax credit relief is a "Case V" subsidiary holding company of the UK group and a foreign subsidiary owned by the ultimate UK parent company is transferred to it.

In the Committee Stage debate on the 1997 Finance Bill, the following statement about mixer companies was made by the Financial Secretary to the Treasury, Mr Michael Jack:

> Several accountancy firms and representative bodies have expressed concern that the bill might catch acquisitions of companies that are made for bona fide commercial reasons, and where the company is acquired by a mixer company in the group or is transferred to the ownership of a mixer company after the acquisition. The Inland Revenue have confirmed that the legislation will not be applied in cases involving acquisitions of companies for bona fide commercial reasons where the acquisition is not a scheme, a part of a scheme or an arrangement that has as its purpose, or one of its main purposes, the obtaining of relief for underlying tax. Acquiring a company in such circumstances will not be caught by the clause just because the acquisition is made using a mixer company, nor will the legislation apply to an internal group reorganisation, if that reorganisation involves a company that was acquired in the circumstances that I have described. That deals with the concern as to whether what I might describe as a legitimate trading enterprise will be affected by the measure.

It may be questioned as to whether the terms of the above statement will necessarily cover all mixer company arrangements. In addition, it was announced at the time of the 17 March 1997 Budget of the new Labour Government in the United Kingdom that a comprehensive review of the UK system of double taxation relief for companies is to be undertaken by the Inland Revenue and consultations on the reform are currently in progress. Although no intended changes have yet been announced, it is expected that the position of mixer companies will be considered as part of this review.

IV. CAPITAL GAINS ON DISPOSAL OR TRANSFER OF PARTICIPATIONS

There are no special reliefs available when a UK holding company realizes a capital gain on the sale of a participation. Any such capital gain will be subject to the full rate of UK corporation tax. The only relief that is available is that, in computing a gain, the cost of the shares will be increased by an inflation indexing allowance based on movements in the UK retail price index between the date of acquisition of the shares and the date of their disposal.

At the time of the 17 March 1997 Budget a comprehensive review of the system of taxation of capital gains for companies was also announced. This accompanied an actual reform introduced by the Budget and the subsequent Finance Bill relating to capital gains arising to individuals. The reform for individuals abolished inflation indexing relief for price increases subsequent to April 1998 and introduced a tapering relief whereby a lower rate of capital gains tax applies to gains on assets which have been held for a specified number of years. It is not yet known whether the reform of the taxation of capital gains for companies will include similar provisions.

It is not always disadvantageous for an international holding company to be subject to tax on capital gains arising from the disposal of participations. In some cases the absence of such a tax in holding company locations such as the Netherlands and Luxembourg may result in capital gains arising to the holding company being taxed on the ultimate parent company under anti-avoidance provisions. For example, if a Japanese parent company owns a foreign holding company which realizes capital gains on the disposal of subsidiaries, the capital gains of the holding company will be subject to Japanese corporate tax on the Japanese parent company under the Japanese anti-tax haven legislation unless the gain has suffered foreign tax at a rate of at least 25 per cent. Accordingly, where such a Japanese parent company owns the foreign subsidiaries through a holding company in a location such as the Netherlands which exempts such gains from Dutch tax under their participation exemption, this simply results in the gains being potentially subject to Japanese corporate tax as they arise. Where, however, the subsidiaries are owned through a UK holding company, the effective UK corporation tax rate on the capital gain will normally just exceed this required 25 per cent rate so that taxation of the gains at the much higher Japanese corporate tax rates will be avoided.

V. DISTRIBUTION OF PROFITS TO SHAREHOLDERS

A. Withholding tax

One of the great advantages of a UK holding company is that the United Kingdom does not impose any withholding tax on dividends. This is the case wherever the shareholder in the UK holding company is resident and includes shareholdings held by tax haven entities. Foreign resident shareholders are also not normally subject to assessment of any UK taxation on the dividend.

This absence of any withholding tax on dividends gives the United Kingdom a substantial advantage as compared to all of the other major continental European holding company jurisdictions, such as the Netherlands, Luxembourg, Austria, Belgium, Denmark, France, Germany and Switzerland. In Austria, Luxembourg and the Netherlands complex arrangements are sometimes put in place to avoid the dividend withholding taxes where shareholders are not entitled to exemption under the EC Parent-Subsidiary Company Directive or a double taxation treaty. Such arrangements are unnecessary with a UK holding company.

Indeed, far from taxing foreign shareholders on dividends paid by a UK holding company, in some cases the UK Inland Revenue will give them a tax refund as well! At the present time a substantial number of UK double taxation treaties grant a tax credit refund on dividends paid to "portfolio" investors owning shares in a UK company who are individuals with any shareholding or companies with less than a 10 per cent shareholding in the UK company. Such tax credit is

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equivalent to 25 per cent of the net dividend payment, less a deemed withholding tax of 15 per cent, 20 per cent or 25 per cent of the dividend plus the tax credit. Most treaties apply the 15 per cent deemed dividend withholding tax, which results in a net refund to the shareholder of 6.25 per cent.

Additionally, the nine UK double taxation treaties with Belgium, Canada, Italy, Luxembourg, the Netherlands, Norway, Sweden, Switzerland and the United States also grant half of the normal tax credit refund to corporate shareholders owning 10 per cent or more of the shares of the UK company, less a deemed withholding tax on the dividend plus the half tax credit of 10 per cent under the Canadian and Norwegian treaties and 5 per cent under the other treaties. For the foreign parent companies entitled to such a half tax credit subject only to the 5 per cent deemed withholding tax, the net tax refund currently given by the Inland Revenue to the foreign shareholder is equivalent to 6.875 per cent of the dividend payment. These tax credits are not available where the dividend from the UK holding company is paid as a foreign income dividend.

These tax credits are, however, drastically changed for dividends paid on or after 6 April 1999 as a result of a cut in the rate of the tax credit from 25 per cent of the net dividend to 11.11 per cent. From that date only those corporate shareholders owning 10 per cent or more of the shares in the UK company who are resident in Belgium, Italy, Luxembourg, the Netherlands, Sweden, Switzerland and the United States will be entitled to any refund and this will now be reduced to the magnificent sum of 0.278 per cent of the net dividend payment! (For other shareholders who are currently entitled to tax credit refunds the deemed withholding tax would exceed the credit from 6 April 1999 so that no refund will be made.)

B. ACT

The major issue in relation to dividends paid by a UK holding company is not, however, taxes imposed on the shareholder, but the ACT which has been payable by the UK company in respect of dividends distributed.

ACT is abolished for dividends paid on or after 6 April 1999 so that from that date it will normally have no relevance to the dividends paid by a UK holding company. Prior to that date the UK holding company can only avoid ACT on distributions through a complex system of FIDs and international headquarters companies.

FIDs and international headquarters companies were introduced from 1 July 1994 in order to mitigate the problem arising from ACT in relation to UK companies which derived a substantial proportion of their income from foreign dividends or other foreign income which had already suffered full rates of foreign corporate taxation. Although ACT is not a withholding tax and is recoverable against the corporation tax liabilities of the UK company distributing the dividend, if that company has little or no actual corporation tax liabilities because of the offset of foreign tax credit relief against the UK corporation tax, in practice the recovery of ACT may not be available and it can then represent a real additional tax burden on dividend distributions as it is charged at the high rate of 25 per cent of the dividend payment. This problem was commonly known as the "ACT trap" and prior to 1994 effectively prevented the United Kingdom from being used as a holding company centre because of the additional ACT payable when the holding company redistributed dividends.

From 1 July 1994, however, a UK company may elect to pay dividends as FIDs. If such dividends are then matched against foreign source profits which have suffered foreign taxes (e.g. dividends from foreign subsidiaries) domestically owned UK companies can then obtain a repayment of the ACT in respect of the dividends, which may otherwise have been irrecoverable or the recovery deferred.

The biggest advantage in relation to foreign income dividends is, however, available to companies which qualify as "international headquarters companies" by virtue of satisfying a required degree of foreign ownership. Such international headquarters companies are allowed to pay FIDs which are exempt from a liability to ACT.

There is, however, a price that will potentially be incurred in relation to the payment of a FID. This is because FIDs do not carry any tax credit. For international headquarters companies, however, whether this will impose a cost will depend as to whether the foreign shareholder would have been entitled to a tax credit in respect of a UK dividend which is not a FID (see above).

The title of "international headquarters company" is rather misleading. Such companies do not have to carry on any headquarters functions, nor are they a particular kind of company. Any company which has a required level of foreign ownership will automatically be an international headquarters company.

The foreign ownership tests which must be satisfied in order for a company to be an international headquarters company are complex, but are summarized below. The legislation sets out four conditions. In order for a company to be an international headquarters company at least one of the conditions (i) to (iii) must be satisfied in addition to condition (iv), except that if condition (ii) is satisfied it is not necessary also to satisfy condition (iv).

The four conditions are as follows:

(i) Throughout the accounting period the company is wholly owned by another company which is a foreign held company in that period;[2]

(ii) throughout the accounting period the company is a 100 per cent subsidiary of a parent company which is not resident in the United Kingdom and whose shares are quoted and dealt in on an overseas recognized stock exchange. The shares must have been quoted not only

2. A company is a foreign held company in an accounting period if:
   - at each given time in the accounting period at least 80 per cent of the company's share capital is owned by persons who are not resident in the United Kingdom in the accounting period or;
   - throughout the accounting period the company is wholly owned by another company and at each given time in the accounting period at least 80 per cent of that other company's share capital is owned by persons who are not resident in the United Kingdom at any time in the accounting period.

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throughout the accounting period, but also for the preceding twelve months. A secondary listing on a UK stock exchange does not affect this last mentioned requirement;

(iii) at each given time in the accounting period each shareholder of the company owns at least 5 per cent of the company's share capital and at least 80 per cent of the company's share capital is owned either by persons who are neither companies nor resident in the United Kingdom throughout the accounting period or by foreign held companies;

(iv) at each given time in the accounting period not more than 20 per cent of the company's share capital is ultimately owned by persons who are not companies and are resident in the United Kingdom, and where any shares are indirectly owned by persons who are not companies, their ultimate ownership can be found by tracing ownership through any corporate holder to those persons on such basis as is reasonable.

The procedure for an international headquarters company to qualify to pay dividends without accounting for ACT is relatively simple. If a company qualified as an international headquarters company for the immediately preceding accounting period and believes that it also qualifies for the current accounting period, it can simply elect to pay the dividend without accounting for ACT. If it is subsequently found that the company did not qualify as an international headquarters company when it paid the dividend, the normal ACT will be due and there is likely to be interest for late payment of the tax.

The exemption from ACT at the time the FID is paid, is not, however, the end of the matter. A payment will be due from the company or paid to the company after the end of the accounting period on the basis of a required comparison. This is that the ACT which the company has not paid on the FID because of its international headquarters company status must be compared with the amount which would have been set off or repaid to the company under the FID provisions if it had not treated itself as an international headquarters company. If the ACT which the company had not paid on the FID exceeds the amount which would have been set off or repaid under the FID provisions, the company will be liable to pay the excess to the UK Inland Revenue within 14 days of the end of the accounting period.

The provisions relating to the set-off or repayment of ACT in respect of a FID are complex. However, if the income of the international headquarters company consisted entirely of foreign dividends which had suffered foreign taxes at a rate of at least 31 per cent there will be no additional payment after the end of the accounting period. It is important to note, therefore, that an international headquarters company cannot currently completely ignore ACT in respect of its foreign source profits. Detailed calculations are needed in order to determine whether any payments must be made to the UK Inland Revenue after the end of the period. Fortunately, the whole FID system and the concept of international headquarters companies becomes redundant from 6 April 1999 with the abolition of ACT since the legislation is repealed on that date. UK holding companies now only have a short further period during which they need to be concerned with these complexities.

VI. FINANCING THE PARTICIPATIONS

Another substantial advantage for a UK holding company is that interest on borrowings to finance participations is potentially fully deductible for UK corporation tax purposes. This includes the opportunity for the UK holding company to surrender excess interest relief as group relief to another UK company, e.g. a profitable trading company, which is part of a 75 per cent owned group of UK companies, which includes the international holding company. Where a foreign group has other substantial operations in the United Kingdom, this can give important opportunities for additional tax relief.

There are currently no specific provisions in UK tax law which restrict the deductibility of interest on borrowings by a UK holding company and are used to finance foreign participations. When a comprehensive reform of the UK interest tax relief rules for companies was introduced under the corporate debt reforms in 1996 concern, however, arose that a general anti-avoidance provision in that legislation might be applied to restrict interest relief in these circumstances. This revision refers to "loans for unallowable purposes" and disallows interest relief where one of the main purposes of a borrowing is the obtaining of a UK tax advantage. However, where a borrowing is for the commercial purpose of acquiring a foreign participation, this anti-avoidance provision is unlikely to be applicable.

During the term of office of the previous government the Inland Revenue did put forward proposals at one stage to seek to restrict the deductibility of interest which related to the acquisition of foreign participations where the dividends received did not give rise to a UK tax liability because of the foreign tax credit relief on the dividends. These proposals did not, however, proceed.

There is some concern that the possibility of restricting interest relief on borrowings to finance foreign participations may be put forward again under the new Labour Government in the United Kingdom. There is a possibility that this issue may be considered as part of the review of the reform of double taxation relief referred to earlier.

At the present time, however, the opportunities for offsetting interest relief on the acquisition of foreign participations against other UK taxable profits in a group represent a major advantage for a UK holding company as compared to the main alternative location in the Netherlands, where no relief is available on borrowings to acquire foreign participations. Many other European holding company centres also have some restrictions on relief for interest on borrowings to finance foreign participations.

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VII. FORMING THE HOLDING COMPANY

Another important advantage of the United Kingdom as a holding company centre is the low cost of forming and capitalizing the holding company. There is no capital duty in the United Kingdom so that no taxes apply to the actual formation of the holding company, its initial capital or any subsequent increase in the capital. This contrasts with the position in the Netherlands and Luxembourg where a 1 per cent capital duty applies to the share capital, including any subsequent increase thereof.

The procedures for forming a new holding company are also simpler in the United Kingdom than in most continental European jurisdictions. It is possible to arrange the formation of a new company immediately through the use of "shelf" companies retained by company formation agents and the formation procedures are very simple so that there is normally no need to involve lawyers.

If the shares of the holding company are ever sold, a stamp duty of 0.5 per cent applies to the sales consideration. This stamp duty is payable by the purchaser.

VIII. THE IMPLICATIONS OF THE EC PARENT-SUBSIDIARY DIRECTIVE

One of the most important considerations for any European holding company is to ensure that it can take the maximum benefit of the EC Parent-Subsidiary Directive. This Directive provides for an exemption from any withholding tax on dividends paid from a subsidiary company resident in an EU country to a "parent company" also resident in an EU country which owns at least 25 per cent of the subsidiary and satisfies various other qualifying conditions. Only dividends paid by a Portuguese subsidiary are an exception to this rule whereby Portugal is allowed to continue to impose a 10 per cent dividend withholding tax up to the end of 1999.

As the exemption under the Parent-Subsidiary Directive often represents a substantial saving over the withholding tax rates specified in double taxation treaties it is vital that any European holding company can qualify for the Directive's benefits in respect of its participations in companies resident in EU countries.

The Directive itself makes no reference to holding company situations, but it does include a provision which states that it "shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse".

Certain of the EU countries have relied on this provision to introduce restrictions on the withholding tax exemptions under the Parent-Subsidiary Directive which may particularly apply to situations where subsidiaries are owned by a European holding company.

In Austria the implementation law provides that an Austrian subsidiary will be obliged to apply the dividend withholding tax to outgoing dividends to a EU parent company if the holding company does not fulfil the following criteria:

- it operates a business other than the pure administration of property;
- it employs a workforce;
- it maintains premises.

Accordingly, Austria expects to see substance in any EU holding company in order for the dividend withholding tax exemption to apply.

France, Italy and Spain each include provisions in their implementation law whereby if the EU parent company is controlled by non-EU shareholders, withholding tax relief under the Directive will not apply if the structure was established primarily to take advantage of the dividend withholding tax exemption.

German law now also includes the provision in Section 50(d) of the Income Tax Act which denies relief under both the Parent-Subsidiary Directive and under double tax treaties for payments to foreign conduit companies if the shareholders of the conduit company are not themselves entitled to the relief, unless the use of the conduit company can be justified by sound economic reasons or it exercises a business activity of its own.

Accordingly, in order to apply the reliefs from withholding tax under the Parent-Subsidiary Directive France, Germany, Italy and Spain would expect groups to be able to demonstrate that a European holding company structure has been established for commercial reasons rather than just to obtain withholding tax reliefs.

As many non-European multinational groups have their main centre of European operations within the United Kingdom, it is often possible to combine a UK holding company with a real European headquarters function and to demonstrate that the structure has been organized primarily for business reasons rather than to obtain tax advantages. This can often be more difficult with Netherlands and Luxembourg holding companies where the group may have no substantive business operations in those countries and the holding company may be little more than a paper company.

It is often, therefore, much easier for a UK holding company to satisfy the requirements of the Parent-Subsidiary Directive than for holding companies in many continental European locations.

IX. THE IMPACT OF ANTI-AVOIDANCE LAWS

One disadvantage of a UK holding company is the existence of two areas of law in the United Kingdom designed to counteract international tax avoidance by UK based groups.

The first of these provisions is the controlled foreign company legislation which could tax a UK holding company on the income of a subsidiary as it arises if that subsidiary were established in a country where the tax rate on its profits, as calculated under UK tax principles, is less than 75 per cent of the corresponding UK corporation tax, unless various complex exemptions can be satisfied. This means that it may not be suitable to use a UK holding company to own subsidiaries

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established in low tax territories, unless it is possible to mix dividend income from such low tax subsidiaries with those of other high tax subsidiaries through the use of an additional "mixer" holding company. However, with the UK corporation tax rate reducing to 30 per cent from 1 April 1999, there will not be very many subsidiaries which breach this requirement.

A UK holding company will be subject to the requirements to obtain Treasury consent under Section 765 of the Income and Corporation Taxes Act 1988 in respect of further issues and transfers of shares and debt securities in foreign subsidiaries of the holding company. There is no exclusion from the requirements of this section where the UK holding company is foreign owned. However, consent will always, in practice, be available in respect of bona fide commercial transactions and where the transaction involves a capital movement within the European Union, the requirement for consent is replaced by an information reporting obligation. This section, therefore, represents only an irritant rather than an obstacle in the great majority of cases.

X. SUMMARY

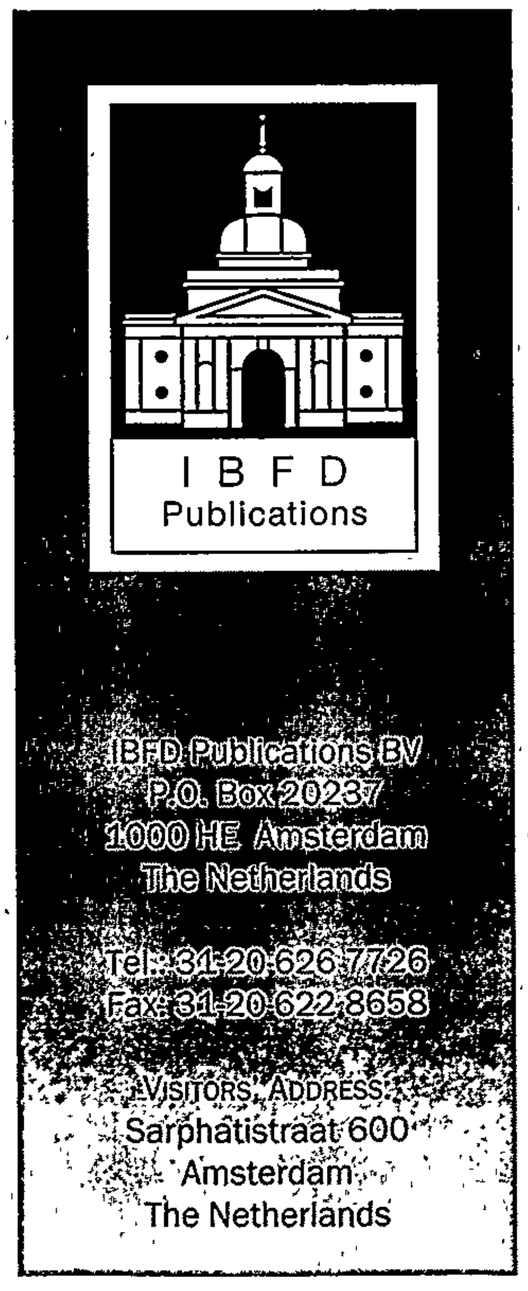
To summarize briefly the main advantages of the United Kingdom over most continental European holding company locations may be highlighted as follows:

- no withholding tax on dividends and from 6 April 1999 no tax of any kind when dividends are distributed to foreign shareholders;
- potentially full relief for interest on borrowings to finance foreign participations and flexible opportunities to offset such relief against other UK taxable profits;
- no capital duty on formation or on subsequent increases in share capital;
- more opportunities, in many cases, to provide the commercial substance to headquarters operations which may be essential for a holding company if it is to avoid problems in qualifying for dividend withholding tax exemptions from EC subsidiaries under the Parent-Subsidiary Company Directive.

These benefits are offset by some disadvantages, such as:

- a foreign tax credit system rather than a participation exemption which, to be fully effective, may need to rely on the use of separate "mixer" holding companies;
- full taxation of capital gains on the disposal of participations, subject only to inflation indexing relief. Sometimes, however, this may avoid the imposition of anti-abuse legislation in the jurisdiction of the ultimate parent company;
- certain restrictions under UK anti-tax avoidance legislation, such as the controlled foreign company provisions and requirements for Treasury consent under Section 765 Income and Corporation Taxes Act 1988.

Clearly the benefits are substantially outweighing the problem areas as the United Kingdom has been rapidly gaining in popularity as a European holding company location for multinational groups over the last four years.



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AUSTRALIA

WILL AUSTRALIA GO "THE FULL MONTY"? ASSESSING PROPOSED CHANGES TO AUSTRALIA'S CORPORATE INCOME TAX SYSTEM

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I. INTRODUCTION

In the lead up to the recent election, the Liberal Government (subsequently returned to power) released plans for revamping the Australian tax system ("the proposals").[1] These plans include not only provision for a general goods and services tax but also flag substantial changes to the Australian corporate income tax system ("the proposed system"). While the Labour Party refused to embrace a general goods and services tax, it did embrace the changes to the corporate income tax system.[2] The primary change is a move from a variable dividend tax credit imputation system to an equalization tax imputation system. Other major changes include the taxation of trusts as companies, refundability of excess dividend tax credits, introduction of a consolidated tax regime for corporate groups and a profits first rule for corporate distributions.[3] This paper focuses on the changes to the imputation system but in that context outlines other changes to the corporate income tax system.

The primary purpose of this paper is to assess the proposed system. As the proposals, in many respects, lack detail, a secondary purpose is to outline various options which are available to flesh out the proposals and assess the reasons why the government may adopt particular options. This is especially the case with respect to the treatment of non-resident shareholders in Australian companies. The government has expressed an intent to make the Australian corporate income tax system favourable to foreign investment. The issue is the extent to which the government is willing to go to achieve this aim, i.e. whether the government is willing to go "the full monty".

This paper is structured under three primary headings. The first heading considers the taxation of corporate income where derived. This heading provides a general outline of Australia's corporate income tax system. The second heading compares the proposed imputation system with the current imputation system. An imputation system is a corporate income tax system that grants dividend relief by providing shareholders dividend tax credits with dividends distributed. Dividend tax credits granted to shareholders are limited to corporate tax that is attributable to profits distributed.[4] Accordingly, the second heading considers the manner in which the current and proposed imputation systems measure the shareholder dividend tax credit by reference to corporate tax. The third heading considers the taxation of shareholders. This heading first considers the taxation of shareholders with respect to distributions of profits and, secondly, the circumstances where such taxation may arise where profits are not distributed.

II. TAXATION OF CORPORATE INCOME ON DERIVATION

The Australian income tax law is in the process of being simplified and rewritten (although the extent to which simplification has been achieved is debatable). Many of the provisions of the Income Tax Assessment Act 1936, as amended (ITAA 1936) continue to apply but are progressively being replaced by the provisions of the Income Tax Assessment Act 1997, as amended (ITAA 1997). This task has been performed over a number of years by the Tax Law Improvement Project. However, rewriting the Australian income tax law is still far from complete. Over the last decade and more, the Australian approach to drafting income tax law has been to attempt to exhaustively define the government/taxpayer relationship. This approach, involving long and detailed legislative provisions, has led to such decay in the overall structure and readability of the income tax law that it is often difficult to discern any particular policy objective underlying various provisions. The government proposes a new approach with a

1. Australian Government (1998), *Tax Reform: not a new tax, a new tax system*, circulated by the Treasury of the Commonwealth of Australia, August 1998 (Canberra: AGPS). This document was released on 13 August 1998.
2. Australian Labour Party (1998), *A fairer tax system with no GST* (Canberra: Better Printing Services) Chapters 5 and 12. This document was released on 27 August 1998.
3. The Labour Party proposals are silent with respect to the latter two proposals.
4. Harris, P.A. (1996), *Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries* (Amsterdam: IBFD) at 71-72.

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preference for general principles and adoption of an integrated tax code. The Tax Law Improvement Project may be "subsumed" in establishing the new tax code.[5] Hence, it is likely that Australia will be in the unenviable position of beginning to write a new tax law before rewriting the old tax law is even completed.

Resident companies are subject to Australian income tax with respect to their worldwide income.[6] By contrast, non-resident companies are subject to Australian income tax only with respect to income derived from Australian sources.[7] Australia already has a broad definition of "company" that includes all bodies corporate as well as unincorporated associations or bodies of persons but not including partnerships.[8] Further, certain limited partnerships and trading trusts are effectively treated in the same manner as companies.[9] The proposals will extend this treatment to other entities that are currently subject to special tax regimes. These entities include all trusts (subject to very limited exceptions), co-operatives and life insurers.[10] The proposals will also permit consolidation of all 100 per cent commonly owned entities subject to company tax treatment. In other words, members of a wholly owned group may elect to be treated as a single entity.[11] While this proposal is welcomed, the continuing high threshold for group relief (100 per cent) may be questioned and appears overly strict in the light of international practice.[12]

Division 4 of ITAA 1997 imposes income tax on companies with respect to taxable income derived during each financial year, i.e. each year ending 30 June. "Taxable income" is defined as assessable income less allowable deductions.[13] "Assessable income" consists of ordinary income and statutory income.[14] Ordinary income is primarily determined by case law. Statutory income consists of amounts specifically included in assessable income.[15] In particular, Section 102-5 of ITAA 1997 includes net capital gains in assessable income. Currently, roll-over relief is available for assets transferred between members of a wholly owned group of companies, i.e. any capital gain may be deferred and any capital loss is deferred.[16] As a general rule, assessable income is a gross income concept, deductions are only permitted to the extent expressly authorized. Business expenses are generally deductible under Section 8-1(1) of ITAA 1997 which provides an allowable deduction for expenses incurred in producing assessable income. Losses on the disposal of capital assets are quarantined, i.e. they are only available for set-off against capital gains.[17] Both revenue and capital losses are available for carry-forward but not back.[18] While members of corporate groups are taxed on a separate entity basis, currently there is provision for the transfer of both revenue and capital losses between members of the same wholly owned group.[19] The proposals note that the adoption of a consolidation regime for group companies will remove the need for the transfer of losses as well as roll-over relief on the disposal of assets between group members.[20]

The company tax rate has fluctuated in the last decade. The introduction of the imputation system in 1987 resulted in an increase in the company tax rate from 46 per cent to 49 per cent. The rate was reduced to 39 per cent in 1989 and to 33 per cent in 1994 but increased to 36 per cent in 1995.[21] This rate applies to both resident and non-resident companies. However, where dividends, interest or royalties are derived by non-resident companies from Australian sources, withholding tax is generally imposed in lieu of income tax.[22] Withholding tax is levied on a gross basis at the rate of 30 per cent of dividends and 10 per cent of royalties and interest.[23] The proposals outline a possible move to a company tax rate of 30 per cent. Whether this rate is adopted will depend on the outcome of consultation with business on proposed reforms to the business investment base and, in particular, the present treatment of changing asset and liability values for income tax purposes.[24]

Also worthy of note are a number of effects that the proposals may have on the taxation of foreign source income derived by Australian companies. Australia unilaterally offers foreign tax relief in the form of both a direct and an indirect foreign tax credit. Further, Australia unilaterally exempts certain foreign dividends received by Australian companies from foreign subsidiaries and certain profits of foreign branches. Foreign profits of foreign branches of Australian companies are exempt from Australian company tax where they are derived from carrying on business in a listed country which subjects such profits to tax.[25] Further, dividends received by Australian companies from 10 per cent subsidiaries resident in listed countries may be exempt under Section 23AJ of ITAA 1936.[26] Further, dividends from 10 per cent subsidiaries resident in unlisted countries may also be exempt, but only to the extent that profits distributed may be traced as having an original source in either Australia or a listed country.

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5. Australian Government (1998), *supra* note 1 at 149.
6. ITAA 1997 Secs. 6-5(2) and 6-10(4).
7. ITAA 1997 Secs. 6-5(3) and 6-10(5). Further, ITAA 1936 Sec. 23(r) generally exempts non-residents with respect to foreign source income.
8. ITAA 1997 Sec. 995-1.
9. ITAA 1936 Part III Divisions 5A, 6B and 6C.
10. Australian Government (1998), *supra* note 1 at 113-115.
11. Australian Government (1998), *supra* note 1 at 122-123.
12. For example, Germany and Mexico permit consolidation between certain 50 per cent owned group members and the United States between 80 per cent owned group members; Corporate Income Tax Law (Germany) Secs. 14-19, Income Tax Law (Mexico) Art. 57A and Internal Revenue Code (United States) Secs. 1501 and 1504, respectively.
13. ITAA 1997 Sec. 4-15(1).
14. ITAA 1997 Sec. 6-1(1).
15. Generally, see ITAA 1997 Sec. 10-5.
16. ITAA 1997 Subdivision 126-B.
17. ITAA 1997 Secs. 102-5 and 102-10.
18. ITAA 1997 Division 36 and Sec. 102-15, respectively.
19. ITAA 1997 Division 170.
20. Australian Government (1998), *supra* note 1 at 123.
21. Income Tax Rates Act 1986 Sec. 23.
22. Withholding tax is regulated by ITAA 1936 Part III Division 11A. Income subject to withholding tax is generally excluded from assessable income, Sec. 128D.
23. Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974 Sec. 7.
24. Australian Government (1998), *supra* note 1 at 125.
25. ITAA 1936 Sec. 23AH. The exemption is not available with respect to certain concessionally taxed foreign income.
26. Dividends are only exempt under ITAA 1936 Sec. 23AJ to the extent they are not distributed from income previously attributed under Australia's Controlled Foreign Company provisions. The distribution of such previously attributed income is exempt under Secs. 23AI and 23AK.

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Where an appropriate exemption does not apply, a direct foreign tax credit is granted with respect to foreign tax paid by Australian companies with respect to foreign source income included in assessable income.[27] The credit is limited to Australian tax chargeable with respect to grossed up foreign income. Accordingly, the Australian foreign tax credit is calculated on a worldwide basis, excess foreign tax credits arising with respect to tax paid in one country may be set against Australian tax chargeable with respect to foreign income from another. However, foreign passive income is effectively quarantined, foreign tax credits granted with respect to such income are calculated separately.[28] Australia also offers an indirect foreign tax credit, although it only applies in limited circumstances. In effect, the indirect foreign tax credit is available for Australian companies receiving dividends from 10 per cent subsidiaries resident in unlisted countries distributed from profits that have not been previously attributed under Australia's accruals regimes. The indirect foreign tax credit extends to income tax paid by subsidiaries and lower tier subsidiaries considered related foreign companies.[29] The indirect foreign tax credit is calculated in accordance with Section 160AFC of ITAA 1936 which deems the amount so calculated to be foreign tax paid by recipient Australian companies entitling them to foreign tax credits under Section 160AF of ITAA 1936. Excess foreign tax credits may be carried forward for five years and, presently, may be transferred within a wholly owned group.[30] This ability to transfer excess foreign tax credits will be removed in the context of the proposed consolidation regime.

Australia has also implemented Controlled Foreign Company (CFC) provisions.[31] Under these provisions, a portion of attributable income of CFCs may be included in the assessable income of attributable Australian shareholders.[32] The proposals intend to limit the availability of the consolidation regime to resident entities subject to company tax treatment. They will not permit a wholly owned CFC to consolidate with its Australian parent. The appropriateness of this approach may be questioned. The policy underlying the CFC regime is to tax controllers on a current basis with respect to profits derived by non-resident subsidiaries. This policy is achieved by permitting non-resident group companies to consolidate with resident companies.[33] Assuming the consolidated group remains resident, the group's worldwide income will be taxed on a current basis.[34] Extending the availability of the consolidation regime to non-resident companies may result in compliance cost savings.

Similarly, it may be useful to investigate consolidation between Australian subsidiaries of a foreign parent and the foreign parent's Australian branches.[35] This may be possible where remittances from Australian subsidiaries and Australian branches are treated in a consistent manner under the Australian corporate tax system, e.g. where they are exempt from Australian dividend withholding tax and any equivalent for branch remittances (this is primarily the present situation in Australia). In particular, equivalent treatment of Australian subsidiaries and Australian branches requires Australian branches of non-resident companies be subject to the imputation system.

III. MEASURING THE SHAREHOLDER CREDIT BY REFERENCE TO CORPORATE TAX

The current Australian imputation system was adopted as part of an extensive reform of the Australian tax system during the late 1980s and early 1990s which also resulted in broadening the tax base and reducing tax rates. Initially, it appeared Australia would adopt an advance corporation tax approach to imputation, similar to that of the United Kingdom. However, by the time the details of the imputation system were announced, the government had changed its mind and decided to adopt a variable dividend tax credit approach.[36] Australia adopted a full imputation system having effect from 1 July 1987.[37] Since adoption, the Australian imputation system has been subject to many amendments (on a virtually annual basis) although the basic structure of the system remains intact.

In only granting shareholders dividend tax credits for corporate tax paid, an imputation system will demonstrate three fundamental characteristics. Firstly, an imputation system will identify corporate profits with corporate tax. I have referred to this as recording the corporate tax. Secondly, an imputation system will incorporate a mechanism which ensures that shareholders do not receive more dividend tax credits with a distribution than corporate tax attributed by the recording mechanism to corporate profits distributed. I have referred to this as a mechanism for adjusting the shareholder credit or corporate tax. Thirdly, assuming that some profits are attributed corporate tax at a different rate than other profits, it is necessary to identify an order in which profits subject to greater or lesser rates of corporate tax are distributed. I have referred to this as allocation of profits as retained or distributed.[38] This heading proceeds to discuss each of these aspects under the current and proposed Australian imputation systems.

As an introduction to that discussion, it is useful to highlight the basic structural features of the present Australian imputa-

27. ITAA 1936 Sec. 160AF.
28. ITAA 1936 Sec. 160AF(7).
29. The concept of "related foreign company" is governed by ITAA 1936 Sec. 160AFB.
30. ITAA 1936 Sec. 160AFE.
31. ITAA 1936 Part X. Australia has also implemented accruals regimes applying to certain foreign trusts and foreign investment funds. These regimes are beyond the scope of the present discussion.
32. ITAA 1936 Sec. 456(1).
33. The Mexican consolidation regime permits consolidation between a Mexican parent and its 50 per cent non-resident subsidiaries provided they are resident in a treaty country; Income Tax Law (Mexico) Art. 57A. The United States consolidation regime may also include wholly owned non-resident corporations which elect to be treated as resident; Inland Revenue Code (United States) Sec. 1504(d).
34. Non-resident subsidiaries would remain non-resident for treaty purposes with the result that Australia would continue to be obliged to provide the consolidated group with foreign tax relief for foreign taxes suffered by non-resident subsidiaries.
35. For example, Germany permits this type of consolidation; Corporate Income Tax Law (Germany) Sec. 18.
36. See Harris (1996), *supra* note 4 at 561 and the references cited therein.
37. ITAA 1936 Part IIIAA inserted by Taxation Laws Amendment (Company Distributions) Act 1987 Sec. 14.
38. See Harris (1996), *supra* note 4 at 135-137.

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tion system and the extent to which the proposals will change those features. The current Australian imputation system aligns the level of company tax paid by Australian companies to dividend tax credits granted to their shareholders by adjusting the level of dividend tax credits attached to dividends. Corporate profits are credited to an account in an amount that is a function of company tax paid by Australian companies. This account measures profits that may be distributed with dividend tax credits attached at the maximum rate. Accordingly, shareholders do not receive dividend tax credits at a constant rate with dividends from Australian companies. Australian companies are, however, required to distribute taxed profits prior to untaxed profits.

By contrast, under the proposed system, the level of corporate tax will be adjusted to dividend tax credits granted to shareholders through the imposition of equalization tax (referred to in the proposals as "deferred company tax"). Equalization tax will be levied where profits are distributed which have not borne company tax at the full rate. This means that under the proposed system, shareholders will receive dividend tax credits at a constant rate with dividends from Australian companies.

A. Recording the corporate tax

While Australian company tax is imposed at a headline rate of 36 per cent, as a result of various preferences, in particular foreign tax relief, the effective rate of tax actually payable to Australia by Australian companies is in many cases less. In order to ensure they pay sufficient tax to fund dividend tax credits granted to their shareholders, Australian companies are required to record corporate profits with respect to which Australian company tax is paid at the headline rate. This record is referred to as the "franking account". There is no specific provision in ITAA which requires companies to maintain a franking account nor, for that matter, which limits the maintenance of a franking account to Australian resident companies. However, the maintenance of a franking account is implicit in ITAA. Presently, each company within a wholly owned group maintains a separate franking account. Further, there is no provision enabling the transfer of credits (except through the distribution of dividends) or debits from one group company's franking account to another. In effect, this will be remedied under the proposed consolidation regime as only one franking account will be maintained for all companies within a consolidated group.

Presently, only resident companies maintain a franking account as only resident companies may distribute dividends with dividend tax credits attached.[39] This means the benefits of the imputation system are currently limited to resident companies. The proposals express as a principle on which further consultation will be based that "the taxation of branches of foreign entities is in line with the entity tax regime."[40] It appears that, in order to comply with this principle, Australian branches of non-resident companies may be subjected to the imputation system. This is not a common practice among imputation countries.[41] In the present context, such treatment will require Australian branches of non-resident companies to maintain a franking account. One imputation country which adopts this type of approach is Mexico. Mexican branches of non-resident companies are required to maintain an account of taxed profits which is similar to that maintained by resident companies under the Mexican imputation system.[42]

ITAA 1936 makes provision for the ascertainment of a franking surplus or deficit of Australian companies at any given point. A franking surplus occurs where companies' franking credits exceed their franking debits and a franking deficit in the reverse situation.[43] Franking credits include: any franking surplus carried over from the previous year,[44] any franked dividends received from other companies (i.e. distributions with dividend tax credits attached)[45] as well as the "adjusted amount" of company tax paid.[46] Franking debits include: the distribution of franked dividends (i.e. distributions with dividend tax credits attached)[47] as well as the "adjusted amount" of refunds of company tax.[48] The "adjusted amount" converts company tax paid or refunded into a corporate profits equivalent, net of company tax.[49] Interestingly, certain credits and debits only arise where companies are sufficiently resident in Australia.[50] Assuming these recording requirements are to be maintained under the proposed system, they will require some adjustment if Australian branches of foreign companies are to be subject to the imputation system. In particular, such branches will record a debit to the franking account where they remit profits to foreign head office (being the closest equivalent to a dividend distribution).

This taxed profits method of recording the corporate tax causes problems where the corporate tax rate changes and Australian experience demonstrates this. Australia has altered its company tax rate three times since the introduction of the imputation system. In the first instance the company tax rate was reduced from 49 per cent to 39 per cent, applicable from 1988. On this occasion the franking account records of Australian companies were not altered. Companies may have paid company tax with respect to profits credited to the franking account at the rate of 49 per cent for the years 1986-1988. Yet where such profits were distributed after 1988 but before 1994, fully franked dividends were only entitled to dividend tax credits at the new rate of 39 per cent of grossed up dividends. In other words, Australian companies were not in a position to attach dividend tax credits at the full rate at which they may have paid company tax with

39. ITAA 1936 Sec. 160AQF.
40. Australian Government (1998), *supra* note 1 at 118.
41. See Harris (1996), *supra* note 4 at 401-403.
42. Income Tax Law (Mexico) Art. 152.
43. ITAA 1936 Sec. 160APJ.
44. ITAA 1936 Sec. 160APL.
45. ITAA 1936 Sec. 160APP.
46. Credits to the franking account are regulated by ITAA 1936 Part IIIAA Division 2 Subdivision B.
47. ITAA 1936 Sec. 160AQB.
48. Debits to the franking account are regulated by ITAA 1936 Part IIIAA Division 2 Subdivision C.
49. ITAA 1936 Sec. 160APA defining "adjusted amount". In accordance with the current company tax rate, company tax paid or refunded is multiplied by $^{64}/_{36}$ to arrive at the adjusted amount.
50. ITAA 1936 Secs. 160APK and 160APW.

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respect to profits distributed, resulting in somewhat less than full dividend relief.

The company tax rate reduction of 1994, 39 per cent to 33 per cent, was treated differently. On this occasion, Australian companies may have accumulated profits of many years taxed at the former rates of 49 per cent or 39 per cent represented by substantial franking surpluses. On this occasion Australia required companies to maintain two franking accounts. The class A franking account records profits fully taxed at the 39 per cent and 49 per cent company tax rates, and the class B franking account records profits fully taxed at the 33 per cent company tax rate. Many of the provisions applying to the franking account were duplicated to reflect the dual account system. Accordingly, assuming a credit in both accounts, companies may have distributed dividends with dividend tax credits (franked amounts) attached at the class A rate (39 per cent of gross dividends) or dividend tax credits attached at the class B rate (33 per cent of gross dividends).[51]

The company tax rate increase of 1995, 33 per cent to 36 per cent, was again treated differently. In this case, Australian companies were required to convert the balances in their class A and B franking accounts into a single balance in a new class C franking account.[52] The balance in the class A franking account was multiplied by $^{39}/_{61} \times {}^{64}/_{36}$ and that in the class B franking account by $^{33}/_{67} \times {}^{64}/_{36}$.[53] The resultant amounts were credited to the class C franking account. This process simplified the Australian imputation system by reducing the number of franking accounts to be maintained by Australian companies. It also ensured Australian companies maintained the full value of company tax paid prior to the rate increase, i.e. all company tax paid is still available to fund dividend tax credits. However, the process divorced the relationship between profits retained by some Australian companies and company tax paid by them.

As mentioned, the proposals outline a possible reduction in the company tax rate from the current 36 per cent to 30 per cent. If this reduction occurs (particularly if it occurs in a number of instalments) and the Australian imputation system continues to record taxed profits, the Australian imputation system will suffer the same difficulties it has suffered as a result of previous company tax rate changes. By contrast, if the imputation system is changed such that it records company tax paid, rather than profits subject to company tax at the headline rate, many of these difficulties will disappear.[54] Recording company tax is a common method by which imputation countries record the corporate tax.[55] There is one issue such a change will not address. Problems will still arise (assuming companies are entitled to credit all company tax paid at previous rates to shareholders) for companies with a substantial surplus of retained profits taxed at the current higher rate. If such companies are only entitled to attach dividend tax credits at the new lower rate, i.e. 30 per cent of grossed up dividends, they may find they have surplus credit in their company tax account even after they have distributed all of their profits.[56]

Australian companies may also maintain a record of certain foreign dividends received in order to reduce the withholding tax liability of non-resident shareholders where such dividends are redistributed. Currently, Australian companies may maintain an account (parallel to the franking account) which records certain profits net of foreign tax, designated a "foreign dividend account" (FDA).[57] The FDA is only credited with certain dividends received from 10 per cent foreign subsidiaries or such dividends redistributed by and received from wholly owned subsidiaries.[58] Income derived by foreign branches of Australian companies may not be credited to the FDA nor may dividends received from CFCs out of previously attributed profits.[59] The amount of dividends credited to the FDA is adjusted in order to ensure that no overlap occurs via crediting the franking account and the FDA in respect of the same dividend, i.e. to ensure no double crediting occurs. Where foreign dividends received are exempt under Section 23AJ of ITAA 1936 (received from 10 per cent subsidiaries resident in listed countries) the whole amount of any such dividend is credited to the FDA. Where dividends are not so exempt (and not distributed from profits previously attributed under the CFC measures) but, rather, a foreign tax credit is available, dividends are apportioned between an amount taxed by Australia and an amount taxed by foreign countries. The FDA is credited with the latter amount which basically reflects the net portion of any such dividend attributable to creditable foreign tax on the assumption such tax is levied at the same rate as Australian company tax.[60] The FDA is debited with expenses incurred by Australian companies in deriving creditable dividends and also with dividends distributed from the FDA.[61]

An issue is the manner in which the proposals may impact on the operation of the FDA. The FDA regime is designed to provide relief from Australian taxation where foreign source income derived by Australian companies for which foreign tax relief is granted is distributed to non-resident shareholders (the "flow-through situation"). The proposals flag potential changes in this area without details other than a stated principle. This principle is that "the Australian taxation system does not unduly impede offshore income passing through Australia to non-residents..."[62] As the FDA was introduced for this purpose, it is assumed that the FDA or something akin to it will continue. Potential amendments to the FDA regime which are consistent with other aspects of the proposals are considered subsequently. However, a num-

51. ITAA 1936 Sec. 160AQF(1) and (1AA).
52. ITAA 1936 Sec. 160ASF.
53. ITAA 1936 Secs. 160ASG and 160ASH.
54. See Harris (1996), *supra* note 4 at 193-200.
55. Presently, the Finnish, Malaysian, New Zealand and Singaporean imputation systems record company tax rather than profits subject to company tax. Malaysia and Singapore have done so since the mid-1950s.
56. For a method to circumvent these difficulties without maintaining two franking accounts, see Harris (1996), *supra* note 4 at 200.
57. Foreign dividend accounts are regulated by ITAA 1936 Part III Division 11A Subdivision B.
58. FDA credits are regulated by ITAA 1936 Sec. 128TA.
59. Although, in the case of CFCs this treatment may be effectively avoided by ensuring CFCs adopt a current distribution policy.
60. Actually, the entire dividend is credited to the FDA and a corresponding debit arises with respect to the portion of the dividend attributable to Australian tax. However, the net effect is as described in the text.
61. FDA debits are regulated by ITAA 1936 Sec. 128TB.
62. Australian Government (1998), *supra* note 1 at 118.

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ber of points are worthy of note at this stage. The proposal to introduce a consolidation regime makes no specific reference to consolidated group companies maintaining a single FDA. Nevertheless, it is likely that such an approach will be adopted together with repeal of the ability to credit the FDA with dividends (with FDA credits attached) received from wholly owned resident subsidiaries.

It is hoped that the consultation process will consider broadening the scope of amounts that may be credited to the FDA, at least to include profits derived through a foreign branch. This is consistent with permitting wholly owned non-resident subsidiaries to consolidate with Australian parents. The flow-through regimes of a number of other countries (including Malaysia, Singapore and the United Kingdom) apply to all foreign source income derived by resident companies and not just foreign non-portfolio dividends.[63] Finally, it is not clear what the effect of treating Australian branches of non-resident companies consistently with Australian companies will mean in the context of the FDA. In principle, the FDA of such branches will record remittances from overseas (perhaps limited to foreign non-portfolio dividends) which may be remitted to the foreign head office without liability to Australian tax. An issue is whether Australia is entitled to tax foreign source income attributable to an Australian branch of a non-resident company.[64]

B. Adjusting the shareholder credit or corporate tax

Presently, Australian companies are, as a general rule, required to attach dividend tax credits at the maximum rate to dividends distributed. That is, Australian companies are required to distribute corporate profits from their franking account until exhausted. Dividends distributed from the franking account are referred to as fully franked dividends. Once credit in their franking account is exhausted, Australian companies may only distribute unfranked dividends, i.e. dividends with no dividend tax credit attached. Under the proposed imputation system, Australian companies will be required to frank what were formerly unfranked dividends through the payment of equalization tax. This means shareholders will always receive franked dividends. This subheading first discusses the manner in which Australian companies presently attach dividend tax credits and FDA credits to dividends and notes how this will be affected by the proposals. Secondly, the subheading considers the extent to and manner in which the Australian imputation system washes out corporate preferences on distribution under both the existing and the proposed systems.

1. Adjustment mechanism

The ability of Australian companies to *frank* dividends (attach dividend tax credits based on the company tax rate) is currently subject to a number of rules. Only certain dividends are *frankable*. For example, certain disguised dividends are not frankable[65] neither are dividends which are reasonably equivalent to interest on a loan or which are distributed from certain disqualifying accounts.[66] Presently, such dividends often result in double taxation because they are taxable in the hands of shareholders without dividend tax credits while distributing companies are also denied a deduction with respect to such distributions. It is hoped that this inconsistency will be addressed by the reform process. Further, dividends may only be *franked* by companies which are resident in Australia at the time of distribution. As noted in III.A, this will have to be changed if Australian branches of foreign companies are to be treated in a similar manner as Australian companies.

Presently, dividends are only franked to the extent specified in a declaration made by companies before dividends are paid.[67] To the extent dividends are not *fully franked*, a portion of such dividends are *unfranked*. Accordingly, dividends may consist of two portions, a franked portion (dividend tax credits attached based on the company tax rate) and an unfranked portion (no dividend tax credits attached) which are determined by a declaration made by distributing companies. It is unlikely that this declaration procedure will continue under the proposed system because there will be no distinction between franked and unfranked dividends. Further, there are a number of rules which currently determine the extent to which dividends may be franked and which, therefore, affect the declaration of franked amounts made by companies. Essentially, these rules are designed to allocate franking credits over dividends distributed during a year. The application of these rules to an equalization tax imputation system appears inappropriate.

For example, companies are required to frank dividends to the maximum extent permitted by their franking surplus at the time of distribution.[68] Special rules apply where companies are committed to pay further dividends on the same day or are obliged to distribute franked dividends later in the year. These rules effectively apportion the franking surplus among the dividends concerned. If these rules are applied under the proposed system, the effect may be to expose distributing companies to a liability for equalization tax despite having credit in their franking account. The removal of these rules appears logical.

Presently, where companies do not frank dividends to the extent required, i.e. they do not attached sufficient dividend tax credits, and the required franked amount is more than 10 per cent of such dividends, a franking debit arises. The franking debit is equal to the difference between the franked and the required franked amount of such dividends.[69] Company tax represented by this debit is never imputed to shareholders. If this rule continues under the proposed system it

63. For a recent comparison of flow-through regimes, see Harris, P.A. (1998), "An International Comparison of Flow-through Regimes: How Does New Zealand's New Regime Rate?", 52 *Bulletin for International Fiscal Documentation* 3 (1998), at 102.
64. Many Australian tax treaties contain a source of income article, e.g. Australia–New Zealand Double Tax Treaty Art. 23. This article typically sources within Australia, for the purposes of Australian law, income (including foreign source income) attributable to an Australian branch under the treaty. The apparently unfortunate result is that the branch is taxable with respect to such income without foreign tax relief.
65. ITAA 1936 Secs. 108, 109 and Part III Division 7A.
66. ITAA 1936 Secs. 46D and 46M.
67. ITAA 1936 Sec. 160AQF.
68. ITAA 1936 Sec. 160AQE.
69. ITAA 1936 Sec. 160APX.

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will also result in the wastage of franking credits because companies will suffer a franking debit and also be liable to equalization tax with respect to the under franked part of dividends. This rule appears to make little sense in the context of the proposed system. Indeed, under the proposed system it is difficult to see what possible benefit could be derived by companies under franking.

Companies are not presently precluded from franking dividends in excess of the required franked amount, i.e. generally attaching more dividend tax credits than their franking surplus at the time of distribution. Companies may do so where they expect further franking credits during a year, e.g. through the receipt of franked dividends. However, companies may be subject to penalty provisions should they misjudge and realize a franking deficit at the end of a year. Companies with a franking deficit at the end of a year are liable for franking deficit tax.[70] Liability to franking deficit tax is calculated by converting any franking deficit (which is measured in terms of profits net of tax) into a tax equivalent.[71] Franking deficit tax is not a penalty tax, it ensures sufficient tax is paid at the corporate level to fund dividend tax credits attached to dividends. Further, franking deficit tax is not an income tax levied on Australian companies but, rather, a corporate distributions tax. Accordingly, franking deficit tax already performs the same function as an equalization tax and will, no doubt, be replaced by it under the proposed system.

Unlike franking deficit tax, franking additional tax is inconsistent with the proposed system. Franking additional tax is a penalty tax which is designed to discourage Australian companies from realizing franking deficits at the end of a year. It is imposed where companies have franked dividends in excess of the required amount and the franking deficit realized at the end of a year is more than 10 per cent of all franking credits entered in a company's franking account during the year.[72] Where these conditions are met, franking additional tax is incurred in the amount of 30 per cent of the franking deficit. This is a penalty tax which may not be set against company tax liability or credited to the franking account. Presently, Australian companies distributing profits which have not been subject to Australian tax (and so not credited to the franking account) typically lower the franked amount of dividends so as to not create a franking deficit at the end of a year and remove exposure to franking additional tax. Franking additional tax is inconsistent with the proposed system because companies distributing untaxed profits will not be able to reduce dividend tax credits attached to dividends, i.e. they must pay equalization tax (equivalent to franking deficit tax).

In the result, it is expected that franking declarations (though perhaps not shareholder dividend statements) will be removed by the proposed system. I am not aware of any country adopting an equalization tax imputation system which uses such declarations. Rather, all dividends will be fully franked and Australian companies will conduct periodic reconciliations of their franking account in order to determine their liability for equalization tax. This liability will be calculated in the same manner as franking deficit tax, i.e. by multiplying the deficit by $^{36}/_{64}$. So, for example, a franking deficit of 64 will give rise to an equalization tax liability of 64 x $^{36}/_{64}$ being 36.

An important issue is the timing of reconciliations of the franking account and liability for equalization tax. The current imposition of franking deficit tax provides one option in this regard. Franking deficit tax is a tax imposed at the end of the tax year based on a franking deficit at that time.[73] This may be the approach taken with respect to the equalization tax under the proposed system and is one already adopted by a number of other imputation countries including Finland, Malaysia and Mexico.[74] However, there are a number of reasons to suspect that equalization tax will be payable on a more regular basis than yearly. With a move to refundable dividend tax credits, the government may be unwilling to grant such credits to shareholders prior to receipt of funds designed to cover the credits. The existence of franking additional tax suggests that the government is already uneasy about granting dividend tax credits which are not covered by company tax paid. Further, franking surpluses and deficits are currently calculated on a continuous basis. Any franking surplus as at the date of payment of a dividend (usually) determines the extent to which a dividend is required to be franked. Such continuous reconciliation is unnecessary in the context of an equalization tax imposed on a yearly basis where it is only the end of year reconciliation which matters.

The government has a number of options if it decides to levy equalization tax on less than a yearly basis. For example, it may levy equalization tax shortly after untaxed profits are distributed. Alternately, equalization tax may be levied on a periodic basis shorter than a year. The imposition of equalization tax by France and Singapore provides an example of the former and advance corporation tax (soon to be repealed) by the United Kingdom of the latter. Under the Singaporean imputation system companies are required to reconcile their imputation account (Section 44 account) on the payment of every dividend. Therefore, there is some similarity with the present Australian system. To the extent that Singaporean companies have paid insufficient company tax to fully frank dividends, they are required to pay equalization tax. This tax is due 14 days after the payment of such dividends.[75] Under the French imputation system, French companies nominate the profits from which dividends are distributed. If these profits have not been taxed at the full corporate tax rate, equalization tax is imposed. Equalization tax is declared by French companies on a special tax return (Form 2750) and is paid no later than the fifteenth day of the second month following the distribution.[76] This may be contrasted with the manner in which United Kingdom companies account for

70. ITAA 1936 Sec. 160AQJ.
71. That is, with the current company tax rate, multiplying the franking deficit by $^{36}/_{64}$.
72. ITAA 1936 Sec. 160ARX.
73. Franking deficit tax is payable on the last day of the month following the end of the tax year, i.e. usually payable on 31 July.
74. Imputation Credit Law (Finland) Sec. 8, Income Tax Act 1967 (Malaysia) Sec. 108(5) and Income Tax Law (Mexico) Art. 10-A, respectively.
75. Income Tax Act (Singapore) Sec. 44. The Sec. 44 account is actually reconciled on the basis of company tax assessed. However, equalization tax is effectively imposed as described in the text.
76. General Tax Code (France) Annex III Art. 46 quarter OF.

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advance corporation tax. Such companies are required to make quarterly returns to the Inland Revenue accounting for advance corporation tax.[77] Such an option may be particularly attractive to the government because it proposes that all companies pay income tax in quarterly instalments.[78]

If quarterly payments are adopted, there is still an issue as to whether the franking account is reconciled for the purpose of calculating equalization tax on a quarterly basis or after the payment of each dividend. The longer the period of time between reconciliations the greater the benefit to companies. For example, a company may pay a dividend in the middle of a quarter at a time when it has no franking surplus. If equalization tax is calculated at the time of payment of each dividend this situation will give rise to a liability to that tax. However, if equalization tax is calculated quarterly this might not be the case. For example, a company tax instalment to be paid at the end of a quarter may be available as a franking credit with respect to such a quarterly calculation, i.e. the instalment may be available to frank the dividend distributed during the quarter. As the premise of the proposed instalment system is that instalments constitute tax payable with respect to profits derived during the quarter, there is a certain logic in adopting such a quarterly reconciliation for equalization tax purposes.

It is also possible to reconcile on a yearly basis but require payment of equalization tax on a quarterly basis. This may be achieved by calculating equalization tax on a quarterly basis but permitting it to be carried forward to set against future company tax instalments (and any final payment) which pertain to the same tax year. Indeed, the shorter the period between reconciliations, the greater the pressure is likely to be to allow equalization tax paid by companies to be available for offset against their future company tax liability. This may partly explain why Singapore changed its imputation system in 1987 to allow companies to carry equalization tax forward (indefinitely) to offset their future company tax liability.[79] The United Kingdom has always permitted advanced corporation tax to be used in this manner.[80] Interestingly, Australia's existing equalization tax, franking deficit tax, may also offset companies' future company tax liability.[81] However, the carry-forward of equalization tax produces some less than desirable results which are described below in the context of the wash out of corporate preferences.

Turning to the FDA, where Australian companies have a FDA surplus they may attach FDA credits to dividends in much the same manner as companies attach dividend tax credits from the franking account. Australian companies may make a FDA declaration specifying the extent to which dividends consist of a FDA declaration percentage.[82] As mentioned at III.A, only non-resident shareholders of Australian companies benefit from FDA credits through a reduction in dividend withholding tax. However, Australian companies may not stream FDA credits only to non-resident shareholders. The FDA declaration applies to all dividends distributed at a given time and the FDA debited with respect to all such dividends.[83] For reasons discussed at III.C, even under the proposed system companies are likely to be required to make a declaration in order to attach FDA credits.

The present structure of the FDA regime raises a number of issues under the proposed system. Distributions from the FDA are, in effect, currently treated as unfranked dividends for residents and franked dividends for non-residents. Therefore, in principle, equalization tax should be imposed with respect to distributions to resident shareholders but not with respect to distributions to non-resident shareholders. However, because equalization tax is a corporate level tax, all the benefit from the reduction in liability to equalization tax as a result of distributions to non-resident shareholders would not be received by the non-resident shareholders. A logical solution to this problem is one which has been adopted in various circumstances by a number of equalization tax countries.[84] That is, levy equalization tax with respect to all distributions from the FDA but permit non-resident shareholders (only) to, either directly or indirectly, claim a refund of equalization tax levied with respect to their distributions. This is discussed further at IV.A.2. A point worthy of note at this stage is that because the FDA records profits gross of Australian tax, if distributions from the FDA are subject to equalization tax, the FDA account should be debited with both dividends distributed and the corresponding equalization tax liability.

The present Australian imputation system contains a number of anti-abuse rules. In particular, there are recently tightened provisions relating to dividend streaming arrangements.[85] These provisions seek to ensure that dividends with attached dividend tax credits are not distributed to shareholders who can use dividend tax credits while dividends with no such credits are streamed to shareholders who cannot use dividend tax credits. The government feels that, with the full franking imposed by the introduction of an equalization tax, these rules can be removed. However, the government sees the need to retain other anti-abuse rules designed to deter trading in dividend tax credits, i.e. the deriving of dividend tax credits by persons who are not considered the economic owners of the dividends.[86] In the past, this trading was primarily achieved through the use of financial instruments such as hedges and options. It is combated by a general anti-abuse rule applicable to disposals of shares for the not incidental purpose of providing a person with franking credit benefits and a rule borrowed from the United States whereby the benefits of dividend credits may, as a general rule, only be claimed by persons holding their shares at risk for a period of at least 45 days.[87]

77. Income and Corporation Taxes Act 1988 (United Kingdom) Sch. 13.
78. Australian Government (1998), *supra* note 1 at Chapter 4.
79. Income Tax Act (Singapore) Sec. 44(11).
80. Income and Corporation Taxes Act (United Kingdom) 1988 Sec. 239.
81. ITAA 1936 Part IIIAA Division 5 Subdivision C.
82. ITAA 1936 Sec. 128TC.
83. Companies may be liable to a penalty tax where distributing dividends with excessive FDA credits attached; ITAA 1936 Sec. 128TE.
84. These countries include France, Germany and, formerly, Italy (which has recently repealed its equalization tax). See Harris (1996), *supra* note 4 at 354.
85. ITAA 1936 Secs. 160AQCB and 160AQCBA. For an assessment of the recent amendments, see Harris, P.A. (1998), "Dividend Streaming", *Australian Tax Review*, September 1998, at 133.
86. Australian Government (1998), *supra* note 1 at 124.
87. ITAA 1936 Sec. 177EA and Taxation Law Amendment Bill (No 5) 1998 Sch. 8 inserting Division 1A in Part IIIAA of ITAA 1936. The provision borrowed from the United States is Internal Revenue Code (United States) Sec. 246(c).

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2. Washout of corporate preferences

In the simple situation, where all corporate profits are distributed each year to individuals, the Australian imputation system, as a general rule, washes out corporate preferences including domestic incentives such as the research and development allowance and foreign tax relief. The receipt by Australian companies of income which is not subject to Australian company tax results in profits available for distribution which are not credited to the franking account. Presently, the result is distributable profits to which Australian companies may be unable to attach dividend tax credits. Such dividends are fully taxable in the hands of recipient individual shareholders without reduction through offset of dividend tax credits. In this way, the current Australian imputation system washes out corporate preferences on distribution at the shareholder level, i.e. through increased taxation when compared to dividends with attached dividend tax credits. In particular, the effect of the Australian imputation system is to reduce any foreign tax relief granted to Australian companies, whether through exemption or credit, to a mere deduction for foreign tax where foreign income of Australian companies is distributed.

There is no suggestion that this wash out will be removed under the proposed system. However, the wash out will occur at the corporate level through the imposition of equalization tax instead of at the shareholder level. This raises issues as to whether, by imposing equalization tax on the distribution of foreign source income of Australian companies for which foreign tax relief is granted, Australia will breach its obligations under tax treaties to provide such relief. On the one hand, if equalization tax is viewed as a tax on corporate income (as its title "deferred company tax" suggests), the imposition of equalization tax on distribution of foreign income reverses the foreign tax relief provided where foreign income is derived. In this case, there is an apparent breach of the obligation to provide foreign tax relief under tax treaties. On the other hand, it may be suggested that equalization tax is akin to a withholding tax imposed on shareholders. In this case, it may be argued that tax treaties do not restrict a full levy of tax at shareholder marginal rates with respect to distributions of Australian companies to Australian shareholders so there is no breach of the obligation to provide Australian companies with foreign tax relief. However, as discussed at IV.A.2, if equalization tax is classified in this way it should be subject to tax treaty dividend withholding tax limitations if it is levied with respect to distributions by Australian companies to non-resident shareholders.

Different considerations arise if Australian branches of foreign companies are subject to the imputation system. In this case, remittances to head office out of profits in excess of the franking account surplus will be subject to equalization tax. One issue is whether the levy of such a tax is contrary to Australia's tax treaties. Such an approach does not appear to breach the non-discrimination article in the OECD Model tax treaty (which Australia does not incorporate in its tax treaties in any case). In particular, paragraph 3 of Article 24 of the OECD Model requires that the taxation of permanent establishments of enterprises of the treaty partner not be less favourable than the taxation of enterprises of the source country carrying on the same activities. If Australian companies are subject to equalization tax, there appears no discrimination in subjecting Australian branches of foreign companies to such tax.

Paragraph 5 of Article 10 of the OECD Model will be of greater concern to Australia in seeking to impose equalization tax on remittances of Australian branches to foreign head office. It requires source countries not subject a treaty partner resident company's "undistributed profits to a tax on the company's undistributed profits..." This provision appears to prevent the imposition of equalization tax on remittances of untaxed profits by Australian branches of treaty partner companies. However, question whether paragraph 5 is applicable if such a branch is classified as an Australian company by Australian domestic law or if remittances of such a branch are classified as dividends. Further, it may be argued that paragraph 5 is targeted at branch profits and accumulated earnings type taxes.[88] The imposition of equalization tax is not a tax on *undistributed profits* of non-resident companies, as such, but rather a tax on *the profits* of their branches which are not taxed at the point of derivation. This is underscored by the fact that the tax is imposed irrespective of whether non-resident companies have previously purported to distribute the branch profits subjected to the tax. It is arguable, therefore, that such a tax is permitted by paragraph 1 of Article 7 of the OECD Model.

The Australian imputation system already causes difficulties where it washes out temporary preferences, e.g. depreciation for tax purposes which exceeds economic depreciation. Australian companies may not frank distributions of income for which temporary preference is granted with company tax levied with respect to such income where the income is distributed before the tax is paid. Accordingly, when temporary preferences fall into charge in later years they may cause companies to be liable to company tax with respect to profits which were previously distributed without dividend tax credits attached. Unless such companies have other preference income to be franked by the later levy of company tax, they may find they have permanent credit in their franking account without profits to distribute. This problem may still exist under the proposed system if equalization tax is levied on the distribution of temporary preference income.

One manner in which this difficulty may be relieved is by permitting equalization tax to be carried forward to set against future company tax liability.[89] However, in principle, this carry-forward should be limited to equalization tax levied with respect to the distribution of temporary preference income. Further, the set-off should be limited to company tax levied with respect to the income for which the temporary preference is granted when such income finally falls

88. Australia imposed a branch profits tax prior to the introduction of the imputation system in 1987. This explains why many Australian treaties exclude para. 5 of Art. 10 of the OECD Model. However, there are a number of more recent treaties which incorporate para. 5, e.g. Australia–China Double Tax Treaty Art. 10(5), Australia–Hungary Double Tax Treaty Art. 10(5) and Australia–Spain Double Tax Treaty Art. 10(6).

89. See Harris (1996), *supra* note 4 at 207-208.

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into charge. Otherwise, the carry-forward of equalization tax effectively allows the reinstatement of all preferences, including permanent preferences (i.e. income with respect to which Australian company tax is permanently reduced such as through an exemption or credit). For example, suppose an Australian company derives exempt foreign source income of AUD 100. The distribution of AUD 64 of that income will give rise to an equalization tax liability of AUD 36. Accordingly, the permanent preference provided by the foreign tax relief is washed out on distribution. However, where the company subsequently derives AUD 100 profits liable to company tax of AUD 36, the equalization tax paid previously will frank that liability. As the new AUD 100 profits may be retained without liability to company tax, the previous preference granted with respect to the foreign income may be considered reinstated.

While at first glance this may be viewed as a desirable result, it has a number of distorting effects.[90] Companies are already discouraged from making distributions in excess of their franking surplus because such distributions result in full shareholder tax liability. This discouragement will be enhanced under the proposed system where it is the company which will be subject to the tax liability on distributions not supported by a franking account surplus. It is likely that equalization tax will be a direct cost to companies, reducing their profits. The reinstatement of corporate preferences will effectively permit companies to fund retention with any untaxed profits derived at any time in the past. This is the case irrespective of whether the preference accorded those profits has previously been washed out through the imposition of equalization tax. The result will be an encouragement, over time, for companies which derive preference income (such as foreign income) to retain greater and greater amounts of profits. To the extent companies do not retain all the preference income they have derived, they will have a bank of equalization tax available for carry-forward. Companies which derive predominantly preference income will have permanent, and potentially large, banks of equalization tax available for carry-forward.

This was precisely the problem faced by the United Kingdom where some companies' banks of surplus advance corporation tax increased to enormous amounts. The United Kingdom experience suggests this will create at least two problems. Firstly, because companies will view the banks of equalization tax carried forward as of little value, there will be endless political pressure that something be done to provide relief, e.g. claims for refunds of equalization tax. This is evidenced by the fact that despite a move to a new corporate tax system from 1999, United Kingdom companies with surplus advance corporation tax have been granted a reserve of limited relief with respect thereto for years to come.[91] Secondly, because some companies will be in a position to use equalization tax offset and others will not, there is an incentive for tax arbitrage through companies attempting to "sell" their carry-forward equalization tax.[92] The problem would not be dissimilar to that already experienced by Australia with dividend tax credit streaming and trading.

An exception to the rule that the present Australian imputation system washes out corporate preferences on distribution relates to distributions by Australian companies from their FDA to non-resident shareholders. This exception is of a limited nature, pertaining only to preference in the form of foreign tax relief for certain dividends received from foreign subsidiaries which are credited to the FDA of Australian companies as discussed at III.A. The FDA regime operates so as to pass such preferences to non-resident shareholders, reducing their liability for dividend withholding tax (which is imposed in lieu of income tax). On the other hand, the FDA regime does not permit such corporate preferences to reduce the effective rate of Australian income tax suffered by corporate profits distributed to resident shareholders. As noted at III.B.1, there is no suggestion that the essence of this position will change under the proposed system. In order to achieve the present result under the proposed system, equalization tax must, in effect, be imposed with respect to distributions by Australian companies from the FDA to resident shareholders but not with respect to such distributions to non-resident shareholders.

C. Allocation of profits as retained or distributed

The current Australian imputation system, as a general rule, considers fully taxed profits of Australian companies as distributed before profits exempt from Australian company tax. This results from the requirement that companies frank dividends distributed to the extent of their franking surplus.[93] This rule is most favourable, permitting Australian companies to fund retention with profits exempt from Australian company tax. However, as mentioned at III.B.2, this approach creates a distortion by encouraging Australian companies to retain any untaxed profits in order to avoid shareholder taxation without dividend tax credits. There is no reason to suspect this position will change under the proposed system where Australian companies may retain untaxed profits in order to avoid equalization tax. Indeed, the effect of permitting equalization tax to be carried forward to reduce future company tax liability would extend the operation of this ordering rule. A more rational result may be achieved by a pro rata ordering rule. Under such a rule, Australian companies would only be entitled to frank dividends from the franking account in an amount equal to the proportion which their franking surplus bears to their overall profits (e.g. accounting profits).[94]

90. See Harris (1996), *supra* note 4 at 217-219.
91. Finance Act 1998 (United Kingdom) Sec. 32 providing the United Kingdom Treasury may by regulations make provision for enabling unrelieved surplus advance corporation tax to be set against liability to corporation tax on profits charged to that tax after April 1999. The Inland Revenue has released a draft of these regulations available at http://www.inlandrevenue.gov.uk/ct_unrel.htm
92. The current United Kingdom anti-abuse rules designed to address this mischief with respect to the set-off of advance corporation tax are Income and Corporation Taxes Act 1988 (United Kingdom) Secs. 245, 245A and 245B.
93. ITAA 1936 Sec. 160AQE.
94. For discussion of this rule, see Harris (1996), *supra* note 4 at 224-225. Taiwan has recently introduced an imputation system which incorporates such a rule, see Fu Chuan-Hsun (1998), "Introduction to Taiwan's Corporate Tax Integration System", Tax Notes International, 20 July, at 189.

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The FDA regime contains no specific ordering rule. Australian companies "may" attach FDA credits to dividends distributed.[95] However, non-resident shareholders receive no benefit should companies declare a FDA credit with respect to franked dividends. In other words, FDA credits are only attached with respect to the unfranked amount of dividends (that portion to which no dividend tax credit is attached). Therefore, it may be assumed that foreign income credited to the FDA will be distributed after fully taxed profits reflected as a credit in the franking account.

Assuming the current ordering rule for distributions from the FDA is maintained under the proposed system, the manner of its implementation may depend on the timing of reconciliations of the franking account. If the franking account is reconciled on the distribution of each dividend, the present ordering rule for the FDA could be maintained. However, if the franking account is reconciled less frequently, e.g. yearly, a different approach may be required. In this case, as a minimum, companies may be required to conduct additional reconciliations of the franking account wherever they distribute dividends from the FDA. To permit companies to distribute dividends from the FDA (without a debit to the franking account) where they have a franking account surplus may give rise to arbitrage opportunities for Australian companies with an increasing proportion of resident shareholders. The present ordering rule may already provide such opportunities with respect to Australian companies with an increasing proportion of non-resident shareholders.

IV. SHAREHOLDER TAXATION

A. Distributions

Under the present Australian imputation system, both resident and non-resident shareholders may use dividend tax credits attached to dividends from Australian companies. However, the manner in which dividend tax credits may be used by resident and non-resident shareholders differs. That difference is likely to continue under the proposed system. Australia has no general dividend withholding tax. However, non-resident shareholders in receipt of unfranked dividends from Australian companies (dividends without attached dividend tax credits) may be liable to withholding tax (unless the dividends are distributed from the FDA). Under the proposed system all dividends will be franked. This suggests that non-resident dividend withholding tax will no longer be required. However, as a result of other changes flagged, the proposed system may see the application of non-resident dividend withholding tax to all distributions by Australian companies to non-resident shareholders.

1. Resident shareholders

For income tax purposes, the Australian imputation system only extends dividend tax credits attached to dividends from Australian companies to resident shareholders. However, the manner in which dividend tax credits extended may be used by residents for income tax purposes differs depending on the type of resident concerned. This use will be altered under the proposed system.

a. *Individual shareholders*

Dividends distributed by companies are specifically included in the assessable income of recipient shareholders.[96] Further, as a general rule, resident individual shareholders in receipt of dividends with dividend tax credits attached are required to include any dividend tax credit granted in assessable income, i.e. gross up is required.[97] The amount to be included in assessable income is calculated as a function of the franked amount of dividends received.[98] A dividend tax credit (referred to as a franking rebate) is granted with respect to such dividends in an amount equal to the gross up. Dividend tax credits are available to individual shareholders who include dividend tax credits in assessable income. Dividend tax credits are available to offset income tax payable by such individuals.[99] Therefore, to the extent that individuals receive unfranked dividends, they are currently subject to full taxation without any dividend tax credits. This will not happen under the proposed system. The introduction of full franking will enable all dividends received from Australian companies to be grossed up by a fixed factor, i.e. $^{36}/_{64}$ of the net dividend received. This also means that dividend tax credits will be available with respect to all such dividends and the amount of the dividend tax credits will be a fixed factor of dividends received.

Individuals are currently subject to five bands of progressive income tax ranging to a maximum rate of 47 per cent.[100] While the rates and thresholds will change as a result of tax reform, the highest marginal rate will not.[101] As a result, for some low rate taxpayers, tax levied with respect to dividends received from Australian companies is less than dividend tax credits attached to such dividends. Under Section 160AQU of ITAA 1936, dividend tax credits are presently available to set against income tax liability of individual shareholders of the year in which dividend tax credits are included in assessable income. This means that dividend tax credits may be set against general income tax liability and not only income tax arising with respect to dividends received. However, where dividend tax credits received exceed an individual's total income tax liability for a year, there is presently no provision for carry-over or refund of excess dividend tax credits. Any dividend tax credit not used by individuals in the year it is included in assessable income is lost. Despite an inflexible stand in this regard for over ten years (by both major political parties in government), the government has finally recognized the inequity created by this situation. Under the proposed system, excess dividend tax credits will be refundable to individuals.[102]

95. ITAA 1936 Sec. 128TC(1).
96. ITAA 1936 Sec. 44.
97. ITAA 1936 Sec. 160AQT.
98. The amount to be included in assessable income is the franked amount multiplied by $^{36}/_{64}$..
99. ITAA 1936 Sec. 160AQU.
100. Income Tax Rates Act 1986 Sec. 12(1) and Sch. 7.
101. The proposed rate scale is set out in Australian Government (1998), *supra* note 1 at 47.
102. Australian Government (1998), *supra* note 1 at 117-118.

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b. *Corporate shareholders*

The benefits of the imputation system are extended to resident corporate shareholders of Australian companies. This is achieved through a combination of an intercorporate dividend rebate and a franking account credit.[103] Dividends received by Australian companies are included in assessable income[104] but a tax credit (rebate) is available where dividends are received from other Australian companies.[105] There are a number of features of this rebate worthy of note. Firstly, it is equivalent to company tax chargeable with respect to dividends received, resulting in an effective exemption for dividends distributed between Australian companies. Secondly, the rebate is not included in assessable income, i.e. gross up is not required. Further, in principle, the intercorporate dividend rebate is available irrespective of whether dividends received are franked or unfranked. As all dividends will be fully franked under the proposed system, the general gross up and credit mechanism applicable to individuals could also be applied to corporate shareholders as well. However, there is reason to suspect that the peculiar nature of the intercorporate dividend rebate may remain under the proposed system.

Currently, the rebate is calculated so as to produce no excess rebate, i.e. the rebate granted in any particular year is limited to companies' company tax liability for the year.[106] This is particularly detrimental to companies in a loss position as they not only loose the benefit of the rebate but the dividend income received reduces their loss carry-forward. This inequitable treatment would be highlighted if loss companies were subject to gross up and credit because they would realize excess dividend tax credits. If the government wishes to remove this inequity there are two models adopted by overseas countries which may be appropriate. The preferred approach is that intercorporate dividends are exempt in the hands of recipient corporate shareholders and do not reduce loss carry-forward. Alternately, such dividends may reduce loss carry-forward but excess dividend tax credits may be available for carry-forward and set-off against future company tax liability in a similar manner as losses.[107] Refunding excess dividend tax credits to corporate shareholders appears inconsistent with carry-forward of losses and may produce arbitrage opportunities.

One effect of the present intercorporate dividend rebate is that corporate preferences may not be washed out until preference income is ultimately distributed to individuals, i.e. no wash out occurs while tax preferred profits remain in corporate solution. An exception to this general rule applies with respect to the receipt of dividends by Australian private companies from other Australian companies which are not wholly owned subsidiaries. A private company is, for present purposes, an unlisted company.[108] In this case, the unfranked portion of any dividend received is denied the intercorporate dividend rebate.[109] In other words, where preference income is distributed by Australian companies (which are not 100 per cent subsidiaries) to Australian private companies, corporate preferences are washed out.

This exception to the availability of the intercorporate dividend rebate will become obsolete under the proposed system as all dividends will be franked. Nevertheless, the treatment of private companies is set to become the norm. This is because all intercorporate dividends will be potentially liable to equalization tax.[110] This will be a large change from the present situation, particularly for public company shareholders. Corporate preferences and, in particular, foreign tax relief, will be washed out just as soon as the income with respect to which such preference is granted is distributed, irrespective of whether such income remains in corporate solution. The only exception will be with respect to dividends distributed within a consolidated group which will be ignored for income tax purposes.

c. *Preference entities*

Australia exempts numerous entities from income tax including religious, scientific, charitable, educational and non-profit associations.[111] The exemption granted to such entities extends to dividends received. However, exempt entities are not presently entitled to the benefit of dividend tax credits with respect to dividends received from Australian companies and, therefore, are not entitled to any refund of company tax in respect of underlying dividends received.[112] Superannuation funds are not exempt from income tax.[113] Complying superannuation funds are currently charged with income tax at the rate of 15 per cent with respect to most dividends received.[114] Like individuals, superannuation funds include dividend tax credits in assessable income and claim a rebate of tax equivalent to the amount so included.[115] The only change under the proposed system is that superannuation funds, like individuals, will be entitled to a refund of excess dividend tax credits.[116]

2. Non-resident shareholders

Non-resident shareholders are presently subject to a 30 per cent withholding tax with respect to dividends received from Australian companies.[117] This rate is generally reduced to 15 per cent under Australia's double tax treaties. Dividends subject to withholding tax are excluded from non-residents' assessable income.[118] As a result, non-resident shareholders of Australian companies are not granted and cannot use divi-

103. ITAA 1936 Sec. 160APP.
104. ITAA 1936 Sec. 44.
105. ITAA 1936 Sec. 46.
106. ITAA 1936 Sec. 46(2).
107. See Harris (1996), *supra* note 4 at 236-246.
108. ITAA 1936 Sec. 103A.
109. ITAA 1936 Sec. 46F.
110. Australian Government (1998), *supra* note 1 at 116.
111. ITAA 1997 Division 50.
112. The intercorporate dividend rebate is limited to tax payable and dividend tax credits granted under ITAA 1936 Sec. 160AQU are not available where dividends received constitute exempt income.
113. ITAA 1936 Part IX.
114. Income Tax Rates Act 1986 Sec. 26.
115. ITAA 1936 Secs. 160AQT and 160AQU.
116. Australian Government (1998), *supra* note 1 at 113. There is one proposed addition in the case of registered charities but only with respect to donations in the form of distributions from trusts that are taxed like companies.
117. Liability to withholding tax is imposed by ITAA 1936 Sec. 128B and rates of tax determined by the Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974.
118. ITAA 1936 Sec. 128D.

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dend tax credits against income tax liability. However, non-resident shareholders of Australian companies are granted the benefits of the imputation system to a limited extent. The franked portion of dividends received by non-resident shareholders is exempt from withholding tax.[119] In this case, non-resident shareholders suffer an effective tax with respect to Australian source income derived through Australian companies at the company tax rate whether shareholders are resident in treaty countries or otherwise. On the other hand, non-resident shareholders are, as a general rule, liable to withholding tax on the unfranked portion of dividends received from Australian companies.

The manner in which non-resident shareholders of Australian companies will be taxed under the proposed system is subject to consultation. However, the government has outlined a number of principles which will be relevant. Firstly, the government expressed a commitment to ensure that "total tax borne on profits distributed to foreign investors is in line with the company tax rate..."[120] This means that the overall taxation of profits distributed from the franking account will not change. However, this statement appears to evince an intent to increase the taxation of profits which are currently distributed as unfranked dividends. Such distributions are typically subject to a 15 per cent withholding tax only (treaty situation). Under the proposed system, the imposition of equalization tax on distributions not supported by a franking account surplus is consistent with the stated intent. The imposition of a 36 per cent equalization tax in place of a 15 per cent withholding tax does represent a substantial increase in taxation of non-residents with respect to such distributions.

The imposition of equalization tax on dividends distributed by Australian companies to non-resident shareholders again raises the issue as to characterization of such a tax. As noted at III.B.1, in order to argue that equalization tax imposed on the distribution of foreign source income for which foreign tax relief has been granted does not breach Australia's treaty obligation to provide foreign tax relief, it may be argued that equalization tax is a shareholder tax (indeed, it is levied with respect to shareholder income, i.e. dividends). However, if the tax is classified in this way and is levied with respect to the distribution of any type of tax preferred income to non-resident shareholders, the tax appears to breach the limitation on the rate of dividend withholding tax which Australia may levy under its treaties, i.e. 36 per cent as opposed to the limitation of 15 per cent. In short, if Australia wishes to levy equalization tax on the distribution of foreign income for which foreign tax relief is available (e.g. to resident shareholders) and on the distribution of tax preferred income to non-resident shareholders, it is necessarily adopting an inconsistent position.[121] Of course, it may be argued that equalization tax is neither a shareholder tax nor a tax on corporate income but this seems a rather hollow argument.

If the present exemption from non-resident dividend withholding tax is continued under the proposed system, that tax may be repealed. This is because all dividends distributed by Australian companies will be franked. However, a second principle outlined by the government provides reason to believe that non-resident dividend withholding tax will not be repealed and, indeed, may be extended to all dividends distributed by Australian companies. Under the proposed system, the government will seek "maximum possible creditability overseas of Australian tax..."[122] As an initial point, the replacement of non-resident dividend withholding tax currently levied on unfranked dividends with equalization tax appears contrary to the achievement of this second principle. If Australia does not subject equalization tax to the dividend withholding tax limitations under its tax treaties it is unlikely that any country will credit the equalization tax under their direct foreign tax credit system. Further, there is a question of the extent to which equalization tax will be creditable under foreign countries' indirect foreign tax credit systems. The problem is that equalization tax is not a tax on corporate income but, rather, a tax on corporate distributions. Australia may have to negotiate the creditability of equalization tax by way of treaty.[123] In the result, equalization tax will be less creditable than the tax it replaces.

In order to maximize creditability of Australian taxes under foreign countries' foreign tax credit systems, there are two current methods adopted by imputation countries which may be followed. Both involve the formal imposition of dividend withholding tax with respect to dividends distributed to non-resident shareholders. The purpose of this is to ensure that such tax is creditable under foreign countries' direct foreign tax credit systems. However, both methods involve indirect relief from this tax. The older of the two methods involves the extension of dividend tax credits to non-resident shareholders under treaty.[124] Both France and the United Kingdom have concluded numerous treaties on this basis. Typically, dividend tax credits granted exceed the withholding tax liability with the country of corporate residence providing non-resident shareholders with a refund of the excess. The issue for the country of corporate residence is whether the refund negotiated is worth securing creditability of the withholding tax (totally offset by dividend tax credits) under the treaty partner's direct foreign tax credit system. I have previously discussed the manner in which Australia may seek to negotiate treaties along these lines.[125]

The second method is exemplified by the New Zealand foreign investor tax credit regime.[126] The substance of this regime is to turn dividend relief at the shareholder level under the imputation system into dividend relief at the corporate level through a company tax credit. Relief at the corporate level leaves the non-resident dividend withholding tax in place with its resultant creditability under foreign countries' direct foreign tax credit systems. As discussed above at

119. ITAA 1936 Sec. 128B(3)(ga).
120. Australian Government (1998), *supra* note 1 at 118.
121. A number of other imputation countries adopt such an inconsistent approach; see Harris (1996), *supra* note 4 at 392-393.
122. Australian Government (1998), *supra* note 1 at 118.
123. See Harris (1996), *supra* note 4 at 355-356.
124. For a detailed description of this practice, see Harris (1996), *supra* note 4 at 368-376.
125. Harris, P.A. (1997), "The Taxation of Transnational Corporate Income Under the Composite Tax Principle: Should International Dividend Streaming Be Permitted?", *Australian Tax Forum*, Vol. 13, No. 4, at 453.
126. Income Tax Act 1994 (New Zealand) Part L Subpart E.

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III.B.1, the problem with providing relief at the corporate level is that it inures for the benefit of all shareholders and not just the non-resident shareholders with respect to whom the company tax credit is granted. It is necessary to return the corporate benefit specifically to the non-resident shareholders. This is achieved through the distribution of a supplementary dividend by companies which is only available to non-resident shareholders. In the result, the supplementary dividend precisely offsets non-resident shareholders' liability for non-resident dividend withholding tax. It is clear, therefore, that this mechanism is an issue of form over substance.

If adopted, the foreign investor tax credit regime is likely to apply under the proposed system in the following manner. Firstly, all dividends distributed to non-resident shareholders will be subject to a 15 per cent withholding tax. The payment of this tax will entitle distributing companies to a company tax credit which is a function of dividends distributed to non-resident shareholders.[127] With a company tax rate of 36 per cent, the company tax credit will equal $^3/_{17}$ of dividends distributed. An example will illustrate the potential application of this regime under the proposed system. Assume a distribution by an Australian company of 64 (100 profits net of 36 per cent company tax) to a non-resident shareholder. The distribution gives rise to a company tax credit of $64 \times {}^3/_{17} = 11.3$. This credit reduces the company tax liability to $36 - 11.3 = 24.7$. However, the availability of the credit gives rise to an obligation on the distributing company to distribute a supplementary dividend only to the non-resident shareholder in an amount equal to the company tax credit. This results in the non-resident shareholder receiving a total dividend of $64 + 11.3 = 75.3$. This dividend is subject to non-resident dividend withholding tax of 75.3×15 per cent = 11.3. The net return is the same as under the present Australian imputation system, i.e. 64. However, according to the New Zealand argument, Australia has in the process generated a direct foreign tax credit of 11.3 for non-resident shareholders in their country of residence.

One issue under such a regime is the manner in which distributing companies may use the company tax credit generated. Under the New Zealand regime, New Zealand companies may use such credits in the current year, carry them back to set against company tax liability of the previous four years and carry any excess forward indefinitely.[128] The purpose of the carry-back limitation is not clear but, perhaps, is designed to provide some substance to the argument that the non-resident dividend withholding tax, the tax set-off or refund to the company and the supplementary dividend are not a round robin which together result in a fiscal nullity. In principle, the company tax credit should be available to reduce the company tax which franks dividends distributed to non-resident shareholders. This means that under the proposed system the company tax credit should be available to set against company tax represented by a franking account surplus (irrespective of when the tax was paid) as well as equalization tax liability. The effect of this process on the franking account should be minimal. Neither company tax refunded nor the supplementary dividend should result in franking account entries (although, of course, the credit for any company tax offset will remain and there will be a debit with respect to the primary dividend distributed).

A third principle outlined by the government which may impact on the treatment of non-resident shareholders in receipt of dividends from Australian companies is that "the Australian taxation system does not unduly impede offshore income passing through Australia to non-residents..."[129] As the FDA regime is specifically targeted at this flow-through situation, that regime is likely to continue in some shape or form. Presently, non-resident dividend withholding tax liability may be reduced where FDA credits are attached to dividends received by non-residents, i.e. unfranked dividends are exempt from withholding tax to the extent they consist of a FDA declaration amount.[130] The FDA regime effectively permits certain foreign tax relief granted to Australian companies to offset Australian withholding tax liability of such companies' non-resident shareholders. To the extent that foreign source non-portfolio dividends received by Australian companies are exempt from Australian company tax on derivation, they may be redistributed to non-resident shareholders without liability to Australian tax.

It is unclear how the FDA regime will operate under the proposed system. As mentioned at III.B.1, it is most likely that equalization tax will be imposed on distributions from the FDA to resident shareholders. The issue is how to remove this liability from non-resident shareholders. One option already mentioned is to allow non-resident shareholders to claim a refund of equalization tax imposed on dividends distributed from the FDA to such shareholders. A second option is to only levy equalization tax on dividends distributed from the FDA to resident shareholders. This appears the more attractive option but requires companies pay such dividends to non-resident shareholders gross of equalization tax and pay resident shareholders their dividends net of equalization tax. The FDA would be debited both with any dividend distributed and any equalization tax levied.

A final issue is the possible interaction between the FDA regime and any foreign investor tax credit regime that may be implemented. Even though the FDA regime is designed to ensure that Australia collects no tax, it would be possible to combine it with a foreign investor tax credit regime in an attempt to manufacture direct foreign tax credits in non-resident shareholders' countries of residence, i.e. credit for tax which, in substance, Australia does not levy. Assume that distributions from the FDA may be made to non-resident shareholders gross of equalization tax. Non-resident dividend withholding tax would be levied as described above and the company tax credit granted with the resultant supplementary dividend paid to non-resident shareholders. There would be no Australian company tax paid with respect to the profits distributed to the non-resident shareholders but the company

127. The formula is: company tax credit = (dividend + company tax credit) x 15 per cent.
128. Income Tax Act 1994 (New Zealand) Sec. LE2. New Zealand companies may similarly set such credits against company tax liability of other members in the same wholly owned group.
129. Australian Government (1998), *supra* note 1 at 118.
130. ITAA 1936 Sec. 128B(3)(gaa).

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tax credit may be available to offset any other Australian company tax liability (including equalization tax). The Australian Government is no worse off than at present because it has the non-resident dividend withholding tax which it presently does not levy. In this way, it may be possible to manufacture a direct foreign tax credit in shareholders' countries of residence for tax which is actually levied by a third country on distributing Australian companies or levied on higher tier companies.

The only type of company for which this system may not work is the pure flow-through company, i.e. an Australian company which has only FDA exempt foreign source income and only non-resident shareholders. The problem for such a company is that it will generate company tax credits but will have no Australian company tax liability. However, the manufactured direct foreign tax credit may work if Australia is willing to go "the full monty". This would involve Australia allowing company tax credits to not only offset Australian company tax liability but refunding excess company tax credits to distributing companies. Alternately, Australian companies may be allowed to set such credits against their liability to withhold non-resident dividend withholding tax from distributions to non-resident shareholders. While it is unlikely that Australia will go "the full monty", the above discussion demonstrates that a foreign investor tax credit regime may be taken to such an extreme that it is little more than a sham at the government level.

It appears the more secure and honourable approach is to extend dividend tax credits under treaty. However, it may be noted that when recent amendments to the United Kingdom's corporate tax system become effective in April 1999, they may produce "the full monty" under treaty. Under those amendments, United Kingdom companies may derive foreign source income which is effectively exempt from United Kingdom corporation tax as a result of foreign tax relief. Where such exempt income is distributed, treaty partner shareholders may be entitled to a (reduced) dividend tax credit.[131] As a result of the amendments, the dividend withholding tax which the United Kingdom is entitled to levy under treaty will virtually always exceed dividend tax credits granted to treaty partner shareholders. However, the United Kingdom will not levy any excess dividend withholding tax.[132] An issue is whether treaty partners, such as Australia, will continue to provide a direct foreign tax credit for dividend withholding tax offset by dividend tax credits despite the fact that the dividend tax credits are not supported by any tax levied by the United Kingdom. As I have commented before, the problem is not with the approach taken by New Zealand or the United Kingdom. The problem is inherent in the foreign tax credit system which is a questionable method of providing foreign tax relief.[133]

V. RETAINED CORPORATE PROFITS

The Australian imputation system incorporates no general mechanism whereby tax levied with respect to retained profits of Australian companies may be imputed to shareholders. As a result of recent amendments, it is now difficult to achieve such a result through a capitalization of profits. Further, Australia does not seek to integrate company tax levied with respect to retained profits with tax levied on gains realized on the disposal of shares in Australian companies. Australia provides no relief with respect to the alleged double taxation which occurs where gains realized on the disposal of shares in resident companies are taxable in full. Accordingly, no specific allowance is made for the portion of gain on the disposal of shares which may be attributable to profits retained by subject companies, such profits being taxed at the corporate level.

A. Capitalization of profits

Prior to amendments made in mid-1998, the capitalization of corporate profits through an increase in the paid up value of shares or the issue of bonus shares expressly fell within the definition of "dividend" for income tax purposes. As such, bonus shares were both taxable in the hands of shareholders and may have carried dividend tax credits. Therefore, Australian companies were able to issue bonus shares, or otherwise capitalize profits, as a method of imputing company tax paid with respect to retained profits to shareholders. This position has changed as a result of recent amendments to Australian corporate law which abolish the par value of shares and permit reductions in capital without prior court approval. The consequent tax law amendments effectively remove bonus issues from the definition of "dividend" and discourage the capitalization of profits.[134] Accordingly, Australian companies may no longer use bonus shares as a method of imputing company tax paid with respect to retained profits to shareholders.

Distributions from Australian companies' share capital account, whether in liquidation or otherwise, are tax free in the hands of shareholders. With the liberalization of capital reductions under the recent corporate law reforms, new anti-avoidance rules were introduced into the tax law to prevent companies streaming distributions from the share capital account to shareholders who would most benefit therefrom.[135] Distributions of corporate profits by liquidators, other than profits applied to replace a loss of paid up capital, are treated as dividends.[136] Further, such distributions by liquidators are considered dividends to which dividend tax credits may be attached under the imputation system.[137] Accordingly, where Australian companies are liquidated they may impute to shareholders remaining company tax paid

131. United Kingdom tax treaties typically grant treaty-partner shareholders in United Kingdom companies the tax credit which is available to resident individuals. Residents are granted tax credits under Income and Corporation Taxes Act 1988 (United Kingdom) Sec. 231.
132. Finance (No. 2) Act 1997 (United Kingdom) Sec. 30(10).
133. See Harris (1996), *supra* note 4 at 470-477.
134. Taxation Law Amendment (Company Law Review) Act 1998 amending ITAA 1936. Dividend reinvestment plans continue to be subject to the previous treatment.
135. Taxation Law Amendment (Company Law Review) Act 1998 Sch. 1 inserting ITAA 1936 Secs. 45,.45A and 45B.
136. ITAA 1936 Sec. 47(1).
137. Such distributions fall within the definition of "frankable dividend" in ITAA 1936 Sec. 160APA.

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reflected as a credit in their franking account. Distributions by liquidators, including returns of capital, are also treated as consideration on the disposal of shares for capital gains tax purposes. However, any capital gain realized is reduced by the amount of such distributions treated as dividends.[138]

Under the proposed system, liquidators are likely to be subject to equalization tax to the extent they distribute dividends in excess of any franking account surplus. Further, the government proposes a profits first rule whereby any distribution by a company (including capital reductions and liquidation distributions) will be treated as a dividend to the extent profits are available.[139] The introduction of this rule, together with the introduction of the equalization tax, should enable the removal of the capital streaming provisions mentioned above. However, the dividend tax credit trading rules mentioned at III.B.1 will be retained. There is no proposal to remove the recently introduced measures discouraging companies from capitalizing corporate profits.

B. Disposal of shares

Australia has a comprehensive system of taxing capital gains, including gains realized on the disposal of shares in Australian companies.[140] However, non-residents are only taxable with respect to gains realized on the disposal of shares in Australian listed companies if during the previous five years they have owned 10 per cent or more of the company's issued share capital.[141] Capital gains and capital losses realized with respect to a particular year are netted.[142] Any net capital gain, including gains realized by shareholders on the disposal of shares in Australian companies, is included in assessable income.[143] On the other hand, net capital losses are not deductible against income but may be carried forward to set against capital gains of future years.[144] Indexation of the cost base of shares for inflation is available to reduce gains realized on disposal.[145]

While it is not true that special tax rates apply with respect to the taxation of capital gains, a form of averaging is available to individuals realizing capital gains. For the purpose of determining the tax rate applicable, only one-fifth of net capital gains are added to assessable income. Tax payable with respect to this one fifth (assuming it to be the last income taxed, i.e. at any higher rate) is multiplied by five to arrive at the amount of tax to be levied with respect to net capital gains.[146] The government has flagged as a possible reform, capping the tax rate applicable to capital gains at 30 per cent and introducing a AUD 1000 per annum CGT tax-free threshold.[147] These reforms will only be available to individuals (there already being a proposal to reduce the company tax rate to 30 per cent) and, perhaps, signal the phasing out of the existing averaging provisions, indexation relief or both. It appears capital gains arising on the disposal of shares in Australian companies will continue to be calculated and tax levied irrespective of whether the gains realized are attributable to retained profits which are taxed in the hands of companies whose shares are disposed of.

VI. CONCLUSION

The Australian corporate income tax system appears set for substantial reform. Many of the proposals made by the Australian Government are designed to simplify the system and remove some of the present anomalies. On this basis, the proposals are welcome. However, previous experience suggests that, if there are a number of manners in which to implement a tax policy, the Australian Government typically adopts the most complex. There is healthy scepticism about the government's ability to deliver meaningful reform and, particularly, simplify the corporate income tax system. This scepticism is well grounded, as evidenced by the progress of the Tax Law Improvement Project. The "word around town" is that while the proposals look good in principle, the "devil will be in the detail". This is almost certain to be true of whatever approach is ultimately taken with respect to the taxation of non-resident shareholders of Australian companies. Australia has flagged an intention to follow the lead of a number of other OECD countries in what may be accurately described as tax planning by governments designed to attract foreign investment. The question is whether in pursuit of its stated principles the government is willing to go "the full monty".

138. ITAA 1997 Sec. 118-20.
139. Australian Government (1998), *supra* note 1 at 124. Special rules will apply to share buy-backs.
140. ITAA 1997 Parts 3-1 to 3-3.
141. ITAA 1997 Division 136.
142. ITAA 1997 Division 102.
143. ITAA 1997 Sec. 102-5.
144. ITAA 1997 Secs. 102-10 and 102-15.
145. ITAA 1997 Division 114.
146. Income Tax Rates Act 1986 Sch. 7.
147. Australian Government (1998), *supra* note 1 at 125.

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MEXICO

OVERVIEW OF MEXICAN CFC RULES AND ANTI-TAX HAVEN LEGISLATION

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I. INTRODUCTION

The notion of low tax assessment locations is not new to the Mexican tax system. In 1989, Mexico incorporated in the Income Tax Law[1] a relatively modest provision designed to ensure a differentiated tax treatment for income received by residents of low tax assessment countries, from the alienation of shares held in Mexican corporations. Article 151 of the MITL, had long provided for two options for the taxation of such income when received by non-residents: 20 per cent on the gross selling price, or 30 per cent on the net earnings. From 1989, this latter option was available only when the income received by the non-resident was subject to a corporate income tax at a rate of 30 per cent or more in the country of residence. In those days, the corporate income tax rate in Mexico was 37 per cent.

Thereafter, in 1994, the benchmark to define a tax haven was modified. It was then established that, again, for purposes of the taxation of income from the alienation of shares of Mexican corporations, the 30 per cent option was applicable only when the income received by the non-resident was taxable in its country at a corporate income tax rate of at least 70 per cent of the then Mexican corporate income tax rate, i.e. 34 per cent. For these purposes the computation proceeded on the basis that such income was the only income received by the taxpayer. A list of relevant countries was published annually as a guideline.[2]

This treatment only applied to the alienation of shares, and highlighted Mexico's efforts to discourage investment in Mexican corporations through tax haven countries.[3]

This old treatment of Article 151 referred to above, was changed in 1997 and finally evolved in 1998 into a jurisdictional approach, whereby instead of the tax threshold, a list was prepared of "countries with a territorial tax system" (CTTS) (see Exhibit B). The criteria for the selection of such locations has not been disclosed, however, the denomination suggests that the generally accepted concept of water's edge taxation was followed. The CFC rules are however addressed primarily at Low Tax Jurisdictions (LTJs) rather than at CTTSs.

As in the case of CTTS, Mexico did not adopt a transactional approach for LTJs, under which the nature of the income would determine whether an entity would fall within the tax haven rules. Instead a jurisdictional approach is followed under which target territories are defined for the application of the rules. LTJs as of 1 January 1998, are listed in Exhibit A. The 1997 CTTS and LTJs lists[4] significantly differ from the 1998 lists.

The lists were restructured for a number of technical and legal reasons, for example, the identification of additional jurisdictions that met the criteria of the legislators, and the use of the legal denomination of most of the locations to avoid ambiguity.[5]

As to the criteria for the selection, although not found elsewhere in the Mexican tax legislation or the technical explanation to the Congress,[6] it is probable that the Mexican legislators took the following factors into account to define the target LTJs:

- no tax system;
- a tax system with very low tax rates;
- a lump-sum tax system;
- tax privileges to certain classes of companies or operations (e.g. non-resident or so-called international entities, head offices, distribution centres, financial holdings).

The legislation regarding CFC and anti-tax haven transactions basically has four modes of implementation:

- Current taxation for investments made through the various specified forms of entities or individual investment.
- Reporting requirements for the above referred to investments as well as for certain bank accounts, held directly or through nominee third parties.

1. Art. 151 of the MITL.
2. As noted, a low tax assessment jurisdiction was defined using a tax threshold, and subsequently confirmed in a list.
3. In light of both the tax deferral and the frequent cases of jurisdictions that allowed the use of "bearer" shares that created a veil between the Mexican company and the ultimate stockholders.
4. Included as Exhibits C and D respectively.
5. For example, as a curiosity, the Lebanese Republic listed in 1998, is listed as Lebanon in the 1997 list.
6. Known as "Exposición de Motivos", which is a transmittal foreword to the proposed legislation of the Congress.

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– Stringent deductibility rules and unfavourable withholding rates for entities located or resident in the legislative territories deemed tax havens.

II. SCOPE OF INVESTMENTS IN LTJs

The MITL does not include a conceptual definition of investment in an LTJ. Instead, it sets out in Article 5[7] the scope of the term "investment in LTJ":

– those carried out through branches of the taxpayer or through corporate entities;
– those carried out through shares and bank or investment accounts;
– those carried out through any form of participation in trusts, joint venture agreements, mutual funds and any other legal structure of a similar nature created or organized in accordance with foreign, i.e. non-Mexican law;
– those carried out through a deputized nominee ("*interpósita persona*"). This term refers to persons that give the appearance of acting on their own, when in fact they are acting on behalf of a third party. In other words, the use of an "interpósita persona" implies the intent of deceit.

For the purposes of the MITL, a company, corporate entity or trust is located in an LTJ when they have physical presence or when they are domiciled or have a post office box in such jurisdiction. As to physical presence of a society, corporate entity or trust, it may be interpreted that the existence of an office, warehouse or other type of facility[8] would cause such physical presence.

Further, the legislation includes a rebuttable presumption that certain currency transfers made to deposit, investment, savings or any other similar accounts held in a financial institution located or resident in a low tax jurisdiction, are transfers effected to accounts held by the taxpayer.[9]

It is important to point out that the legislation states that when the taxpayer's spouse or concubine, direct ascendant or descendant, or its agent appears as account holder, joint account holder, beneficiary or signatory in a tax haven bank account, such accounts will be deemed to be owned by the taxpayer. This then clearly triggers a charge to tax on the "deemed" taxpayer, however, the tax treatment of the legal owner of the account is not specified. Technically, more than one person may not be taxed on the same income. The above situation triggers double taxation, without apparent relief under current legislation.

A definition of direct investment in an LTJ is included in the legislation primarily for purposes of expanding the situations in which a Mexican resident investor may be subject to CFC rules as discussed below. This definition includes situations where the taxpayer interposes one or more companies, entities or trusts resident in a non-LTJ between the taxpayer and the company, entity or trust located or resident in the LTJ. The extension of the concept of direct investment in an LTJ was incorporated in the 1998 tax reform. Similar provisions were published with certain limitations in 1997 through rules of the 1997 annual temporary rulings known as "Miscelánea Fiscal".[10] However, such 1997 rules also included interposed investments located in LTJs as opposed to the 1998 law that includes investments in non-LTJs only.

The situation described in the previous paragraph does not apply under any of the two following situations:

– when the revenues of the interposed company, entity or trust, other than dividends, royalties, interest, capital gains or commissions[11], all those presumably from Mexican source, represent at least 80 per cent of the revenues of the company located or resident in the LTJ; or
– when the interposed company, entity or trust in the previous situation, resides in a country which has CFC legislation that applies to such company, entity or trust.

For 1997, a list of countries with CFC legislation was published in the Official Gazette of 23 June 1997 and is herewith provided as Exhibit E., a similar list is expected to be published for 1998. The wording of the provision infers that the CFC legislation should be *applicable* rather than *necessarily applied* to the interposed company, entity or trust. Therefore, it may be interpreted that if CFC rules exist in the non-LTJ, but because of specific circumstances surrounding the company, entity or trust, the rules are not applied, the exemption referred to above is nevertheless effective.

Thus, for example, if a Mexican company has both a Danish and a Spanish subsidiary (both countries have CFC legislation based on a 50 per cent direct or indirect holding of shares or voting power of a CFC) which in their turn own a company in a territory deemed an LTJ, and own shares equally, they would avoid the application of the corresponding CFC regimes in Denmark and Spain, since no control is held and their stake does not exceed the 50 percent limitation. As to Mexico, the Danish and Spanish subsidiaries would not meet the criteria to be considered an interposed company.

Another exemption to the scope of investment in an LTJ is given when the investment is made in the shares of companies or other legal entities which are publicly traded on a recognized stock market.[12] Investing in branches of companies that publicly quote their stock is not sufficient to obtain the exemption (e.g. a Mexican individual that invests cash in the LTJ branch of a Mexican bank would not qualify for the exemption.

Further, in 1997, relief was also given for entities located or residing in a tax haven that engaged in entrepreneurial activities when their investment in fixed assets, land or inventories represented at least 50 per cent of the total assets of such entity, provided that such assets were utilized in the

7. This definition was incorporated in Art. 5 as of 1 January 1997 as amended effective 1 January 1998.
8. Through ownership, lease or even a commodatum.
9. Assuming that such transfers are bound with documentation of accounts held by the taxpayer in other financial institutions either resident in Mexico or abroad. As stated, the taxpayer has the right to prove otherwise.
10. Rule 3.6.14 for corporations and rule 3.16.5 for individuals.
11. As defined in the law.
12. Under the provisions of Art. 16-C of the Federal Fiscal Code it is considered that a recognized market includes the Mexican Stock Exchange and the Stock Exchanges and Quotation systems that have authorization to operate as such in accordance with the law of the country in which they are located.

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entrepreneurial activities of the entity. The value of the assets was computed under the provisions of the Asset Tax Law disregarding the deductions for investments given in the ITL.

Mexican CFC legislation applies where a taxpayer has an indirect investment of such a magnitude that enables it to participate in the control or management of the company and thus to know whether or not the company invests in low tax jurisdictions. For purposes of the ITL, taxpayers must overcome the rebuttable presumption that their stake bestows influence or control over the entity. The absence of guidelines to ascertain the situations in which the taxpayers have influence or control makes the application of this provision a subjective one that creates legal uncertainty.

III. CURRENT TAXATION OF INVESTMENTS

A. Subjects and exemptions

As mentioned above, CFC legislation was incorporated in the Mexican legislation as of 1 January 1997. The scope of application of the 1997 rules was unlimited since control did not need to rest with the taxpayer in order to apply the legislation. Technically, all of the proportional income of the company (see exemptions section) located or resident in the tax haven was attributable to the taxpayer, regardless of the taxpayer having control or not, since the mere fact of being cognizant of the investment implied the observance of the law. Therefore, a minority shareholder was subject to tax on undistributed profits of the CFC, even though it did not have the power to influence payment of such profits.

However, as of 1 January 1998, the scope of these rules is limited to the cases where the taxpayer has effective control of the company, entity or trust. Although no specific references are given in the law, we believe that to determine the effective control, a valid source of interpretation would be the effective control criteria followed for tax consolidation purposes,[13] the relevant parts of which are set out below:

- when the business activities of a company are primarily carried out with its holding company or its controlled companies;
- when the holding or the controlled companies hold along with other *related* individuals[14] or corporate entities, an interest of over 50 per cent in the voting stock of the relevant company;
- when the holding or the controlled companies have an interest in the relevant company of such a magnitude that it allows them to exercise a salient influence over the operations of the company.[15]

Accordingly, from 1998, in order to be subject to the CFC rules, taxpayers have to fall within one of the three situations stated above.

B. Accrual of income from low tax jurisdictions

1. Corporations

Under Section XI of Article 17 of the MITL, corporations must consider as accruable income of the fiscal year,[16] a proportion of the gross taxable revenues obtained in the same fiscal year by the companies, entities or trusts located or resident in LTJs. The relevant proportion is their average direct daily participation therein in the corresponding fiscal year, when they are shareholders, actual beneficiaries or have the right to the distribution of profits, and provided that such income has not been previously taxed in Mexico.

This accrual will be made even when dividends are not distributed and it will be determined for each calendar year in accordance with the provisions of Title II of the MITL, however, this income will not be considered for purposes of the provisional income tax.[17]

The law also contemplates the accrual of income received by companies, entities or trusts located in an LTJ from their investments in other companies, entities or trusts located in LTJs.[18]

In this case, the taxpayer should accrue the gross taxable revenues of the latter, in the proportion of the daily direct investment of the first in the latter. This provision is incorrect since it bases the accrual proportion on the investment of the first investee in the ultimate investee, rather than the proportional interest of the investor in the first investee. For example, a taxpayer that maintains during one full year a 25 per cent investment in a company located in the Cayman Islands that also maintains during the same year a 100 per cent investment in a company located in Barbados, would have to accrue 100 per cent of the Barbados gross taxable revenues, instead of 25 per cent.

When the taxpayer puts the accounting books and records of the companies, entities or trusts located in an LTJ at the disposal of the tax authorities for scrutiny,[19] the taxpayer is eligible to accrue the proportional taxable income and other benefits as follows:

13. Sec. II of Art. 57-C of the MITL.
14. The last paragraph of Sec. XI of Art. 17 of the MITL cross references Art. 64-A for purposes of defining a related party, which follows OECD guidelines. Further, it is established that both resident and non-resident parties should be considered.
15. As to this situation, the absence of a benchmark to establish the level of magnitude that facilitates the exercise of a salient influence over the operations, leaves the taxpayer, and the tax authorities, in a position to apply subjective judgments for such purpose.
16. Under Mexican law, all Mexican taxpayers must observe a calendar year for tax purposes.
17. Monthly or quarterly income tax estimated payments are required by law based on the income received in the previous month or quarter.
18. Added on 1 January 1998 as a new paragraph to Sec. XI of Art. 17 of the MITL.
19. As a guide for 1997, rules 3.6.4. and 3.6.5. provided for a definition of accounting books and records for these purposes. Similar guidelines are expected to be published for 1998.

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- the taxpayer may claim deductions of the company, entity or trust located in the LTJ that may reduce the accruable gross revenues.[20]
- losses (those incurred beginning with fiscal year 1997)[21] may be utilized. In this case, they may be deducted from the profits obtained during the following five years.[22]

An amount equivalent to the income tax actually paid by the LTJ company, entity or trust on its gross taxable revenues, may be deducted from such gross taxable revenues in the proportion of the direct investment in the CFC. The income tax to be deducted is that paid to the tax authorities of the LTJ, although the wording is not precise, accordingly, it would be feasible to deduct the income tax paid on the gross taxable revenues of the CFC located in the LTJ to the tax authorities of other jurisdictions, as the case might be. The income tax deducted under this provision may not exceed the corporate income tax that would have been due under the related provisions of the MITL. Further, the deduction would cause the taxpayer to forfeit its right to credit the tax upon the receipt of dividends.[23]

The taxpayer may elect not to include in its taxable income the dividends or profit distributions received, provided that such dividends or profit distributions arise from gross taxable revenues or taxable income previously taxed on the basis discussed above.

In connection with dividends distributed by the CFC to Mexican resident corporate shareholders, when the accounting books and records are not at the disposal of the tax authorities for scrutiny, the taxpayer may choose to accrue the dividends, and claim a credit against the Mexican income tax payable. The credit will be limited to the tax amount thereof due on the dividends paid by these entities, as if the dividends were the taxpayer's only income. Further, the amount of taxes subject to credit may be updated for inflation from the date of payment through to the date of application. The creditable taxes may not exceed the amount of taxes corresponding to the dividends or profits[24] received from the CFC.

However, for purposes of the distribution of dividends or profits, the MITL does not specify whether the dividends must be treated as being paid from the oldest profits, recent profits or, an average of both.

With respect to the sale of shares, capital reduction or liquidation of a CFC, if the taxpayer accrues the income regarding such operations, it will be eligible to credit a proportion[25] of the corresponding tax against the tax liability arising from the said transactions.

2. Individuals

Individuals that carry out investments in LTJs will be subject to the same accrual rules that apply to corporations. These revenues should be considered taxable under Articles 74 and 132 of the MITL that address other income received by individuals and will be considered as obtained in the fiscal year that the company, entity or trust located in an LTJ should accrue it if it were subject to the rules for Mexican entities. On the other hand, in accordance with the general rule applicable for individuals, they are not obligated to make provisional income tax payments for the incomes herein referred to.

3. Small transactions

Under transitory provisions,[26] in the case of investments in LTJs that do not exceed MXN 160,000 (about USD 20,000 as of January 1998), instead of the accrual procedure described above, the taxpayers, both corporations and individuals, are only subject to tax on the income from such investments when it is distributed.

4. Other matters

As explained above, in 1997 the Hacienda issued annual temporary rules, which included a number of important guidelines for the interpretation and application of CFC rules and anti-tax haven legislation. It is expected that similar rules will be issued for 1998. Below we discuss some of the most relevant.

Where the taxpayer receives payments from the CFC, such income will not be attributable under these rules provided that the 35 per cent rate was paid on the gross amount of the transaction. In the case that a lower than 35 per cent rate was applied (e.g. 30 per cent for commissions) only the proportionate income corresponding to the difference between the rate applied and 35 per cent will be attributed.

If the individual decides not to accrue the dividends or profits received from the CFC, whose income was previously attributed and taxed, it is stated in rule 3.16.5 that the taxpayer may not claim a credit for the taxes paid under the attribution rules.

Further, rule 3.16.16 provides that individuals must also include as investment income under the attribution rules disposals made in those countries during 1997.

The same exemptions apply for the application of the CFC rules as explained earlier.[27]

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20. In addition to the requirements for deductions given in Arts. 24 and 25 of the ITL, rule 3.7.31 published in the Official Gazette on 23 June 1997 provides specific requisites for deductions under the CFC rules.
21. Sec. IX of transitory Art. 4 of the 1997 tax reform.
22. If the entity that is located in the LTJ has losses, they will not be deductible for the taxpayer in the proportional part, however they may be amortized in the subsequent five years as explained above. The tax losses will be determined in accordance with the MITL statute, however it is important to note that if eligible tax losses are not utilized in an employable fiscal year, the carry-over right will be forfeited for the subsequent years, up to the amount that might have been applied.
23. Art. 6 of the MITL provides for a foreign tax credit to the recipient of dividends.
24. Computed on the basis that they were the taxpayer's only income.
25. Proportionate to the profits from the taxable revenues corresponding to said stocks, provided that a credit has not been previously applied. The creditable tax shall not exceed the tax that would have been paid on the dividends or profits from the taxable income or tax result if they were received by a Mexican corporation.
26. Sec. VIII of transitory Art. 4 of the 1998 tax reform, applied retroactively to 1997.
27. Including when a 35 per cent rate has been applied on the payments made to entities located or resident in a tax haven country.

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IV. REPORTING REQUIREMENTS

Entities, individuals and even entities who are not considered as taxpayers in accordance with Title III of the MITL, are obliged to file an annual return on February of each year before the General Directorate of International Fiscal Affairs of the SAT (Dirección General de Asuntos Fiscales Internacionales), in which the entity or individual declares the investments that it carried out or maintained in the legislative target territories or with corporations or entities located in these jurisdictions. The taxpayer must include with this return the bank account statements of its deposits, investments, savings or any other account, or further documentation required by the Hacienda.

For purposes of this return, both deposits and withdrawals made by corporations or individuals are considered as investments in low tax jurisdictions and thus reportable.

When the final balance of investments in a fiscal year is zero, reporting entities or individuals are relieved from enclosing their bank account statements with the return, provided that it is demonstrable that such balance is the result of transferring the investments to Mexico or to countries with which Mexico has entered into an exchange of information treaty.

It is extremely important that this return is filed since Section V. of Article 111 of the Federal Fiscal Code states that there will be a sanction of between three months and three years in prison for those more than three months late in filing the annual return of investments made or maintained in low tax jurisdictions or in corporations or entities resident or located in such jurisdictions.

According to transitory provisions, the first annual return must be presented in February 1998 in connection with 1997 investments.

Finally, an amendment introduced in 1998 states that this return may only be used for tax purposes.

V. STRINGENT DEDUCTIBILITY RULES, UNFAVOURABLE WITHHOLDING RATES AND SOURCE OF TAXATION PROVISIONS FOR ENTITIES RESIDENT OR LOCATED IN THE LEGISLATIVE TERRITORIES DEEMED TAX HAVENS

Section XXIII of Article 25 of the ITL establishes that payments made to entities located or resident in a tax haven country are not deductible, unless the taxpayer demonstrates that the price or the amount of consideration agreed upon between the companies is the same that unrelated parties would pay in similar circumstances.

The last paragraph of Article 64-A of the ITL brings an additional burden with the presumption that transactions between Mexican residents and entities located or resident in a tax haven country are between related parties and are not made at arm's length.

Section XIV of Article 58 of the ITL provides that companies that engage in transactions as defined in the preceding paragraph must produce and retain documentation to support the application of the arm's length standard.[28]

These provisions are also applicable for individual taxpayers that carry out entrepreneurial activities in accordance with Section XVII of the MITL.

As it may be observed, in most cases the burden of proof that the operations were agreed upon at arm's length prices falls totally on the taxpayer, in such a way that if the taxpayer cannot demonstrate otherwise, any payment made to the CFC will be non-deductible.

Furthermore, due to the weak drafting of this provision, it could be incorrectly interpreted, that the deduction could only be claimed where the taxpayer materially demonstrates that the operation was carried out at arm's length, unless the options given under rules 3.6.7 and 3.16.17 are followed as explained below.

Regarding withholdings or tax payments from income sourced in Mexico by entities residing in a low tax jurisdiction the rates are significantly higher than those of countries with which Mexico has entered into tax treaties and in some cases with the general rules for non-residents.

In the case of time sharing agreements the applicable rate is 35 percent instead of the 21 per cent for other non-residents,[29] both rates apply to the gross amount of the transaction.

Mexico generally imposes a non-treaty rate to the gross revenues sourced in Mexico for technical assistance of 15 per cent and on royalties for patents, commercial names and marketing a rate of 35 per cent. In the case of payments made to entities residing in low tax jurisdictions the 35 per cent rate prevails.[30]

For commissions paid to such entities the rate is 30 per cent on the gross transaction. In addition, other requirements set out in the Regulations to the MITL must be complied with.[31]

Interestingly, rules 3.6.7 and 3.16.17 published on 23 June 1997 state that royalties, interest and commissions paid to entities located or resident in a low tax jurisdiction will be deductible if the 35 per cent tax rate on the transactions has been applied and the tax thereof paid (ignoring whether they are arm's length or not). As one may see, in the case of commissions, a premium of 5 per cent has been included to make payments deductible without further proving the adherence to the arm's length standard. Note that this is a 1997 rule whose applicability in subsequent years has to be confirmed.

Finally, inconsistencies are found in relation to the entities which are subject to the rules herein commented upon, since Title V of the MITL only includes companies *resident* in a tax haven, whereas other provisions in the MITL include *entities located or resident* in tax havens.

28. See Luis Coronado and Mauricio Monroy, "Mexico's New Transfer Pricing Rules", 51 *Bulletin for International Fiscal Documentation* 3 (1997) at 147.
29. Art. 148-A of the ITL.
30. Art. 156 of the ITL.
31. Art. 159-A of the ITL.

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EXHIBIT A

LOW TAX JURISDICTIONS
XI. The following shall be considered as low tax jurisdictions for Income Tax Law and for Federal Fiscal Code purposes:

Antigua and Barbuda
Aruba
Netherlands Antilles
Bahrain
Barbados
Belize
Bermuda
Campione (Italy)
United Arab Emirates
Kuwait
Gibraltar
Luxembourg
Grenada
Guam
Hong Kong
Anguilla
Isle of Man
Norfolk Island
Cayman Islands
Cook Islands
Guernsey and Jersey (Channel Islands)
Mauritius
Pacific Islands
Turks and Caicos Islands
British Virgin Islands
US Virgin Islands
Kiribati
Labuan
Bahamas
Madeira
Maldives
Montserrat
Nevis
Niue
Belau
French Polynesia
Andorra
Liechtenstein
Monaco
Puerto Rico
Qatar
Albania
Cape Verde
Cyprus
Costa Rica
Djibouti
Dominican Republic
Guyana
Honduras
The Marshall Islands
Liberia
Malta
Nauru
Panama
San Marino
The Seychelles
Trinidad and Tobago
Vanuatu
Uruguay
American Samoa
Western Samoa
St Kitts
St Vincent and the Grenadines
Sri Lanka
Brunei
Oman
Swaziland
Tonga
Tuvalu
Special Canary Zone
Ostrava Free Zone

EXHIBIT B

COUNTRIES UNDER A TERRITORIAL TAX SYSTEM
X. The following countries shall be considered under a territorial tax system:

Jamaica
Morocco
Libya
Bolivia
Botswana
Cameroon
Ivory Coast
El Salvador
Guatemala
Guinea
Lithuania
Namibia
Nicaragua
South Africa
Venezuela
Zaire
Zimbabwe
Paraguay
Senegal
Dominican Republic
Gabon
Lebanon

EXHIBIT C

1997 COUNTRIES WITH TERRITORIAL TAX SYSTEM

Article 4

...

VII – The following will be considered as low tax jurisdictions for purposes of Article 151 of the Income Tax Law:

Albania
Andorra
Antigua
Netherlands Antilles
Aruba
Bahamas
Barbados
Belize
Bermuda
Bolivia
Botswana
Brunei
Cape Verde
Cameroon
Campione
Cyprus
Ivory Coast
Costa Rica
Bahrain
Djibouti
El Salvador
United Arab Emirates
Gabon
Gibraltar
Grenada
Guam
Guatemala
Guernsey
Guinea
Honduras
Hong Kong
Anguilla
Channel Islands
Isle of Man
Norfolk Island
Cayman Islands
Cook Islands
Marshall Islands
Turks and Caicos Islands
British Virgin Islands
Jamaica
Jersey
Kiribati
Kuwait
Labuan
Lebanon
Liberia
Libya
Liechtenstein
Lithuania
Luxembourg
Madeira
Maldives Islands
Malta
Morocco
Monaco

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Montserrat
Nauru
Nevis
Nicaragua
Niue
Oman
Panama
Paraguay
Belau
French Polynesia
Puerto Rico
Qatar
Namibia
Dominican Republic
American Samoa
Western Samoa
St Kitts
San Marino
St Vincent and the Grenadines
Senegal
The Seychelles
Sri Lanka
South Africa
Swaziland
Tonga
Tuvalu
Uruguay
Vanuatu
Venezuela
Zaire
Zimbabwe

EXHIBIT D

1997 LOW TAX JURISDICTIONS

Article 4

...

VIII – The following will be considered as low tax jurisdictions for purposes of Section V of Article 111 of the Federal Fiscal Code and for those of the Income Tax Law (except for the provisions of Article 151 thereof):

Albania
Andorra
Antigua
Netherlands Antilles
Aruba
Bahamas
Bahrain
Barbados
Belau
Belize
Bermuda
Bolivia
Brunei
Cape Verde
Campione
Cyprus
Djibouti
United Arab Emirates
Gibraltar
Grenada
Guam
Guernsey
Guinea
Honduras
Hong Kong
Anguilla
Channel Islands
Isle of Man
Norfolk Island
Cayman Islands
Cook Islands
Marshall Islands
Turks and Caicos Islands
British Virgin Islands
Jamaica
Jersey
Kiribati
Kuwait
Labuan
Liberia
Liechtenstein
Madeira
Maldives Islands
Malta
Monaco
Montserrat
Nauru
Nevis
Niue
Oman
Panama
French Polynesia
Puerto Rico
Qatar
American Samoa
Western Samoa
St Kitts
San Marino
St Vincent and the Grenadines
The Seychelles
Sri Lanka
Swaziland
Tonga
Tuvalu
Vanuatu

EXHIBIT E

1997 COUNTRIES WITH CFC LEGISLATION

Exhibit 10 Section D of 1997 Miscellaneous Tax Provisions. Countries that have controlled foreign corporation legislation. Published in the Official Gazette on 23 June 1997.

Germany
Australia
Canada
Denmark
Spain
United States of America
Finland
France
Indonesia
Japan
Norway
New Zealand
Portugal
United Kingdom
Sweden

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INTERNATIONAL

PROSPECT THEORY AND TAX REPORTING DECISIONS: IMPLICATIONS FOR TAX ADMINISTRATORS

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I. INTRODUCTION

Archival data in the United States suggest the existence of a "withholding phenomenon" where taxpayers who have tax to pay at the time they file their tax return exhibit lower compliance rates than taxpayers who are entitled to a tax refund at filing time (Chang and Schulz, 1990). The primary purpose of this article is to examine the level of support for this "withholding phenomenon" and the resulting implications for tax policy makers. Current theories of taxpayer compliance do not explain the apparent anomalous situation where individuals' tax reporting decisions are affected by their withholding or prepayment positions. One stream of literature, originating from public economics, models tax reporting decisions as rational economic decisions based on expected utility theory (e.g. Cowell 1990). Another stream suggests that prospect theory and other psychology-based models may have more descriptive validity in explaining tax reporting decisions (Lewis 1982). In reviewing these literature streams, Alm (1991, p. 578) notes that the failure of expected utility theory in the analysis of tax compliance reflects a growing dissatisfaction with this approach in the analysis of individual choice under uncertainty. Alm (1991, p. 590) concludes that compliance decisions depend on numerous factors, and to explain the level of reporting behaviour will require a shift beyond classical expected utility theory into theories of behaviour suggested by psychologists, sociologists and anthropologists.

The remaining sections of this article are structured as follows. The next section outlines models of tax compliance behaviour and how they have been based on either an expected utility theory framework or an economic-psychological framework. Section III discusses the development of prospect theory and reviews existing prospect theory research in the tax domain. Section IV identifies some important implications stemming from the results of prospect theory research, while Section V offers some concluding remarks.

II. MODELS OF TAX COMPLIANCE

A. Background

In practice, virtually all taxation systems face the problem of taxpayers who are not fully complying with their legal requirements with respect to how much tax should be paid. Substantial figures are involved. For example, in the United States, the annual amount of tax evasion is estimated to be approximately USD 83-94 billion, which represents about 18 per cent of total federal income tax revenue (IRS, 1990).

The quantum of and reasons for tax evasion lead to important policy issues for any government, as tax evasion has significant fiscal, social and economic ramifications. These include the ability to meet revenue needs and the significant audit and collection costs incurred by Revenue authorities to detect and recover tax evaded. The wider social consequences of evasion will include a redistribution of the taxation burden on to those who do not evade, reducing the level of horizontal equity in the taxation system.

From an individual viewpoint there is a gain to individual evaders of the amount of taxation that they have successfully managed to evade, but in order to realize this benefit the individual may incur certain costs. These costs may include professional fees, information search costs in determining if evasion is possible, and the costs of setting up the structures and processes which allow successful evasion. Associated with these are costs incurred by taxpayers facing an audit. There are several comprehensive reviews of the state of tax compliance research both on individual taxpayers, and on the role of tax preparers – e.g. Jackson and Milliron, 1986; Cowell, 1990; Hasseldine, 1993; Roberts, 1998. Rather than review all previous research, the purpose of this section is to simply illustrate two types of tax compliance models that attempt to explain how individuals base their evasion decisions.

B. Expected utility models of tax compliance

These models incorporate the concept of a rational economic taxpayer who will evade tax as long as the pay-off from evading is greater than the expected cost of being caught. Allingham and Sandmo (1972) propose a seminal economic deterrence model based on the following expected utility function of the taxpayer who evades:

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$$E(U) = (1 - p)U(W - QX) + pU[W - QX - a(W - X)]$$

where:

E(U)	=	expected utility
p	=	probability of being investigated by the tax agency
W	=	actual income (known only to the individual)
Q	=	the individual's tax rate
X	=	reported income in the tax return
a	=	penalty tax rate (a is assumed > 0).

This model incorporates several aspects. First, the taxpayer has some level of risk aversion, the more risk averse the taxpayer is, the less likely (s)he is to evade taxes. Second, the taxpayer needs to have knowledge regarding the taxation system in order to assess the probability of being detected, and the extent of the penalties that may be incurred upon detection. These last aspects may be uncertain for the taxpayer. Jackson and Milliron (1986) found that under conditions of uncertainty the taxpayer is likely to be more conservative and more averse to evasion. Many recent extensions to the early expected utility models have been published (e.g. Cowell (1990) demonstrates the large amount of theoretical literature that has evolved in this area).

C. Economic-psychological models

In contrast to expected utility models from public economics, economic-psychological models examine the attitudes and beliefs of taxpayers in order to predict actual behaviour. The basis of this reasoning is proposed by Ajzen and Fishbein (1980) who maintain that attitudes are unbiased indicators of real behaviour. Lewis' (1982) model of tax evasion suggests a profile of taxpayers with high propensities to evade can potentially be developed from an examination of taxpayer attitudes and beliefs. This profile might include background factors like age, sex, social-economic background, education, and occupation. Hopefully, from an examination of these attitudes and beliefs, some of the reasons why taxpayers evade can be identified and appropriate measures taken in an attempt to change those attitudes and beliefs.

Lewis (1982, p. 132) reviews early economic-psychological and expected utility models and states that the central frame of reference should be what taxpayer perceptions actually are, rather than what they are assumed to be on the basis of rational and self-interest assumptions. He does however maintain that theoretical analyses are important, as these provide an underpinning of relationships to be tested in behavioral research.

III. DEVELOPMENT AND EMPIRICAL TESTS OF PROSPECT THEORY

A. Development

Prospect theory was developed by Kahneman and Tversky (1979, 1981) as an alternative theory of individual decision making under risk. The theory was developed for two simple choices (prospects) with monetary outcomes and stated probabilities, but it has been extended to more involved choices. Kahneman and Tversky distinguish between two phases in the choice process. First, there is an early editing phase which involves a preliminary analysis of the offered prospects. Second, is an evaluation phase in which the edited prospects are evaluated.

Prospect theory can be distinguished from expected utility theory in two main areas. First, value function outcomes are expressed as positive or negative deviations (gains and losses) from a natural reference point (such as the individual's current asset position), which is assigned a value of zero. This is in contrast to expected utility theory which defines the value function over a final asset position. Kahneman and Tversky propose that the value function is S-shaped and (1) is defined over perceived gains and losses, (2) is concave in the domain of gains and convex in the domain of losses and (3) considerably steeper for losses than gains. Accordingly the value function predicts individuals will be risk averse if they face a gain situation, e.g. they are owed a tax refund, and risk seeking if they face a loss situation e.g. they owe tax at the end of the tax year.

The second departure concerns the decision weighting function. This is a monotonic function of the probability, although it is not a probability. The weighting function has the following properties. First, impossible events are discarded. Second, low probabilities are overweighted, moderate and high probabilities are underweighted, with the latter effect being more pronounced than the former. Yates (1990, pp. 302-3) criticizes prospect theory on two grounds that involve the weighting function. For instance, he cites the ambiguity around the endpoints of the weighting function and second, why do decision weights behave the way they do. Kahneman and Tversky (1981, p. 454) anticipated these criticisms with their comment that "the scales should be viewed as an approximate, incomplete, and simplified description of the evaluation of risky prospects".

B. Early research

If underpayment penalties and the time value of money are ignored, individuals should not be from a normative viewpoint affected by their tax prepayment position. Despite this, survey work suggests that many people do prefer to file a return showing a tax refund. The initial recognition that prospect theory could be generalized to a taxation context came from Kahneman and Tversky (1979, p. 286) in their original paper where they comment:

> So far in this paper, gains and losses were defined by the amounts of money that are obtained or paid when a prospect is played, and the reference point was taken to be the status quo, or one's current assets. Although this is probably true for most choice problems, there are situations in which gains and losses are coded relative to an expectation or aspiration level that differs from the status quo. For example, an unexpected tax withdrawal from a monthly pay check is experienced as a loss, not as a reduced gain.

Most early research drawing upon prospect theory used simple experimental settings, often with student subjects. For instance, Chang et al. (1987) use a tax-audit lottery field experiment and report that the perception that taxpayers have

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of their tax payments, (either as a reduced gain or as a loss), affects their attitude to risk in tax evasion.

Jackson and Jones (1985) use student subjects to investigate whether the audit rate or penalty amount is a greater deterrent to tax evasion. They conclude that consistent with prospect theory, the weighting function is sub-additive for small probabilities such that the penalty rate is more important than the audit rate. However, the actual parameters used by Jackson and Jones are later criticized by White et al. (1993) for being unrealistic.

Hite et al. (1988) manipulate two experimental conditions (refund/tax due) and ask prospective jurors, rather than students, how much income they would report from a hypothetical part-time job that paid cash wages of USD 1,000. No audit rate was given, but subjects were told that these payments were difficult for the government to trace. There was no main effect for the withholding variable and perhaps as the detection rate was implicitly very low; the subjects discarded the low probability of audit in an editing process.

Schadewald (1989) split his subjects into two groups. One group of subjects were informed that they had overestimated a refund, while the other group were told they had underestimated a refund. The effect of withholding on compliance was manipulated within subjects. Unlike Hite et al. (1988) who asked if subjects would return income from a cash job, Schadewald's experiment asked if they would claim a dubious deduction. His results did not support the hypothesis that a taxpayer's withholding position affects outcome framing and he concludes that although the relationship between risk preferences and the framing of outcomes as gains or losses may be widespread in general, these may not be automatic with respect to tax reporting decisions.

C. More current research

Chang and Schultz (1990) use data from the US Internal Revenue Service's Taxpayer Compliance Measurement Programe, which they split into three groups – those where the return should have reported a tax balance due (under-withheld position), should have claimed a refund (over-withheld position) or should have reported prepayment equal to the tax liability. Their dependent variable is the voluntary compliance rate and their results support the proposition that taxpayers in a refund-due situation are more likely to comply than those in a balance-due position. This result is true regardless of filing status, source of income, income level, or the actual size of the balance or refund due. As this is a form of archival research, causality cannot be established and Chang and Schultz (1990, p. 92) suggest that experimental approaches may also be useful in this area.

Their suggestion has been followed up by a number of researchers. Robben et al. (1990a) develop an experimental approach which entails subjects imagining that they are shopkeepers running a small supermarket. As part of the task, subjects must complete tax forms etc. Robben et al. (1990a, p. 359) found that participants who recalled having to make an extra tax payment evade tax more often than those who recalled receiving a refund of tax. In a similar study, Robben et al. (1990b) explore decision frames and opportunity in an international study. Subjects from six countries (Belgium, England, The Netherlands, Spain, Sweden, United States) were given a task ostensibly involving the management of a retail business making a number of business related decisions. The reason for camouflaging the tax evasion decision in these two studies is that Webley and Halstead (1986) argue that the purpose of early experimental simulations of tax evasion is transparent and that as most subjects perceived these as profit maximizing "games", these simulations contain serious research validity problems and are not a true analogue of the tax declaration situation. The results of Robben et al. (1990b) on decision frames support prospect theory and its relevance to tax evasion behaviour.

Schepanski and Kelsey (1990) extend Schadewald (1989) by again manipulating a decision frame that involves an evasion opportunity. This study can be distinguished from earlier work as it uses repeated trials and a spread of simulated detection rates and penalties. Schepanski and Kelsey find that individuals are less likely to claim a dubious deduction if they are in the tax refund condition (positive frame) than if they are in the tax due condition (negative frame). Accordingly their results can also be taken as supporting prospect theory.

Casey and Scholz (1991) do not explicitly test Prospect Theory, but conduct a series of experiments to examine how the cognitive heuristics evoked by how the risks of non-compliance are described, and how the decision makers preferences are expressed, affect tax compliance. They find that taxpayer preferences are significantly influenced by descriptive and procedural variables that traditional expected utility models ignore. They conclude by calling for field research to test the usefulness of behaviourial concepts in explaining compliance behaviour outside the laboratory – a call unheeded to date.

White et al. (1993) vary detection and penalty rates to obtain a wide range of expected values. Their primary result is that taxpayers in a tax due position are more likely to engage in evasion behaviour than taxpayers in a tax refund position across a wide range of outcomes. Prospect theory is supported as individuals exhibit risk seeking behaviour in the tax due position (loss framing condition) and risk averse behaviour in the tax refund position (gain framing condition). The second main contribution of White et al. (1993) is that they use two samples – undergraduate accounting students and adults. They suggest that using undergraduate students as surrogates for experienced taxpayers appears appropriate for analysing the *relative* effects of behaviourial variables on tax compliance decisions, but not for the *absolute* effect of behaviourial variables on such decisions. Consequently, they conclude that the conflicting results of earlier research are probably not due to the use of different subject groups. In a study consistent with White et al. (1993), Dusenbury (1994) finds that prepayment position affects the level of risk that subjects prefer in tax reporting situations. Taxpayers were more willing to take a risky position when they owed tax than when they were due for a refund and reported 20 per cent

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more of the uncertain taxable income in the refund case than in the high tax to pay case. Dusenbury (1994) concludes that tax filing prepayment position may indeed induce risk preference reversals.

IV. IMPLICATIONS OF PROSPECT THEORY RESEARCH

A. Responses to tax evasion implied by prospect theory research

Early tax compliance research which examined whether prospect theory is applicable in this domain yielded conflicting results. However more recent studies such as White et al. (1993) suggests that these early studies may not have been conducted with realistic parameters (i.e. those approximating extant real life penalty and audit rates). Conflicting results prior to 1990 should therefore be viewed with some scepticism. Robben et al. (1990a) in a related point note that in early tax compliance experiments, the hypothetical choices which subjects were confronted with were embedded with gain versus loss language within the choice situation, so this may also affect the extent to which the results might endorse prospect theory's applicability.

There are three important implications of early prospect theory testing. First, if external validity is important – and when testing for prospect theory effects in this context, it surely is – then realistic penalty and audit rates should be used. Second, the general design of the experiment is important. For example, the actual income reporting decision could be contained as part of a more realistic business simulation study or it could be a simple gamble that typifies early experimental work on risky choice and tax evasion behaviour i.e. an "evasion-game type scenario" in which subjects may not internalize the experimental scenario. Finally, prospect theory highlights the importance of the general framing of questions and experimental instruments themselves. Alm et al. (1992) reinforce the need to consider this point with their parallel study with identical treatment conditions – the only difference being that for one subject group, "tax and evasion terminology" was used and in the other group of subjects, "neutral framing" was used – i.e. the word "tax" was not mentioned at all. Interestingly, the two treatments produced almost identical results and Alm et al. (1992, p. 35) suggest that earlier compliance experiments may not have been substantially affected by the use of tax terminology.

If prospect theory is applicable to this context and the main issue concerns the actual decision frame i.e. taxpayers are less likely to engage in evasion if they are in a refund due situation, then an option for tax policy makers arises. Loftus (1985, p. 38) states: "The IRS [US Internal Revenue Service] has one simple way to put more people in the "gain" situation and make them more risk averse". This refers to increasing the amount of withholding tax deducted from source income such as wages and salaries to put more individuals into the domain of gains, (i.e. in a refund-due prepayment position), and therefore have fewer risk seeking individuals evading tax. At the very least, tax agencies should continue policies which discourage under-withholding (Schepanski and Shearer, 1995). Whether individuals would eventually shift their reference points (and by how much) after several years of tax refunds is unclear, but is certainly possible. This is unlikely to be a panacea and Dusenbury (1994) cautions that habitual tax evaders will not necessarily be compliant when filing for a refund, although the tax payment system can be used to affect the riskiness of filing choices.

B. Contrasts with responses supported by expected utility theory models

In contrast to the prior section, expected utility models predict that economically rational taxpayers (or evaders) will evade taxes as long as the pay-off from evading is greater than the expected value of the penalties incurred if caught. Manipulation of the pay-offs obtained through evasion is possible as a response option and is often used by policy makers. The most direct means is to increase the expected cost of being caught by increasing evasion penalties, or by increasing the probability that the evasion will be detected. An associated measure, used in the United States but not widespread internationally, might be for the imposition of tax-preparer penalties where an anti-Revenue tax position is held that is not substantiated by the underlying facts of the case. These penalties are aimed at curbing any trend by tax advisers to continually opt for aggressive stances.

V. CONCLUDING REMARKS

This article has outlined the development of prospect theory and two broad types of models that are frequently used to explain tax reporting decisions. The issue of whether prospect theory is applicable to tax compliance is a narrow question, although one with non-trivial implications for tax policy, given the high levels of tax evaded. The results of the early research on the "withholding phenomenon" are confusing; although one reason for the conflicting results is that early research designs and experimental simulations have been less than perfect – some might say less than adequate. Recent research is more encouraging with most studies lending support to prospect theory i.e. the tax filing position of individuals does, on average, affect their tax reporting decisions.

In practice, tax preparers play an important role in tax compliance decisions. Roberts (1998, p. 95) suggests that year-end payment status alone does *not* play a large role in preparers' compliance recommendations, (although underpayment status may interact with other factors e.g. the taxpayers' aggressiveness, amount of tax at stake etc.), due to the fact that preparers have to justify their fees to their clients.

The findings of this article suggest that an obvious issue for tax policy makers to investigate is if more taxes are withheld at source, and more individuals are in a tax refund frame, are they more risk averse and more likely to comply with the tax laws? Another possibility raised by Schepanski and Shearer (1995, p. 184) is that the "withholding phenomenon" may

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assist in the identification of non-compliant taxpayers. Whether such an approach might be an effective part in the management of the tax evasion problem remains to be seen.

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PAKISTAN

TAX AND INVESTMENT INCENTIVES FOR NON-RESIDENT INVESTORS

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I. INTRODUCTION

It is important for non-resident investors to select a suitable legal form of ownership through which to conduct their business undertaking. The three most common forms of business ownership in Pakistan are: (i) sole proprietor, (ii) partnership firm and (iii) limited liability company.

Generally, non-residents prefer to conduct business in Pakistan as individual entrepreneurs or through a company. Investment through a company is either through a branch of a foreign company or through a Pakistani subsidiary or associate of a foreign company. This article discusses in brief the legal, financial and tax structures for non-resident investors in Pakistan.

II. RESIDENTIAL STATUS

The scope of the income liable to tax under the Pakistani Income Tax Ordinance 1979 (ITO) depends on the taxpayer's residential status during the tax year which is called the "income year". It does not depend on citizenship or domicile. Under the ITO "income year" is defined as a period of 12 months beginning 1 July and ending on 30 June next (in special cases the competent authority may specify a different period). The income of an income year becomes due for assessment in the next financial year, which is called the "assessment year".

An individual is considered "resident" in Pakistan in a specified income year if he or she is in Pakistan in that year for an aggregate period of 182 days or more, or having been within the four years preceding that year in Pakistan for an aggregate period of 365 days or more, or is in Pakistan for an aggregate period of 90 days or more in that year.

A company is "resident" in Pakistan if it is a Pakistani company and in case of a non-Pakistani company if its control and management is *wholly* situated in Pakistan. A firm or other association of persons is considered "resident" in Pakistan if the control and management is situated *wholly or partly* in Pakistan during the relevant income year. A taxpayer is "non-resident" in Pakistan if he is not a "resident" of Pakistan.

The formation of a company in Pakistan is an easy process. It can be formed by nominees of a single person including a foreign company. The Corporate Law Authority (CLA) has issued standing instructions to the Registrar of Joint Stock Companies to accept the Memorandum and Articles of Association signed by an agent if he is authorized by a power of attorney. The legal provisions also facilitate non-resident individuals and foreign companies in forming a company in Pakistan through their nominees. A company registered in Pakistan is a Pakistani company regardless of the fact that some or all of its equity capital is held by non-residents.

III. NEW INVESTMENT POLICY

Over the years, Pakistan offered a host of incentives in the form of tax-free industrial zones, accelerated depreciation, carry-forward of losses, and a total tax holiday where the enterprise is export-oriented or is established in a free trade zone and/or is engaged in manufacturing or the processing of goods. The government of Pakistan has provided investors with enforceable legal rights to ensure an environment conducive to investment. A number of economic reforms were introduced on 7 November 1990 relating to the privatization of public sector enterprises and nationalized banks, introducing fiscal incentives for industrialization and deregulation of investment, banking, finance, exchange and payment systems, holding and transfer of companies. All these policies are protected under the Protection of Economic Reforms Act, 1992. This Act provides protection for foreign investors and specifically excludes compulsory acquisition by the government. To attract more foreign direct investment, the government, in a radical departure from the past, introduced a new Investment Policy in November 1997 bringing drastic structural changes; salient features are summarized briefly below.

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A. Integrated strategy

The Investment Policy 1997 has been formulated to provide an integrated strategy for creating an investor friendly environment with the focus on further opening up the economy and marketing the potential of all economic sectors for investment. At present foreign investment in Pakistan is limited to the manufacturing sector only, which represents just 19 per cent of the GDP. The current policy, identifies other sectors of the economy such as infrastructure, housing and real estate, wholesaling/retailing, agriculture, health and education.

B. Human capital

Special attention has been given to the development of human capital as the base for quality services. The Policy comprises three sections, i.e.

- policies;
- incentives; and
- facilitation.

C. Earlier incentives

Until now foreign direct investment in Pakistan has been limited to the manufacturing sector. Under the previous investment policy, the following incentives were available:

- foreign exchange controls were relaxed;
- foreign investors were allowed participation in local projects on 100 per cent equity basis;
- there was no compulsion for a limited company to offer shares to the public even if its paid-up capital exceeded PKR 100 million;
- full safeguards were provided to protect foreign investment;
- there was no requirement to have local partners and full repatriation of capital, dividends and capital gains was allowed;
- ceilings on payments of royalties and technical fees were abolished;
- work-permit restrictions on expatriate managers and technical personnel working in an industrial undertaking were withdrawn and remittance restrictions were eased;
- no government sanction was required for setting up an industry in any field, place and size, except for:
  (a) arms and ammunition;
  (b) high explosives;
  (c) radio-active substances;
  (d) security printing, currency and mint;
- there was no requirement to obtain a No Objection Certificate from the provincial government for locating the project anywhere in the country (except in certain specifically listed areas).

D. New incentives[1]

The 1997 investment policy prioritized four areas of the manufacturing sector:

(i) value-added or export industry: all those units which can attain a minimum of 40 per cent value added will be taken as value-added units and all those industries which can export 80 per cent of their production will be classified as export industry;
(ii) hi-tech;
(iii) priority industry; and
(iv) agro-based industry.

These categories will be liable to change, as a result of a review by the Cabinet Committee on Investment as and when deemed necessary.

The industries falling under categories (i) & (ii), e.g. leather, textile, footwear, surgical, sports goods, carpets, electronic, seafood, mining, powder metallurgical and manufacture of alloys and stainless steel, information technology, solar technology, aerospace and defence production etc. will get First Year Allowance (FYA) on capital expenditure/investment of 90 per cent and Reinvestment Allowance (RA) of 50 per cent of capital/investment in respect of modernization, replacement and expansion. The net effect of these allowances will be that profits will not be taxable until the capital expenditure has been recovered.

The customs duty has been totally abolished on the import of plant, machinery and equipment (which is not manufactured locally) under these two manufacturing categories.

The industries falling under categories (iii) & (iv) which cover the main areas of engineering/capital goods, petrochemicals, chemicals, production of quality/hybrid seeds, edible oil extraction/refinery, livestock/poultry feed, milk processing, agro-based value-added productions etc. will be entitled to a 75 per cent FYA. Similarly these industries will also be entitled to a 50 per cent RA.

Where an industry does not fall under any of the four categories, a 50 per cent accelerated depreciation allowance will be granted.

E. Agricultural sector

In the agricultural sector, the import tariff on plant and machinery (not manufactured locally) used for agriculture will be zero-rated. A list of relevant machinery and equip-

1. This article was written before the promulgation of "Temporary Foreign Exchange Restriction Order" by the President of Pakistan on 28 May 1998.

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ment will, however, be notified later. Certain other incentives are available to this sector.[2]

F. Service sector

The activities in the service sector available for foreign investment will be:

(i) wholesale, distribution and retail trade;
(ii) transportation, storage and communications/infrastructure projects including development of industrial zones: deregulated services in the telecommunications sector, real estate development including development of commercial buildings, apartment buildings, housing projects, supermarkets, shopping malls, urban development, development of new communities hotels, tourism and travel-related services;
(iii) technical testing facilities;
(iv) audio-visual services;
(v) sporting and other recreational services;
(vi) rental/leasing services relating to transport equipment and machinery, equipment and tools for land development and agricultural purposes;
(vii) environmental services.

In the service sector it has been decided that:

(a) The amount of foreign equity investment will be at the level of at least USD 1 million.
(b) A minimum 40 per cent of the equity will be held by Pakistani companies or investors in the company or project.
(c) The import tariff on plant, machinery and equipment (not manufactured locally) will be leviable at a standard rate of 10 per cent and no sales tax shall be leviable.
(d) Unless the title of property is transferred into the name of the foreign company, it may not develop real estate projects.
(e) An Inter-Provincial Regulatory Authority will be established at federal level to regulate and monitor the land and real estate development by foreign companies.
(f) The condition of induction of 40 per cent Pakistani equity, will not be applicable in case of hotels and tourism; infrastructure and telecommunication projects including development of industrial zones; and export and import trade (export domestic retail trading and distribution).
(g) In the social sector, 100 per cent foreign investment on a repatriatable basis will be allowed in education, technical and vocational training, human resource development as well as hospitals and medical/diagnostic services, provided the equity investment is at least USD 1 million.
(h) Reinvestment. To encourage investors to reinvest their earnings by expanding their existing manufacturing facilities and improving the technology or diversifying their product line, RA at 50 per cent of capital expenditure/investment will be allowed in case of modernization, replacement and expansion.

Similarly, to encourage the establishment of Small and Medium Industries (SMIs), industrial sheds and structures sold/leased to SMIs will be granted an enhanced depreciation allowance of 30 per cent (in the first year) of the cost which has been incurred on the development of these sheds/structures.

G. Facilitation

Under "facilitation", in order to provide support services and utilities under one umbrella and to remove other procedural, operational and social bottlenecks:

- A composite scheme of National Industrial Zones (NIZs) comprising Industrial Estates, Free Industrial Zones, Free Trade Zones and Export Oriented Units will be launched at a few selected prime sites. Export-oriented units may however, be set up all over the country. An export unit will undertake production and operation in a bonded factory under customs control.
- The scheme focuses on providing an investor-friendly environment. It will promote local and foreign investment through encouraging the participation of the private sector in development of the zones and provision of incentives, facilities and a *one window* service by the government to support the investors in the establishment and operation of their projects.
- Infrastructure within the zone will be developed by private sector investors. The development, management and marketing of industrial estates/free industrial zones and free trade zones will be open to local and foreign investors. Provision of infrastructure and utility facilities up to the zone will be the responsibility either of relevant agencies of the government or the developer/investor.
- The industry specific tariffs and fiscal incentives and other concessions as set out in the new Investment Policy will be available to the projects located in these zones.
- Country specific zones may be established by the developer/investor to attract industrial units preferably from export-oriented industries.
- To compensate the developer for provision of utilities and infrastructure facilities up to the gate of the zone, the

2. These other incentives are set out below:
- In line with the reforms announced in the Agricultural Package, there will be no upper ceiling of land for registered agricultural companies which are involved in production, processing and marketing of agricultural products on commercial lines. However, the income of these companies would be taxable.
- The proposals related to foreign investment in the agricultural sector will be processed by the Board of Investment (BoI) in consultation with the respective provincial government and will be approved by the competent Decision-Making Forum.
- The land for agricultural purposes will be available on long leases, i.e. initially up to 30 years, extendable for a further period of 20 years.
- Foreign companies, interested in investment in the agricultural sector will not be allowed to transfer or sell such land to any other foreign company unless specifically permitted by the federal and the relevant provincial governments.
- The amount of foreign equity investment will be at the level of at least USD 1 million.
- A minimum of 40 per cent of the equity will be held by a Pakistani company or individuals.
- The permissible activities will be:
(i) Land development/reclamation of barren, desert and hilly land for agricultural purposes and crop farming; (ii) reclamation of water front areas/creeks; (iii) crops, fruits, vegetables, flowers farming/integrated agriculture (cultivation and processing of crops); (iv) modernization and development of irrigation facilities/water management; and (v) plantation/forestry and horticulture.

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cost of land may be reduced where this is owned by the government. The government will facilitate the acquisition of the land under the existing law where the land is privately owned.
- Each industrial zone will reserve a separate area for setting-up Small and Medium Industries.
- Land for zones will be offered to developers/investors on long-term lease of 50 years extendable by a further 50 years with the approval of the National Industrial Zones Authority.
- Exemption from labour laws and application of the relevant laws will be the same as applicable to the existing Export Processing Zones.
- A composite National Industrial Zones Authority will be set up with statutory powers to undertake the management of the National Industrial Zones. However, the existing Export Processing Zones Authority Ordinance 1980 will continue to apply to the Free Industrial Zone (previously Export Processing Zone) and Free Trade Zone. The National Industrial Zones Authority will be established through an enactment, which will provide a legal framework for management and providing necessary facilities and services to the zones.
- Policy matters and issues with respect to the zones will be dealt with by the Board of Investment.
- The National Industrial Zones Authority will provide a one window facility to give permissions incorporating all the required clearances of various departments and arrange utility facilities and other related services etc.[3]
- The prime sites for the National Industrial Zones will include adjacent land of the existing industrial estates and new areas alongside Islamabad–Lahore Motorway having potential for development.
- The facility for contracting foreign private loans will be made available to all foreign investors who make investment in sectors open to foreign investment, for financing the cost of imported plant and machinery required for setting up the project.
- Foreign controlled manufacturing concerns may borrow domestically to fully fund their working capital requirement, irrespective of their exports.
- For foreign controlled semi-manufacturing concerns, the borrowing entitlement will be increased to 75 per cent of paid-up capital including reserves and in case of foreign controlled non-manufacturing concerns, it will be increased to 50 per cent.
- Growth and capital[4] formation in the organized industrial sector is painfully slow. The encouragement of the formation of holding companies will result in:
  - a larger market capitalization which will attract foreign institutional interest and help in raising money through the issue of international instruments;
  - will free resources for new investments;
  - promote easier fund raising from financial institutions due to a broader capital base.

To facilitate the formation of holding companies, it is recommended that:
- Preparation of consolidated financial statements be made mandatory for listed companies.
- Section 208 of the Companies Ordinance 1984 be amended whereby exemptions presently available to wholly owned subsidiaries be extended to subsidiaries, whether or not wholly owned. As Section 208 relates to investment both in respect of equity and loans, the suggested amendment will be restricted to equity investments only.
- The holding company should be listed, while the subsidiary companies should be de-listed, and shareholders be given shares of the holding company.
- Provision be made to offset tax losses incurred by other subsidiaries.
- Dividends of subsidiaries should not be taxed.
- Taxes paid by subsidiaries should be set off against the tax liability of the holding company.

H. Incentives for transfers of technology and amendments in labour/industrial laws

In order to encourage transfers of technology, the government has declared the following measures:
- Payments on account of royalties and technical service fees to foreign companies will be taxed at 15 per cent. However, reduced rates under Pakistan's tax treaties will remain applicable.
- A law for the protection of intellectual and industrial property rights will be introduced and a mechanism will be devised to enforce the law.
- Procedures with regard to immigration, work visas, opening up of a branch office and grant of citizenship have been streamlined in consultation with the Ministry of the Interior.

3. A management committee will run the administrative and management affairs of the zone. It will have representatives from the developer, sponsor and National Industrial Zones Authority. Personnel of various departments of the government working in the zone will be under the administrative control of the management committee of the zone.
4. Indeed there is a flight of capital.

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- Various measures will be introduced to improve the labour market including measures to increase productivity and flexibility.[5]
- In accordance with the recommendation of the Corporate Law Commission, Section 4(a) of the Monopolies and Restrictive Trade Practices (control & prevention) Ordinance 1970 shall be deleted/repealed. There will be no ceiling on the total value of assets of an undertaking for retaining 100 per cent ownership by the investors.
- To keep the domestic manufacturing sector competitive the tariff structure will be adjusted. The duty on finished products will attract higher rates than those applying to the imported raw materials or inputs. Therefore, the incidence of duties and taxes on locally produced goods would be less than the incidence of duties and taxes on finished imported goods. Reasonable tariff protection will be available to domestic manufacturing depending upon value added.

I. Ownership rights applying to foreign and Pakistani investment

The existing legal rights of ownership applying to foreign and Pakistani investment will be extended to the newly opened sectors. The benefits and incentives for investment, provided by the government shall continue in force and will not be reduced to the disadvantage of investors. Accordingly, Foreign Private Investment (Promotion and Protection) Act 1976 and the Protection of Economic Reforms Act 1992 shall be amended. A serious obstacle in the way of private sector investment has been the questioning by the authorities of the investor's source of funds. In future, the source of investments made in any sector will not be questioned by any official authority.

IV. TAX INCENTIVES

Some important amendments made by the Finance Act, 1997, which are of interest to non-residents, are discussed below.

A. Income tax rates

The Finance Act 1997 introduced a substantial reduction in income tax rates effective from assessment year 1998-99 (i.e. assessment year commencing 1 July 1998, corresponding to income year 1997-98). The Act has also withdrawn the levy of a surcharge applicable to salaried and non-salaried assessees, except where income (other than salaries) exceeds PKR 100,000 and the return qualifies under the self-assessment scheme, in which case a surcharge of PKR 300 is leviable.

The pre-amendment and post-amendment rates of income tax are:

Total income (PKR)	Post-amendment	Pre-amendment
up to 100,000	5%	10%
100,000 – 200,000	5,000 plus 10% of amount over 100,000	10,000 plus 20% of amount over 100,000
200,000 – 300,000	15,000 plus 15% of amount over 200,000	30,000 plus 30% of amount over 200,000
over 300,000	30,000 plus 20% of amount over 300,000	60,000 plus 35% of amount over 300,000

The exemption limits of PKR 50,000 and PKR 40,000 for salaried and other assessees respectively, remain unchanged, while the exemption for a working woman is proposed to be increased from PKR 55,000 to PKR 60,000. Further a credit in tax payable of PKR 2,500, 3,000 and 2,000 for salaried assessees, working women and other assessees as a consequence of the reduction in tax rates was introduced in the Finance Act 1997. The special tax rebate of 25 per cent for assessees of 65 years of age or above continues to be applicable.

B. Tax rates for companies

The tax rates for companies from assessment year 1997-98 to assessment year 1999-2000 are as follows:

Assessment year	Banking company	Public companies other than banking companies	Other companies
1997-98	58%	33%	43%
1998-99	55%	30%	40%
1999-2000 and thereafter	50%	30%	35%

5. In this regard the following proposals have been made.
- To improve working relations among the employers and employees and to increase productivity. It is proposed that Labour Laws be improved in consultation with the Ministry of Manpower and Labour.
- In order to improve productivity and efficiency the contract labour system will be encouraged so that industries may improve their work forces and be competitive in world markets.
- The right to replace unwilling workers will be exercised under the provisions of the relevant laws concerning violence, indiscipline, and loss of productivity.
- A commission will be constituted for the purpose of consolidation, simplification and rationalization of labour laws.
- Outside trade union activity under ILO Agreement will be trade based and not factory based.
- The rapid growth of trade unions at the plant level has been a source of constant disruption in industrial relations foiling genuine efforts by the parties to promote mutual confidence. In order to check this growth, unions receiving less than 20 per cent of the votes in a referendum will be automatically dissolved and their registration cancelled.
- A National Productivity Council will be set up to suggest measures to increase productivity and to also link wages with productivity.
- A Tripartite National Wage Council will be set up to systematically determine the minimum wage for different business activities, industries and occupations in different provinces by taking into account the typical realities and state of economic growth of the province.
- In view of the rise in the cost of living, the Worker's Profit Participation Fund Law will be amended so as to enhance the wage limit to a reasonable extent and to give the benefit of profit share to the maximum number of workers. A Committee consisting of representatives from the Ministry of Labour, Federation of Pakistan Chamber of Commerce and Industry (FPCCI) and National Trade Unions shall decide the limit for this purpose.

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The Act now provides for a reduction in tax rate from 50 per cent to 35 per cent for assessment year 1998-99 for companies other than banking and public companies, where the company allocates 2 per cent of its net profits as a contribution to the education, health, pensions, and gratuities of its workers.

C. Exemptions for non-residents

Either a complete or partial exemption of certain foreign source income is available. Complete exemption is provided in respect of interest payable on the money borrowed from, or the debts owed to, sources outside Pakistan by:

- the government;
- a local authority;
- an industrial undertaking;
- the Industrial Finance Corporation;
- any other financial institution;
- a company; or
- an individual [clauses (75) to (77A), Part I of the Second Schedule to the ITO].[6]

Certain clauses of the Second Schedule dealing with the nature and extent of other exemptions or tax reliefs available to non-residents in Pakistan are set out below.

(12A) Any income of a person who, not being a citizen of Pakistan or a person resident in Pakistan, is engaged as a contractor, consultant or expert on a project in Pakistan financed out of grant funds in accordance with the terms of a bilateral or multilateral technical assistance agreement entered into by the government of Pakistan with any foreign government, international donor agency or bank or other aid-giving organization and derives such income out of the funds of the grant in pursuance of such agreement:
Provided that such person is a citizen or resident of the donor country and receives payments from grant funds of such donor country or is a person who is a citizen or resident of any of the European Economic Community Member States and receives payments out of grant funds provided by the European Economic Community.

(77B) Any profit derived by a non-resident, being a foreign individual, company, firm or association of persons, in respect of the Islamic mode of financing, including *istisna, murabaha, musharika.*

(80A) Any income derived by an individual, unregistered firm, association of persons, Hindu undivided family or an artificial juridical person, other than a company, from rated and listed Term Finance Certificates being the instruments of redeemable capital under the Companies Ordinance 1984, issued on or after 14 September 1997.

(115) Any income derived by a person from the plying of any vehicle registered in the territories of Azad Jammu and Kashmir, excluding income arising from the operation of such vehicle in Pakistan to a person who is resident in Pakistan and non-resident in those territories.

(127) Any income chargeable under the head "salary" received by, or due to, any person (who is neither a citizen of Pakistan nor was resident in Pakistan in any of the four years immediately preceding the year in which he arrived in Pakistan) from an industrial undertaking set up in an area declared by the Federal Government to be a "Zone" within the meaning of Export Processing Zone Authority Ordinance 1980 (IV of 1980), for a period of five years from the date of his arrival in Pakistan and for such further period as may be allowed by the federal government.

(177) Payments made on or after the first day of July, 1991, for a supply of plant, equipment and machinery to Hub Power Company Limited by a non-resident being a foreign individual, company, firm or association of persons.

PART II, SECOND SCHEDULE TO THE ITO

(10) In the case of a non-resident O&M Contractor payments, received in full or in part including a payment by way of an advance, for the operation and maintenance of a private sector power project and transmission line projects approved by the federal government shall be deemed to be the income of the said O&M Contractor and charged to tax at the rate of five per cent of such payments for a period of three years beginning with the date of commencement of company's operations which shall constitute the final discharge of tax liability by the O&M Contractor under this Ordinance in respect of the said project.

6. Clauses 75 to 77A are set out below.
(75) Any interest payable to a non-resident in respect of such private loan to be utilized on such project in Pakistan as may be approved by the federal government for the purposes of this clause, having regard to the rate of interest and the terms of re-payment of the loan and the nature of the project on which it is to be utilized.
(75A) Any interest payable to a non-resident on a loan in foreign exchange against export letter of credit which is used exclusively for export of goods manufactured or processed for exports in Pakistan.
(76) Any interest payable by an industrial undertaking in Pakistan (i) on moneys borrowed by it under a loan agreement entered into with any such financial institution in a foreign country as may be approved on this behalf by the federal government by a general or special order; and (ii) on money borrowed or debts incurred by it in a foreign country in respect of the purchase outside Pakistan of capital plant and machinery in any case where the loan or debt is approved by the federal government, having regard to its terms generally and in particular to the terms of its payment, from so much of the tax payable in respect thereof as exceeds the tax or taxes on income paid on such interest in the foreign country from which the loan emanated or in which the debt was incurred (hereinafter referred to as the "said country"):
Provided that, where the amount of such tax or taxes paid in the said country exceeds the amount of the tax payable in Pakistan, no refund of the amount paid in excess shall be allowed:
Provided further that, where the said country exempts such interest or allows credit against its own tax for the tax which would have been payable in Pakistan if the said interest were liable to tax in Pakistan, no tax shall be payable in Pakistan in respect of such interest.
(77) Any income of an agency of a foreign government, a foreign national (company, firm or association of persons), or any other non-resident person approved by the federal government for the purposes of this clause, from interest on moneys borrowed under a loan agreement or in respect of foreign currency instrument approved by the federal government.
(77A) Any interest payable to a non-resident being a foreign individual, company, firm or association of persons in respect of a foreign loan as is utilized for industrial investment in Pakistan provided that the agreement for such loan is concluded on or after the first day of February 1991, and is duly registered with the State Bank of Pakistan.

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Various limitations to the above exemptions are set out in part IV, second schedule to the ITO.[7]

V. CONCLUSION

Foreign investment plays an important role in the growth and development of any economy. The pace of industrial development, specifically in the developing countries, depends largely on investment from foreign companies as well as in transfers of technological know-how etc. In addition to transferring financial resources, direct foreign investment makes available to the local partner management skills and technical know-how. The presence of foreign enterprises with superior administration/management techniques and technologies tends to stimulate innovation and adaptation and improve management efficiency in local companies. Direct foreign investment is an important source of technology and valuable foreign exchange. Pakistan has been conscious of the need for economic and industrial development and has provided a number of incentives to encourage the transfer of technology and foreign investment. It is hoped that foreign investors will:

- bring in foreign capital;
- introduce new technology and knowledge;
- create employment;
- reinvest profits;
- provide the much needed competitive edge.

As discussed above, Pakistan now provides the best possible tax and investment incentives for foreign investors bringing capital and technology to this part of the world.

7. Certain extracts from Part IV, Second Schedule to the ITO are set out below.
(9A) The provisions of Section 80C shall not apply in respect of a non-resident person unless he opts for the presumptive tax regime:
Provided that a declaration of final and irrevocable option is furnished in writing along with the return of total income under Section 55.
(10B) The provisions of sub-section (7) of Section 50 shall not apply to any payment made by way of profit or interest to an individual, unregistered firm, association of persons, Hindu undivided family or an artificial juridical person, other than a company on rated and listed Term Finance Certificates being the instruments of redeemable capital under the Companies Ordinance 1984, issued on or after 14 September, 1997.
(12) The provisions of clause (30) of Section 2 in so far as these relate to the application of rate of tax under sub-paragraph (3) of Paragraph A of Part IV of the First Schedule shall not apply to an individual being –
(i) a government servant staying abroad on official assignment or with the permission of the federal government or provincial government; and
(ii) a Pakistani national who is not resident in Pakistan in any year and not earning any income abroad.

Conference Diary

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

NOVEMBER

UK Tax Planning, Practice & Regulation, St. James Court Hotel, London, the United Kingdom, 23-25 November 1998 (English):

AIC Worldwide Ltd., 2nd Floor, 100 Hatton Garden, London EC1N 8NX, the United Kingdom, Tel.: 44-171-242 2324, Fax: 44-171-242 2320.

Tax Planning and the Euro, 86 Park Lane, Grosvenor House, London W1A, the United Kingdom, 24 November 1998 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

The Future of European VAT, ICM's fourth pan-European Conference, Amsterdam, the Netherlands, 24-25 November 1998 (English):

ICM Marketing Ltd, 4 Cavendish Square, London W1M OBX, Tel.: 44-171-436 5735, Fax: 44-171-436 5741.

Taxation in Central and Eastern Europe, the Marriott Hotel, Vienna, Austria, 25 November 1998 (English):

Business Seminars International Ltd., Sussex House, High Street, Battle, East Sussex, TN33 OAL, the United Kingdom, Tel.: 44-171-490 3774, Fax: 44-1424-77 3334, E-mail:communications@bsisussex.co.uk

Offshore Tax Planning for Central & Eastern Europe and Russia/CIS, The ANA Grand Hotel, Vienna, Austria, 26-27 November 1998 (English):

Business Seminars International Ltd., Sussex House, High Street, Battle, East Sussex, TN33 OAL, the United Kingdom, Tel.: 44-171-490 3774, Fax: 44-1424-77 3334, E-mail:communications@bsisussex.co.uk

Ceny Transferowe w Polsce – Transfer Pricing, Hotel Bristol, Krakowskie Przedmiescie 42/44, Warsaw, Poland, 26-27 November 1998 and 26-27 January 1999 (English and Polish):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6913 (UK), 48-22-657 0401 (Polska), Fax: 44-171-878 6885 (UK), 48-22-657 0111 (Polska).

International Tax Planning Aspects of Doing Business with MERCOSUR, Amsterdam, the Netherlands, 27 November 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

School of Transfer Pricing, The Hampshire Hotel, London WC2, the United Kingdom, 30 November & 1 December 1998 (English):

Euro Forum, 45 Beech Street, London EC2Y 8AD, Tel.: 44-171-878 6888, Fax: 44-171-878 6885.

DECEMBER

US Transfer Pricing Update, Miramar Sheraton, Los Angeles CA, the United States, 3-4 December 1998 (English):

CITE/FDTA, P.O. Box 1637, White Plains, NY 10602, the United States, Tel.: 914-328-5656, Fax: 914-328-5757.

OECD & IBFD, International Initiatives to Curb Harmful Tax Competition, Chateau d'Esclimont Saint-Symphorien-le-Chateau, near Paris, France, 4 December 1998 (English):

International Bureau of Fiscal Documentation, attn: Mr J. Zeebregts, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-622 8658.

Fourth International Tax Planning Conference, Taj Mahal Hotel, Mumbai, India, 4-5 December 1998 (English):

Bombay Management Association, 9 Podar House, "A" Road, Churchgate Mumbai - 400 020, India, Tel.: 91-22-204 7650, Fax: 91-22-202 4743, E-mail:bma@bom5.vsnl.net.in

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BOOK CHOICE

Barry Larking

Head of IBFD Library and Source Information

THE IMPROPER USE OF TAX TREATIES WITH PARTICULAR REFERENCE TO THE NETHERLANDS AND THE UNITED STATES

Stef van Weeghel
Kluwer Law International, 1998

What to most people is "treaty abuse" has been de-sensationalized in the title of this book (following OECD terminology) to the "improper use of tax treaties". Despite the title's somewhat moralizing tone, the author points out that this is not a question of failing to live up to a moral standard, backing this up with Professor Vogel's reference to the "well-established maxim of tax law that taxpayers are free to arrange their economic affairs in the manner they deem most beneficial for them".

To find out just what was meant by the title, a good place to start the book seemed to be the part entitled "Improper Use of Tax Treaties". However, since this meant skipping over the first third of the book I was rather curious to know whether I would miss anything of significance. I discovered a compact discourse – on the history, context and structure of double taxation treaties plus, more interestingly, an extended review of theory and case law on the concept of beneficial ownership. Noteworthy was a recommendation to the OECD to drop references to "paid" and "recipient" in the passive income articles (since no-one seems quite certain what these terms mean) and to reformulate the articles solely on the basis of "beneficial ownership". Having demonstrated an equal lack of agreement over the meaning of this latter concept, the author puts forward five definitions to choose from. It will be interesting to see whether the OECD takes the hint.

The part of the book dealing with beneficial ownership had the title "Structure" (of treaties) which made me wonder whether the structure of the book might not have been improved by saving the discussion at least until improper use had first been explained. Improper use turned out to be just as controversial a term equally devoid of a commonly accepted meaning: "Some will deem improper use of a tax treaty to be present if the taxpayer acted to avoid tax by using the treaty" – others, by implication, will not. The difficulty arises from the initial proposition that improper use is determined by reference to the "purpose" of the treaty. Is the purpose of tax treaties limited to the avoidance of double taxation or does it extend to prevention of the other "avoidance", namely the avoidance of domestic taxation? Are, other factors, such as the expectations and policy objectives of the treaty parties relevant? Following on from these thoughts, the author concludes that both tax avoidance and frustration of expectations and policy objectives (preferably interpreted according to OECD principles) should be present to constitute improper use. The next chapter sets out in depth a range of situations and structures, starting with treaty shopping, which may be perceived as instances of improper use.

A definition of improper use is, of course, of little value without also identifying what consequences flow from it. It is therefore unfortunate that in the final two parts of the book a clearer distinction is not made between, on the one hand, the methods available for combating – or rather establishing – cases of improper use, such as extensive interpretation, application of domestic anti-avoidance principles and treaty based provisions, and, on the other hand, the "penalties" attached to such use, which, as the author clearly acknowledges, can range from taking steps to renegotiate the treaty to restriction or denial of its benefits. The possible impact of these different consequences on the definition of improper use and the question of which "penalty" is appropriate for which cases might then have been given greater consideration.

As one might expect from a doctoral thesis the book contains a wealth of technical detail, in particular thorough studies of relevant US and Dutch case law and bibliographical references, as well as a number of thought-provoking conclusions and recommendations. The work should be a valuable step towards attaining the uniformity of understanding as regards the improper use of tax treaties, the need for which the author so strongly advocates.

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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 54-56 of the January 1998 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

South Africa

Miller, R.J.; Irwin, W.; Botha, M.
Tax advantages of life insurance.
Durban, MDR Publications (A division of Butterworths), 8 Walter Place, Waterval Park, Mayville 4091, Durban. 1997.
Loose-leaf publication on the taxation of individuals, trusts and deceased estates, retirement annuity funds, pension, taxation of lump sum benefits, donations tax, estate duty, and capital transfer tax in South Africa. Extracts from the Income Tax Act and the Estate Duty Act, Insurance Act, Pension Funds Act, and the tax on Retirement Funds Act as amended to November 1997 are appended.
(B. 13.578)

Foreign nationals working in South Africa.
Amsterdam, Coopers & Lybrand. 1997, pp. 44.
Guide intended to assist foreign nationals working in South Africa with their income tax planning before and after arriving in South Africa. It gives a broad background of taxation in South Africa and also identifies important aspects to be considered by a foreign national working temporarily in South Africa. The guide reflects tax and other laws and practice as at January 1997.
(B. 13.580)

ASIA & THE PACIFIC

Asia

The concise tax guide. Selected corporate tax aspects in the Asia Pacific.
Hong Kong, Baker & McKenzie. 1998, pp. 61.
The booklet contains information on the tax treatment of dividends, interest and royalties, foreign tax credits and treaty relief, tax incentives, and income in general which is subject to tax in the Asia-Pacific region as of March 1998.
(B. 58.509)

Taxation in the Asia-Pacific region.
A salute to the 25 years of regional cooperation in tax administration and research.
Manila, Study Group in Tax Administration and Research (SGATAR). 1997, pp. 261.
The book contains a summary of SGATAR's annual discussions on trends and perspectives in taxation in Asia and pacific region. Includes reports on the structure of tax offices in SGATAR member countries: Australia, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand, the People's Republic of China and Chinese-Taipei.
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Australia

Deutsch, R.L.; Gates, S.J.; Gibson, M.M.; a.o.
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North Ryde, Australian Tax Practice, 13-15 Lyon Park Road, North Ryde, NSW. 1998, pp. 3200. ISBN: 0 86460 084 4.
This tenth edition has been completely rewritten and updated. It covers the full spectrum of income tax law and details of other taxes, e.g. capital gains tax, deductions, technology and investment incentives, international taxation, anti-avoidance provisions, fringe benefits tax, auditing and accounting.
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Arora, V.B.; Norregaard, J.
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IMF Working Paper WP/97/129, pp. 33.
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(B. 58.402)

Hong Kong

Foreign nationals working in Hong Kong.
Amsterdam, Coopers & Lybrand. 1997, pp. 32.
Brochure intended to help foreign nationals with their understanding of income tax issues before they arrive in Hong Kong and afterwards.
(B. 58.514)

Indonesia

Foreign nationals working in Indonesia.
Amsterdam, Coopers & Lybrand. 1997, pp. 24.
Brochure intended to help foreign nationals with their understanding of income tax issues before they arrive in Indonesia and afterwards.
(B. 58.510)

Macau

Linhas de acção governativa plano de investimentos 1998.
Macau, Government Printer. 1998, pp. 239.
Government policies investment plan 1998. Analysis of the economic and financial situation in the Territory of Macau.
(B. 58.492)

Singapore

Soin B.S.
Business operations in Singapore.
Washington, Tax Management Inc. 1998.
Tax Management Foreign Income Portfolio, No. 983-2nd, pp. 110.
This portfolio provides US businesses and individuals interested in conducting business operations in Singapore with a general description of the relevant statutes and regulations governing business activities from both the tax and general legal perspectives.
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Amsterdam, Coopers & Lybrand. 1996, pp. 32.
Brochure intended to help foreign nationals with their understanding of income tax issues before they arrive in Singapore and afterwards.
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Sri Lanka

Goods and services tax (GST). Registration guide.
Colombo, Inland Revenue. 1998, pp. 20.
Notice issued by the Department of Inland Revenue on how to complete the application form for GST registration.
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Company law in the British Virgin Islands.
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A guide to the laws relating to companies incorporated in the British Virgin Islands or having a place of business in the British Virgin Islands. Part one deals with international business companies incorporated under the International Business Companies Act; Part two deals with companies incorporated under the Companies Act; and Part three deals with companies incorporated outside the jurisdiction of the British Virgin Islands.
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Guide to the law relating to partnerships in the British Virgin Islands. The law is stated as at October 1996.
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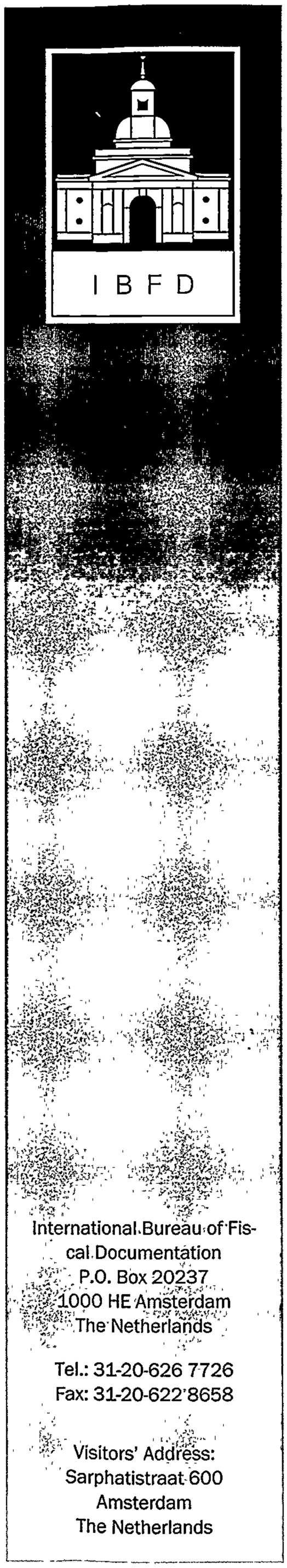

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TREATY MONITOR

PROF. DR KLAUS VOGEL

IN COOPERATION WITH THE IBFD'S TAX TREATY UNIT

TREATY NEWS

Prof. Dr Klaus Vogel

I. CONSTRUCTIVE DIVIDENDS

Do tax treaty rules on dividends apply to constructive dividends? The French *Cour d'appel de Paris* denies this with respect to France's tax treaties with the Netherlands and with Saudi Arabia. The Court held, therefore, that under the Dutch treaty France had no authority to levy withholding tax, rather that the constructive dividends were taxable solely by the recipient's state of residence, in this case the Netherlands, under a provision corresponding to Article 21 of the OECD Model Convention. France's treaty with Saudi Arabia, however, has no such "other income" article. From this the Court concluded that France was free to tax the income in question according to its domestic law.

The ruling surprises because the dividend definitions of both treaties are identical (in the case of the Netherlands: practically identical) with Article 10 (3) of the Model Convention. According to this provision "dividends" mean "income from shares ..." (etc.), in French "*les revenus provenant d'actions...*". That seems to include income which, though not labelled as a dividend, is effectively received by a shareholder or a person related to him as a consequence of his corporate rights. Moreover, there is agreement that "paid" should be given as broad an interpretation as possible which is confirmed by the OECD Commentary to Article 10 in its paragraph 7 ("[t]he term 'paid' has a very wide meaning", in French "*revêt un sens très large*"). Finally, the Commentary expressly states in its paragraph 28: "Payments regarded as dividends may include not only distributions of profits decided by annual general meetings of shareholders, but also other benefits in money or money's worth, such as bonus shares, bonuses, profits on a liquidation and disguised distributions of profits" ("*et distributions cachées de bénéfices*"). This explanation was included in the Commentary as early as 1963 as its paragraph 36. Therefore, regardless of the general question to what extent the Commentary is binding, it can be assumed that France and its two treaty partners in concluding these particular treaties wanted the dividend definition to be understood in accordance with the Commentary, i.e. to include silent distributions.

II. TAXATION OF AIRCRAFT CREW MEMBERS

Under Article 15(3) of the Model Convention "remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic" may be taxed by the state of effective management of the vessel. In 1992 Denmark, which until that time had taxed non-resident aircraft crew members only on their salary received for work in the Danish territory or in the air above it, inserted a provision into its Source Tax Law (*Kildeskattelov*) modelled in accordance with Article 15(3) in order to extend Danish taxation to the income earned by non-resident crew members of Danish aircraft, even when earned abroad.

Recently Denmark's National Tax Court (*Landsskatteret*) had to decide whether this provision applied to salary paid for working time spent outside Denmark on standby or flying in planes of other airlines. Relying on the words "employment exercised aboard" ("*arbejde udført om bord*") the Court held that under the provision in question only the time of work on board as shown by the aircraft's log book and, of course, of work in Denmark, though outside the aircraft, was subject to Danish taxation. Though formally this ruling concerned Danish domestic law only, it is of interest for treaties containing a provision similar to Article 15(3), because the words "exercised aboard" are exactly the same as in the Model. Considering that Article 15(3) does not only apply to aircraft, but also to ships whose crew members often have to carry out activities outside the ship, but on behalf of the ship, e.g. when the ship is docking or being loaded, or may enjoy shore leave, I doubt whether the narrow interpretation adopted by the Danish Court can be transferred to the treaty provision. This argument may in turn affect the interpretation of the Danish domestic rule which was meant to follow the Treaty Model, but that is for Danish people to decide.

III. BASE COMPANIES AND DOMESTIC ANTI-AVOIDANCE LEGISLATION

The Austrian High Administrative Court (*Verwaltungsgerichtshof*) had to decide a case involving dividends paid by an Austrian corporation to a Dutch letter-box company which in turn was wholly owned by a UK corporation and was managed on behalf of that company by a Dutch bank. The Austrian tax authorities relying on Section 22 of the Austrian General Tax Code (*Abgabenordnung*) had allocated the dividends to the UK parent. The Court on formal grounds cancelled this assessment. But in doing so it mentioned that the reallocation did not violate Austria's tax treaty with the Netherlands, because it is a question of domestic income tax

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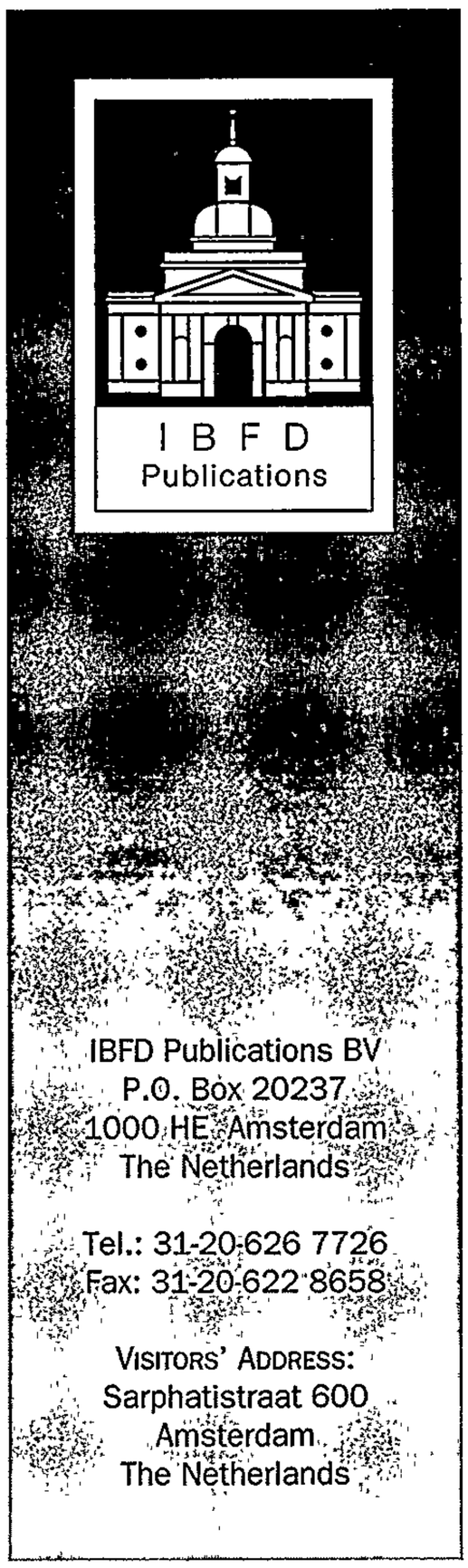
law not affected by the treaty to whom income is attributed. This is in accordance with the famous *Aiken* decision of the US Tax Court and with international practice and prevailing doctrine. It should be kept in mind, however, that applying domestic anti-avoidance rules to the application, considered improper, of a treaty provision is a different question. Non-application of a treaty clause must be authorized by international law, be it customary or derived from the treaty itself.

RECENT TREATIES

Countries	Date of conclusion
France–Syria	17 July 1998
Seychelles–South Africa	26 August 1998
India–Portugal	11 September 1998
Macedonia–Netherlands	11 September 1998
Bulgaria–Moldova	15 September 1998
Kazakstan–Romania	21 September 1998
Iran–Poland	1 October 1998
New Zealand–Thailand	22 October 1998
Ireland–Mexico	31 October 1998
Cyprus–Thailand	3 November 1998

None of these treaties are yet in force.



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Australia

TREATY SHOPPING IN AUSTRALIA

Ian V. Gzell QC BA(Hons) LL B, BCom, FCPA, FTIA*

Editorial
Prof. Richard Vann will write on the *Lamesa case* in a forthcoming issue of the Treaty Monitor.

I. INTRODUCTION

The Australian decision in *Federal Commissioner of Taxation v. Lamesa Holdings BV*[1] is as interesting for what was not dealt with by the Court as it is for what the Court said.

The case involved a prime example of treaty shopping. Instead of a limited partnership resident in the United States of America investing directly into Australia, it established a Dutch company which undertook the investment.

II. THE FACTS

A limited partnership formed in the United States, Green Equity Investors LP (GEILP), acquired Lamesa Holding BV (Lamesa), a company incorporated in the Netherlands. Lamesa acquired an Australian company, Australian Resources Limited (ARL) and it acquired another company, Australian Resources Mining Pty Limited (ARM).

ARM made a successful on-market takeover of Arimco NL (Arimco). One of its wholly owned subsidiaries, Arimco Mining Pty Limited (Arimco Mining), held gold mining leases.

Within two years of the takeover, the group was refloated by ARL issuing new capital which was quoted on the stock exchange.

Lamesa made a profit in excess of AUD 200 million by selling out of its stake in ARL in two tranches two years apart.

III. AUSTRALIA'S DOMESTIC TAX REGIME

Under Australian domestic law, income according to ordinary concepts derived by a non-resident from a source in Australia is included in the non-resident's "assessable income".[2] Assessable income less deductions constitutes taxable income[3] upon which tax is levied.[4]

Upon a disposal by a non-resident of a 10 per cent shareholding in an Australian company listed on the stock exchange,[5] a capital gain equal to the difference between the capital proceeds on disposal and the asset's cost base, indexed for general inflation,[6] arises.[7] A "net capital gain" is this amount offset by any capital loss,[8] and a net capital gain is included in assessable income.[9]

IV. THE TREATY PROVISIONS

Lamesa accepted that the profits on sale of its shares in ARL were included in its assessable income.[10] It claimed, however, the protection of the business profits article in the Australia–Netherlands treaty, Article 7, which is in the familiar form of the business profits article in the 1977 OECD Model Double Taxation Convention on Income and Capital (1977 OECD Model) upon which it was based.[11]

One of the exceptions to the business profits article is the capital gains article, Article 13. Unlike the article in the OECD Models, the Australian capital gains tax article is limited to real property including rights to exploit or explore for natural resources and shares or comparable interests in a company, the assets of which consist wholly or principally of such rights. There is no provision that gains from the alienation of property not otherwise specified is taxable only in the country of residence.

The article is as follows:

Alienation of Property

(1) Income from the alienation of real property may be taxed in the State in which that property is situated.

(2) For the purposes of this Article –

(a) the term "real property" shall include –

(i) a lease of land or any other direct interest in or over land;

(ii) rights to exploit, or to explore for, natural resources; and

* Ian V. Gzell was senior counsel for Lamesa in the court proceedings.

1. (1997) 77 FCR 597.
2. Income Tax Assessment Act 1997 (1997 Act), Sec. 6-5(3) replacing Income Tax Assessment Act 1936 (1936 Act), Sec. 25(1)(b). The latter provision was extant at the time the profits were made.
3. 1997 Act, Sec. 4-15(1), 1936 Act, Sec. 6(1).
4. 1997 Act, Sec. 4-10(3), 1936 Act, Sec. 17(1), Income Tax Rates Act 1986, Sec. 12,
5. 1997 Act, Secs. 136-10 and 136-25, 1936 Act, Sec. 160T(1)(d).
6. 1997 Act, Sec. 114-1, 1936 Act, Sec. 160ZJ(4).
7. 1997 Act, Sec. 104-10(4), 1936 Act, Sec. 160Z(1)(a).
8. 1997 Act, Sec. 102-5(1), 1936 Act, Sec. 160ZC(1).
9. 1997 Act, Sec. 102-5(1), 1936 Act, Sec. 160ZO(1).
10. Lamesa objected to assessments based upon the capital gains provisions and the Commissioner issued amended assessments in the same amounts but under the ordinary income provisions. This was thought to give Lamesa a tactical advantage in attracting the business profits article in the treaty.
11. Although the treaty was signed by Australia in March 1976 there was expert evidence that it was based upon a widely publicized forward copy of the 1977 OECD Model.

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(iii) shares or comparable interests in a company, the assets of which consist wholly or principally of direct interests in or over land in one of the States or of rights to exploit, or to explore for, natural resources in one of the States.

(b) real property shall be deemed to be situated –

(i) where it consists of direct interests in or over land – in the State in which the land is situated;

(ii) where it consists of rights to exploit, or to explore for, natural resources – in the State in which the natural resources are situated or the exploration may take place; and

(iii) where it consists of shares or comparable interests in a company, the assets of which consist wholly or principally of direct interests in or over land in one of the States or of rights to exploit, or to explore for, natural resources in one of the States – in the State in which the assets or the principal assets of the company are situated.

(3) Gains from the alienation of shares or "jouissance" rights in a company the capital of which is wholly or partly divided into shares and which is a resident of the Netherlands for the purposes of Netherlands tax, derived by an individual who is a resident of Australia, may be taxed in the Netherlands.

V. THE COMMISSIONER'S ARGUMENTS

The Commissioner argued that the gold mining leases held by Arimco Mining were rights to exploit or explore for natural resources and Article 13 applied to the exclusion of the protection under Article 7.

First, the Commissioner contended that indirect rights to exploit or explore for natural resources fell within Article 13. The absence of the word "direct" in Article 13(2)(a)(ii) meant, he contended, that indirect rights to exploit or to explore for natural resources fell within the extended definition of real property and Lamesa had an indirect right to exploit or explore for natural resources because, at the very least, it could at any time exercise its legal rights to wind up all intermediate companies in the group and take a distribution in specie of the mining leases.

Secondly, if direct interests alone were encompassed, the Commissioner argued that that concept was susceptible of a lineal meaning so that, just as a grandchild was a direct descendant of a grandparent, so the gold mining leases held by Arimco Mining were direct rights of Lamesa to exploit or explore for natural resources.

Thirdly, the Commissioner submitted that a controlling shareholding by an ultimate parent company of a wholly owned group which held mining leases was a comparable interest in the company holding the mining leases.

Finally, the Commissioner relied upon an "in substance" approach arguing that in substance the shares in ARL were those of a company, the assets of which consisted wholly or principally of rights to exploit or to explore for natural resources under Article 13(2)(a)(iii) because the Court was entitled to look through the corporations between ARL and its mining assets and to treat the mining assets as the assets of ARL. It was submitted that it was inconsistent with the objects of the Australia–Netherlands treaty to interpret it as ousting Australian taxing law where Dutch law did not impose tax, or the only explanation for the application of the Australia–Netherlands treaty was a deliberate election to avoid taxation by engaging in treaty shopping.

VI. THE COURT'S DECISION

Of the first two arguments the Full Court[12] said, that the direct interests in or over land in Article 13(2)(a)(i) were analogous to the specifically mentioned leasehold interests and did not include rights to wind up companies and seize control of assets. Since an authority to prospect might not be encompassed in such a direct interest, the explicit naming of such rights sufficed to explain the terms of Article 13(2)(a)(ii).[13]

Not only had it been submitted on behalf of Lamesa that transfers of mining leases in Queensland (Qld) and in Western Australia (WA) and exploration licences in WA, where the gold mining interests were held, required consents by the State Ministers for Mines and the Foreign Investment Review Board (FIRB),[14] but also it was pointed out that if indirect or lineal interests were encompassed within Article 13(2)(a)(ii), it would render otiose Article 13(2)(a)(iii).

Evidence had been adduced from Professor Maarten J. Ellis[15] before the judge at first instance that the Dutch word *belang* was used in Article 13(2)(a)(i) which encompassed indirect interests, with the consequence that the Dutch equivalent of the word "direct" was necessary to exclude indirect interests. In Article 13(2)(a)(ii), however, the Dutch word *recht* was used which needed no such qualification because in Dutch the word did not include indirect interests.

The primary judge relied upon this evidence,[16] in reaching his conclusion that indirect or lineal interests were not encompassed within Article 13(2)(a)(ii).

The fact that the Full Court arrived at its view in general terms rather than relying upon the Dutch language version of the treaty means that *Lamesa's case* is authority for the exclusion of indirect or lineal interests from comparable provisions in other treaties, even where the other language version is not so circumscribed as is the Dutch version of the Australia–Netherlands treaty.

Of the submission that a controlling shareholding by the ultimate parent company of a wholly owned group which held mining leases was a "comparable interest" in the company holding the mining leases, the Full Court said,[17] that comparable interests are stock or warrants or other rights comparable with shares in a company the assets of which consist

12. A taxpayer may take his objection to an assessment by the Commissioner to a Tribunal or to the Federal Court of Australia constituted by one judge. An appeal lies on a point of law from the single judge to a Full Court of the Federal Court constituted by three judges. Lamesa elected to have its objection dealt with by a single judge of the Federal Court who found in its favour. The Commissioner's appeal to the Full Court failed.
13. 77 FCR at 606-607.
14. Mineral Resources Act 1989 of Qld, Secs. 276(1)(g) and 300, Mining Act 1978 of WA, Secs. 64 and 82(1)(d), Foreign Takeovers Act 1975 of the Commonwealth, Sec. 21A.
15. Professor of Law at Erasmus University, Rotterdam.
16. 97 ATC at 4237.
17. 77 FCR at 606-607.

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wholly or principally of one of the two classes of assets in Article 13(2)(a)(i) and (ii), that is, direct interests in land or rights to exploit or explore for natural resources.

It had been submitted on behalf of Lamesa that comparable interests were interests other than shares such as the rights of a holder of stock or the rights of a member of a company limited by guarantee or, under Dutch law as Professor Ellis had pointed out, jouissance rights in real estate companies.

The primary judge had dismissed the argument on the basis that what was sold by Lamesa were shares and not some alternative to shares.[18]

In cross examination, Professor Ellis said that on the facts as he knew them he could not see a reason for GEILP choosing the Netherlands other than the exclusion of dividends and other profit distributions and capital gains on the disposal of its shares from corporate income tax in the Netherlands under the Dutch domestic law participation exemption.[19]

Of the "in substance" argument of the Commissioner, the Full Court said[20] that resort to the purpose of the Australia–Netherlands treaty in the words "for the avoidance of double taxation with respect to taxes on income" was of little assistance in the resolution of the problem. If Article 13 applied, the profit was taxable in the country of situs and if not, it was taxable in the country of residence.[21]

The Full Court[22] disregarded the circumstance that because of the participation exemption, Lamesa was not subject to tax on the profits in the Netherlands. If the situation had been reversed, there would have been no exemption from tax in Australia on the profits on sale of shares in a Netherlands holding company, yet the Australia–Netherlands treaty must operate uniformly whether the realty was in the Netherlands or in Australia.

The Court went on to conclude that it was consistent with the rational policy underlying the Australia–Netherlands treaty that it was intended to assimilate as realty only one tier of companies rather than numerous tiers. This was not to adopt an illiberal view of the treaty, but merely to interpret its language in light of the broad purposes of juridical allocation of taxing power which the treaty embodied.

VII. THE GOVERNMENT RESPONSE

On 27 April 1998 the Australian Government announced that it would amend the International Tax Agreements Act 1953 (Agreements Act), under which Australia's treaties are given the force of law domestically, with effect from midday on that day, to ensure that Australian law applies to profits arising from the indirect alienation of real property by non-residents.

The Government rejected the alternative course of seeking to amend its treaties as being too time consuming,[23] although it did announce that its treaty partners were to be advised of the proposed action.

No amending bill has yet been introduced to the Parliament.

VIII. THE TREATY SHOPPING ARGUMENT

It is interesting that neither the Full Court nor the primary judge dealt with the alternative argument of the Commissioner as to treaty shopping.

Lamesa had submitted with respect to the in substance approach that what the Commissioner was seeking to do was to approbate the separate existence of corporations for the purpose of taxing Lamesa, but to reprobate it for the purpose of seeking to deny the protection of Article 7 of the Australia–Netherlands treaty.

It was pointed out that the structure of the treaty denied piercing the corporate veil because Article 9 dealt with the situation where an enterprise of one State participated directly or indirectly in the management, control or capital of an enterprise of the other State, not by lifting the corporate veil, but by recognizing the separate legal status of the entities and adjusting any transfer pricing to arm's length amounts.

Of the treaty shopping argument, it was pointed out that the accusation was really levelled at GEILP which was not the taxpayer assessed and the proposition ignored the fact that income would, prima facie, be taxable in the United States on distribution from Lamesa subject to a foreign tax credit for withholding tax paid in the Netherlands.[24]

It was submitted that treaty shopping was a matter to be addressed either by specific provision in a treaty or by provision in the domestic laws of the Contracting States. It was pointed out that there was an anti-treaty shopping provision in the United States–Netherlands treaty in the lengthy and complex Article 26, and that in the absence of a specific anti-treaty shopping provision in the Australia–Netherlands treaty,[25] the only recourse available to the Commissioner was the general anti-avoidance provision in Australia's domestic

18. 97 ATC at 4235.
19. Corporate Income Tax Act (*Wet op de vennootschapsbelasting 1969*) Art. 13.
20. 77 FCR at 607.
21. In so saying, an obvious mistake emerges in the judgment. The Full Court said that in the latter case the profits were taxable under Art. 4. That article defines residence. The Court must have meant that Art. 7, the business profits article, would apply if Art. 13 did not.
22. 77 FCR at 607.
23. Unilateral amendments of domestic law affecting treaty obligations are becoming more prevalent. See, for example, the introduction by the United States in August 1997 of Sec. 894 to the Internal Revenue Code (US Code) denying the lower rates of withholding tax under its treaties with respect to fiscally transparent entities and cf. the announcement of June 1997 in the United Kingdom in Inland Revenue Tax Bulletin No. 29 at 440-441 that US limited liability companies (LLCs) would be treated as non-transparent for the purposes of the United Kingdom–United States Treaty.
24. US Code, Secs. 61(a)(7), 901(a) and (b).
25. Australia's treaties contain few anti-treaty shopping provisions. Art. 16 of the Unites States–Australia treaty denies treaty relief unless a 75 per cent beneficial entitlement in residents of one or other country or a stock exchange requirement is met. Art. 4(5) of the Australia–China treaty denies the lower withholding tax rates to an entity deliberately set up for that purpose. Art. 23(1) of the Australia–Vietnam treaty denies Vietnamese tax sparing for foreign tax credit purposes with respect to a conduit. Australia's other treaties contain no anti-treaty shopping provisions.

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law,[26] upon which the Commissioner had not relied in raising the assessments.

IX. NON-APPLICATION OF AUSTRALIA'S GENERAL ANTI-AVOIDANCE PROVISION TO TREATIES

There is a provision in Australia's domestic law that its treaties which are contained in schedules to the Agreements Act under which they are given the force of law domestically, have effect notwithstanding anything inconsistent in Australia's other domestic tax legislation.[27] The exceptions to this provision are the domestic limitation of foreign tax credits to the amount of Australian tax of the year in question and Australia's general anti-avoidance provisions in Part IVA of the 1936 Act.

Under Part IVA a scheme, characterized by reference to eight categories of indicia,[28] giving rise to the conclusion that a person entered into any part of it with the dominant purpose of enabling a taxpayer to obtain a "tax benefit", allows the Commissioner to make a determination cancelling that benefit.[29]

Relevantly for present purposes, a tax benefit is defined as the exclusion of an amount from assessable income that might reasonably be expected to have been included, but for the scheme, and the allowance of a deduction which might reasonably be expected not to have been allowable, but for the scheme.[30]

In my view there is an essential weakness in the argument that Part IVA applies to treaty benefits, notwithstanding a legislative assumption that it does.

Subject to an exception irrelevant for present purposes, there is a provision in Part IVA to the effect that nothing in the provisions of the 1936 Act other than Part IVA or in the Agreements Act is to be taken as limiting the operation of Part IVA.[31]

In Australia, extrinsic material may be taken into account in confirming the ordinary meaning, or to resolve an ambiguity, in a provision of an Act of the Australian Parliament.[32] One source of extrinsic material specifically mentioned in this context is any explanatory memorandum relating to a bill containing the provision that was laid before, or furnished to the members of, the House of Representatives or the Senate by a Minister before the time when the provision was enacted.[33]

When Part IVA was introduced to the Parliament,[34] the explanatory memorandum stated:[35]

> The basic purpose of proposed section 177B is to give to Part IVA a position of paramount force in the Income Tax Law.
>
> As explained elsewhere in this memorandum, Part IVA will be applicable where from an objective view of a scheme and its surrounding circumstances it would be concluded that it was entered into for the sole or dominant purpose of obtaining a tax benefit, (as defined). Against this background, *sub-section (1)* of section 177B will mean that the anti-avoidance operation of Part IVA is not to be limited by anything else in the general income tax law, whether in the Principal Act or in a double taxation agreement with another country that is given the force of law in Australia by the Income Tax (International Agreements) Act 1953 (see also clause 13).

Clause 13 of the 1981 Bill contained an amendment to the Agreements Act to insert a reference to Part IVA.[36] The explanatory memorandum said of this amendment:[37]

> The amendment proposed by this clause is of a consequential nature and relates to the section of the Agreements Act – section 4 – on which Australia's double taxation agreements with other countries depend for their legal force. It assists in giving effect to the object of proposed sub-section 177B(1), that the operation of the anti-avoidance provisions of Part IVA is not to be limited by anything else in the general income tax law, whether in the Income Tax Assessment Act or in a double taxation agreement that is given the force of law in Australia by the Agreements Act.
>
> This clause proposes an amendment to sub-section 4(2) of the Agreements Act so that, if there is anything in Part IVA that is inconsistent with the provisions of that Act (including an agreement contained in a Schedule to that Act), Part IVA will prevail.

It was clearly thought that in appropriate circumstances Part IVA could negate a benefit under one of Australia's treaties.

Part IVA only operates, however, if there is a tax benefit as defined.[38] A treaty will normally provide a benefit by excluding the right of Australia to tax. That was the type of benefit which arose in *Lamesa's case*.

Relevantly for present purposes, the only type of benefit which might enliven Part IVA is an amount not being included in assessable income which, but for the scheme, might reasonably be expected to have been so included.[39]

The term "assessable income" is defined[40] as having the meaning given by provisions[41] which speak in terms of income according to ordinary concepts and statutory amounts.

In my view the benefit available to Lamesa under the Australia–Netherlands treaty did not amount to an exclusion from assessable income. The profit on sale of the shares was included in Lamesa's assessable income.[42] The effect of the treaty was that Australia's right to tax that assessable income was forgone.

---

26. 1936 Act, Part IVA.
27. Agreements Act, Sec. 4 provides:
(1) Subject to subsection (2), the Assessment Act is incorporated and shall be read as one with this Act.
(2) The provisions of this Act have effect notwithstanding anything inconsistent with those provisions contained in the Assessment Act (other than section 160AO and Part IVA of that Act) or in an Act imposing Australian tax.
28. 1936 Act, Sec. 177D(b).
29. 1936 Act, Sec. 177F(1).
30. 1936 Act, Sec. 177C(1).
31. 1936 Act, Sec. 177B(1).
32. Acts Interpretation Act 1901 (Interpretation Act), Sec. 15AB(1).
33. Interpretation Act, Sec. 15AB(2)(e).
34. Income Tax Laws Amendment Bill (No. 2) 1981 (1981 Bill).
35. At 8-9.
36. Agreements Act, Sec. 4(2).
37. At 24.
38. 1936 Act, Secs. 177C(1) and 177CA.
39. 1936 Act, Sec. 177C(1)(a).
40. 1997 Act, Sec. 995-1(1).
41. 1997 Act, Secs. 6-5, 6-10 and 6-15.
42. 1936 Act, Sec. 25(1)(b).

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Treaty benefits are, in my view, much like tax rebates. They have no affectation upon assessable income but limit taxing ability.

The Commissioner asserts,[43] that the substitution of a dividend subject to a rebate[44] for an equal amount of assessable income not so subject is within the purview of Part IVA.

There may be some doubt about that proposition. A similar line of reasoning, however, demonstrates that Part IVA is not devoid of operation with respect to treaties.

The Australia–Ireland treaty contains a provision in the capital gains article that income or gains from the alienation of assets other than real property unconnected to a permanent establishment in the country of situs may only be taxed in the country of residence.[45]

If one transfers shares in an Australian company from an Australian holding company to an Irish holding company which then sells to the ultimate purchaser thereby invoking the protection of the capital gains article, Part IVA has a potential operation with respect to the interposition of the new treaty entity. But for the scheme, an amount may well have been included in the assessable income of the Australian holding company.

The argument against my proposition is that the 1936 Act is incorporated and to be read as one with the Agreements Act[46] such that income the subject of treaty protection is exempt income for the purposes of the 1936 Act and the effect of a treaty is, therefore, to exclude an amount from assessable income because exempt income is excluded from assessable income.

The fact that it was thought necessary to amend the Agreements Act[47] to include the reference to Part IVA and to include the specific provision in Part IVA,[48] militates against this argument, as does the inclusion in the 1936 Act[49] of the other specific limitation mentioned in the Agreements Act.[50]

The term "exempt income" is defined in the 1997 Act[51] in terms of a provision[52] which refers to a list of other provisions with respect to exempt income[53] which set out in great detail the provisions of the 1936 Act and of the 1997 Act with respect to exempt income. No mention is made of the operation of the Agreements Act or of the treaties scheduled thereto.

My interpretation of Part IVA is contrary to the assumption underlying the explanatory memorandum to the 1981 Bill which was that it has a direct operation with respect to treaty benefits.

While that means that there is added difficulty in convincing a Court that Part IVA has no direct application to treaty benefits, the task is by no means futile. When Part IVA was introduced it was seen as a generally applicable anti-abuse provision. Upon critical analysis it may be seen not to have the scope with respect to treaties that it was originally thought to have.

X. THE UNITED STATES–AUSTRALIA TREATY IF PART IVA APPLIED

The Commissioner did not argue in *Lamesa's case* that Part IVA applied to exclude the interposed Dutch company. Had he done so, the question would have arisen whether GEILP was entitled to the benefit of the business profits article under the United States–Australia treaty.

A vexed question which arises in this context is whether GEILP is a resident of the United States for the purposes of the treaty.

The US Treasury Department's Model Income Tax Treaty of 17 May 1977 (US Model) contains a proviso to the definition of a resident of a Contracting State in the case of a partnership, estate or trust limiting the inclusion of such persons as residents to the extent that income is taxed in the State of residence either in the hands of the partnership, estate or trust or in the hands of the partners or beneficiaries.[54]

The United States has been successful in including such a proviso in many of its treaties.

Article 4(1)(b) of the United States–Australia treaty is in the following terms:

> (1) For the purposes of this Convention:
> .....
> (b) a person is a resident of the United States if the person is:
> (i) a United States corporation; or
> (ii) any other person (except a corporation or unincorporated entity treated as a corporation for United States tax purposes) resident in the United States for purposes of its tax, provided that, in relation to any income derived by a partnership, an estate of a deceased individual or a trust, such person shall not be treated as a resident of the United States except to the extent that the income is subject to United States tax as the income of a resident, either in its hands or in the hands of a partner or beneficiary, or, if that income is exempt from United States tax, is exempt other than because such person, partner or beneficiary is not a United States person according to the United States law relating to United States tax.

The term "United States corporation" is defined to mean a corporation which under US law relating to US tax is a domestic corporation.[55] The term "United States tax" is defined to mean tax imposed by the United States to which the treaty applies by virtue of Article 2.[56] That article provides that the treaty applies to the Federal income taxes imposed by the US Code.[57]

43. Income Tax Ruling IT 2456.
44. 1936 Act, Sec. 46(2).
45. Art. 14(3).
46. Agreements Act, Sec. 4(1).
47. Agreements Act, Sec. 4(2).
48. Sec. 177B.
49. 1936 Act, Sec. 160AO(3).
50. Agreements Act, Sec. 4(2).
51. 1997 Tax Act, Sec. 995-1(1).
52. 1997 Tax Act, Sec. 6-20.
53. 1997 Tax Act, Secs. 11-5, 11-10 and 11-15.
54. Art. 4(1)(b).
55. Art. 3(1)(g)(i).
56. Art. 3(1)(i).
57. Art. 2(1)(a).

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Since GEILP was treated as a partnership, it was not a US corporation and hence was not a resident of the United States under Article 4(1)(b)(i) of the United States–Australia treaty.

The term "person" is defined to include a partnership, a company and any other body of persons.[58]

The term "United States person" is defined in the US Code[59] to include a domestic partnership and GEILP was treated as a domestic partnership under the US Code.[60]

GEILP thus, prima facie, fell within Article 4(1)(b)(ii) of the United States–Australia treaty as a person resident in the United States for purposes of its tax, being a domestic partnership for the purposes of the US Code.

A domestic partnership is, however, transparent for the purposes of the US Code.[61] Thus GEILP fell within the proviso to Article 4(1)(b)(ii) of the United States–Australia treaty.

This is a matter, in my view, for determination according to the domestic laws of the United States as the *lex societatis* (the law governing the legal status of the foreign entity) rather than the domestic laws of Australia as the *lex fori* (the law of the forum).

Such an approach has recently been confirmed by the Brussels Court of Appeals[62] to be the law of Belgium.[63]

The United States–Australia treaty contains the usual provision that any term not defined shall, unless the context otherwise requires, have the meaning it has under the domestic taxation laws of the State to which the treaty applies.[64]

That provision has no operation in this context, however, because the provisions in question are definitions.

This position is to be contrasted with that which recently emerged in the decision of the UK Court of Appeal in *Memec Plc v. Inland Revenue Commissioners*[65] where, in the absence of a general definition of the term "dividend" for the purpose of the Germany–United Kingdom treaty, the Court characterized a silent partnership, transparent according to German law, to lack the characteristics of a partnership according to English law.

Since GEILP as a US partnership was not subject to tax in the United States, it would not be a resident of the United States within Article 4(1)(b)(ii) of the United States–Australia treaty to the extent that its partners were not subject to tax in the United States or it or its partners were exempt other than because they were not US persons.

Since the limited partners of GEILP were all US residents, it follows that GEILP was a US resident for the purposes of the United States–Australia treaty. Even if a limited partner was exempt from tax in the United States that was for a reason other than residence and hence the proviso did not operate to exclude GEILP from the definition.

The anti-treaty shopping provision in Article 16 of the United States–Australia treaty is as follows:

> *Limitation on Benefits*
>
> (1) A person (other than an individual) which is a resident of one of the Contracting States shall not be entitled under this Convention to relief from taxation in the other Contracting State unless:
>
> (a) more than 75 percent of the beneficial interest in such person (or in the case of a company, more than 75 percent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by any combination of one or more of:
> (i) individuals who are residents of the United States;
> (ii) citizens of the United States;
> (iii) individuals who are residents of Australia;
> (iv) companies who are described in subparagraph (b); and
> (v) the Contracting States;
>
> (b) it is a company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange in one of the Contracting States; or
>
> (c) the establishment, acquisition and maintenance of such person and the conduct of its operations did not have as one of its principal purposes the purpose of obtaining benefits under the Convention.
>
> (2) For the purposes of subparagraph (1)(b), the term "a recognized stock exchange" includes, in relation to the United States, the NASDAQ System owned by the National Association of Security Dealers, Inc.
>
> (3) Where:
>
> (a) income derived by a trustee is to be treated for the purposes of this Convention as income of a resident of one of the Contracting States; and
>
> (b) the trustee derived the income in connection with a scheme a principal purpose of which was to obtain a benefit under this Convention,
>
> then, notwithstanding any other provision of this Convention, the Convention does not apply in relation to that income.

Since GEILP was neither a company nor a person more than 75 per cent of the beneficial interest in which was owned directly or indirectly by individuals who were either residents of the United States or citizens of the United States, Article 16(1)(a) and (b) would not have applied.

In order to obtain the benefit of the business profits article, therefore, GEILP would need to have shown that its establishment and the conduct of its operations did not have as one of its principal purposes the purpose of obtaining benefits under the treaty in terms of Article 16(1)(c).

In light of the *modus operandi* of LGA as the general partner of GEILP in placing the members of its portfolio of investors in a series of limited partnerships, I would not have thought that this would have presented any problem to GEILP.

In any event, it was the withholding tax benefit under the United States–Netherlands treaty and not the business profits benefit under the United States–Australia treaty which was sought.

In my view, therefore, had the Commissioner raised Part IVA and set aside the interposition of Lamesa between GEILP and ARL, the same result would have eventuated.

58. Art. 3(1)(a).
59. Sec. 7701(a)(30)(B).
60. Under the current regulation §301.7701-3(b) it would be so treated in default of an election to be treated as an association and thus a corporation under regulation §301.7701-2(b)(2).
61. Sec. 701.
62. Decision of 30 April 1998.
63. Marnix van Keirsbilck, "Tax Treatment of General Partnerships: A Landmark Court Decision", 38 *European Taxation*, 8 (1998), at 249.
64. Art. 3(2).
65. 1998 BTC 251.

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GEILP would have been entitled to the benefit of the business profits article in the United States–Australia treaty and the exception of the capital gains article would not have arisen because it is in essentially the same terms as that in the Australia–Netherlands treaty.[66]

XI. CONCLUSION

Whether or not the Australian Government introduces legislation to extend the definition of the term "real property" for the purposes of its treaties to include indirect rights to exploit, or to explore for, natural resources, *Lamesa's case* highlights Australia's limited arsenal against abusive treaty shopping.

Few of its treaties contain any anti-treaty shopping provisions and its general domestic anti-avoidance provisions in Part IVA do not, in my view, apply to treaty benefits.

As EU countries come under pressure to introduce measures to combat harmful tax competition,[67] Australia may become an attractive alternative for tax effective investment structures.

66. Art. 13(2)(b) and Art. 6(2)(ii).

67. As a result of the agreement of 1 December 1997 by the Finance Ministers to adopt a voluntary code of conduct to combat fiscal competition between Member States, or as a result of the report Harmful Tax Competition an Emerging Global Issue approved by the OECD Council on 9 April 1998.

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SWITZERLAND

ELECTRONIC COMMERCE AND TAXATION: A SWISS PERSPECTIVE[1]

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I. INTRODUCTION

In Switzerland electronic commerce is now beginning to attract serious attention. While there is little doubt that electronic commerce currently represents only a small part of the commercial transactions conducted within Switzerland and internationally, the number of people owning a computer and having access to the Internet is growing dramatically. The liberalization of the telecommunications market, which is taking place in Switzerland, will make the use of the new technologies easier and cheaper. In some areas, access to the Internet is already possible via TV-cable, thus granting larger bandwidth and enhanced services to the users. Many observers believe that, because of the limited internal Swiss market, Swiss customers and businesses will be tempted by the opportunities offered on the global market place and will not hesitate to conduct commercial activities electronically.

The implications of electronic commerce for the Swiss tax system are difficult to evaluate as except for business-to-business operations commerce through the Internet is still something new. In addition, Switzerland is a federal country with three different levels of taxation (federal, cantonal and municipal). Cantonal and municipal taxes represent approximately two thirds of the total direct tax burden. Therefore, one can assume that the consequences could vary between each canton. For the time being, federal and cantonal tax administrations are just starting to discuss those implications and no specific legal provisions have been adopted pertaining to the taxation of electronic commerce. However, it should be mentioned that a new official information brochure from the Federal Tax Administration on telecom VAT taxation was published in June 1998.[2]

In addition to this legislative vacuum, it is worth noting that, to the best of our knowledge, there are no published rulings, no case law and, more surprisingly, no relevant publications focusing on electronic commerce and taxation and its implications for Swiss tax systems.

This paper will therefore give few answers. Our aim is only to formulate some issues and comments concerning electronic commerce with respect to direct taxation. The analysis will be based on existing fiscal principles in federal and cantonal tax laws, double taxation treaties and related case law.

II. DIRECT TAXATION

Liability to Swiss tax is based on the domicile or residence of the taxpayer. The result is a full tax liability, giving Switzerland the right to tax, in principle, worldwide income and capital (Articles 6 paragraph 1 and 52 paragraph 1 of the Federal Direct Tax Law of 14 December 1990 [hereafter DTL]). Liability to Swiss taxation can also be based on source, provided that a specific income source is located within Switzerland. Tax liability is then limited to that part of the income and related capital (Articles 6 paragraph 2 and 52 paragraph 2 DTL; see also Article 4 of the Federal Withholding Tax Law of 13 October 1965, hereafter WHTL).

Several provisions of the Swiss DTL deal with full and limited tax liability of individuals and corporations. This paper will ignore the slight variations imposed by cantonal laws as there are many; in any event the Federal Tax Harmonization Law of 14 December 1990 (hereafter THL) will gradually remove differences which still exist between cantons. The cantons (including municipalities) are indeed compelled to adjust their tax rules in accordance with THL, by no later than 1 January 2001.

Moreover, the application and scope of Swiss domestic tax rules are limited by the numerous double taxation treaties signed by Switzerland.

As electronic commerce raises more crucial issues with respect to limited tax liability, these will be analysed first.

1. This contribution was written within the framework of the IFA project on electronic commerce taxation. A thorough and general analysis of the topic will be found in Doernberg R.L. and Hinnekens L. , *Electronic commerce and international taxation*, Kluwer, The Hague, to be published.
2. See FTA, Brochure 610.507-30.

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A. Limited tax liability

1. Business profits

a. *Existing provisions*

Under Article 51 paragraph 1 DTL, legal entities which have neither their registered office nor their place of effective management in Switzerland are subject to taxation based on economic affiliation if they:

- are partners in any business operation in Switzerland;
- maintain a permanent establishment in Switzerland;
- have an ownership right, an interest or an economically equivalent personal right of use with respect to real estate situated in Switzerland;
- are creditors or usufructuaries with respect to claims secured by mortgages or pledges on real property situated in Switzerland;
- are a broker or dealer in real property situated in Switzerland.

Normally, electronic commerce would not give rise to economic affiliation based on partnerships or real estate businesses. The key issue will be to determine whether a foreign corporation engaged in electronic commerce with Swiss customers is deemed to have a permanent establishment in Switzerland.

Article 51 paragraph 2 DTL states that a permanent establishment is a fixed place of business that is wholly or partially engaged in the business activities of an enterprise. A non-comprehensive list of permanent establishments includes branches, manufacturing plants, workshops, sales offices, permanent agencies etc.

It has to be underlined that Article 51 DTL is very similar to Article 5 OECD Model Treaty. Most of the treaties signed by Switzerland follow the same pattern. The existence of a permanent establishment is evidenced by either the presence of a fixed place of business, or the presence of an agency.

A permanent establishment requires: (a) the existence of a *place of business*, such as premises or, in certain instances, machinery or equipment at the disposal of the enterprise; (b) that this place of business be *fixed*, i.e. established at a distinct place with a certain degree of permanence; and (c) that *all or part of the business activity* of the enterprise is carried on therein. As per Article 5 paragraph 4 OECD, (so-called "negative list"), the term permanent establishment shall be deemed not to include, the use of facilities or the maintenance of stock for the purpose of storage, display or delivery of goods or merchandise, the maintenance of a fixed place of business solely for the purpose of collecting information, or of carrying on, for the enterprise, other activity of a *preparatory or auxiliary* character. The carrying on of the business of the enterprise usually means that personnel conduct the business in the country where the place of business is located. However, a permanent establishment exists even if business is carried on mainly by *automatic equipment* provided that, on the one hand, personnel assemble and maintain the machinery or equipment and that, on the other hand, the company conducts at least part of its business through this equipment.[3]

Although an enterprise may not have a fixed place of business in Switzerland, there may nonetheless be a permanent establishment if an *agent* (a person or an enterprise) acts on behalf of an enterprise and has, and actually exercises, in such country, an authority to conclude contracts in the name of the enterprise (Article 5 paragraph 5 OECD Model Treaty).

The leading case on the definition of permanent establishment, concerned the treaty between Spain and Switzerland,[4] the Swiss Supreme Court judged that the mere fact that a Spanish company was "engaged in trade or business" within Switzerland, was not sufficient to constitute a permanent establishment. The Supreme Court noted that the definition of permanent establishment, as an exception to the residence jurisdiction, must be interpreted *restrictively*. In this case, a Spanish bank had opened a representative office in Geneva whose mission was to provide information to potential Swiss customers regarding the Spanish economy and banking services offered by the bank in Spain. No contracts were signed and no banking activities took place in Switzerland. The central issue was whether the representative office carried on the business of the enterprise. The Supreme Court judged that there was no business activity of the bank carried on in Switzerland, insofar as banking was the activity concerned. This was arguably enough to dismiss the existence of a permanent establishment in Switzerland. In any case, the representative office was not considered to perform an essential and significant part of the activity of the enterprise as a whole. Its activity could then be qualified as preparatory and ancillary, falling therefore within the exceptions of Article 5 paragraph 3 of the Spain–Switzerland treaty.

Some guidance may also be sought in the extensive – and sometimes fairly old – case law pertaining to the allocation of taxing rights between the various cantons (inter-cantonal taxation). Based on Article 46 paragraph 2 of the Swiss Constitution, which forbids double taxation by different cantons of the same Swiss taxpayer, the Supreme Court has defined the compulsory rules of attribution of the power to tax inter-cantonal transactions. It is interesting to note that, some cases took a less restrictive approach in the definition of permanent establishment. For instance, the Supreme Court judged, during the first half of this century, that energy and transport companies incorporated in a canton carried on business through a fixed place of business located in another canton by the mere fact that high- and low-tension lines, transformers,[5] water pipelines,[6] railways and rail stations[7] were located within the territory of the other canton. Thus, these transport companies were deemed to have permanent establishments. The Supreme Court reached the same conclusion even where

3. See OECD Commentary on No. 10 ad Art. 5 para. 1.
4. Supreme Court Judgement of 19 September 1976, ATF 102 Ib 264.
5. Supreme Court Judgements of 13 October 1904, ATF 30 I 649.
6. Supreme Court Judgement of 3 March 1955, reported by Locher and Locher, § 8, I C, 5 No. 4 o.
7. Supreme Court Judgements of 11 November 1915, ATF 41 I 432; of 28 February 1920, ATF 46 I 31.

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a railway company only had the right to use a railway station, i.e. it did not actually own the station.[8]

In the above mentioned Spanish/Swiss case, discussing the agency issue, the Supreme Court did not consider the representative office as an agent because it had neither the power to negotiate nor the power to sign contracts in the name of the Spanish company.

If a permanent establishment is deemed to exist, only the profits (and capital) which is attributable to the permanent establishment is taxable. Switzerland, does not follow, in particular, "the force of attraction" principle. It should be noted that the definition and scope of the attribution method applicable under Swiss law is currently a matter of controversy. Article 52 paragraph 4 DTL provides that:

> Tax subjects having their registered office and place of effective management abroad shall be required, at a minimum, to pay taxes on the profit earned in Switzerland and the capital invested in Switzerland.

In general, for Swiss residents with permanent establishments located abroad, allocation of income and capital is normally made, using the indirect method (Article 52 paragraph 3 DTL, Article 7 paragraph 3 OECD Model Treaty). Article 52 paragraph 4 DTL raises however the question whether the direct (and not the indirect) method of allocation should apply to Swiss permanent establishments of foreign resident companies. According to the Federal Tax Administration, the direct method should apply in this case.[9]

In the above-mentioned inter-cantonal taxation case law, the Supreme Court allocated companies' profits and capital between cantons according to the closeness of both geographic and economic links between the company and each canton. Thus, in the case of a railway company, the ratio between the lengths of the railway networks in each canton on the one hand, and the ratio between related turnovers (passengers and goods transportation) on the other hand, were used by the Court to determine an average.[10]

b. *Application to electronic commerce*

Under what conditions does a foreign company involved in electronic commerce with customers located in Switzerland have a Swiss permanent establishment? In accordance with the above a few hypotheses can be considered.

First of all, no Swiss permanent establishment can exist without premises or, at least, machinery or equipment located in Switzerland. The mere fact that customers access an Internet site located in a foreign country from Switzerland, for instance, cannot be deemed as a fixed place of business. The vision of a Web page on a Swiss customer's computer screen is not sufficient to establish such place of business because there are no premises, no machinery or equipment in Switzerland. Moreover, the Internet service provider (hereafter ISP) of the customer is clearly not an agent of the company as it has no power to carry on the company's business.

The situation becomes less clear whenever the company has electronic devices, such as servers, routers or dedicated data lines located within Switzerland. In our opinion, it is not relevant whether this equipment is owned or rented (wholly or partly) by the foreign resident company, provided it is at the disposal of this company. However, this equipment must be *fixed*, i.e. have a certain degree of permanence. As moving such devices from one country to another is quite easy, it will be very difficult to ascertain such permanence.

Assuming that some devices are considered to be fixed, we must focus on the functions fulfilled by the equipment located in Switzerland. In order to establish that *all or part of the business is carried on in Switzerland through these devices*, these devices must at least be able to take and process customers' orders on-line. The ability to provide sales information and a downloading service would be further evidence.

Therefore, data lines and routers should not lead to the existence of a permanent establishment, insofar as their sole function is to transmit information without processing it, even though inter-cantonal case law mentioned above considered electrical lines, railways and water pipelines as permanent establishments. In our view, the fact that electrical (or digital) impulses are carried through electrical (or digital) lines does not mean that part of the business of the company is carried on through these lines, as per Article 5 paragraph 1 OECD Model Treaty.

A server located in Switzerland could become a permanent establishment if its activities were not limited to offering information to potential customers or proposing services which are considered to be preparatory and ancillary under Article 5 paragraph 4 OECD Model Treaty. We see that limits between business activity, on the one hand, and preparatory and ancillary operations, on the other hand, are becoming very difficult to establish.

It is a matter of specific circumstances whether a company or individual, like a Swiss resident ISP, managing a server located in Switzerland may be considered as a dependant agent of the company and, therefore, may constitute a permanent establishment. In any case, only human beings can be agents according to current tax treaty provisions (Article 5 paragraph 5 OECD Model Treaty).

2. Independent and dependent services income

Under Article 5 DTL, individuals without a tax domicile or tax residence in Switzerland shall be subject to taxation on the basis of source jurisdiction if they engage in gainful activity in Switzerland.

The term "independent personal services" covers in Swiss tax law all professional, industrial, commercial and trading activities, i.e. not only the typical liberal professions (Article 18 paragraph 1 DTL). However, tax treaties signed by Switzerland limit independent services taxation to professional services, excluding industrial and commercial activities. To be taxable in Switzerland, according to Article 14

8. Id.
9. This opinion is shared by some commentators, see P. Agner, B. Jung and G. Steinmann, (1995), No. 2 ad. Art. 52 LIFD and Locher (1996) at 314, while others follow different opinions, in particular Riedweg and Fricker (1995/96) at 522 and Höhn (1996/97) at 171.
10. Supreme Court Judgement of 28 February 1920, ATF 46 I 31.

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OECD Model Treaty, such independent activity must be carried on through a *fixed base*. This concept is very similar to that of permanent establishment and reference is hereby made to Section II.A.1. above.

Under international tax principles, *dependent personal services income* (such as wages) is taxable where the activity takes place (Article 15 OECD Model Treaty). Due to telecommunication technologies use, it can be very difficult to say whether the place of activity is inside or outside Switzerland.

Because cross-border activity was already substantial in the past, due to Switzerland's geographic location, special provisions for frontier workers were introduced in treaties and ad hoc Agreements with most neighbouring countries. The aim of these agreements is to avoid double taxation, often giving one state the exclusive right of taxation and providing the other state with an equitable compensation. Generally speaking, frontier workers are employees who commute daily between their place of residence in one state and their place of employment in another state.[11] One interesting question is whether rules applying to employees commuting daily from a state to another can be extended to employees telecommuting whenever necessary between their place of residence and the place where the employer is located (or places where access to the corporate network is offered).

3. Capital income

Certain types of investment income, lottery gains and insurance benefits are subject to source taxation, in the form of a withholding system of taxation, as per Articles 4, 6 and 7 WTL. It must be pointed out that Switzerland does not levy withholding tax on royalties. Therefore, the key issue, that is whether payments for transactions over the Internet are business profits or royalties, is less sensitive under Swiss law, because there is generally no difference in fiscal treatment between these categories.

However, if a permanent establishment or a fixed base exists in Switzerland, the characterization issue of payments as "business profit" or "royalties" becomes crucial. Indeed, the latter will in most cases be taxable in the beneficiary's country of residence (Article 12 OECD Model Treaty), while business profits attributable to the permanent establishment (fixed base) will be taxable in Switzerland (Article 7 paragraph 1 OECD Model Treaty).

B. Full tax liability

1. Individuals

a. *Existing provisions*

With regard to individuals, full tax liability can be determined under two main criteria. First, under Article 3 paragraph 1-2, Article 6 paragraph 1 DTL and Article 3 paragraph 1-2 HTL, individuals are subject to income tax on their worldwide income if they have a *domicile* in Switzerland. Domicile exists if individuals "reside in Switzerland with the intent of permanently staying or if Swiss federal law assigns to them a special legal domicile".[12] However, one should note that the legal reference to the intention of the taxpayer has to be corroborated by factual circumstances. Domicile will probably be deemed to exist if the taxpayer's centre of life (personal and business relations) is within Swiss territory.[13] Second, unlimited tax liability will occur whenever individuals are deemed to have their residence in Switzerland (Article 3 paragraph 1 DTL). This is the case if an individual stays in Switzerland for over 30 days undertaking a gainful activity or for over 90 days without such an activity. A physical presence on Swiss territory is necessary.

According to Article 24 of the Swiss Civil Code of 10 December 1907 (hereafter SSC), merely ceasing to be Swiss resident or domiciled is not sufficient to terminate full tax liability. Tax liability will not come to an end until the taxpayer can prove he has acquired a new domicile.

Almost every tax treaty signed by Switzerland contains a provision similar to Article 4 OECD Model Treaty, which cross-refers to the domestic legislation concepts of domicile and residence. Thus, the above mentioned national rules will also apply for international taxation purposes.[14] Nevertheless, insofar as double full tax liability could occur by the application of domestic laws from two countries, subsidiary criteria provided by tax treaties are used to avoid such double taxation. These criteria are found in Article 4 paragraph 2 OECD Model Treaty: i.e. existence of a *permanent home*, a *habitual abode* and *nationality*.[15]

Individuals who are considered to be resident in Switzerland under the above mentioned rules and who benefit from the Swiss lump-sum tax regime, will usually be regarded as Swiss residents. They will therefore be entitled to take full advantage of tax treaties, except those signed between Switzerland and France, Germany, Austria, Belgium, Italy and Norway.[16]

Moreover, specific "waiting periods" have been introduced in treaties with Germany, the Netherlands and Sweden, in order to extend tax liability to individuals leaving their country to live in Switzerland. Normally, these extensions grant countries of origin the right to levy taxes for a period of five years on income generated within their territory, as if taxpayers were still residents of those countries.

11. Supreme Court Judgement of 19 June 1984, 55 *Archives de droit fiscal* at 585.
12. "Legal special domiciles" will not be discussed hereafter.
13. Court decisions regarding inter-cantonal double taxation have laid down special rules about individuals with personal and business ties in different cantons. Despite the pre-eminence of personal ties in ordinary cases, if a taxpayer holds a high management position within a large corporation under certain circumstances (the so-called "fonction dirigeante"), domicile is deemed to be in the place of business.
14. With the exception of Art. 24 SCC.
15. Cantonal Administrative Court (Neuchâtel) Judgement of 10 May 1995, 51 *Revue de droit administratif et fiscal*, at 336.
16. The so-called "Modified method of calculation" is however possible, under certain conditions, in order to benefit from the treaty, see Oberson and Hull (1996) at 68.

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b. *Application to electronic commerce*

Though electronic commerce will make it possible for individuals to move their residence in or out of Switzerland more easily, there is no doubt that such a transfer of residence implies fundamental choices (family and social life, working opportunities etc.) which are far beyond technological progress and related fiscal issues. Other legal barriers, such as the administrative authorization to reside in Switzerland, will probably prevent, in the short term, such flexibility.

In practice, Swiss tax authorities could become stricter in ascertaining whether a person has left his or her Swiss domicile or residence. Already taxpayers can be asked to submit their telecommunications bills to prove that no voice/data calls have been made from Swiss territory. All evidence indicating domicile or residence will be scrutinized and one can assume that computerized systems could give great support to the tax authorities by providing useful records.

Generally, it seems that current Swiss tax law criteria in determining residence of individuals are sufficient to deal with the electronic commerce revolution. Of course, physical presence during 30 or 90 days is a barrier which can be easily bypassed using telecommunication techniques, but this is where other criteria based on facts and circumstances step in.

Nonetheless, uncertainty exists as to whether "waiting-period exceptions" will be introduced into more tax treaties. It goes without saying that "waiting periods" create a greater risk of double taxation and legal insecurity. This could be bad news for people wanting to move to Switzerland.[17]

2. Corporations

a. *Existing provisions*

A corporation is considered as resident (subject to full taxation) if it is either (a) incorporated in Switzerland or (b) if its place of effective management is located in Switzerland (Articles 50 DTL and 20 paragraph 1 HTL). Under the *place of incorporation* test, a company is resident at the place where the headquarters of the company is registered according to the company's statutes. In addition, even though formally incorporated abroad, a company could still be treated as a Swiss resident for tax purposes, under the *place of effective management* test. The place of effective management, in principle, is deemed to be where important corporate decisions are taken. The place where the directors meet, the domicile of the managers and directors of the company as well as the location where accounts and documents are held are relevant factors, although shareholders residence is not.

Most tax treaties signed by Switzerland are consistent with Article 4 OECD Model Treaty. However, an Anti-abuse Decree of 14 December 1962 (hereafter Abuse Decree) has been introduced into Swiss legislation, limiting treaty relief for Swiss companies which are controlled by non-Swiss interests. These provisions aim in particular at fighting against the transfer of treaty favoured income to non-qualifying persons (Article 2 paragraph 2 (a) Abuse Decree) and inappropriate accumulation of such income by Swiss companies (Article 2, paragraph 2 (b) Abuse Decree). Moreover, due to specific tax privileges offered by Swiss federal and cantonal laws, treaties with countries like the United States, Germany, France, Italy and Belgium include special anti-treaty shopping provisions.

Conversely, it is interesting to note that there are no specific legal provisions in Swiss domestic law concerning, for instance, companies incorporated in an offshore tax haven but which are held by Swiss interests, the so called "controlled foreign corporations".[18]

In case of abuse (tax evasion doctrine), Swiss tax authorities could deem the distribution of income to foreign corporations who are controlled by Swiss companies or individuals as fully taxable in Switzerland and ignore the existence of such foreign entities.

b. *Application to electronic commerce*

Undoubtedly, the application of traditional residence rules to companies is increasingly difficult. The place of incorporation is an objective but formal criterion which can easily be used to relocate anywhere in the world. Further, the place of effective management is a highly controversial concept, which is based on different, sometimes conflicting, elements. Above all, telecommunication technologies like video conferencing make it possible to manage a company from several different places at once, thus reducing the scope of the effective management test. In the medium term, it will be necessary to rethink these criteria.

Moreover, on the one hand, treaty abuses "via" Swiss companies are already strongly discouraged by the 1962 Abuse Decree. On the other hand, the lack of Swiss legislation with regard to offshore companies held by Swiss interests, whose number might notably increase because of new telecommunication services, could lead the Swiss tax authorities to routinely look through offshore companies and subject their income and capital to Swiss tax.

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17. This could also be bad news for concepts such as domicile and residence, as high tax countries seek to introduce further exceptions to face globalization.
18. However, the Luxembourg–Switzerland treaty disqualifies for treaty relief purposes Luxembourg holding companies incorporated under 1929 and 1938 Luxembourg law. Companies located in Madeira too are deemed not to be Portuguese resident within the scope of the Portugal–Switzerland treaty. This latter exception is based on practice.

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Conference Diary

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

CONFERENCE DIARY

DECEMBER

China Tax, Century Hong Kong Hotel, Wanchai, 14 December 1998 (English):

THC Press Ltd., 3/f Arbuthnot House 1-12 Arbuthnot Road, Central, Hong Kong, Tel.: 852-2536-9764, Fax: 852-2521-9594.

JANUARY 1999

Tax Planning Offshore Trusts and Companies, The London Marriott Hotel, London, the United Kingdom, 29 January 1999 (English):

IBC UK Conferences Limited, Gilmoora House, 57-61 Mortimer Street, London W1N 8JX, the United Kingdom, Tel.: 44-171-453 5497, Fax: 44-171-636 6858, E-mail: cust.serv@ibcuk.co.uk

FEBRUARY

Preparing for and Defending Transfer Pricing Audits, Park Lane Hotel, 36 Central Park South, New York City, N.Y., the United States, 3-4 February 1999 (English):

American Conference Institute, 41 West 25th Street, New York, N.Y. 10010, Tel.: 1-888-ACI-2480, Fax: 1-416-927 1563, E-mail: mktg@cicomm.com

MARCH

Conquering the Tax Wilderness, 14th National Convention, Hotel Grand Chancellor, Hobart, Australia, 24-27 March 1999 (English):

Taxation Institute of Australia, 7th Floor, 64 Castlereagh Street, Sydney NSW 2000, Tel.: 61-02-9232 3422, Fax: 61-02-9221 6953, E-mail: wildtax@taxia.com.au

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ITALY

NEW DUAL INCOME TAX SYSTEM ON BUSINESS PROFITS

Riccardo Michelutti

I. INTRODUCTION

Pursuant to Law No. 662 of 23 December 1996, the Italian Government has been authorized by the parliament to implement widespread tax reforms. In particular, the parliament laid down the guidelines for the introduction of a dual income tax system to be applied to business profits. The dual income tax regime has now been enacted through Legislative Decree No. 466 of 18 December 1997.[1] The underlying rationale of the new regime is to encourage the capitalization of companies[2] through the introduction of a more favourable income tax treatment to the portion of income attributable to the increase in net equity, as defined by the new provisions.

II. THE MECHANISM OF APPLICATION OF THE DUAL INCOME TAX

A key feature of the dual income tax is that it will be charged at a reduced rate of tax (19 per cent). This rate will apply *in lieu* of the ordinary corporate income tax (*imposta sul reddito delle persone giuridiche* or IRPEG) rate of 37 per cent, to the portion of income attributable to a qualified increase in the capital invested in the company.[3] The dual income tax regime is mandatory.[4, 5]

The new regime requires the following steps to be considered:

- determination of the net equity of the company resulting from the balance sheet at the end of the financial year current on 30 September 1996 (hereinafter "the reference accounting period"), without taking into consideration the net profit of such year;[6]
- determination of the net equity at the end of each subsequent financial year;
- determination of the increase in the net equity. Such increase is only relevant to the extent it derives from (i) cash contributions or (ii) profits set aside to reserves, with the exception of the undistributable reserve made in compliance with the net equity method of evaluation of participations. The increase in the net equity is diminished by the amount of reductions of share capital and reserves due to distributions to shareholders, both in cash and in kind. In any event, the increase in the net equity is only relevant to the extent it does not exceed in any given year the book net equity of the company, excluding the profit of the year;
- determination of the theoretical income attributable to the increase in the net equity, on the basis of a predetermined rate to be fixed through a Ministerial Decree, issued by 31 March of each year. This rate shall take into account the average yield of public and private bonds, increased by up to 3 percentage points as a premium for risk;[7]

1. Published in the *Official Gazette* No. 3 of 5 January 1998, (Ordinary Supplement) No. 3/L.

2. As pointed out by the Ministerial report to the legislative decree, the new regime is a first step towards the progressive reduction of "the fiscal discrimination among various funding options, through an approach in favour of the injection of risk capital, rather than debt capital".
For a comprehensive description of the various dual income tax systems proposed for implementation in other tax jurisdictions (the *comprehensive business income tax* elaborated by the US Treasury Department in the United States, the *allowance for corporate equity* elaborated by the Institute for Fiscal Studies in the United Kingdom) or already implemented (the *dual income tax systems*, based upon the distinction between "earned income" and "capital income", introduced in the Nordic countries), see S. Giannini, "Il dibattito sulla riforma dell'imposizione del reddito delle società e le novità della legge 662/96: analisi preliminare su un campione di imprese", (March 1997), *Credito Italiano*; T. Di Tanno, *La dual income tax*, Milano, (1998), 5 ss.; P.M. Panteghini, "Alcune considerazioni sulla dual income tax italiana", in *Riv. dir. fin. sc. fin.*, (1998), I, 3 ss.. As for international literature, see M. Gammie, "Corporate tax harmonization: an "ACE proposal"", in 31 *European Taxation*, 8 (1991), at 238; S. Cnossen, "Company taxes in the European Union: criteria and options for reform", in *Fiscal studies*, (1996), at 67; P.B. Sørensen, "From the global income to the dual income tax: recent tax reforms in the Nordic countries", in *International tax and Public finance*, (1994), at 57; L. Stevens, "Dual income tax systems: a European challenge?", in *EC Tax Review*, (1996), at 6.

3. Indeed, the dual income tax regime has been extended also -- as an option – to individual entrepreneurs and partnerships, subject to personal income tax (*imposta sul reddito delle persone fisiche* or IRPEF). For this purpose, due to the progressive rates of IRPEF, a special mechanism of separate taxation (at the reduced rate of 19 per cent) has been created. In any event, the application of the dual income tax regime to such persons seems to be quite marginal, so that it will not be further discussed in this paper.

4. With the exception of individual entrepreneurs and partnerships, as pointed out in the previous footnote.

5. The draft legislative decree, approved by the Council of Ministers on 12 September 1997 (published in *Il Fisco*, (1997), at 9931) clearly provided for the dual income tax regime to be mandatory. The final version of the decree adopts the term "assoggettabile" ("subject to tax") instead of "assoggettato" ("subjected to tax"), so that, at first sight, one could argue that the dual income tax regime is not mandatory. However, such interpretation does not appear to fit into the rationale of the new regime, as shown by the different term used with reference to the optional application of the regime for partnerships and individual entrepreneurs, which adopts the expression "può essere assoggettato" (i.e. "*may* be subjected to tax").

6. The reference to the net equity as resulting from the balance sheet means that no relevance shall be attributed to the determination of the net equity from a fiscal standpoint, and precisely for the purposes of the net worth tax, regulated by law decree 30 September 1992, No. 394, converted into law 26 November 1992, No. 461. The opportunity to take into account the definition of the net equity provided for the purposes of the net worth tax was maintained by some scholars, before the implementation of the legislative decree (see, T. Di Tanno, "La dual income tax – Problemi e prospettive", in *Boll. trib. inf*, (1997), at 823).

7. The remuneration rate established for the year 1997 is equal to 7 per cent (Ministerial Decree of 24 March 1998).

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- application of a reduced corporate income tax rate (19 per cent), *in lieu* of the ordinary rate (37 per cent), to the taxable basis constituted by the theoretical income determined pursuant to the criteria described directly above;
- in any event, the actual average rate applied to the taxable income in the fiscal year cannot be lower than 27 per cent.[8] This means that the theoretical income subject to the reduced rate (19 per cent) cannot exceed 55.55 per cent of the taxable income of the company.[9] This calculation must be made each fiscal year: i.e. the benefit of the reduced rate is a permanent benefit as long as the net equity at the end of each fiscal year is higher than the net equity resulting from the balance sheet of the reference accounting period;
- as a special rule, it is provided that for companies incorporated after 30 September 1996, any capital increase in cash, including the capital paid in upon incorporation of the company, is eligible for the dual income tax rate. Nonetheless, also for these companies the actual average rate cannot be lower than 27 per cent.[10]
- the company may carry forward the right to the reduced rate, in the event that such reduced rate cannot be used in full in a tax period.

Such carry-forward applies when:
(a) the application of the reduced rate of tax to the entire eligible amount would result in an average rate of tax lower than 27 per cent;[11]
(b) the actual taxable income is lower than the amount eligible for the reduced rate of tax.[12]

The carry-forward of the difference between the amount of income eligible for the reduced rate of tax and the actual taxable income can be made for the following five tax periods. As a consequence of the carry-forward, such a difference is added to the income of the first tax period in which the reduced rate of tax can be applied.[13]

III. THE REGIME FOR BANKS AND INSURANCE COMPANIES

The first draft legislative decree concerning the dual income tax regime stipulated that banks and insurance companies could not benefit from the new regime. According to the ministerial report on the draft decree, the reason for such an exclusion was:
(i) the delegation law No. 662/96 required the new regime to be granted, taking account of the requirements of efficiency, strength and rationalization of the productive structure (the area of banking and insurance, although in broad terms belonging to the productive apparatus, is not characterized by the risk that is peculiar to the activity of the companies the new regime is conceived for);
(ii) the application of the new regime to banks and insurance companies would give rise to a huge loss in the tax yield.[14]

The final version of the legislative decree has repealed the above mentioned exclusion, so that the dual income tax regime also applies to banks and insurance companies. However, taxpayers engaged in banking and insurance businesses will benefit from the dual system not earlier than the fourth tax period following the one current on 30 September 1996. Thus, if the financial year coincides with the calendar year and no extraordinary events (such as mergers, demergers or

8. A lower rate is established for companies that are admitted to a listing on an Italian regulated market as from the day following the date of entry into force of the decree (i.e. as from 21 January 1998). The reduced rate is 7 per cent, instead of 19 per cent; the actual overall rate is 20 per cent, instead of 27 per cent. Such rates are applicable for three taxable periods, following the one during which the company is admitted to a listing. Thus, if a company is admitted in 1999 and its tax period coincides with the calendar year, for the years 1997, 1998 and 1999, the company will benefit from the dual income tax at the ordinary rate of 19 per cent. As from the year 2000, until the year 2002, the company will benefit from the special rate of 7 per cent, but the increases in the net equity eligible for the dual income tax that occurred from 1997 up to year 2000 will still be relevant also for the purpose of the application of the reduced rate of 7 per cent.
It is worth pointing out that the above-mentioned regime is available only for companies that are admitted to a listing on a Italian regulated market, thus discriminating against Italian companies that are admitted to a listing on a foreign market.

9. The calculation is as follows:
X = taxable income subject to the reduced rate (19%)
Y = taxable income subject to the ordinary rate (37%)
$19X + 37Y = 27 (X + Y)$

If the overall taxable income of the year is 100:
$100 = X + Y = X + 0.8X = 1.8X$

$X = \frac{100}{1.8} = 55.55\%$
$Y = 44.45\%$

10. Actually, the delegation law No. 662 of 23 December 1996, at Art. 3, para. 162, letter (c) stated that special provisions had to be set forth for companies incorporated after 30 September 1996. On the contrary, the Legislative Decree simply extends to those companies the same rules set out for existing companies.
The Ministerial report to the decree clarifies that: (i) the purpose of the delegation law was to prevent newly incorporated companies from benefiting from a too favourable regime compared to existing companies. However, the discrimination envisaged by the delegation law would be only formalistic, in as much as it is possible to channel the new investments in an already existing company, even if this is a dormant company.
(ii) The more favourable treatment granted to the newly incorporated companies, with regards to the determination of the increase of capital, would in any event be drastically reduced as a result of the application of the average rate of tax, which cannot be lower than 27 per cent.

11. The ministerial report to the decree correctly points out that the average rate of 27 per cent is not, from a juridical standpoint, a rate of tax, since the corporate income is subject only to the reduced rate of 19 per cent and the ordinary rate of 37 per cent. The reduced rate of 19 per cent will cease to apply when the average rate is lower than 27 per cent.
As highlighted at *supra* note 9, this will happen when the income subject to the reduced rate of 19 per cent exceeds 55.55 per cent of the overall taxable income of the company.
See the following example:

taxable income	100
amount eligible for the reduced rate of tax	80
minimum corporate tax	27
amount subject to the reduced rate of tax	55.55
amount eligible for the carry-forward (80 — 55.55)	24.45

12. See the following example:

taxable income	50
amount of income eligible for the reduced rate of tax	100
amount eligible for the carry-forward (100 — 50)	50

13. In order to provide evidence of the amount of income that is carried forward in each tax period, the Ministerial Decree of 25 March 1998, providing for the filing instructions of the tax return for the tax year 1997, has introduced a specific table that shall be enclosed with the annual tax return.
14. It would therefore also lead to a relevant reduction of the benefit to the entrepreneurial system as a whole.

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liquidations) take place in the meantime, banks and insurance companies may benefit from the dual income tax regime as from the year 2000.

In this respect, the amendment to the draft decree conforms to a suggestion contained in the opinion issued by the special parliamentary committee (composed of 15 members of the Chamber of Deputies and 15 members of the Senate, and commonly known as the "Committee of 30"), which has been set up pursuant to Article 3, paragraphs 13 to 16 of the delegation law No. 662/1996.[15]

Even though the Ministerial report to the final version of the legislative decree is quite unclear on the point, it emerges from the discussions held in the meetings of the Committee of 30 that the exclusion of banks and insurance companies might be considered unconstitutional, since it might violate the general principle of equality set forth in Article 3 of the Italian Constitution.

It is worth pointing out that the final version of the decree simply shifts the commencement date of the dual income tax regime for banks and insurance companies, but it does not modify the mechanism of application of such regime, as described above.

This means that all the increases in the net equity of banks and insurance companies occurring from the tax period running at the date of 30 September 1996 are eligible for the reduced rate of tax, even if such reduced rate only applies with respect to the taxable income of the fourth financial year following that current at 30 September 1996.[16]

Similarly, banks and insurance companies incorporated after 30 September 1996 will be eligible for the new regime, and the relevant increase in the net equity will include the capital contributed upon incorporation and all subsequent capital increases, even if taking place before the fourth financial year following the reference accounting period.

IV. THE CALCULATION OF THE INCREASE IN THE NET EQUITY

As indicated earlier, the relevant increase in the net equity of companies is determined as a difference between two elements:

- cash contributions made by shareholders and net profits allocated to reserves;
- distributions of net equity to shareholders, whether in money or in kind.

A. Cash contributions and profits allocated to reserves.

Cash contributions are relevant if they result in a formal increase of the share capital of the company (following a shareholders' resolution) or they consist of capital contributed informally by way of gift, thus resulting in an increase in net equity.[17] When determining the increase in the net equity, cash contributions are computed on a pro rata basis from the date of payment, i.e. not the date of subscription.[18]

The Ministerial report to the legislative decree points out that the waiver of debt claims made by shareholders is not to be treated as a cash contribution. Such conclusion probably derives from an assimilation of the waiver of a debt claim to a contribution of the debt claim to the capital of the company, thus resulting in a contribution in kind that is not eligible as an increase in the net equity.[19] This view cannot be shared, for the following reasons:

- from a company law standpoint, the waiver of a debt claim towards the company is quite different from a contribution of the debt, since it is not subject to the specific procedure of appraisal required for contributions in kind by Article 2343 of the Civil Code;[20]
- from a tax standpoint, the Ministry of Finance has recently taken a different view. In fact, in the *circular letter No. 137/E* of 15 May 1997,[21] the tax authorities expressed the opinion that the increase of capital through a conversion of convertible bonds shall be treated as a

15. The opinion rendered by the Committee of 30 is published in *Fisco*, (1997), at 13933.

16. See the following example, which assumes a rate of remuneration attributable to the increase in the net equity equal to 8 per cent (for the sake of simplicity the financial year is deemed to coincide with the calendar year, so that the dual income tax applies as from the year 2000):

relevant increase in the net equity from the year 1996	1000
taxable income of year 2000	200
theoretical income attributable to the relevant increase in the net equity (1000 x 8%)	80
amount of income eligible for the reduced rate of tax in the year 2000	80
amount of income subject to the ordinary rate of tax in the year 2000 (200 — 80)	120

17. For a comprehensive description of the various kinds of contributions that can be made in favour of a company, and that are considered as part of the company's net equity, see G. Tantini, *I versamenti in conto capitale tra conferimenti e prestiti, Quad. giur. comm.*, Milano, (1990).

18. See the following example: a cash contribution of 1000 is made (the sum is actually paid to the company) on 28 April 1997. For the year 1997, the cash is held for 248 days (i.e 28 April to 31 December), so that the cash contribution is determined as follows:

$$1000 \times \frac{248}{365} = 679$$

19. According to D. Stevanato, "Rinunce a finanziamenti dei soci ed incremento della base DIT", in *Il Fisco*, (1997), at 12763, the waiver of a debt-claim would also not be eligible on the grounds that the waiver does not result in an actual payment in favour of the company, with the consequence that it would not be possible to determine a proper date of payment, as required by the law. Indeed, the issue seems to be rather theoretical since, by making a cash contribution that is immediately used to repay the shareholders' loan, an identical result is achieved.

20. The legitimacy of a contribution to the company through a waiver of a debt claim and the inapplicability in that case of the rule of estimation provided by Art. 2343 civil code is recognized by the prevailing doctrine and jurisprudence. See, C. Angelici, "Appunti sull'articolo 2346 c.c. con particolare riguardo al conferimento mediante compensazione", in *Giur. comm.*, (1988), I, at 175; A. Lamanna, *Debiti di conferimento del socio e compensazione* ,in *Il Fallimento*, (1995), at 598; Trib. Venezia, 18 September 1984, in *Società*, (1985), at 612; Trib. Perugia, 22 December 1990, in *Il Fallimento*, (1991), at 737; App. Napoli, 17 December 1994, in *Riv. not.*, (1995), II, at 1341; Supreme Court, 5 February 1996, No. 936, in *Foro it.*, (1996), I, at 2490; Supreme Court, 24 April 1998, No. 4236, in *Guida normativa*, (26 August 1998), at 27.

21. Published in *Boll. trib. inf*, (1997), at 863. The opportunity to characterize the waiver of a debt claim against the company as a contribution of money for the purposes of the net worth tax is emphasized by the Italian association of Joint Stock Companies (Assonime), in the circular letter No. 115 of 6 November 1996.

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contribution in money for the purposes of the net worth tax. The conversion of convertible bonds results in a transformation of a debt claim against the company into capital, and therefore is very similar to a waiver of a debt claim. In another case,[22] the tax authorities took the view that the waiver of a debt claim related to an item of income taxed when cashed in the hands of the shareholder implies the "juridical collection" of the credit. This means that, following the Ministerial interpretation, the waiver of a debt claim has to be split into two transactions: (a) the collection of the credit by the shareholder; (b) the subsequent contribution of the money raised thereby to the net equity of the company. Such view clearly conflicts with characterizing the debt waiver as merely a contribution of the credit.

Furthermore, the requirement that a cash contribution must occur in order to qualify as an increase of invested capital leads to an exclusion of:

- all increases of share capital due to a transfer of reserves; and
- all increases in the company's net equity due to mere accounting procedures, like the merger (or demerger) surplus deriving from an exchange of shares or from the cancellation of the participation in the absorbed company (or the beneficiary company in a demerger).

Likewise, the increase of capital of the absorbing company (or the beneficiary company in a demerger) due to the merger (or demerger) deficit deriving from the exchange of shares is not treated as a cash contribution.

Profits allocated to reserves through a shareholders' resolution, made pursuant to Article 2364 of the Italian Civil Code, are always relevant, irrespective of whether such an allocation is mandatory pursuant to the law or to the company's statute (i.e. the yearly allocation to the legal reserve or to the statutory reserve) or it is entirely based upon the shareholders' discretion.[23] Such profits are relevant from the beginning of the financial year the reserves are made, that is to say when the shareholders' meeting resolves to allocate the profits of the previous year.

The sole exception is provided for profits allocated to the specific undistributable reserve laid down by Article 2426, paragraph 1, No. 4 of the Italian Civil Code,[24] in respect of the step up in the value of participations effected within the context of the application of the net equity method. Indeed, as pointed out by the Committee of 30, in the event that the profits set aside to the above reserve were to be relevant for the dual income tax regime in the hands of the participating company, a duplication of the benefit would arise, since the same profits would determine an increase in the net equity of the affiliated company, eligible for the computation of the reduced tax rate basis.[25] The purpose of such provision is clearly to counter an abuse of the new regime. Nevertheless, the fact that it applies as a non-rebuttable presumption of duplication of the benefit might sometimes lead to an unjustified denial of the benefit. This is the case where a participation in a non-resident affiliated company cannot benefit from the dual income tax regime. Clearly, no duplication of the benefit would occur in such case, since the increase in the net equity of the foreign company, would not be eligible for the computation of the reduced tax rate. In this respect, it would have been fairer to provide that only in the event of an actual duplication of the benefit of the dual income tax would the anti-avoidance rule set forth in Article 37-*bis* of Presidential Decree 29 September 1973, No. 600, as specifically provided by Article 6, paragraph 2 apply.

Indeed, Article 6 paragraph 2 of the legislative decree stipulates that Article 37-*bis* of Decree No. 600/1973 also applies in respect of the rules governing the dual income tax system. For these purposes, it is deemed to be fraudulent behaviour to duplicate the basis of computation of the reduced corporate income tax rate by using the same additional capital investment. It is also fraudulent to take into account the special reserve created as a consequence of applying the equity method to value the participation since the profits accrued in the hands of the affiliated company would be eligible for the reduced rate both for the affiliated company and for the controlling company.

The anti-avoidance rule requires the tax authorities to provide evidence that the transaction is made without valid economic reasons, with the purpose of circumventing the application of obligations or prohibitions established under tax laws, and at obtaining tax reductions or refunds, that are otherwise undue.

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22. See, Circular letter No. 73/E of 27 May 1994, in *Boll. trib. inf.*, (1994), at 852.

23./24. In the Circular letter No. 76/E of 6 March 1998, relating to the application of the dual income tax (in *Boll. trib. inf.*, (1998), at 521), the Ministry of Finance has listed the following profit reserves eligible for the dual income tax system:

- legal reserve;
- statutory or extraordinary reserve;
- reserve for own shares in portfolio;
- reserve for anticipated depreciation;
- reserve for grants by shareholders, ex Art. 55(3)(b), d.p.R. No. 917/1986.

As far as the reserve for anticipated depreciation is concerned, the Circular letter requires a formal allocation of the annual profits, to be resolved by the shareholders' meeting, and therefore seems to exclude the accrual to the reserve through a direct provision in the profit and loss account made by the board of directors. Such an exclusion appears discriminatory, so that a more reasonable view must be preferred, that considers eligible also the reserve for anticipated depreciation made by the board of directors, provided that such behaviour is ratified by the shareholders' meeting that approves the balance sheet [accordingly, see the Italian association of Joint Stock Companies (Assonime), in the circular letter No. 42 of 27 May 1998].

According to the accounting principle No. 21 of December 1996, issued by the Italian committee of Chartered Accountants, manufacturing companies shall compute the higher value of the participation recorded with the net equity method as an item of income in the profit and loss account. That item of income, if not absorbed by the losses of the participating company, shall be set aside to the special reserve at the moment of the shareholders' approval of the annual balance sheet. Accordingly, see the most authoritative scholars: G.E. Colombo, "Il bilancio di esercizio e il bilancio consolidato", in *Trattato delle S.p.A.*, Turin, (1996), Vol. 7*, at 285; N. Girolamo-P. Scarioni-L. Rossi, "Le partecipazioni societarie nel reddito di impresa", *Bologna*, (1997), at 111. The same view has been recently taken by the Regulatory Commission of listed companies (CONSOB), in the Communication No. DAC/98046967 of 5 June 1998.

On the contrary, with respect to banks and financial entities, the legislative decree No. 87 of 27 January 1992, expressly provides that the higher value of the participation shall be directly set aside to the special reserve, without being credited to the profit and loss account.

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B. The distribution of net equity to shareholders.

The amount of net equity which is relevant for the dual income tax regime shall be reduced by way of any voluntary attribution of part of the net equity to shareholders. Such a voluntary distribution may be a distribution of profits (be this yearly profits or reserves) or a reduction of share capital or capital reserves.

However, no relevance shall be attributed to all decreases of net equity that are not made at the company's discretion. This is the case for operating losses, since these involve an involuntary reduction of the net equity.

Equally, reductions of net equity that do not result in an assignment to shareholders are disregarded. This is the case, for instance, where a company buys back its own shares with the intention of keeping them in the company's portfolio or of using them for trading or for the implementation of stock option plans etc.

In fact, the mere purchase of own shares does not give rise to a reduction of the company's net equity and even where the shares are subsequently cancelled the consequent reduction in net worth should not have negative implications for dual income tax purposes.

In fact:

- the mere purchase of own shares does not lead to any assignment to the shareholders. Indeed, from the shareholders' perspective, a buy-back would give rise to a capital gain rather than income from capital;[26]
- the subsequent cancellation of the shares (if such cancellation did not constitute the purpose of the buy-back[27] should not lead to a recharacterization of the previous transaction (the buy-back itself), even if it gives rise to a reduction of the net equity of the company.

In any event, the increase in the net equity compared to the net equity resulting from the balance sheet of the reference accounting period, is relevant only inasmuch as it does not exceed the net equity resulting from the balance sheet at the end of each financial year, excluding the yearly profits.[28]

The above mechanism can be illustrated as follows:

Example 1

net equity at the end of the year 1996 (excluding the yearly profit)[29]	20
allocation to reserves of the profits of the year 1996	50
losses of the year 1997	(30)
net equity at the end of the year 1997 (20 + 50 –30)	40
increase in the net equity relevant for the dual income tax (50 –20)[30]	30

Example 2

net equity at the end of the year 1996 (excluding the yearly profit)	20
allocation to the reserves of the profits of the year 1996	50
losses of the year 1997	(45)
net equity at the end of the year 1997 (20 + 50 – 45)	25
increase in the net equity relevant for the dual income tax[31]	25

25. The same view is shared, among scholars, by A. Simoni, *Gruppi di imprese e dual income tax: una difficile convivenza*, in *Dir. prat. trib.*, (1997), at 888.

26. Accordingly, see Circular letter No. 24/9/035 of 3 September, 1992, in *Boll. trib., inf.*, (1992), at 1526.

27. In the event the share buy-back is made in the view of a subsequent cancellation through a unique shareholders' resolution of reduction of share capital, pursuant to Art. 2357-*bis* of the Italian Civil Code, there is an actual assignment to shareholders.
This is confirmed also by the tax treatment of such income in the hands of the shareholders.
According to Art. 44, para. 3, of d.p.R. No. 917 of 22 December 1986, income from this type of buy-back is regarded as income from capital, whose taxable base is equal to the difference between the amount received for the shares that were cancelled and the value of such shares recognized for Italian tax purposes.

28. The Circular letter No. 76/E of 6 March, 1998 clarifies that the comparison between the increase in the net equity eligible for the dual income tax and net equity resulting from the balance sheet at the end of each financial year, excluding the yearly profits shall be made *before* taking into account the reductions deriving from group capitalizations, set out in Art. 2 and Art. 3 (with the sole exceptions of cash contributions received from non-resident companies).
It is worth pointing out that such conclusion may give rise to adverse tax consequences where the net increase in the net equity eligible for the dual income tax is higher than the net equity resulting from the balance sheet at the end of the financial year.
See the following example:

relevant increase in the net equity	500
relevant decrease in the net equity	(100)
balance (500 – 100)	400
net equity resulting from the balance sheet	300
increase in the net equity relevant for the dual income tax	300
reductions from the increase in the net equity	(200)
final increase in the net equity eligible for the dual income tax (300 – 200)	100

If, on the contrary, the comparison between the increase in the net equity eligible for the dual income tax and the net equity resulting from the balance sheet at the end of each financial year was made *after* taking into account the reductions deriving from group capitalizations, the result would be more favourable for the taxpayer, as evidenced below:

relevant increase in the net equity	500
relevant decrease in the net equity	(100)
balance (500 – 100)	400
reductions from the increase in the net equity	(200)
increase in the net equity relevant for the dual income tax (400 –200)	200
net equity resulting from the balance sheet	300
final increase in the net equity eligible for the dual income tax	200

29. On the contrary, the net equity is reduced by the yearly losses. The Circular letter No. 76/E of 6 March 1998 maintains that some reserves made pursuant to specific tax provisions (such as the reserve for anticipated depreciation, ex Art. 67(3), d.p.R. No. 917/1986, or the reserve for grants by shareholders, ex Art. 55(3)(b), d.p.R. No. 917/1986) are included in the calculation of the net equity resulting from the balance sheet only if they originate from yearly profits set aside to such reserves.
Such limitation is clearly contrary to the law, which simply states that the increase in the net equity which is relevant for the dual income tax shall not exceed "the net equity resulting from the balance sheet, excluding the yearly profits", without making further distinction.
It is worth noting that, with reference to the tax on the net worth of enterprises, which equally applied on the net equity as resulting from the balance sheet (Art. 2 of Decree Law No. 394 of 30 September 1992, converted through Law No. 461 of 26 November 1992), the Implementing Decree of 7 January 1993 issued by the Ministry of Finance expressly stated that the reserves for anticipated depreciation were not included in the base for computation of the net worth tax, thus meaning that such reserves are ordinarily part of the net equity resulting from the balance sheet (accordingly, see Circular letter issued by Assonime No. 51 of 31 March 1993, with specific reference to the reserve for grants by shareholders).

30. The lower of the net equity resulting from the balance sheet (40) and the increase in the net equity relevant for the dual income tax, excluding the yearly losses (30).

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In any event, the amount of the increase in the net equity that is in principle relevant for the dual income tax (30) and that exceeds the book net equity at the end of the year 1997 (25) is not lost indefinitely as it may be recaptured in the following years as a consequence of the increases of the book net equity of the company, that do not give rise to a corresponding increase of the net equity which is relevant for the dual income tax.

Following the example, if in the year 1998 the book net equity of the company (excluding the yearly profits) goes to 30 (through contributions in kind, which do not benefit from the dual income tax by themselves) the amount of 5 would benefit from the dual income tax in the year 1998. As a final remark, it is worth pointing out that, where there is no attribution of the net equity to shareholders, the decrease in the net equity deriving from the imputation to reserves of the net worth tax or other substitute taxes[32] does not have any relevance for the dual income tax.

V. THE ANTI-AVOIDANCE RULES FOR GROUP CAPITALIZATIONS

Article 3, paragraph 162, letter (b) of the delegation law No. 662/1996 states that the benefit of the dual income tax regime may be limited or denied where the increases in the capital invested in the company are made for purposes other than the efficiency, strength and rationalization of the productive structure.

A. The increase in value of bonds and the purchase of going concerns.

The decree illustrates a series of transactions that are deemed to give rise to a duplication of the benefit in the hands of more than one group company. In this respect, Article 2 of the decree stipulates that the increase in the net equity of a company is disqualified up to:

– the increase in value of bonds (*valori mobiliari*)[33] and securities other than participations.[34] This limitation does not apply to banks and insurance companies on the grounds that such financial investments are part of their core business.

  In order to avoid the above-mentioned disqualification of the net equity eligible for the dual income tax regime, the company might sell the bonds and securities a few days before the year's end and buy them back at the very beginning of the subsequent year. Such behaviour, which is clearly aimed at reducing the value of bonds and other securities held at the end of the year, might probably be challenged through the application of the anti-avoidance rule set forth in Article 37-*bis* of Presidential Decree 29 September 1973, No. 600, which also contemplates the transfer and the valuation of bonds and securities;

– the price for the purchase of going concerns owned by a controlled enterprise or by an enterprise belonging to the same group. The provision aims at counteracting the following abuse: instead of making a contribution of a going concern, which does not qualify for the dual income tax, the shareholders make a cash contribution and the receiving company uses the cash to buy a going concern from other group companies.[35]

B. Cash contributions to the benefit of other group companies.

Article 3 of the decree provides that the increase in the net equity of a company that is in principle eligible for the dual income tax is not recognized up to:

(a) the value of cash contributions made, after the reference accounting period, to the benefit of other Italian group companies benefiting from the dual income tax. For such purposes, group companies are qualified as follows: the Italian company controlled, directly or indirectly (through the ownership of voting shares as well as by way of contractual relationship, as stated by Article 2359 of the Civil Code) by the company benefiting from the dual income tax; the Italian company controlled, directly or indirectly, by the same company (whether resident or non-resident) that controls the company benefiting from the dual income tax;[36]

(b) the value of cash contributions received[37] from non-resident companies, provided that such non-resident companies are controlled by resident companies. However, the above contributions become eligible for the dual income tax upon the condition that a favourable ruling is obtained from an ad hoc committee;

(c) the value of cash contributions received from companies resident in countries that have not entered with Italy into any double tax treaty providing for exchange of information.

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31. The lower of the net equity resulting from the balance sheet (25) and the increase in the net equity relevant for the dual income tax, excluding the yearly losses (30).

32. The net worth tax was introduced with Decree Law 30 September 1992, No. 394, converted into Law 26 November 1992, No. 461. The net worth tax has disappeared as from the year 1998, by virtue of its replacement with IRAP, laid down by Legislative Decree 15 December 1997, No. 446.

33. The definition of bonds to be assumed for these purposes is likely to be found in Art. 1 of the Legislative Decree 23 July 1996, No. 415 (EUROSIM Decree). As a consequence thereof, cash and bank or postal current accounts are to be excluded.

34. The ministerial report to the decree holds that such provision is aimed at:
– countering all abusive sales of bonds and other securities in order to obtain cash that will subsequently be contributed to other group companies;
– penalizing financial investments *vis à vis* entrepreneurial investments.

35. Indeed, the decree does not refer to "group companies", but mentions the broader concept of "enterprises belonging to the same economic entity". Thus it also includes the sale of a going concern originally held by an individual entrepreneur or by a partnership.

36. The law does not contemplate cash contributions made to the benefit of the company controlling, directly or indirectly, the company benefiting from the dual income tax, for the valid reason that such a transaction is prohibited by the Italian Civil Code (see, Art. 2359-*quinquies*).

37. The Circular letter No. 76/E of 6 March 1998 holds that the value of cash contributions received from non-resident companies (including those received from companies resident in countries that have not entered with Italy into any exchange of information agreement) shall be deducted from the increase in the net equity which is eligible for the dual income tax before taking into consideration the reductions set forth in Arts. 2 and 3, para. 2 of the decree.
Such interpretation, though logical, is not in conformity with the literal formulation of the law, which clearly states that: "the *residual* increase in the net equity (i.e. the one that results after the deductions set out in Art. 2 and 3, para. 2) is disqualified....".

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With respect to the provision under (a) above, the value of cash contributions made to other Italian group companies reduces the net equity eligible for the dual income tax, irrespective of whether the controlling company sells the participation before the year's end.[38] Moreover, the above reduction is final, so that it applies also with respect to the tax periods following the one in which the sale of the participation takes place.[39]

The provision under (b) above is meant to prevent the abusive interposition of non-resident companies (that are not eligible for the dual income tax regime) between two Italian companies of the same group, in order to indirectly obtain the prohibited result of a duplication of the benefit of the dual income tax within the group.

Example

An Italian company (A) uses accrued profits to set up another company in Luxembourg through a cash contribution. The Luxembourg company, in turn, contributes the cash received to another Italian company (B).

In the absence of any specific rule, the above transaction would result in an unjustified duplication of the dual income tax benefit through the same additional equity investment: first, in the hands of the Italian company A and secondly, in the hands of company B. In fact, the interposition of the Luxembourg company would make the described transaction escape the provision under (a) above, since the cash contributions are not made directly from an Italian company to another Italian company.[40]

In any event, the presumption of abuse in all cash contributions that flow through a non-resident company controlled by a resident company may be rebutted by the taxpayer if he can demonstrate to the ad hoc anti-abuse committee, set up pursuant to Article 21 of the law of 30 December 1991, No. 413, that the contribution made by the non-resident company to the Italian company (B) is not made with cash received from the controlling Italian company (A), either through capital contribution or through credit facilities, but with other resources autonomously raised by the non-resident company. In this latter case, company B may benefit from the dual income tax.

In contrast, the provision under (c) above provides a non-rebuttable presumption that cash contributions made by companies resident of countries that have not entered into any exchange of information agreement with Italy[41] are not eligible for the dual income tax in the hands of the Italian receiving company.

1. Discrimination against foreign owned companies.

The rules set forth with reference to cash contributions coming from non-resident companies appear to be in conflict with the non-discrimination rule set out in Article 24, paragraph 5 of the OECD Model Convention. The said provision deals with "ownership non-discrimination", stipulating that:

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

As pointed out by scholars,[42] the rule is meant to give protection against discrimination of foreign owned enterprises in comparison with enterprises owned either by residents of the same State, or by residents of a third State. Discrimination may occur if an Italian company owned, directly or indirectly, by a foreign company is subject to a more burdensome tax treatment than a company having the same legal form and owned by another Italian company.

As for the non-rebuttable disqualification of cash contributions received by an Italian company from a company resident in a State that has not entered into a treaty with Italy which provides for exchange of information [Article 3(3)(c)], it may well be said that such rule clearly violates the non-discrimination principle.

Assume for instance that an Italian company (A) receives a cash contribution from its Swiss[43] parent company.[44] Company (A) is not granted the same treatment that is granted to

38. It is worth pointing out that the reduction of the net equity eligible for the dual income tax in the hands of the contributing company takes place even if the receiving company does not have any taxable income, so that it can only carry forward the right to the reduced rate to the following five tax periods. Such adverse consequence derives from the fact that the application of the dual income tax regime is mandatory, as outlined at note 5 *supra*. If, on the contrary, the receiving company could elect not to apply the dual income tax, the contributing company would not suffer a reduction of its net equity eligible for the reduced rate, since no duplication of the benefit would occur.

39. The ministerial report to the decree maintains that the reduction of the net equity eligible for the dual income tax in the hands of the company that makes the cash contributions follows the general purpose of preventing the same investment being used to duplicate the benefit of the reduced income tax rate within group companies. Therefore, the above reduction shall apply regardless of whether the company in a given year sells the whole or part of the participation, thus losing control over the affiliated company.

40. Under a literal interpretation, the provision applies only if the Italian company (B), in its turn controls (directly or indirectly) another Italian company or is owned by the same controlling company (irrespective of its State of residence) of another Italian company.
Thus, if company B does not directly or indirectly control another Italian company (C) and if company B and company A are not controlled by the same company, strictly the provision should not apply.
A different view is taken by the Ministry of Finance, in the Circular letter No. 76/E of 6 March 1998, which maintains that the control relationship may occur only between the Italian company (B) and the foreign company, the presence of another Italian group company not being necessary. In particular, according to the Ministry of Finance, cash contributions are disqualified even when made by a non resident company that is controlled by the Italian company receiving the contributions.

41. Such companies are listed in the Ministerial Decree of 4 September 1996, in *Boll. trib. inf.*, (1996), at 1435.

42. See K. van Raad, *Non discrimination in international tax law*, Deventer, (1986), at 185, J. F. Avery Jones et al., "The non-discrimination article in tax treaties", in 31 *European Taxation*, 10 (1991), at 310; K. Vogel, *Double taxation conventions*, (Third ed.), Kluwer, (1997), at 1329.

43. Switzerland is one of the countries that is not listed in the Ministerial Decree of 4 September 1996.

44. The reference made by Art. 24(5) of the OECD Model Convention to the "ownership or control" of the capital of the company seems to indicate that ownership refers to capital participation, whilst control may involve other factual means of influence, such as the right to appoint managers or directors or a contractual dependence. Accordingly, see K. van Raad, *Non discrimination*, *supra* note 42, at 190.

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another Italian company (B) that is owned by resident shareholders.[45]

Indeed, discriminatory treatment may also arise under the provision laid down by Article 3(3)(b) of the decree, described above, dealing with the interposition of a foreign company between two Italian companies. Assuming that a Dutch company, controlled by an Italian company (A), makes a cash contribution to another Italian company (B), this latter company may not benefit from the dual income tax unless it obtains a favourable ruling from the special committee set up according to Article 21 of law No. 413/1991. The Italian company (B) is clearly discriminated against compared to another Italian company (C) that receives cash contributions from:

- foreign companies resident of countries that have entered into a double tax treaty with Italy providing for exchange of information, provided that such foreign companies are not controlled by another Italian company;
- other Italian companies, regardless of the fact that such companies are controlled by other Italian companies.

In both cases, the Italian company (C) receiving the cash contributions may automatically benefit from the dual income tax, whilst Italian company (B), in order to get the same treatment, needs to undertake a time consuming procedure in order to obtain a favourable ruling from the tax authorities. In this case the discrimination against Italian company (B) is constituted by the more burdensome "*connected requirements*" compared to Italian company (C).

C. The increase of loans granted to other group companies.

Furthermore, Article 3, paragraph 3, letter (c) of the decree provides that the increase in the net equity eligible for the dual income tax is also disqualified up to the increase of loans granted by the Italian company to other group companies that may benefit from the dual income tax, compared to the value of such loans as they result from the balance sheet of the reference accounting period.

This is meant to affect all transactions whereby the borrowing company uses the proceeds coming from the loan for an eligible equity increase in other group companies.[46]

The legislation is designed to counteract the following:

- an Italian company (A) uses its accrued profits to make a loan to another Italian company (B);
- the Italian company (B), then contributes the cash received to a third Italian company (C).

The above cash flows may give rise to an unjustified duplication of the dual income tax benefit through the same additional equity investment: first, in the hands of company A and then again, in the hands of company C. As for the definition of group companies, the law makes reference to the list contained in Article 3, paragraph 1, i.e.:

- a company benefiting from the dual income tax that is controlled, directly or indirectly (through the ownership of voting shares as well as by way of contractual relationship, as stated by Article 2359 of the Civil Code) by another company benefiting from the dual income tax;
- a company benefiting from the dual income tax that controls, directly and indirectly, another company benefiting from the dual income tax;
- a company benefiting from the dual income tax that is controlled, directly or indirectly, by the same company that controls another company benefiting from the dual income tax.

Thus, under a literal interpretation, loans granted by an Italian company benefiting from the dual income tax to a non-resident company that controls or is controlled, directly or indirectly, by the former company, would not be relevant. Equally, no relevance should be attributed to loans granted by an Italian company benefiting from the dual income tax to a non-resident company that is controlled, directly or indirectly, by the same company that controls the Italian company.[47]

45. In fact, in the latter case, the Italian company (B) would not suffer any disqualification of cash contributions received by shareholders, since the reduction of the net equity eligible for the dual income tax, if any, would apply in the hands of the controlling company.

46. If the accrued profits in the hands of company A are equal to 100, and the same amount is contributed by company B to company C, both company A and company C may benefit from the dual income tax on the same amount (100). In such case, the same results are achieved as if company A directly made a cash contribution to company C.

47. Again, a different view is taken by the Ministry of Finance, in the Circular letter No. 76/E of 6 March 1998. Under the ministerial interpretation, a loan granted by an Italian company (A) to a foreign company (B) which controls or is controlled by the former company would determine a reduction of the net equity eligible for the dual income tax in the hands of the Italian company (A), regardless of the fact that the foreign company (B) controls or is controlled, in its turn, by another Italian company (C).

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IFA NEWS

THE SECRETARY GENERAL'S ANNUAL REPORT 1997/1998

J. Frans Spierdijk

INTRODUCTION

During the New Delhi General Assembly Sven-Olof Lodin (Sweden) was unanimously elected as President of our Association, succeeding Pietro Adonnino (Italy) after four years of excellent and unfailing service. On behalf of all the IFA members, the Central IFA Officers and the General Secretariat in particular, I would like to express our sincere gratitude to Pietro for the wisdom, devotion and enthusiasm with which he carried out this task. A solace is that IFA will certainly not lose him as an active member and that he will continue to play a significant role in our Association. The title of Honorary President which was bestowed upon him could not have been more deserved. All of us welcome Sven-Olof at the helm of our Association, and look forward to a pleasant and fruitful working relationship. Sven-Olof has been actively involved in IFA for many years, as Chairman of the Swedish Branch, President of the 1990 Stockholm Congress, member of the Permanent Scientific Committee and in numerous other functions, and we are privileged to have him as our President.

I would like to draw your attention to the fact that this year IFA is celebrating its 60th Anniversary. Unlike 10 years ago, when IFA celebrated its 50th Anniversary in the Peace Palace in The Hague where the Association was founded, we will not have a special ceremony. However, it is good to note on this occasion that IFA continues to play a prominent role in the world of international taxation, with a steadily growing membership of more than 9,500 experts in over 85 countries, and well-attended annual Congresses offering an interesting and diversified scientific programme. Without the dedicated work of many people, specially also in our 47 National Branches, it would not have been possible to achieve the Association's objectives during IFA's first 60 years. In this rapidly changing time, and as we approach a new era, let this be a source of inspiration for the future.

It is my sad duty to remind you that on the first day of 1998 our Honorary President, Dr Paul Gmuer, passed away after a full life in which IFA played an important role. He will be sorely missed by all who knew him as an outstanding lawyer and a good friend. IFA owes him a great deal of gratitude for everything he has contributed, in his capacity as Chairman of the Swiss Branch, President of IFA and in numerous other functions. Kurt Stocker pays tribute to this grand personality in the 1997 Yearbook.

We were also shocked to receive the news of the passing away, in June 1998, of Dr Alberto López from Argentina, who has played a significant role in our Association, as Chairman of the Argentine Branch, member of our Executive Committee and Vice-President of the 1984 Buenos Aires Congress. In Alberto we lose a devoted member of our Association and a dear friend.

NEW DELHI CONGRESS

Our 51st Congress, the first to take place in the South Asia Region, was held in New Delhi, the ever beating heart of India which, together with its twin city of Delhi, provides a blend of the ancient and the modern. The Congress attracted 781 participants and 347 accompanying persons, a rewarding number for all who worked hard in preparing the Congress, and proved to be very interesting and successful. We owe thanks for this in the first place to Mr O.P. Vaish, to Mr O.P. Dani, to Mr N.S. Jain and to Mr R.K. Poddar, and the many India Branch members who assisted them.

A tropical time table was observed, leaving enough time for recreation, shopping and to have a glimpse of India's history and cultural heritage. I am sure that those members who attended the Congress in this fascinating and vast country found it an unforgettable experience.

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. Mr S.R. Lainoff (USA) and Dr R.C. Vaish (India) acted as General Reporters on Subject I "The taxation of income derived from the supply of technology", Prof. Dr A.H.M. Daniels (Netherlands) as Discussion Leader and Mr A. Vohra (India) as Secretary. Members of the Panel were Mr H. Birk (Canada), Mr A. Camelot (France), Prof. C.S. Lee (Korea, Republic of) and Mr G. Leonardos (Brazil). General Reporters for Subject II "The taxation of investment funds" were Dr P.J.M. Bongaarts (Netherlands) and Mrs L.J. Ed (United Kingdom). The Discussion Leader was Mr Y. Prussen (Luxembourg) and Mr D. Bouzoraa (Tunisia) acted as Secretary. Members of the Panel were Mr D. Choksi (India), Dr H. Krabbe (Germany), Mr J. Newberg (USA) and Mr A. Pelvang (Denmark).

Seminar A on "OECD Model Convention – 1997 and beyond" was chaired by Prof. Dr K. Vogel (Germany) and Panelists were Mr L. de Broe (Belgium), Ms P. Brown (USA), Mr D. Lüthi (Switzerland), Mr N.P. Sahni (India), Dr A. Schäfer (Germany) and Prof. A. Skaar (Norway). Mr B. Elvin (USA) acted as Secretary. "Cross border valuation for income tax, VAT and customs duties (transfer pricing) was the title of Seminar B, with Prof. F. Vanistendael (Belgium) as Chairman, and Mr R. Cole (USA), Dr A. Manganelli (Italy), Prof. Y. Masui (Japan) and Mr P.V. Ramanan (India) as Panelists, and Mr J. S. Wilkie (Canada) as Secretary. Seminar C treated the "Taxation of expatriates". Chairman was Prof. R. Krever (Australia) and Members of the

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Panel were Mrs A.N. Dranof Borger (Brazil), Prof. L. Burns (Australia), Mr P. Kelley (Belgium), Mr R. Leitner (Austria) and Justice Ranganathan (India). Seminar D "Presumptive Income Taxation" was chaired by Prof. R. Avi-Yonah (USA), and the Panelists were Mr S.F. Dastur (India), Mr J. Gonzalez Bendiksen (Mexico), Prof. F. Grapperhaus (Netherlands), Mr H.E. Kaplan (Argentina) and Mr M. Taly (France). Mr P. Byrne (USA) acted as Secretary. Prof. P. Shome (India) was the Chairman of Seminar E on "Doing business in India", and the Panelists, all deriving from India, were: Mr B. Gupta Ramola, Dr B.K. Modi, Mr N.K. Singh, Mr R. Srinivasan and Mr R. Tyagarajan.

Seminars A, B, C and D will be published in our "Congress Seminar Series" and will become available from Kluwer Law International in due course.

PERMANENT SCIENTIFIC COMMITTEE

In February the PSC enjoyed the kind hospitality of our British Branch at their meeting in London at the Institute of Chartered Surveyors.

Chairman Tillinghast welcomed Prof. J.P. le Gall, France, as new member of the Committee. Prof. Le Gall is the successor of Mr R. Baconnier, who, after many years of faithful service for which we are very much indebted to him, left the Committee in order to join the Executive Committee.

In view of the decision of the General Council to expand the Committee with government administrators, who will be a different "category" member in the sense that national origin will not be a consideration, it will be proposed to the London meeting of the General Council that Mrs L. Kana (Chile), one of the treaty negotiators of the Chilean government, join the Committee. Also, the Committee will be reinforced by a VAT expert in the person of Mr M. Aujean, Director of Taxation of DG 21 of the European Commission. Further proposals are that Mr M. Gammie (United Kingdom) and Prof. R. Krever (Australia) become members of the Committee; as well as Prof. M. Lang (Austria) and Mr M. Tron (Mexico), successors to Prof. DDr H.G. Ruppe (Austria) and Mr P. Olavarrieta (Mexico), long-time and greatly appreciated members of the Committee, who have tendered their resignation as of the London Congress. It is relevant here to refer to the decision of the General Council to propose to the General Assembly that Article 13 of our Articles of Association be changed to reflect a maximum term of ten years for PSC members (excepting the Chairman and the Vice-Chairman), with a transitional provision for existing members.

In reviewing the proceedings of the scientific programme at the 1997 New Delhi Congress the PSC noted that many Congress participants had repeatedly expressed the view that a drawback of the present structure of the Working Sessions of the two Main Subjects is that the discussions tend to concentrate on the text of the draft resolution rather than on the subject matter itself, and that too little time is devoted to a discussion on substantive issues. In attempting to respond to this criticism, the New Delhi Discussion Leaders and General Reporters had been requested to prepare not only a draft resolution, but also an issues paper which would be the basis for the discussion, so that the emphasis would be on exposition and analysis of issues and not on any particular resolution or conclusion. A specified amount of time had been reserved for discussion of the draft resolution, at the end of each section in the case of Subject I, and after all issues had been covered for Subject II.

The PSC felt this went reasonably well, although there is still room for improvement. In light of this it was decided to embark on a new experiment for the London Working Sessions in not having resolutions prepared or adopted. Instead, a small Committee will prepare a summary of the discussions (a Précis) for eventual publication. This Précis will reflect the views expressed in the discussion. To assure that any divergent viewpoints are taken into account, the Discussion Leaders have been directed specifically to reserve time out of the discussion of each segment of the subject (time otherwise devoted to discussing the draft resolution) to assure that participants can express their views. The Précis will be presented, in English only, to the General Assembly on Thursday, 8 October 1998, but no vote will be taken on it, although there will be an opportunity for members to raise comments about the text of the Précis.

As usual an issues paper describing the highlights of the Subject will be mailed to registered Congress participants some six weeks before the London Congress. This will form the basis of the discussions. The original English versions may also be obtained from our WEB site on the Internet. (http://www.ifa.nl).

The PSC will obviously carefully evaluate the merit of this experiment, since it is known that a number of Branches have expressed a strong preference for resolutions.

Only five applications were received for the 1998 research associate position, from Italy (2), Germany, New Zealand and Sweden. Happily, we were able to engage Mr P. Pistone, Italy, a very promising young tax lawyer who I am sure will do a fine job, as our research associate for 1998. I would take this opportunity to make an appeal to all of you to encourage young people with an academic background in taxation, some work experience and a working knowledge of English and one or preferably two other languages, to apply for this function. By assisting the PSC in selecting Congress subjects and Seminar topics a unique opportunity is provided to do research in an international environment and to get acquainted with the activities of our Association.

Two Austrian scholars participated in the New Delhi Congress Poster Programme. I am very glad to note here that the appeal made to many of you to encourage young people who are working on their dissertation to apply for this programme has been very successful: The London Poster programme is fully booked!

The preparations for the London Congress are well under way. A very full programme of technical discussion is being offered. Subject I deals with "The tax treatment of corporate losses", and apart from the General Report prepared by Prof. A. Michelsen (Denmark) 34 National Reports appear in Volume A of the 1998 "Cahiers de Droit Fiscal International".

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Prof. D.W. Williams (United Kingdom) is General Reporter for the second Subject "Practical issues in the application of double tax conventions", and 30 National Reports have been submitted.

The following Seminars will be held:

A: The OECD Model Convention – 1998 and beyond
Chairman: Prof. Dr K. Vogel (Germany)
B: Internet/I.T. communication issues
Chairman: Prof. Dr K. van Raad (Netherlands)
C: 24 hour global trading
Chairman: Mr G. Pennells (United Kingdom)
D: Practical experience with the OECD transfer pricing guidelines
Chairman: Mr M. Taly (France)
E: Triangular Treaty problems
Chairman: Dr J. Avery Jones (United Kingdom)
F: Recent international transactions of interest
Chairman: Mr E. Troup (United Kingdom)
G: VAT on cross-border services
Chairman: Prof. Dr H. Kogels (Netherlands)

The two Main Subjects for the Israeli 1999 Congress will be I: "Taxation of non-profit organizations" with Prof. D. Gliksberg (Israel) as General Reporter, and II: Advance rulings" for which Prof. M. Ellis (Netherlands) has agreed to be General Reporter. Subject I of the Munich Congress in the year 2000 will treat "Tax treatment of hybrid financial instruments in cross-border transactions" and "Taxation of deferred compensation payments other than pensions" is the title of Subject II. Initial discussions on the scientific programme for the 2001 Congress in San Francisco are being held with our friends from the USA Branch. It seems very likely that one of the main Subjects will deal with a topic on taxation and electronic commerce which, especially in view of the close proximity of Silicon Valley, seems very appropriate.

IFA SPONSORED RESEARCH PROJECT

I am pleased to report that a very constructive meeting took place in London on 9 May 1998 between the Rapporteurs for the first Segment of our Project on Electronic Commerce and Taxation, Prof. R. Doernberg (USA) and Prof. L. Hinnekens (Belgium), and National Branch representatives. About 30 persons with a high level of expertise attended and many interventions which were extremely informative to the Rapporteurs took place. Fifteen National Branches submitted written comments. In the meantime the Rapporteurs have reconsidered their draft report in light of the discussions, and the manuscript has gone to press. The publication should be ready in the fall of this year, and will include a précis by Prof. le Gall (France), thus making sure that views expressed which are not adopted or referred to in the report are reflected. Kluwer Law International is the publisher and the book will be offered with a 25% discount to IFA Members.

I would like to take the opportunity, on behalf of the entire Association, to express our sincere appreciation and gratitude to Richard Doernberg and Luc Hinnekens in the first place for undertaking this very arduous but important assignment, which I am confident will make a substantial contribution to the development of sound international tax law. Our thanks go also to the Consultants who worked with the Rapporteurs, Prof. Dr H.A. Kogels (Netherlands), Prof. Y. Masui (Japan) and Mr E. Romano (Mexico); the National Branches and their representatives; and all persons who have spent time and energy on this project. The cooperation by members of the OECD Committee on Fiscal Affairs has also been greatly valued.

I would like to take this opportunity to make particular mention here of the initiator of this IFA sponsored Research Project, our untiring and ever inspiring Chairman of the PSC, David Tillinghast.

So far as the second segment on innovative financial instruments is concerned, we shall have more news for you at the General Assembly in London on Thursday, 8 October 1998; and hopefully also on a third research study of international tax issues of timely interest the PSC is contemplating. So do make sure to be there!

EXECUTIVE COMMITTEE

Because of serious concern about the security situation in Jerusalem, the General Council, at its 1997 New Delhi meeting, gave the Executive Committee a mandate to carefully investigate and evaluate the situation, and to take a final decision on the location of the 1999 Congress. During its extraordinary meeting in London on 5 February 1998 the Executive Committee, in consultation with the Israeli Branch and after serious deliberations of all aspects concerned, decided to shift the venue of the 53rd Congress to Eilat. The Israeli Branch and Central IFA will put in every effort to make this a wonderful and memorable event, with a full scientific programme to cater for all tastes, and an exciting social programme. We look forward to welcoming you in large numbers!

The thriving city of London was also the venue of the 10 May 1998 meeting of the Executive Committee. Our English friends proved again to be excellent hosts. President Lodin welcomed Mr R. Baconnier (France), Prof. J.P. Lagae (Belgium) and Prof. J.L. Shaw (Uruguay) as new members of the Committee. At the last meeting of the Executive Committee during the London Congress, regretfully, we shall have to say goodbye to Mr H. Birk (Canada) and, quite unexpectedly, to Mr G. Andrew (South Africa) who, for business reasons is not in a position to continue his membership on the Committee. I wish to take the opportunity of thanking both of them for their dedicated services towards the work of the Committee and the Association as a whole. New candidates will be submitted to the General Council in London.

As regards the further composition of the Executive Committee it will be proposed to the General Council that Dr M. Desax (Switzerland), Prof. R.L. Deutsch (Australia), Prof. Dr D. Juch (Netherlands), Mr T. Miyatake (Japan), Mr J.D.B. Oliver (United Kingdom) and Prof. K.S. Tikka (Finland) be re-elected for another term of two years.

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Quite a long list of household matters was discussed. Worth mentioning here is a discussion on the importance of attracting civil servants of revenue departments, academics as well as young professionals in private practice as members of our Association. In agreeing that IFA should set this as one of its goals for the future the conclusion was reached that the National Branches are likely to be much better suited to achieve this aim than Central IFA. I have sought the advice of the Branches on what methods could be used, or possibly are being used already in order to bring this about and asked for any further suggestions, such as how to encourage the participation from industry. I am glad to say that quite a few Branches have reacted already. Further discussion on this issue will be held at the London meeting of the Committee, and I shall certainly keep you posted on this important issue.

The General Treasurer was pleased to be able to report that the Association is in a rather stable financial situation. The year 1997 was closed with only a small deficit of NLG 15,000 and future prospects continue to be rather positive. I must make mention here of the contribution of the India Branch of NLG 25,000 – part of which consists of membership fees arrears – out of the successful organization of the 1997 New Delhi Congress. With a third scientific research study forthcoming such contributions are being put to some very good use.

Other matters reviewed and discussed by the Executive Committee are mentioned under the headings hereunder.

MEMBERSHIP FEES

The General Treasurer will propose to the General Council to maintain the membership fees for 1999 at the 1998 level, being:

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.

Also on behalf of Jos Westerburgen I would like to thank those Branches who faithfully cooperate in collecting the fees, which is much appreciated. 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.

NATIONAL BRANCHES AND MEMBERSHIP

We did not have the pleasure of welcoming new Branches in our midst at the 1997 Congress. However, we continue to actively promote IFA. The fact that IFA organized its first Congress in the South Asia Region has proved to be very effective in terms of membership in especially India. This Branch, with a sub-section in Mumbai, has grown very rapidly over the past years and now has more than 250 members. This is greatly due to the untiring efforts of Honorary Chairman O.P. Vaish, Chairman O.P. Dani and their colleagues. A Newsletter is being issued and many interesting Seminars are taking place. Our congratulations on this achievement, and please keep up the good work.

In November 1997 President Lodin participated in a very successful, well-attended and interesting conference in Moscow. Apart from local participants some 35-40 persons from outside Russia took part. Mrs Irina Rusakova and her colleagues deserve praise for a well-organized event.

Also in November I had the pleasure to participate in the 14th *Hamburger Tagung zur Internationalen Besteuerung*, organized by Prof. L. Fischer and his colleagues and co-sponsored by our German Branch. As usual, this was an interesting experience, and a good opportunity to learn at first hand about what goes on in the field of international taxation in Germany.

Worth mentioning here is that the membership administration at the General Secretariat will be restructured to better facilitate the link with the Internet. It is also the intention to insert members' e-mail addresses in future IFA membership lists, for easier communication. Members will be contacted in due course in order to bring this about. We trust that in this way we shall be able to improve on our services towards our National Branches and members.

CONTACT WITH INTERNATIONAL ORGANIZATIONS

Our contacts with CIAT are being carefully maintained. I participated in the Madrid, November 1997 meeting and hope to attend their October 1998 conference in Amsterdam. I continue to attend the meetings of the ICC Tax Committee. Last December I travelled to Geneva for the meeting of the UN Ad Hoc Group of Experts on International Cooperation in Tax Matters. The main item on the Agenda was a discussion on the UN Model Treaty and the reaction of non-OECD countries to developments in the OECD Model Treaty. IFA's contacts with OECD continue to be constructive and fruitful – as demonstrated by the IFA/OECD Seminar which has become a greatly appreciated feature at our annual Congresses. IFA has also participated in several OECD meetings dealing with different aspects of the topic Electronic Commerce.

On further contacts with international organizations I refer to the reports of our "Ambassadors" as published in the IFA Yearbook.

MITCHELL B. CARROLL PRIZE 1997

The Jury decided to award the 1997 Prize to Dr Achim Pross (Germany) for his work entitled "Swap, Zins und Derivat – Finanzinnovationen im nationalen und internationalen Steuerrecht unter besonderer Berücksichtigung des Zinsbegriffes". The Prize was officially awarded during the New Delhi Opening Ceremony by Prof. DDr H.G. Ruppe (Austria), Chairman of the Jury.

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Disappointingly this Prize does not attract many contenders. I would like to remind you that the amount winners receive has recently been increased to NLG 5,000, in addition to IFA granting a contribution towards travel expenses and waiving the Congress fee. The General Secretariat intends to produce a promotional flyer for distribution to Universities and other institutions, in the hope that this will have the desired effect. I would like to make an appeal to all of you to give whatever assistance is necessary in order to attract more applications. Conditions governing the award of the Mitchell B. Carroll Prize are printed in the IFA-Yearbook and are also available on IFA's home page on the Internet.

INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION

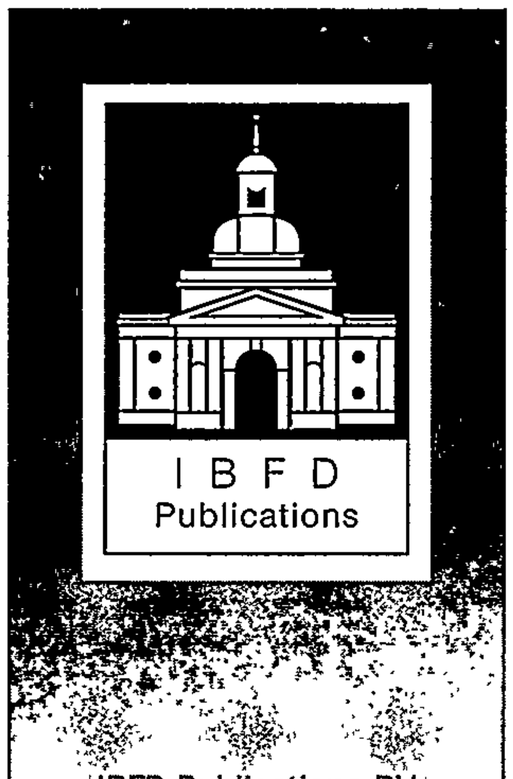
Like IFA the International Bureau of Fiscal Documentation (IBFD) is celebrating its 60th Anniversary, and congratulations are due for their many achievements in such a relatively short period of time.

Established by IFA in 1938, the IBFD has pioneered the objective, scientific study of the effect of national tax legislation on international investment. Today the IBFD enjoys a unique worldwide reputation among tax and business professionals as the premier source of clearly presented, systematic descriptions and analyses of changes and trends in global taxation and foreign investment legislation, and its main activities are research, publishing, education and training.

We feel privileged to be able to maintain such close contacts with them for the benefit of both our organizations, and in particular with its chief executive, Prof. Hubert Hamaekers, who, as *ex officio* member of our PSC, is a very useful source of information. We wish Hubert and his colleagues and staff every success in carrying out their valuable work.

THE 52nd CONGRESS IN LONDON, 4-9 OCTOBER 1998

We are looking forward with anticipation and pleasure to our 52nd London Congress. David Oliver and his colleagues are working hard to ensure a smooth running of the Congress. The scientific and social programmes are tempting. Those of us who remember the previous Congresses in London (in 1965, 1975 and 1985) have an additional reason to look forward to a renewed visit to that city in "IFA atmosphere". I hope you will grace the Congress in large numbers.



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AN INTRODUCTION TO SWISS INTERNATIONAL TAX LAW – ITS CHARACTERISTICS AND GUIDING PRINCIPLES

SWITZERLAND IN INTERNATIONAL TAX LAW

by Xavier Oberson and Howard R. Hull

The Swiss approach to international taxation is very much in line with its reputation as a centre for international trade and finance, a reputation that has been earned over years of financial and political stability. Many tax privileges have been introduced in order to entice foreign investment in Switzerland, while there are very few restrictions on Swiss investment abroad. Switzerland also has an extensive network of treaties for the avoidance of double taxation.

This introduction to the main characteristics of Swiss international tax law has been written, principally, for tax professionals wishing to acquire a working knowledge of the issues involved in international cross-border investment to and from Switzerland; both domestic and international laws are explained in detail. The authors have paid particular attention 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 extensive Swiss case law developed for the avoidance of intercantonal double taxation, which is often automatically applied in international context. Other subjects covered include the forfeitary tax credit mechanism and the Swiss approaches to transfer pricing and the implementation of mutual agreement procedures. The authors also examine Switzerland's restrictive approach to the exchange of information, in the light of domestic law and international tax treaties.

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SUMMARY OF SCIENTIFIC PROCEEDINGS –1998 IFA CONGRESS

In the first Subject, **The tax treatment of corporate losses,** the thrust of the discussion was that the tax treatment of losses, whether within a jurisdiction or across tax borders, was an important topic: if profits were taxed and corresponding losses were disallowed, the tax system would distort business decisions by imposing a tax penalty on risk-taking. In principle, all business losses should be deductible, although this result could be achieved in different ways by different tax systems.

The discussion of Subject II **Practical issues in the application of double tax conventions** avoided both the substance of double tax conventions and their interpretation. Its focus was on their application and the way in which their purpose could be frustrated by inflexible procedures, onerous time limits and the like. Two main themes emerging from the discussion were that formalities imposed by the authorities should not be disproportional to the concerns they were addressing and that the OECD should seek to identify and promulgate the best practice in these areas among its various member states.

Seminar A, entitled " The OECD Model Convention – 1998 and Beyond", was once again jointly organized by the OECD and IFA. As per custom, the high-ranking OECD officials started the seminar with a discussion of the current work programme of the Committee on Fiscal Affairs and of Working Party 1. Professor Hugh Ault, representing the OECD, indicated that the two major issues being examined were: harmful tax competition and tax policy aspects of the communications revolution. He also discussed the OECD's analysis of arbitration as a means to resolve controversies, a topic to be discussed at length at next year's IFA Congress.

Mr Daniel Lüthi, Chairman of Working Party 1, continued and indicated that the next model treaty update is expected near the end of 1999 or in 2000. He suggested that there may be new commentary discussing the proper treatment of partnerships and transparent entities under the model. In addition, comments regarding software payments and Article 14 issues are also expected. Other issues being discussed include pensions and permanent establishments.

The second hour began with Ms Joni Walser discussing the meaning of "beneficial ownership" under the model. The discussion became quite interesting as Mr Bruno Gouthière suggested that a strict interpretation is required, which would be "agent" or "nominee". Professor Bertil Wiman seemed to agree, though he was in favour of a more extensive treaty definition of the terms. It was also clearly noted that treaty shopping was possible in certain situations of strict interpretation. No clear resolution was reached by the panel.

During the third hour, Mr Hans Mooij gave several examples addressing the qualification of retirement income under Article 18 of the Model Convention.

The Panel of **Seminar B** "Electronic Commerce and International Taxation" focused its attention on two issues: whether electronic commerce gives rise to a permanent establishment in the country where customers reside; and whether a payment from a customer constitutes a royalty, a payment for services, a purchase of goods or a rental payment. With regard to the first issue, the Panel considered the treatment of a server under current treaty principles and also considered whether an expanded permanent establishment concept would be appropriate. In addition, the Panel focused on the difficult problem of attributing income in the case where a permanent establishment is indeed found to exist. With regard to the royalty issue, the Panel discussed the newly released OECD Commentary on the characterization of royalties, it also considered whether a base erosion approach implemented through a modest withholding tax may be appropriate in the future.

The session was concluded with a highly successful videolink with Ottawa where the OECD Government/Business Dialogue on Tax and Electronic Commerce was taking place. There was a vigorous exchange of ideas, culminating in a pledge to provide some certainty for business engaged in cross-border electronic transactions and satisfactory division of tax revenue for the governments involved.

Seminar C on "24 hour global trading" considered the topic of global trading and its implications for tax purposes by applying the analysis to two separate case studies.

Under the first, involving the "home market" model, a salesman employed by Company X in Country B would simply be selling securities held in the inventory of its affiliate Company Y in Country A. It was agreed that such a model would normally require analysis of the appropriate transfer price under Article 9(1) of the OECD Model Treaty. This would normally involve a functional analysis and the use of comparable pricing information. Under these arrangements, Company Y would not usually be regarded as operating a permanent establishment in Country B. It was noted that practical difficulties often arise in relation to finding suitable comparable information.

The second case study, using the "integrated trading" model, was designed to illustrate the difficulties that arise when an integrated securities or derivatives trading business is conducted in a number of jurisdictions. The major problems encountered in practice include (1) identifying a suitable method for allocating fairly the profits to the entities in the jurisdictions involved (whether under Article 7 or Article 9) and (2) the analysis of whether the arrangements create multiple permanent establishments in the jurisdictions concerned following the provisions of Article 5. Various practical problems were discussed and the current and future work of the OECD was noted.

Seminar D on "Practical experience with the OECD Transfer Pricing Guidelines" considered whether the Guidelines had started to influence tax legislation or the practice of Revenue authorities. The seminar reviewed recent developments in

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transfer pricing legislation throughout the world. It considered the results of a questionnaire to multinational groups in the Association, and the views of panel members and other participants. Most speakers agreed that consistency between different countries was essential to prevent double taxation and to allow international business to operate efficiently. The OECD guidelines would be an extremely valuable influence in this direction. Nevertheless, many important jurisdictions, notably the United States, took a fundamentally different approach from the OECD in some respects. The seminar agreed that it would wish to see progress towards further uniformity. It recognized that the mutual agreement procedures in some tax treaties may help to achieve this. It also welcomed the study of arbitration procedures by the OECD.

Seminar E discussed "Triangular treaty problems", that is where two treaties apply to the same income, particularly where the taxpayer is a dual resident or has a permanent establishment and receives income from, or pays interest to, a third state. The panel first considered receipts attributable to a permanent establishment from a third state, the main problems being obtaining relief in the permanent establishment state for the third state tax and whether the treaty between the source state and the permanent establishment state should apply. They considered, without reaching agreement, whether the EC Treaty required the permanent establishment state to give credit even in cases when the taxpayer was not an EU resident.

The conclusion was that the non-discrimination article already provided for relief, although not all states in fact give it. There is a case for making the treaty between the source state and the permanent establishment state apply even though this results in the source state imposing tax at the lower of the two treaty rates. Secondly, the panel discussed payments of interest attributable to a permanent establishment to a third state, under which the OECD Model apparently allowed both the head office state and the permanent establishment state to impose withholding tax, although some members of the panel argued that the treaty between the head office state and the permanent establishment state prevented this, (the others disagreed with that view).

The panel concluded that the alternative wording in paragraph 30 of the Commentary to Article 11 should be adopted more generally so long as the permanent establishment state imposed a withholding tax on interest paid. Thirdly, they discussed problems of dual residents receiving income from or paying interest to a third state, concluding that an internal law solution was the best way to prevent a taxpayer being treated as a resident of the losing state under the dual residence article. It was also suggested that Article 10(5) should be clarified to make sure it applied to dual residents.

Seminar F "Recent international transactions of interest" examined the tax issues surrounding a parallel bond issue by the Siemens Group of companies. The panel discussed the choice of location for a group finance company, concluding that, while the United States and the United Kingdom had attractions, the Netherlands still remains the preferred location. Intra-group financing issues were addressed, and it was suggested that greater harmonization of thin capitalization rules and limitation on benefits provisions in tax treaties was desirable. The panel discussed the introduction of the Euro, its impact on existing financing issues and the likely effects of the proposed EU savings directive. The panel noted that national tax authorities' concerns about the protection of their own tax base could conflict with their aim of promoting efficient capital markets.

Seminar G discussed "VAT on cross-border services". After a general introduction describing the rules relating to the supply of cross border services in the EU, Switzerland, Russia and Israel, the discussion both from the panel and the floor led to a consideration of the difficulties of enforcement of VAT on personal importation of services, the need for a new double tax treaty network for VAT (for which there was not much enthusiasm), and difference in the treatment of intra-branch supplies of potentially exempt supplies when made to third parties.

Specific issues were then discussed relating to difficulties in identifying the place of supply and the fixed establishment from which a supply is made having regard to recent judgements of the ECJ. Active participation from the floor (130+ participants) indicates that this is an issue of widespread interest and concern with recognition that the difficulties lay not so much with the interpretations of the ECJ but the wording of Article 9.1. of the Sixth Directive itself.

Finally, consideration was given to the use of the Internet for business transactions, such as intra-group management charges and transactions by private individuals. There was agreement that for transactions between businesses there should be no VAT on export (but with the right to deduct) and the reverse charge should be operated by the importer? For individuals the issue is more difficult. It may be necessary to have a system that requires suppliers to register for VAT in the recipient country if the supplies exceed a certain threshold but difficulties of enforcement were recognized and would need to be addressed.

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SUBJECTS – 52ND IFA CONGRESS, LONDON 1998

SUBJECT I: TAX TREATMENT OF CORPORATE LOSSES

Précis (original version)

The treatment of corporate losses was discussed as Subject I of the 52nd Congress of the International Fiscal Association held in London in 1998.

A "Cahier" with 34 National Reports had previously been made available to the participants as background information and a Panel presentation opened the general discussion.

The participants in the discussion accepted the view that tax policy on losses should reflect economic analysis of the subject. Where corporate tax is payable on profits relief should be available for corresponding losses:

- Failure to provide offsetting relief for losses discourages risk taking;
- Inadequate loss carry-back may precipitate early termination of projects; and
- The tax burden on companies, especially multinational companies, varies in inverse relationship to global profits, as losses reduce net profits without necessarily reducing the taxes paid on profitable activities, so reducing the ability to finance new projects from internally generated funds at a time when governments may wish to stimulate more investment.

These distortions result in loss of welfare for shareholders, employees and governments. Governments and the private sector have a common interest in the success of the economic enterprise and in ensuring that loss provisions do not distort decision-making.

The participants in the discussion took the view that restrictions on loss relief impede optimal trading and investment. The Copenhagen Congress in 1979 identified the interplay of tax sovereignty, annual basis of assessment and separate identity of companies as underlying impediments. The participants expanded that list to include restrictions on loss relief and noted the divergent policies of governments.

The participants noted that barriers in the way of loss relief include limitations on carry-forward and carry-back, limitations affecting particular industries or activities, the establishment of income baskets, failure to recognize the economic unity of groups of companies and the failure to offset losses of controlled foreign companies where profits of these companies are subject to immediate taxation.

The participants discussed:

- Single company domestic losses:
  - Carry-forward. Participants generally favoured a move towards unlimited loss carry-forward and expressed concern about the use of baskets that restrict the utilization of losses;
  - Carry-back. Participants recognized the general need for carry-back and in addition special unhindered carry-back on the shut down of operations with high dismantling and environmental costs; and
  - Start-up losses. Participants wanted full recognition to be given to expenditure incurred before operations begin.
- Grouping or consolidation. The participants supported a facility whereby a group of companies operated as a single economic entity is entitled to be treated as a consolidated group to provide offset of losses of one company in the group against profits of other companies in the group.
- Mergers. Participants noted the different rules relating to the availability of loss carry-forward following a merger or reorganization.
- Sale of loss-making companies. The participants supported the facility to sell loss-making entities to reward risk taking and to provide funding for new business activity.
- Cross-border losses. Participants:
  - Regretted the slow implementation of the conclusions in Copenhagen;
  - Supported the need for recognition of foreign losses whether the credit or exemption method is adopted in the country of residence;
  - Applauded the method which permits the compensation of losses of foreign subsidiaries against profits of the parent and vice versa; and
  - Supported the EU proposed loss directive with the modification that losses of a group member be available for offset against other members' profits.
- CFCs. Participants sought to tie in the allowance of losses to taxation of income.

The participants agreed that loss relief should have neutral economic impact.

SUBJECT II: PRACTICAL ISSUES IN THE APPLICATION OF DOUBLE TAX CONVENTIONS

Précis (original version)

This subject was discussed as Subject II at the 52nd Congress of the International Fiscal Association held in London in 1998.

A "Cahier" with 30 National Reports had previously been made available to the participants as background information and a Panel presentation opened the general discussion.

It was pointed out that the discussion would be limited to issues arising from the application of double tax treaties rather than their interpretation. This subject had not previously been covered at an IFA Congress and there is little literature on it. It was suggested that there is considerable scope for further analysis and discussion of the subject.

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One object of the discussion was to identify best or preferable practices of states in applying their tax treaties. The discussion considered that tax treaties should be applied in a manner that promotes rather than undermines the intention of the treaty partners. The discussion emphasized the need for clarity and fairness in whatever administrative approach is adopted. It was recognized that the pursuit of clarity may involve trading simplicity for accuracy. The need for proportionality or constructive pragmatism was also emphasized. This may involve tax administrations ensuring that their administrative costs and the compliance costs of taxpayers in securing treaty relief do not outweigh treaty benefits. It was noted that administrative costs may be reduced through the use of tax identification numbers, the use of such numbers avoiding duplication of processes by both source and residence states. Of further consideration in this regard is the tax administration's duty to oversee compliance and defend the tax base. The discussion considered whether best practices identified should be incorporated within model treaties. It was noted that this approach might provide less flexibility than incorporating such practices in specific bilateral rules. It was felt that in the absence of specific rules tax administrations should display transparency and openness and provide ease of access to procedures.

The discussion was structured in the following manner:

1. State of source
1.1 Relief given by discharge of the obligation to withhold
1.2 Refund procedures
1.3 Is it in accordance with tax treaty law to refuse the application of the lower withholding tax rate provided by a treaty?
2. State of residence
2.1 Exemption method
2.2 Credit method
3. Mutual agreement procedure as means to solve treaty application issues

As regards 1.1, the discussion considered the obligation of proving that a taxpayer (payee) is a resident of a treaty partner in order to qualify for reduced withholding. It was noted that the payee usually bears the burden of this obligation. Although practices vary, it was felt that the level of burden should be on the balance of probabilities. It was noted that one form of discharging this obligation is through production of a certificate of residence authorized by the treaty partner. The discussion considered acceptance of a certificate of residence by source states as a best practice and noted the desirability of a fixed minimum period of validity for such a certificate. It was further noted that in requiring treaty partner residents to produce such a certificate source states incorporate an aspect of treaty partners' law into their own. The position of the party obliged to withhold (payer) was also considered. It was recognized that payers are often required to act in an administrative capacity in determining the payee's right to reduced withholding under a treaty. It was felt that this role should be accounted for in prescribing the manner of determination, e.g. satisfaction by identifying the address of the payee only, and any penalties imposed for inappropriate withholding.

The discussion considered special problems of proof faced by transparent entities with many members. In particular, the cost of proving eligibility for treaty relief for each particular member may outweigh the benefits to be secured under the treaty. A number of treaty practices were identified which seek to address this type of practical problem. For example, the discussion identified Swiss and Japanese treaty practice whereby transparent partnerships and investment funds may be recognized as residents of a treaty partner for purposes of reduced withholding. It was noted that such an approach might promote simplicity but might also produce some arbitrariness.

As regards 1.2, there was some discussion suggesting a preference for reduced withholding on payment (noted as consistence with self-assessment) rather than full withholding with provision for refund of excess over the treaty rate at a later date. Where a refund procedure is used, it was suggested that a maximum handling time limit for its tax administration should be specified by the source state. The time limit should reflect the tax administration's need for a reasonable time to assess a claim. The importance of certainty for the taxpayer with respect to the extent of this time limit was stressed, particularly in light of exposure to exchange gains and losses. With reference to experience in handling customs duties, it was noted that taxpayer certainty might also be promoted through the use of model forms for claiming refunds. Further, the payment of interest by source states was viewed as appropriate where there is unreasonable delay in refunding excess withholding. Assistance by residence states' tax administrations in processing refunds by source states within reasonable time limits was identified as a desirable practice.

As regards 1.3, the Discussion Leader questioned whether refusal to grant reduced withholding on payment (i.e. require application for a refund) may be interpreted as contrary to treaty law. In this regard, a lack of clarity in the reference to the mutual agreement procedure in Article 10 of the OECD Model was noted. The non-discrimination article in tax treaties or, in a European Union context, the European Communities Treaty might also impose restrictions. Doubt was expressed as to the applicability of the former to any discrimination evident against treaty partner residents through requiring them to apply for refunds of excessive withholding. It is widely accepted that non-discrimination articles following the OECD Model permit many types of discrimination between residents and non-residents. It was noted that any such discrimination might be reduced through the payment of interest by source states on funds improperly withheld. Other potential restrictions may be imposed by the most-favoured nation and national treatment principles espoused in the GATT (and GATS), particularly where claims for reduced withholding are treated by a source state differently under different tax treaties.

As regards 2.1, the discussion focused on the evidentiary burden required in order to secure double tax relief in the form of an exemption. Residence states require proof, typically of taxpayers, that the income has a foreign source and, potentially, that it is subject to foreign tax. The right of taxpayers to claim an exemption with respect to a particular item of

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income may depend on proof that the payer resides in a particular state, e.g. because the income is thereby considered sourced in that state. In this case, the claimant (payee) may be in the difficult position of having to prove the residence of another (payer). The General Reporter raised a further issue where the relief from double taxation article in a tax treaty refers to the granting of an exemption by the residence state where income "may be taxed" by the source state. He questioned whether the residence state might validly require that the income be taxed by the source state before double tax relief is provided. It was noted that states primarily adopting the credit method of providing double tax relief may use the exemption method in an effort to reduce compliance costs associated with the credit method, e.g. with respect to income derived by residents from comparable tax states. An intervention from the floor identified this as a major benefit of the exemption method.

As regards 2.2, the discussion considered evidence required as to payment of foreign tax with respect to foreign income in order to secure double tax relief in the form of a credit. It was suggested as preferable that residence states provide some flexibility as to the form of proof, e.g. assessment, receipt or letter from the source state's tax administration. It was noted that difficulties arise with respect to time limits imposed on claiming double tax relief, particularly where evidence from the source state as to tax paid is not timely. Particular difficulties may be faced by minority members in widely held transparent entities where such members are required to prove that foreign tax has been paid by their entity. Further difficulties arise where the source and residence states identify the taxpayer differently. Difficulties may also arise for entities receiving large numbers of small foreign payments if they are required to prove foreign tax paid on each receipt separately. Other difficulties relate to the crediting of non-final assessments, e.g. instalments, and the treatment of tax refunds. Further, after recognizing the importance of the related policy issues, it was noted that there may be difficulties in the calculation and application of tax sparing credits. In all these matters it was accepted as desirable that tax administrations adopt a flexible approach and that there should be an assumption that source states act in good faith.

The discussion also considered problems that may arise as a result of timing differences. Timing differences may exist as to when source and residence states consider income as derived. Further differences may exist as to payment of tax with respect to a particular item of income, e.g. as a result of different years of income or base years for calculating tax liability. A number of methods for addressing these issues were identified. As to miss-match in timing the payment of tax, residence states may delay the imposition of their tax with respect to foreign income until foreign tax with respect thereto has been paid. Otherwise, a timely refund may be provided once foreign tax is paid. As to miss-match between years of income, residence states may provide some flexibility by permitting residents to align their year of income for worldwide tax purposes with the year of income of the source state. Difficulties in this regard may also be addressed by the carry-forward of excess credits. This approach may also address timing differences as to when income is derived.

As regards 3, the discussion considered use of the mutual agreement procedure to resolve treaty application issues. It was noted that use of this procedure might lead to general solutions to application problems in contrast to methods that only address particular taxpayers' circumstances. A number of issues relating to the practical application of the mutual agreement procedure were raised. Uncertainty as to taxpayers' access to this procedure was noted and clarification of the position suggested desirable. Even where the procedure is available, the outcome for taxpayers depends on the processes of two tax administrations. It was observed that the mutual agreement procedure does not involve arbitration or judicial process and its outcomes may be subject to negotiating between treaty partners. This procedure is time consuming and some states require taxpayers exhaust domestic avenues of dispute resolution prior to granting access to this procedure. An intervention from the floor suggested that this procedure be accelerated through the establishment of a committee of experts that provides non-binding opinions as to the application of particular treaties.

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