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Tax Legislative Process

Richard K. Gordon and Victor Thuronyi

> I do not have any doubt that when we proceed to shift the taxes around so that one set of taxpayers pays a lot more taxes and somebody else pays a lot less taxes, the people who benefit from it do not remember it very long. They tend to feel that it should have been that way all the time, and the people who are paying the additional taxes resent it very bitterly.
>
> —Sen. Russell Long.

I. Institutionalizing the Tax Reform Process

A. In General

An enormous amount has been written on the ideal structure of tax laws or on specific technical problems in their design. Far less attention has been paid, both in the academic literature and in technical assistance, to the *process* of designing and drafting tax legislation in developing and transition countries.[1]Oliver Oldman, Institutionalizing the Process of Tax Reform: A Comparative Analysis (1975) and the sources cited therein; Richard Goode, *Obstacles to Tax Reform in Developing Countries, in* Taxation in Developing Countries 121 (Richard Bird & Oliver Oldman eds., 4th ed. 1990). In most member countries of the Organization for Economic Cooperation and Development (OECD), the tax legislative process has developed into a complex ritual whereby different groups compete to pass through the legislature their vision of an appropriate tax policy. A major tax bill in a country like the United States involves the input of thousands of professional lobbyists, policy analysts, lawyers, accountants, economists, and even ordinary citizens. By contrast, the tax legislative process is much simpler in most developing and transition countries, and has not had the opportunity to become established in many of these countries. Far fewer people are involved. This has advantages and disadvantages. A smaller group of well-qualified people can often do a better job in shaping a relatively coherent law. On the other hand, the lack of institutionalized experience with tax legislation means that the process often does not move forward smoothly,

[1]With some notable exceptions. *See, e.g.,* Michael McIntyre & Oliver Oldman, Institutionalizing the Process of Tax Reform: A Comparative Analysis (1975) and the sources cited therein; Richard Goode, *Obstacles to Tax Reform in Developing Countries*, in Taxation in Developing Countries 121 (Richard Bird and Oliver Oldman eds., 4th ed. 1990).

does not involve adequate consultation,[2] and often does not involve people with the necessary expertise at relevant stages of the process. Bureaucrats responsible for tax policy and their foreign advisors often see tax policy issues as a series of fires that need to be put out rather than an ongoing long-term effort. The thesis of this chapter is that substantial improvements in tax legislation can result if those responsible for tax reform focus on process as much as on substance. The process by which tax legislation is developed can be of key importance in determining its quality, effectiveness, and acceptability.

This chapter offers recommendations for establishing a well-functioning tax legislative process. These recommendations are in the nature of an ideal, and they will not all be attainable in most countries. Those responsible will have to establish priorities and tailor the details of the process to the institutions of the particular country. We would like to make it clear, therefore, that the discussion below is not intended to propose a model to be rigidly applied in all circumstances. The personalities of specific individuals involved can also make an important difference, particularly when relatively few people are involved in tax policy formulation and drafting. Generalizations are therefore difficult to make, but some basic issues common to most countries can be identified.

Management of the tax legislative process involves both internal bureaucratic organization and procedure and domestic politics as well as—for many countries—relations with foreign technical assistance advisors. Given our personal experience and ongoing role as foreign advisors, we devote particular attention in this chapter to how foreign advisors might fit into the process.[3]

B. Identifying the Problems to be Addressed by Legislation and Establishing the Pace of Reform

Problems in existing legislation can arise from different sources: new tax policy choices, changes in the economy, improved techniques of tax avoidance, and earlier bad choices in policy, drafting, and administration. To ensure that the tax laws are able to respond to each of these problems, the finance ministry should undertake a continuous review of tax laws.[4] A single review committee, drawing on a single person from each area of substantive tax expertise, could coordinate the process.

Such a review committee should maintain close contacts with the relevant parliamentary committees. It should be chaired by a senior member of the ministry, perhaps a deputy minister. Once a problem area is identified as requiring more detailed review, a working group should be formed to develop a response.

[2]*See infra* sec. III.

[3]*See infra* sec. V.

[4]In most countries, the finance ministry is responsible for tax policy; this chapter is written on that assumption. Where another agency (most frequently, the agency responsible for tax administration) has this responsibility, the reference to the finance ministry should be changed to be to this agency. While there is no correct answer as to which agency should be responsible for tax policy, it is clear that problems arise where (1) this responsibility is not clearly assigned or (2) it is fragmented among different agencies. *See infra* sec. II.

Because tax laws tend to be numerous and complicated, it would be impossible to subject them to complete review at all times. It should be the duty of the review committee to work closely with the tax administration, which is likely to be a primary source for notification of problems, and with research staff. In addition, it is important for the review committee to pay close attention to the private sector. Private sector professional associations may be an excellent source of information regarding problems.

Foreign advisors can also serve an important function in identifying problems. To the extent of their expertise in comparative law, they are often able to note difficulties that have arisen with similar rules in other jurisdictions.

The establishment of a review process should include an effort to keep the tax laws as stable as possible by minimizing the frequency of change. Frequent changes in tax legislation upset the expectations of investors and make it difficult for taxpayers to understand and comply with the laws. A careful consideration of proposed reforms can minimize the extent of changes needed by way of technical corrections and by way of budgetary compensation for hastily enacted, overly generous provisions.

C. Research Support

For tax policy working groups to function adequately, they need effective research support. Three important research areas are (1) revenue estimating, (2) surveys of current practice, and (3) comparative law.

1. Estimating Revenue

Overall estimates of revenue must of course be made as part of the budget process, which is beyond the scope of this discussion. But revenue estimates of particular provisions (or proposed provisions) can also be critical in the tax policy process. Revenue estimates can be an important weapon in opposing special tax concessions. By showing the cost of the concession, the revenue estimate brings home the extent to which taxes on others must be raised in order to pay for the concession. Unfortunately, estimating revenues is an extraordinarily difficult task. The data required include macroeconomic projections, a detailed understanding of the effects of a tax rule, and data on what private sector firms will be affected, including size and number. In many developing and transition countries, these data may be difficult to come by, and the actual numbers obtained may not be very accurate. Nevertheless, it may be possible to come up with serviceable estimates. Sophisticated models for estimating revenues are now available for a number of jurisdictions, and private accountancy firms have designed tax calculator models for developing and transition countries.

2. Surveys of Current Practice

Experience with applying current law can suggest what tax reforms may be needed. One way of obtaining information about this experience is through surveys. They can be taken of those affected by a particular law, and can provide important information for those determining tax policy. Such surveys can be taken through interviews, written questionnaires, or sampling of tax returns. They can also involve reports from local or regional tax offices on their experience with administering the law. The ability of a research department to carry out surveys of current practice may be one of the most important of all research skills. Such survey capability not only allows those formulating tax policy to be aware of the issues and problems they are likely to confront, but also allows them to do so without relying too much on individual taxpayers in the private sector. Too much reliance on individual taxpayers for information can result in at the very least the appearance of impropriety or excessive influence by a few. To avoid this, surveys are typically anonymous.

3. Comparative Law

Much can be learned from studying the experience of other jurisdictions with their tax laws. Comparative studies can suggest positive directions for change, and can help avoid potential problems. Examining the laws of other jurisdictions can also help show how their rules might interact with proposed rules in one's own jurisdiction to affect transnational business and trade. Comparative legal analysis is one area in which foreign technical assistance advisors with the requisite experience can be of considerable value.

II. Interdisciplinary Nature of Taxation

As with many other areas of law, taxation must be approached in an interdisciplinary manner. Given the specialization of academic disciplines, this may create a problem in terms of who is involved in the process. It is unlikely that any one expert will be competent to advise on all aspects, and managers of the process should be aware of this. To design a package of tax reform proposals, a variety of areas of knowledge must typically be brought to bear. Economists should analyze the economic effects of different policy alternatives, as well as their revenue effects. Tax law experts should develop the detailed design of proposed rules, based on knowledge of the details of tax rules of different countries. Tax lawyers with drafting experience should work on the actual legislative language. Lawyers should also ensure the integration of proposed rules with the rest of the legal system (commercial law, constitution, etc.). Accountants should advise on the compatibility of proposed tax rules with accounting rules and practices. Experienced tax administrators should evaluate the administrative problems arising from proposed rules and suggest alternatives based on relevant experience (again, with comparative knowledge of practice of different countries where relevant).

Tax rules must seek to implement sound economic theory. They must, however, also be drafted in response to the realities of law, business practice, and bureaucracies, and the social and political settings in which these realities exist. This requires people from many disciplines to work together to craft rules that reflect the knowledge and experience of those disciplines. Local and foreign experts need to be able to work together as a team.

While it may not always be possible to mount such a full collaborative effort, steps can be taken to ensure that consultations among different experts are as extensive as possible. For example, a group consisting of at least one economist, one lawyer, and one public administrator could be identified and made jointly responsible for the final outcome of a legislative reform project. Careful follow-up at each stage should be required, from policy evaluation through drafting to implementation. And, wherever possible, careful consultations should be made with those people (from both public and private sectors where feasible) who are most familiar with the particular circumstances found in the jurisdiction.

The problem of lack of coordination in the tax policy process is not peculiar to developing countries. For example, in a comparison of the tax policy process in Canada, Australia, and New Zealand, Professor Brian Arnold argues that the three major components of tax policy formulation (policy development, technical analysis, and statutory drafting) should be performed by a single agency.[5] In Australia, problems arose because these functions were divided among three different units. The Tax Policy Division of the Treasury, consisting of about 30 individuals, mostly economists, is responsible for developing tax policy ideas. The Legislative Services Group of the Australian tax administration (about 60 professionals, mostly lawyers or accountants) is responsible for translating into legislation the tax policy proposals developed by the Treasury. The actual drafting is, however, done independently by about three full-time tax law drafters in the Office of Parliamentary Counsel. Arnold suggested that these three groups should be combined into one agency, similar to the practice in Canada, where the Tax Policy and Legislation Branch of the Department of Finance, with personnel consisting of economists, accountants, and lawyers, is responsible for all aspects of tax policy development including the embodiment of policy in legislative language.[6]

III. Communication and Collaboration in the Tax Reform Process

A. Reform Considered by Working Groups Composed of Ministry Macroeconomists, Tax Policy Experts, Lawyers, and Administrators

Different groups are usually involved in the design and implementation of tax policy. In many ministries of finance these are divided into bureaucratic groups by discipline, including macroeconomists, tax policy experts, lawyers, and administrators, each with their own perspective and expertise. If all are not consulted on an ongoing basis, and instead a law is developed in a sequential manner, serious problems may arise.

Such a sequential process can result in general policies that cannot be easily translated into detailed rules, detailed rules that cannot be easily drafted, and statutes that cannot be easily enforced. In a world full of legal and institutional constraints, when basic policy is adopted, legal and administrative problems must be taken into consideration. Provisions, when drafted, should reflect what the policymakers really wanted to accomplish. The drafting process requires additional policy choices to be made, and to be worked out with tax policy specialists. Finally, provisions must, when administered, reflect both the policy choices made and the provisions as

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[5] *See* Brian J. Arnold, *The Process of Tax Policy Formulation in Australia, Canada and New Zealand,* 7 Australian Tax Forum 379 (1990).

[6] *See id.* In the United States, tax policy formulation for the executive branch is the responsibility of the office of the Assistant Secretary for Tax Policy, which is staffed by lawyers, economists, and some accountants.

drafted. In other words, the administration must be able to implement the system as designed. Where a new law will result in substantial changes in administrative practice, it is particularly important to involve in the drafting process individuals with responsibility for administering the law. There must be a mutual understanding of precisely how the new rules will be applied. Otherwise, there is a real danger that those applying the new law will ignore it or misunderstand it.

On the one hand, there is a danger in studying a tax reform project to death. On the other hand, one can easily underestimate the complexity of the undertaking. In many countries, adequate staffing and expertise are simply not brought to bear in drafting legislation. Sometimes this is the result of bureaucratic infighting or individual sensibilities, and it is not always possible to remedy the human foibles that get in the way of a good coordinated effort. But where these can be overcome, the country stands to gain a great deal from an effective piece of legislation drafted by a coordinated team. This is not to say that a committee approach is the most appropriate at all stages. Sometimes it is better for a small group, or a single person, to take on a problem, produce draft statutory language, and bring it back for consideration by a larger group.

Technical assistance advisors from each field can play an important role in advising the working group. Such advisors who have experience in other countries with regard both to particular tax laws and to the process of developing tax legislation can provide at each step comparative information of great utility. Advisors with comparative experience in tax administration can also be of considerable assistance at all stages of the working group's consideration of tax reform.

B. Consultation with Other Government Experts

While macroeconomists, tax policy specialists, lawyers, and administrators should be directly involved in designing and implementing tax policy, other government experts should also be consulted. This may include individuals within the ministry of finance as well as from other ministries. For example, units concerned with company law, accounting standards, and regulation of the financial sector will often have contributions to make to the development of tax legislation and should be kept involved. In some instances, the importance of these topics will require that experts be full members of the ongoing working group. In other cases, only an ongoing process of consultation will be required.

C. Consideration of Related Tax Issues by Different Working Groups

Problems can arise when related rules are developed by different groups. Depending on the size of the bureaucracy, tax policy responsibility may be divided among several divisions. It is essential for those involved in designing different aspects of a single tax, or of related tax rules, to consult with each other. It is not uncommon, for example, for a division that develops an individual income tax law to fail to communicate with another division working on a corporate income tax law; or persons responsible for accounting rules under the value-added tax (VAT) may not consult with those responsible for accounting rules under the income tax.

Because the interrelations among various tax laws are important, most particularly among the different parts of a single tax such as the income tax, no one group should be working in isolation from another. In most cases, this will mean that the chairs of each working group should consult with each other on a regular basis and that papers should be circulated among working groups.

D. Consultations with Parliament

Often, those involved in tax policy and implementation in the executive branch do not coordinate effectively with the legislative branch. This can cause serious problems; parliament is unlikely to respond well if its views are not adequately taken into consideration during the preparation of the bill. The method and degree of coordination will differ from country to country, depending on the traditions of openness between the government and the legislature, the legislative process, and the constitution. Within local institutional constraints, the finance ministry should consult with appropriate members of parliament, including members of the parliamentary committees charged with consideration of tax legislation, and with parliamentary staff. It is often preferable for the chair of the ministry working group to consult directly with the committee chairs, and perhaps with a number of key committee members. It may be appropriate for one or more chairs, or other committee members or committee staff, to be members of the working group for a particular tax law reform.

Part of the process should be to educate all deputies, who will often know little about the tax system. The ministry should identify key deputies to be involved in the process of education, and ensure that they understand the issues and can communicate to their colleagues the choices to be made and their consequences. While such "education" may not equal "consultations," these efforts can result in a smoother legislative process once a bill is submitted for consideration.

During the consideration of the legislation, the working group, under the direction of the minister of finance, should provide guidance to parliament, and assist it in understanding all the issues involved and in making any required changes. The earlier consultation, if successful, should minimize the extent of the changes that have to be made at this stage.

E. Consultations with the Private Sector

Often tax policy analysts fail to consult adequately with business interests. Unless the government is aware of the activities and problems of business, it will not be able adequately to design effective laws or fix defective ones. Adequate consultations will usually mean communicating with the main accounting and law firms engaged in tax practice, and with a number of interested business persons, often through sectoral business associations. It is important to consult with these persons because (1) they are familiar with accounting and other problems involved in complying with the tax laws, (2) they can point out unfair or burdensome provisions, and (3) their support for legislation can be politically important.

Depending on the particular economy, the concerns and activities of transnational business and nonresident investors may be of great importance. Foreign tax advisors, particularly tax lawyers and tax accountants, can play an important role in assembling information from this part of the private sector. They often have practical experience in, and may have informal contacts with, transnational law firms, accountancies, and companies.

There are, however, dangers in involving members of the private sector too deeply in the formulation of tax legislation. Fundamentally, the interests of any one group in the private sector will often be opposed to the general public interest in raising revenue in an evenhanded manner. Their knowledge of the details of proposed legislation can also lead to provisions being defeated in the legislature, because of the political clout that they exercise. Accordingly, handling relations with them is a delicate matter.

Sometimes ministries deal with the problem by inviting selected tax practitioners to review drafts on a confidential basis. This practice raises problems of conflict of interest and favoritism (if some private practitioners learn about the government's proposals in advance while others hear only when they are announced). The better practice therefore is not to make representatives of the private sector privy to tax proposals until they are publicly announced. They can then comment on them on the same basis as any other citizen.

Where this is the governmental tradition, members of the private sector should still be surveyed to discover relevant facts. Sometimes formal surveys can be undertaken, while in other instances it may be possible to assemble a group of experienced lawyers or accountants who can give advice without being apprised of the details of the particular proposals. Members of the government may, however, be tempted to allow private sector representatives access to the formulation of the tax laws on the theory that this will be politically advantageous for them. If this occurs, the minister should not hesitate to support the public interest and to call for balance in the process. For example, it has been known for representatives of a business advisory council to sit down with those ministry of finance officials drafting a tax law and (with the approval of officials at the highest level) to require them to change any provision of the proposed law that they do not like. This should be absolutely forbidden. The private sector should be listened to, but should not be permitted to dictate the contents of proposed tax legislation, this being the responsibility of the government and the civil servants entrusted with representing the public interest.

Once tax proposals have been publicly announced, efforts should be made to organize seminars between tax officials and private sector representatives to discuss the provisions of the proposed law. If these are open to the public, then the problems of conflict of interest and favoritism alluded to above can largely be avoided.

F. Responsibility for Process of Tax Legislation

It should be the specific responsibility of the finance minister to ensure that the working groups are sufficiently inclusive. The minister should also be responsible for coordinating consultations with other government departments that are not a part of the working group, with representatives of those in the private sector who are likely to be affected by the law, and the relevant parliamentary committees.

IV. Drafting Process

Once the details of proposed legislation have been agreed upon in a working group paper, a draft piece of legislation must be prepared. The drafter, who should be a member of the working group, should ideally be a lawyer thoroughly familiar with the laws and practices of the country. Ideally, the drafter should also be a specialist in the drafting of tax legislation. In some countries, such a person does not exist in the relevant government agency, and a foreign tax advisor can be used to do the drafting. In such cases, it is important for the advisor to work with a local drafter.

Once a draft law has been prepared by the finance ministry, there is usually a requirement that the justice ministry review the law for its legal adequacy, conformity with the constitution, and drafting style. If this review is conducted at the end of the process, mistakes can be introduced into the law. The lawyers in the justice ministry are typically not familiar with the operation of the tax laws. They may raise objections that are not well considered, but people in the finance ministry may be inclined to go along with them in order to move the law through the process, or may not themselves fully grasp all the implications of changes that the justice ministry suggests. A better approach would be to involve the justice ministry at an earlier stage, perhaps by including a person in the working group or by circulating group papers to the justice ministry, so that it becomes more familiar with how the tax law works and so that enough time exists to consider its concerns.

In OECD countries with common law legal systems, tax legislation is drafted by lawyers who are specialists in legislative drafting, and often subspecialists in drafting tax legislation. Depending on the legislative tradition, these may be found in offices attached to the legislature itself or in the finance ministry or equivalent. In the United Kingdom[7] and Australia, the task lies with the Office of Parliamentary Counsel (in the U.S., the House Legislative Counsel and the Senate Legislative Counsel). In Canada, federal legislation is generally drafted by the Ministry of Justice, but tax legislation is drafted by the Tax Counsel Division of the Department of Finance.[8] In civil law countries, there is less of a tendency to regard legislative drafting as a specialty, with the result that laws tend to be drafted by personnel in the ministries rather than by specialized parliamentary counsel. Nevertheless, those responsible for drafting tax laws tend to be lawyers.

V. Special Considerations in Using Foreign Legal Advisors

Many developing and transition countries have used foreign legal advisors in drafting their tax legislation. Depending on considerations of language, the qualifications of local personnel, the qualifications of the foreign advisors, and the desires of the officials responsible for developing a draft, the contribution of foreign advisors can involve commenting on a draft written by local drafters, producing a draft in collaboration with local drafters, or producing the entire draft themselves for the review of local officials. Varying situations can lead to the need

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[7]In the United Kingdom there has been a recent move to involve tax lawyers from the private sector as consultants in the drafting process. *See* Jim Kelly & Robert Rice, *Lawyers Set to Breach Inner Sanctum,* Financial Times, March 29, 1995, at 8.

[8]*See* Arnold, *supra* note 5, at 385.

for foreign advisors on drafting. Some developing countries may have considerable experience in administering taxes and may have some well-qualified officials in government service, but cannot afford to retain sufficient numbers of staff with the requisite experience in tax law, most of whom tend to leave government for the private sector. In addition, it will often not be efficient for a small country to maintain a complete staff of tax legislative drafting experts, particularly if the country only infrequently makes major revisions in its tax legislation. Talented staff can often be better assigned to other functions. Countries in transition also face the problem of attrition to the newly emerging private sector; in addition, although many officials in ministries of finance are highly educated, their degrees and experience tend to be in areas outside tax law. This is due simply to the fact that a market-based tax system is relatively new for these countries; the education and experience required to draft tax legislation will take years to develop. Other countries have well-educated and experienced tax staffs, but these do not necessarily have the extensive experience in comparative tax law that is required to draft measures to deal with more sophisticated problems; these countries may consult foreign experts on more limited questions.

For the above reasons, many countries have found it useful to consult foreign legal advisors in drafting tax legislation. Such advisors may have a great deal to contribute, assuming that they have considerable experience and knowledge of the detailed operation of tax law in different countries. There have been many successful cases where drafts were chiefly authored by foreign advisors. However, there have also been many cases where drafts prepared by foreigners have not been successful. While it is not possible to guarantee that the process will always work perfectly, some factors can be identified as leading to potential problems, even assuming that the foreign legal advisor is highly competent in tax law and has a good sense of tax policy. Awareness of these potential problems can alert the responsible officials to forestall them, thereby enhancing the likelihood of success of the drafting project.

One problem is language. It is desirable to use foreign experts who have at least the ability to read in its original language the law being drafted. Translation is a cumbersome process, and problems of ambiguity or terminology are often obscured by translators, sometimes even by those of the highest quality and longest experience. Moreover, the cost of translation and the time involved are such that the amount of local material that the foreign advisor can read will be limited. It is ideal to draft the text directly in the original language. It takes about three times the amount of work to draft a law in two languages (e.g., original in English and translation in the language of the country). An intermediate possibility that works if the foreign advisor does not know the local language well enough to draft in that language, but well enough to be able to read it, is for the foreign advisor and a local counterpart to first discuss the concept (perhaps with the help of an interpreter), then for the local counterpart to draft a provision. The foreign advisor can then review the draft and point out and discuss any problems, until the two jointly come to an acceptable version. Where the foreign advisor cannot read the local language well enough, he or she will not be in a position to guarantee the integrity of the draft, and local officials will be on their own to some extent. If the foreign advisor prepares a draft, it is helpful, instead of having a translator translate the draft, for the local official who prepares the local-language draft to be able to read and discuss the draft with the advisor.

A second problem lies in the appropriate choice of paradigm. Most developing and transition countries will choose to base a tax law on the legislation of one or more other countries. The extent of the similarity to foreign law will vary from case to case. In some cases, a few concepts and stylistic and organizational matters are borrowed. In other cases, large chunks of statutory language may be lifted. This process of borrowing from the tax legislation of another country often makes a great deal of sense. Tax legislation is so complicated that it makes no sense to reinvent the wheel each time a new tax law is written. By borrowing from the concepts of tax legislation in another country, the experience in interpreting and applying those concepts, and perhaps also particular legislative language, can be taken advantage of. For example, if the same statutory language is used, then the regulations, court decisions,[9] and practice in the other country in applying that language can be drawn on in interpreting the same language in the borrowing country. Of course, this does not mean that the same language should always be borrowed verbatim. Often there will be rules that the borrowing country does not wish to adopt. By studying the entire complex of legislation in the source country, the borrowing country can decide which portions of the tax law to adopt. The technique of borrowing from a foreign jurisdiction can be seen in a broader context, in that such borrowing tends to go on in other areas of law as well. To the extent that such borrowing has occurred elsewhere in the legal system, it may make sense to do so for the tax law as well.

Where a country wishes to borrow from the laws of country *X*, it is desirable, even essential, to use a foreign legal advisor who is familiar with the tax law of *X*. A national of another country will often not be equipped to do the job. Thus, in drafting an income tax law, what may be needed is not simply an expert on income tax law, but specifically a person who is an expert on the income tax legislation of a particular country or legal system.

This leads to an additional quality that a foreign legal advisor should have. The advisor should not be a person who seeks to impose the law of the advisor's own country on that of another country, or who, regardless of intentions, is equipped only to do so. Rather, it is important that he or she have a knowledge of comparative tax law. This will be less important where the country clearly wants to base its tax legislation on that of the advisor's home country. Even in this case, the foreign expert should not be one who unthinkingly will seek to impose all aspects of the legislation of country *X* on the borrowing country, but rather one who is capable of adapting this legislation to the particular circumstances of the target country. But where the country would appropriately model its legislation on that of a different country, or use a composite system, it can be disastrous to use an advisor who can work only within his or her own system.

A third problem that can arise when foreign advisors are used is lack of expertise in drafting. Often, foreign advisors are experts in tax law, but do not actually have substantial experience or skills in drafting tax legislation. Drafting is a subspecialty that most practicing tax lawyers or academics do not normally cultivate, often because it is reserved for specialists in their home countries. An individual who might be a perfect match in all other respects—knowledge of comparative law, language skills, knowledge of tax policy—might not be such a

[9]For example, courts in Commonwealth countries frequently refer to the judgments of other Commonwealth courts in construing statutes where the statutory language is similar.

good drafter. In such a case, it will be important to team the advisor up with someone who has drafting experience. In any event, a drafter should not work in isolation, and a second person with experience in drafting should check over the work.

Fourth, unless she or he is stationed in the country for a substantial period, a foreign advisor will not know all the ins and outs of the country's legal system. Tax law is to a large extent a domain unto itself; therefore, much can be done without a detailed knowledge of the rest of the legal system. However, to produce a draft that is fully suited to the country's circumstances, it is necessary to consult local lawyers. The foreign advisor must take care to do so, lest a draft be produced that is legally inadequate or inappropriate. Ultimately, only local lawyers can give a legal opinion on the adequacy of the draft.

Fifth, the draft must be understandable both to local officials and to taxpayers and must respond fully to the tax policy goals that the lawmaker wishes to promote. The foreign advisor must take care to explain the draft fully so that it becomes the product of local officials as much as her or his own. Paradoxically, working in a different language can help here because the process of producing the draft in the local language forces the local officials writing the local-language draft to understand the draft thoroughly. The process of drafting in the local language involves more than literal translation and in fact consists in writing a new draft. The foreign advisor who does not take the time and effort to make sure that every aspect of the draft is understood and accepted (or has been adequately rendered in the country's language if drafting is done in a different language) is not doing the job properly. Part of this function of explanation is the preparation of an explanatory memorandum, which should accompany most drafts. This would appropriately explain both how the new law functions and how it differs from current law. Detailing the differences from current law and practice is a particularly important part of the process of making sure that the new law corresponds to local needs.

Finally, the use of an outside advisor raises issues of the respective role of the advisor and of local officials. Where the ministry of finance uses its own staff to prepare legislation, the organizational hierarchy of the ministry makes it clear who is responsible for what. By contrast, where an outside advisor is used, the role of the advisor needs to be clarified. The best results occur when the foreign advisor is kept involved in all steps of the process up to final enactment. The foreign advisor should not have the power to make changes in a draft prepared by local officials—decisions on changes are a matter for local officials—but should have an opportunity to raise and explain problems that he or she perceives. When this has not been done, substantial errors have almost invariably crept in to the legislation. It may be helpful for the government and the outside advisor to agree at the outset on the procedure to be followed by way of regular communication on drafting changes, so as to help ensure that this communication will take place.

2

Legal Framework for Taxation

Frans Vanistendael

Taxation without representation is tyranny.

—James Otis

Modern fiscal systems emerged in Western Europe and North America during the half century that followed the American and French Revolutions. Although modern income and turnover taxes did not yet exist, by the middle of the nineteenth century the basic legal framework for raising these taxes had been established and with it the foundation for the spectacular increase in tax revenue that would occur almost a century later during and after World War I.

In general, the basic legal framework calls for taxation according to the rule of law. The fundamentals of this framework are that (1) a tax can be levied only if a statute lawfully enacted so provides, (2) a tax must be applied impartially, and (3) revenue raised by a tax can be used only for lawful public purposes, not for the prince's private ends. The rule of law contemplates that these principles will be enforced by independent courts.

The role of the courts is often referred to in this chapter. In some developing and transition countries, however, the judicial system does not, for various reasons, effectively fulfill its role. This is a substantial impediment to the rule of law in tax matters. A discussion of the ramifications, although important, is beyond the scope of this chapter.

In addition to these very general principles, the power to make tax laws is subject to several types of legal limitations. Their sources include (1) constitutional or other basic legal principles underlying an organized society, (2) international agreements, (3) interpretation of the tax laws by the courts, (4) the general framework of civil law and public law, and (5) the political structure of the country as a centralized or a federal state.

Tax laws must be drafted in the context of this legal framework, as it applies in the particular country in question. This chapter reviews the principles underlying this

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Note: Victor Thuronyi contributed to the writing of this chapter.

framework in general terms and on a comparative basis. Of course, where a particular country is concerned, further study will be needed to determine specifically how these principles are applied in that country.

I. Legal Foundation; Power to Make Tax Laws

The first principle is that any tax must have a firm basis in law. Much of the history of Western political movements has been based on opposition to arbitrary taxation. Parliamentary government in Britain evolved largely to constrain the monarch's ability to raise revenue. During the seventeenth century, the House of Commons, the elected lower house, was recognized as having the exclusive right to initiate revenue laws.[1] The American Revolution began as a protest against Britain applying taxes to the American colonies without the consent of their elected legislatures. As democratic government spread, legislative branches became the seat of power of the purse.

In light of this history, in most countries there is a basic constitutional principle that any act of taxation must have a legal basis. This principle means that no tax can be levied except under authority of a law.[2] In many countries, this principle is written into the constitution.[3]Third Session of the Sixth National People's Congress on Authorizing the State Council to Formulate Interim Provisions or Regulations Concerning the Reform of the Economic Structure and the Open Policy (adopted Apr. 10, 1985), *reprinted in* Bureau of Legislative Affairs of the State Council of the P.R.C., 1 Laws and Regulations of the People's Republic of China Governing Foreign-Related Matters 391 (1991). In others, the principle is not directly stated in the constitution, but is derived from another constitutional rule, as in Switzerland, where the principle of the legality of taxation is derived from the principle of equality of taxation.[4] In Germany, the legal basis for

[1]The main events ending taxing prerogatives of the king were the Petition of Rights of 1628 and the acknowledgment of the Bill of Rights in 1689.

[2]A special case is the customs tariffs and the minimum rates of the value-added tax (VAT) in the European Union, which are not determined by the national legislators, but proposed by the European Commission and decided by the European Council of Ministers. Even in this case, a statute would be needed to implement the decision in domestic law.

[3]*See* Bundes-Verfassungsgesetz [Federal Constitution] art. 18 (AUT); Grondwet [Constitution] art. 170 (BEL); Const. art. 91(3)(CAN); Grundlov [Constitution] § 43 (DNK); Hallitusmuoto [Constitution] § 61 (FIN); Const. art. 34 (FRA); Const. art. 23 (ITA); Const. art. 99 (LUX); Const. art. 106(2) (PRT); Const. art. 133 (ESP). Although art. 58 of the Constitution of the People's Republic of China provides that legislative power is exercised by the National People's Congress and its Standing Committee, there is no constitutional provision that requires a specific legal basis for imposing taxes. The National People's Congress can also delegate legislative power to the State Council, which is the highest executive organ of state administration. Xianfa [Constitution] art. 85. As a result, there has been some confusion as to which institution in China has the power to propose and approve tax laws. In 1985, the National People's Congress authorized the State Council to make provisional laws and regulations with respect to foreign investment and economic reform. *See* Decision of the

[4]Const. art. 4 (CHE); *see* Jean-Marc Rivier, Introduction à la fiscalité de l'entreprise 27 (1990).

taxation rests on the combination of two other constitutional provisions: the provision guaranteeing personal freedom, which cannot be restricted except by law,[5] and the provision requiring a legal basis for any act of administration, including any administrative act of tax assessment and collection.[6]

Constitutions differ in the extent to which they allow the legislature to delegate tax law making authority. At one extreme, the principle of legality can mean that no delegation is permissible; at the other extreme, it can require only that taxes have a legal basis under the constitution, and if the constitution permits delegation of legislative power generally, then delegation is also permitted in matters of taxation. An intermediate position places limits on delegation, holding that for a tax to have a firm basis in law, its essential elements must be provided in an enabling law. Such elements would include, among others, definitions of taxpayer, taxable event or object of taxation, and tax base; tax rates; and basic rules for administration. This does not mean that all the details must be included in the law. As discussed below,[7] implementing regulations can be issued by the executive branch of government in accordance with the framework of administrative law. In some cases, the law may take the form of a decree by the executive branch, if permitted under the constitution.

Because a state must have revenue to survive, the constitution usually allocates, either explicitly or implicitly, some tax-levying authority to the central government, but the power to enact particular types of tax laws may be limited.[8] Such limitations can create serious problems for tax policy. For example, in the United States, the legislative powers of the Federal Government are limited to those specified in the Constitution. The Constitution provides specifically that the Congress has the "power to lay and collect taxes, duties, imposts and excises" through an act of Congress.[9] The procedure for enactment sets forth a special requirement for tax legislation: such legislation must originate in the House of Representatives.[10] Otherwise, the same procedure must be followed for tax laws as with any other laws. There is, however, a specific limitation on direct taxes, requiring these to be apportioned on the basis of population. This provision was held not to authorize enactment of an individual income tax.[11] When this was

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[5]Grundgesetz [GG] arts. 1, 2/1 (DEU).

[6]*Id.* art. 20/3.

[7]*See infra* sec. IV.

[8]*See, e.g.,* Const. art. 245, seventh schedule, List I, item 82 (IND) (parliament may establish taxes on income other than agricultural income); *id.* item 92A; *id.* List II, item 54 (parliament may tax the sale or purchase of goods where the sale or purchase takes place in the course of interstate trade or commerce, but other sales are subject to taxation only by the states); *id.* List II, item 53 (only the states may tax the consumption or sale of electricity). In 1976, Pakistan, which has a similar setup, amended its constitution to grant to the Federal Government power to tax "the sales and purchases of goods imported, exported, produced, manufactured, or consumed." *See* Const. art. 142, fourth sched., item 49 (PAK).

[9]Const. art. 1, § 8 (USA).

[10]*Id.* art. 1 § 7.

[11]*See* Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

corrected by constitutional amendment, the Supreme Court read the amendment relatively narrowly, taking to itself the decision as to whether a statute taxed "income" within the meaning of the amendment.[12]

Although there is no written constitution in the United Kingdom, British tax law also respects the principle of legality on the basis of the prescription of "no taxation without representation" that was introduced in the Magna Carta in 1215. This principle was reiterated in 1628 in the Petition of Rights, which states that "no man be compelled to make or yield one gift, loan, benevolence, tax or such like charge, without common consent by act of Parliament." This principle is one of the cornerstones of Western democracies, in that the consent to be given by the representatives of the taxpayers in parliament is considered to be a democratic guarantee against arbitrary taxation by the government.

From the principle of legality, some countries have derived the principle of annuality,[13] according to which a tax law can only have effect for one budgetary year. This does not mean that all tax laws have to be voted by parliament every year, but that parliament must annually consent to the government's levying taxes in accordance with existing statutes for the next budgetary year. In most countries, this principle is accepted as a principle of budgetary law, rather than of tax law, and its specific operation will depend on the constitutional provisions and other laws governing the process for adopting the annual budget.

The general principle of the legality of taxation has in some countries given rise to another principle that the tax administration may not conclude an agreement on tax liability with the taxpayer.[14] This is because when the statute says that tax is due, it must be strictly applied, and it is not within the power of the tax administration to agree to reduce the amount of tax. In some countries, the prohibition of such agreements is based on the idea of the tax law as being of public order.[15] This means that the tax law has a special status as a statute that is essential to an organized society, similar to that of criminal law, on which agreement between the police authorities and the criminal is not

[12]*See* Eisner v. Macomber, 252 U.S. 189 (1920).

[13]*See* Grondwet [Constitution] art. 174 (BEL); Const. art. 47 (FRA) and Ordonnance No. 59–2 of Jan. 2, 1959, Portant loi organique relative aux lois de finances, art. 4, Dalloz, Législation [D.L.] 175 (1959); Guy Gest & Gilbert Tixier, Droit fiscal 33–34 (4th ed. 1986); Const. art. 81 (ITA); Const. art. 134 (ESP). In the United States, the Constitution requires congressional consent for any spending of public money, U.S. Const. art. 1, § 9, but does not require annual consent for taxation. Accordingly, if Congress withheld its consent to public spending, the Government would have to stop spending, but the liability of citizens to pay taxes would remain unaffected.

[14]*See* Const. art. 42 *quater* (CHE), *translated in* XIX Constitutions of the Countries of the World (Albert P. Blaustein & Gisbert H. Flanz eds., 1982) ("The Confederation is entitled to enact regulations, by means of legislation, against arrangements with taxpayers granting unjustified tax advantages").

[15]This is the case in Belgium, although this principle has not been incorporated in the constitution. *See also* Gest & Tixier, *supra* note 13, at 41; DEU AO § 85.

possible either.[16] This principle also plays an important role in the interpretation of tax laws by the courts.

II. General Principles and Limitations on Power to Make Tax Laws

A. Principle of Equality

The principle of equal treatment under the law applies not only to taxation, but to all laws. It can be viewed as an application of the concept of legality, under which the law must be applied without exception to all those in the same circumstances.[17] It has two meanings, one essentially procedural and one substantive. The procedural meaning is that the law must be applied completely and impartially, regardless of the status of the person involved. This means that no one may receive either preferential or discriminatory treatment in the application of the law or may be denied procedural rights to challenge application of the law to him or her.

The substantive meaning of the principle of equal treatment starts from the position that persons in equal circumstances should be treated equally. Without clarification, this principle does not mean very much, because it admits that people who are not in the same circumstances can be treated differently. Therefore, the question becomes whether laws are prohibited from using certain criteria to discriminate among persons. While the list of prohibited criteria differs among various jurisdictions, they usually include ethnicity, religion, and gender. The exact application of this prohibition against discrimination in a particular country will depend on (1) whether the courts are competent to strike down legislation as unconstitutional and (2) what kind of discrimination is prohibited under the constitution.[18] The principle also requires that both the purpose of the unequal treatment and the means to effect it have a rational basis. For example, treating higher-income taxpayers differently by applying graduated rates satisfies both tests; it is rational both to conclude that a taxpayer's ability to pay increases with his or her income and to enact graduated rates as an implementing technique. While some approaches to tax legislation are clearly rational, many distinctions that tax laws draw are difficult to evaluate. Whether they are seen to violate the principle of equality depends on the level of scrutiny to which the rule is subjected.

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[16]As a consequence, the institution of plea bargaining (not contesting a charge of a lesser offense in order to avoid a charge under a major offense), which is well known in the United States, does not exist in these countries in respect of major offenses.

[17]In Switzerland, the principle of legality is considered an application of the principle of equality. *See supra* note 4.

[18]In most countries that have constitutional control by the courts, the constitutional court is competent to check whether a law violates any constitutional provision. This is the case in France, Germany, Italy, and the United States. In some countries, however, the constitutional court has limited control. This is the case in Belgium, where the Cour d'arbitrage can only check violations of the rule of equality and laws violating the constitutional distribution of power and the economic and monetary union of the country.

The principle of equality has been applied in different ways by the courts of different countries to limit the power of the legislator. In France, the principle of equality before the law has been held to prohibit the denial of procedural rights to some citizens but not to others.[19] The constitutional court has also struck down distinctions drawn by the legislator on the basis that they did not rationally carry out a purpose of the statute in the public interest.[20] In Germany, the Constitutional Court has interpreted the constitutional guarantee of equality as calling for equal taxation of similarly situated persons. It has found, for example, the de facto unequal taxation of interest income (due to the absence of withholding) to be constitutionally impermissible, thereby requiring the legislature to enact measures to lead to more comprehensive taxation.[21] In Slovenia, the Constitutional Court has found a provision of the income tax law in violation of article 14 of the Constitution, which provides, "[a]ll are equal before the law."[22] The provision in question included reimbursed expenses of independent contractors in the tax base, thereby treating this class of persons unequally compared with employees. In Belgium, the principle of equality was held to prohibit taxing companies providing professional services (lawyers, accountants, t__ consultants, physicians) at the maximum rate of the progressive rate scale of the corporate income tax, thereby excluding these companies from the lower brackets, while all other companies could benefit from these lower rates. It was held that the circumstance that a company was engaging in professional services was irrelevant as a criterion to determine the tax rate applicable under the corporate income tax.[23] It should be noted, however, that although the Belgian principle of equality is similar to the equal protection clause in section 1 of the Fourteenth Amendment to the U.S. Constitution, the U.S. Internal Revenue Code (IRC) contains a specific provision denying the application of the lower corporate income tax brackets to personal services companies.[24] In the United States, this distinction is not considered a violation of the

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[19]*See* Judgment of Dec. 27, 1973, Conseil constitutionnel [Con. const.], 1974 La Semaine juridique (Juris-Classeur Périodique) [J.C.P.] II, No. 17691. The decision concerned former article 180 of the General Tax Code, as amended by the 1973 Finance Act, which allowed taxpayers to contest the *taxation d'office*, under which income tax could be imposed on the basis of the taxpayer's expenditures, by proving that the expenditures were financed by resources other than taxable income. This opportunity for proof, however, was unavailable to taxpayers whose income exceeded a specified level. It was this denial——to one group of taxpayers only——of an opportunity to prove their case that the court found objectionable.

[20]*See* Judgment No. 95-369 of Dec. 28, 1995, Con. const., 1996 J.C.P. II, No. 67749. In this case, the court held that a reduction in the inheritance tax on an interest in a business, conditioned only on the heir retaining the property for five years, without being required to participate in the management of the company, discriminated in favor of one type of property without any rational legislative purpose.

[21]*See* Judgment of June 27, 1991, Bundesverfassungsgericht [BVerfG], 84 Entscheidungen des Bundesverfassungsgerichts [BVerfGE], No. 18, at 239 (DEU).

[22]*See* Decision of Dec. 1, 1994 of the Constitutional Court, Official Gazette of the Republic of Slovenia 143 (Jan. 13, 1995).

[23]*See* Judgment of Dec. 14, 1994, Arbitragehof [Court of Arbitration], Belgisch Staatsblad [B.S.] No. 89/94, at 32.119 (Dec. 28, 1994).

[24]*See* USA IRC § 11(b)(2).

equality principle. The U.S. courts have generally been reluctant to strike down tax laws on the basis that they fail to provide equal treatment to equals.[25]

B. Principle of Fair Play or Public Trust in Tax Administration

The principle of fair play or public trust means that the taxation authority must not be allowed an unfair advantage in its dealings with taxpayers. Application of this principle suggests that (1) the authority must notify a taxpayer of any action the authority may take relating to that taxpayer, (2) during litigation, a taxpayer must be afforded all the rights of process allowed the authority, and (3) the authority must be bound by its interpretation of the law as applied to a taxpayer's particular situation. In most countries, these rules of fair play are part of the general administrative law. However, exceptions to these rules can be made when fair play does not suffer as a result. For example, an authority may take action without notice if it reasonably suspects that the taxpayer would destroy evidence or flee the jurisdiction.

This principle is somewhat contrary to the principle of public order, according to which the tax statute must be strictly applied under all circumstances.[26] Thus, the principle of fair play would hold that a taxpayer can rely on the statements of the tax administration if the taxpayer has given to the tax administration a full and fair representation of all the facts. The taxpayer can invoke the interpretation of the law by the tax administration even when such interpretation is erroneous. On the other hand, the principle of public order would suggest that if the tax administration erroneously applies the tax law, it is entitled to correct this application, even if this were disadvantageous to a taxpayer acting in good faith. Since both principles are usually applied simultaneously, there are sometimes contradictory decisions in the courts. One way that courts strike a balance is by holding that a taxpayer is not entitled to the tax treatment following from the administration's erroneous interpretation, but that the taxpayer is not liable for penalties if he or she followed the administration's interpretation in good faith.[27]

The principle has in some cases been codified. In the United States, penalties are abated where the taxpayer relied on erroneous written advice furnished by an employee of the Internal Revenue Service.[28] In France, taxpayers can rely on a favorable

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[25]*See, e.g.,* Nordlinger v. Hahn, 505 U.S. 1 (1992); *see also* Apache Bend Apartments, Ltd. v. United States, 964 F.2d 1556, 1562–69 (5th Cir. 1992). In that case, the court upheld so-called rifle-shot transition rules, which singled out particular taxpayers (usually those with effective lobbying representation) for transitional relief from the application of the Tax Reform Act of 1986. The court refused to find that this type of ad hoc transition relief was so arbitrary as to violate the constitutional requirement of equal protection of the law.

[26]*See supra* sec. I.

[27]*See, e.g.,* the following U.S. cases: Druggists' Supply Corp. v. Commissioner, 8 T.C. 1343 (1947); H. Fort Flowers Foundation, Inc. v. Commissioner, 72 T.C. 399, 411 (1979).

[28]*See* USA IRC § 6404.

administrative interpretation of tax statutes and regulations in contesting an assessment of deficiency in tax, even if the interpretation is contrary to law.[29]

The principle of public trust in the tax administration has also been used as a basis for preliminary rulings that can be issued by the tax administration on the application of the tax laws.[30]

C. Principles of Proportionality and Ability to Pay

The principle that tax liability should be based on the taxpayer's ability to pay is accepted in most countries as one of the bases of a socially just tax system. The principle of ability to pay is, for example, opposed to head or poll taxes, against which the British revolted in 1990.[31] Although it is used as a general principle for legislators in the design of the tax system, it is not included in the constitution of most countries and therefore cannot be enforced before the courts to limit the taxing power of the government.

The ability-to-pay principle is, however, constitutionally binding in some countries. For example, under the Italian Constitution, "everyone shall contribute to public expenditure in proportion to his resources."[32] The Italian Constitutional Court has held that ability to pay represents a specific application of the general principle of equality.[33] The Court held, for example, that an income tax whereby the income of married people is taxed jointly violates the principle of equality and the ability to pay.[34] The Spanish Constitution contains almost the same wording as the Italian.[35] The German Constitutional Court held that the principle can be derived from article 3(1) of the Constitution, which states that all persons shall be equal before the law. It has concluded,

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[29]*See* FRA LPF § 80A.

[30]*See infra* sec. IV(E).

[31]*See* Peter Passell, *Furor Over British Poll Tax Imperils Thatcher Ideology,* N.Y. Times, Apr. 23, 1990, at D1.

[32]Const. art. 53, cl. 1 (ITA), *translated in* IX Constitutions of the Countries of the World (Albert P. Blaustein & Gisbert H. Flanz eds., 1987). Art. 53(2) of the Constitution of Romania provides that "[t]he legal taxation system must ensure a fair distribution of the tax burden." These provisions have probably been inspired by the French Déclaration des droits de l'homme et du citoyen of Aug. 26, 1789, which is an integral part of the present 1958 constitution of France, and art. 13 of which says: "*Pour l'entretien de la force publique, et pour les dépenses d'administration, une contribution commune est indispensable; elle doit être également répartie entre tous les citoyens, en raison de leurs facultés.*"

[33]*See* Judgment of July 6, 1972, Corte costituzionale [Corte cost.], 1972 Giurisprudenza Costituzionale [Giur. Cost.] I, No. 120, at 1289; Judgment of Apr. 19, 1972, Corte cost., 1972 Giur. Cost. I, No. 62, at 272; Judgment of Dec. 13, 1963, Corte cost., 1963 Giur. Cost. I, No. 155, at 1546.

[34]*See* Judgment of Mar. 26, 1980, Corte cost., 1980 Giur. Cost. I, No. 42, at 287.

[35]"All shall contribute to the sustenance of public expenditures according to their economic capacity through a just tax system based on the principles of equality and progressiveness, which in no case shall be of a confiscatory scope." Const. art. 31, § 1 (ESP), *translated in* XVIII Constitutions of the Countries of the World (Albert P. Blaustein & Gisbert H. Flanz eds., 1991).

for example, that a provision in the income tax that placed a limit on the deduction for required maintenance payments was unconstitutional because it failed to provide an adequate deduction and, therefore, failed to base the tax on the taxpayer's ability to pay.[36]

The principle of proportionality is increasingly used by Western European courts in general and by the European Court of Justice in particular. It means that there must be some proportional relationship between the goals to be attained and the means used by the legislator.[37]The United Kingdom, App. No. 8531/79, 23 Eur. Comm'n H.R. Dec. & Rep. 203, 211 (1981). In this case, discussed in the text at note 47, *infra,* the Commission found that the retroactive application of the statute was reasonably related to the aim of the legislator (prevention of further use of tax shelters). In the tax area, this means that taxes cannot be excessive. Even when this principle is applied to taxation, it has not prevented governments from imposing progressive taxes. In some cases, progressivity of tax rates is enshrined in the constitution.[38] The principle of proportionality is generally interpreted as imposing only a marginal limitation on the taxing power of governments in the sense that they cannot impose confiscatory taxes.

In Switzerland, protection against confiscatory or excessive taxes is provided by a combination of article 22 *ter* of the Constitution, which guarantees private property to the citizen, and article 31, which establishes the freedom of commerce and industry. As in Switzerland, the principle of proportionality has not been enshrined in the German Constitution. It is implicitly recognized, however, by the combination of (1) the protection of personal freedom, which cannot be restricted except by law, so that each citizen is entitled to a decent subsistence minimum,[39] (2) the freedom to work or to exercise a profession,[40] and (3) the protection of property and inheritance.[41]

D. Principle of Nonretroactivity

The principle that tax statutes may not be applied retroactively can be justified on the basis that taxpayers should be able to make economic decisions with knowledge of their tax consequences and that it is unfair to provide tax consequences for an investment or other economic decision that differs from the tax treatment at the time the decision was made. Applied strictly, however, this principle would preclude any change in law, because any change, even if effective only in the future, affects the value of existing wealth. The balance is often struck by defining impermissible retroactive provisions as

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[36]*See* Judgment of Feb. 22, 1984, BVerfG, 66 BVerfGE, No. 14, at 214.

[37]The European Commission on Human Rights has stated that tax legislation can be scrutinized under the European Convention on Human Rights on the basis of whether "a reasonable degree of proportionality existed between the means employed and the aim sought to be achieved." A., B., C. and D. v.

[38]Const. art. 53, cl. 2 (ITA); Const. art. 31, § 1 (ESP); Const. arts. 106, § 1 and 107, §§ 1, 3 (PRT).

[39]GG arts. 1/1, 2/1, 11 (DEU).

[40]*Id.* art. 12.

[41]*Id.* art. 14.

including only those with nominal retroactive effect, that is, those that affect a tax liability that has been fixed before the date on which the new law is passed. However, this is an arbitrary line, inasmuch as the economic effect of a tax change on existing investments does not closely correlate with the nominal retroactivity of the change.[42] The arbitrariness of any definition of nominal retroactivity suggests that even if legal protection is given against nominal retroactivity, the degree of protection can never fully correspond to economic reality. Because virtually every change in tax law has an effect on existing investments, the problem of retroactivity can be dealt with only as a policy matter and not by means of a formal legal rule.

In most countries, the principle of nonretroactivity is observed not as a legally binding principle (except for a few special cases, discussed below), but as a principle of tax policy that the legislature follows as it considers appropriate. For example, in the United States, some amendments of tax law (particularly those considered to be technical corrections) are made with retroactive effect;[43] by contrast, in other cases special relief is given against the application of tax changes to transactions in progress, even where the amendments are nominally prospective.[44]

In some countries, the principle of nonretroactivity is stated in the civil code.[45] In these countries, the tax law can provide for retroactive effect, when it specifically does so in exception to the civil code. However, if there are no specific provisions in the tax statute, the civil code's general principle of nonretroactivity will apply as the ordinary rule.[46]

The European Commission on Human Rights has dismissed a challenge to a retroactive tax law of the United Kingdom, holding that it did not violate the right of property under the European Convention on Human Rights.[47] In this case, section 31 of the Finance Act 1978 was applied retroactively to April 6, 1976, a date that preceded even the Government's announcement that it would legislate in this area. The provision in question denied a deduction for certain losses from tax shelters. The Government determined that retroactive application of this provision was necessary in order to deter

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[42]*See generally* Michael J. Graetz, *Retroactivity Revisited,* 98 Harv. L. Rev. 1820, 1822 (1985).

[43]*E.g.,* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1881, 100 Stat. 2085, 2914 (1986).

[44]*E.g., id.* §§ 204, 633, 1277, 1312-17.

[45]*E.g.,* Code civil art. 2 (BEL); Code civil art. 2 (FRA). *See* Claude Gambier and Jean-Yves Mercier, Les impôts en France §§ 2280–81 (1991) (explaining that, under the civil code, in the absence of an explicit statement in the law, provisions take effect for taxable events occurring after publication in the official gazette; in the case of income tax, this means that if publication occurs before Dec. 31, the current year will be affected, since the taxable event is considered not to occur until the close of the year).

[46]"The courts recognize that the legislator may deviate from the ordinary rule of non-retroactivity in light of an overriding interest of public order." Louis Trotabas & Jean Marie Cotteret, Droit fiscal 138 (1985) (ed. trans.).

[47]*See* A., B., C. and D. v. The United Kingdom, App. No. 8531/79, 23 Eur. Comm'n H.R. Dec. & Rep. 203, 211 (1981).

tax shelter promoters from devising new schemes. If anti-tax-shelter legislation were applied prospectively only, tax shelter promoters would be undeterred, because any scheme based on existing law would be valid for the period until new legislation were passed.

In countries where retroactive tax legislation is generally permitted, there are often some limitations for extreme cases. For example, the French Constitutional Court has stated that legislation may not be retroactively applied if it is penal in nature and that retroactively applied legislation generally may not affect individual cases that have already been decided by a court.[48] The U.S. Constitution also prohibits retroactive criminal legislation.[49] In the tax area, the U.S. Supreme Court has held that as long as the retroactive application of a statute "is rationally related to a legitimate legislative purpose," the retroactivity is permitted by the Constitution.[50]

In other countries, there are broader constitutional principles limiting the permissible scope of retroactive legislation. For example, in Germany there is no general constitutional or statutory rule on nonretroactive effect of tax laws. However, the German Constitutional Court has based the principle of nonretroactivity on the concept of the "Rule of Law,"[51] which includes the concepts of legal security[52] and public trust.[53] The German Constitutional Court distinguishes between retroactive tax laws[54] and retrospective tax laws.[55] A tax law is considered to have retroactive effect when it affects transactions that have been closed in the past, that is, before the law was approved and/or promulgated by the legislator. The law has a merely retrospective effect when it affects the future transactions or legal positions that have not yet been closed. The court requires a higher standard for retroactive laws, which with a few exceptions are prohibited in principle, while merely retrospective laws are permitted. The Constitutional Court held unconstitutional an amendment to the corporate income tax law passed in 1952 that was applied to the 1951 taxable year.[56] The prohibition against retroactivity under German jurisprudence is not absolute; retroactive legislation will be sustained where the

[48] *See* Judgment No. 86-223 of Dec. 29, 1986, Con. const., 1987 J.C.P. II, No. 20903; Judgment No. 95-369 of Dec. 28, 1995, Con. const., 1996 J.C.P. II, No. 67749 (court decisions may be overturned retroactively only for reasons based on the public interest).

[49] *See* Const. art. 1, § 9, cl. 3 (USA).

[50] United States v. Carlton, 129 L.Ed.2d 22, 31 (1994).

[51] *Rechtsstaatsprinzip.* Similarly, the Polish constitutional tribunal struck down income tax amendments that would have come into effect less than one month after the legislation was passed on the basis that taxpayers were given inadequate notice. *See* Janusz Fiszer, *Constitutional Battle over Poland's 1996 Personal Income Tax Rates*, 12 Tax Notes Int'l 246 (1996).

[52] *Rechtssicherheit.*

[53] *Vertrauensschutz. See* 1 Klaus Tipke, Die Steuerrechtsordnung 182-83 (1993).

[54] *Steuergesetze mit echter Rückwirkung.*

[55] *Steuergesetze mit unechter Rückwirkung, oder tatbestandlicher Rückanknüpfung.*

[56] *See* Judgment of Dec. 19, 1961, BVerfG, 13 BVerfGE, No. 26, at 261.

taxpayer's reliance on existing law was not reasonable, where the resulting damage for the taxpayer is almost nonexistent, where existing law was unclear or technically deficient, or in certain cases of overriding public necessity.[57]

Even where there is no legal prohibition on retroactive legislation, in most cases, the legislature decides to pass tax legislation on a largely prospective basis. In fact, in many cases, the political process provides taxpayers with generous protection from the effects of tax legislation for transactions in progress or investments that have been made. In some cases, however, legislatures act retroactively in order to protect tax revenue.

The following are examples: (1) The government announces that the excise tax on alcohol will be increased. The higher rate is often applied to stocks on hand (including floor stocks at the wholesale or retail level) on the date of announcement, as well as to production after that date. Otherwise, consumers would buy alcohol in large quantities to avoid the higher tax. (2) A mistake is discovered in a tax law that, if left uncorrected, could lead to a substantial revenue loss. The mistake is typically corrected with retroactive effect. Otherwise, taxpayers could take advantage of the time before the legislature passes the necessary legislation to reduce their tax liability, thus losing considerable revenue for the budget. (3) The government proposes in October 1995 changes in the individual income tax for 1996. However, the legislature does not pass the bill until May 1996. Nevertheless, the new rules can be applied for the 1996 taxable year. This is a case where the law may be considered nominally not retroactive, but merely retrospective because the law is passed before liability for 1996 is determined (i.e., December 31, 1996).[58]

Countries that allow retroactive tax legislation often apply a new tax law as of the date the bill was introduced in parliament. By setting an early date for the application of the tax law well before the final approval of the law by the parliament, the government prevents taxpayers from escaping the new tax provisions by rearranging their affairs during the period between the announcement of the new tax measures and the final vote in parliament. If the government announces the early date of application, the taxpayers will be warned about the new measures, so that they can take the tax consequences into account. Under such conditions, it can be accepted that the public trust of the taxpayer has not been violated.

In addition to the question of the retroactive effect of tax legislation, it is also important to consider legal restrictions on the retroactive application of delegated legislation.[59] Regulations and other normative acts interpreting tax legislation are

[57]*See* 1 Tipke, *supra* note 53, at 184, 195.

[58]*See id.* at 188.

[59]*See generally* John S. Nolan & Victor Thuronyi, *Retroactive Application of Changes in IRS or Treasury Department Position,* 61 Taxes 777 (1983). The German Constitutional Court applies its doctrine concerning retroactivity to regulations as well as to statutes. *See* Judgment of June 8, 1977, BVerfG, 45 BVerfGE, No. 6, at 142.

typically applied with an effective date the same as that of the law being interpreted.[60] Otherwise, there would be the strange situation that the same law would be interpreted with one meaning up to a certain date and with a different meaning after that date. However, where a regulation provides a new rule of which taxpayers could not have been aware, it is often applied with prospective effect. This decision is typically left up to the body authorized to issue the normative act. For example, under section 7805 of the U.S. Internal Revenue Code, the Secretary of the Treasury decides the extent to which regulations will have retroactive effect.

E. Other Constitutional Limitations

Depending on the provisions of a country's constitution, various other limitations on the power to make tax laws may apply. Besides requirements for equal treatment of taxpayers already mentioned above, there may be prohibitions against the taking of private property, requirements of regional equality, prohibitions against taxing certain items or discouraging certain activities, or prohibitions against taxing an item twice. As a general principle, the constitutional provisions that limit legislative power will apply to tax legislation as to any other legislation.[61]

For example, in Germany, the income tax provision subjecting the aggregate income of husband and wife to a progressive rate schedule in such a manner that a married couple could pay a higher tax than if they were taxed separately was held to violate article 6/1 of the constitution, relating to protection of marriage and family.[62] Moreover, articles 1/1 and 14 of the constitution are interpreted as allowing each citizen a decent subsistence income, so that the Government may not tax income below this minimum; as a consequence, the German Constitutional Court held that dependency exemptions under the income tax for 1983–85 were constitutionally insufficient.[63]

The constitutions of many countries contain provisions with respect to the freedom of speech and religion. In countries where the courts have the power to enforce constitutional provisions, these provisions are held to mean that the government may not hinder the exercise of these rights through taxation, for example, by imposing heavy taxes on churches.

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[60] *See* Gambier & Mercier, *supra* note 45, at § 2284.

[61] For example, in the United States, the power to levy taxes is subject to the general limitations on legislative power in the constitution, such as the due process clause of the Fifth Amendment. In practice, U.S. federal tax legislation is very rarely found to be unconstitutional. An important exception is the Pollock decision. *See* Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

[62] *See* Judgment of Jan. 17, 1957, BVerfG, 6 BVerfGE, No. 9, at 55; *see generally* 1 Tipke, *supra* note 53, at 380. Art. 6/1 of the Constitution of the Federal Republic of Germany provides: "Marriage and family shall enjoy the special protection of the state." VIII Constitutions of the Countries of the World (Albert P. Blaustein & Gisbert H. Flanz eds., 1994).

[63] *See* Judgment of May 29, 1990, BVerfG, 82 BVerfGE, No. 7, at 60, 85; Judgment of June 12, 1990, BVerfG, 82 BVerfGE, No. 12, at 198; 2 Tipke, *supra* note 53, at 697-98, n.431.

In Germany and Switzerland, special taxes are levied for the financing of church activities. In Germany, the combination of article 140 of the Constitution and article 137(6) of the Weimar Constitution of 1919 allows the church to impose taxes on the members of their congregations, within the limits imposed by state law. However, articles 2/I and 4/I of the Constitution prohibit the states from granting authority to churches over nonmembers of their congregations, so that nonmembers cannot be subjected to church taxes. Since only physical persons can be members of a congregation, imposition of church tax on legal entities is prohibited in Germany. There has been a trend in recent years for people to deregister as members of a church, in order to avoid paying the church tax.

In Switzerland, cantons are entitled to impose taxes to cover the expenses of the churches; unlike in Germany, it is not the church that imposes the tax. However, article 49/6 of the Constitution provides that no person can be obliged to pay taxes for a church to which he or she does not belong. This provision is based on the freedom of thought and religion. Consequently, persons not belonging to a church are entitled to refuse to pay the tax. However, unlike in Germany, legal entities are not protected by this clause and can be subjected to taxes levied for the benefit of a church.

In many other countries (such as the United States), a church tax would be unconstitutional, because it would violate the constitutional rule of separation of church and state.

There are great differences from one country to another in the extent to which courts use constitutional grounds to strike down tax legislation. As the examples cited above suggest, the German Constitutional Court has been particularly active in testing tax legislation against constitutional principles. Inevitably, this has involved the Court in difficult-to-resolve problems and has made it an almost permanent player on the tax policy agenda. Germany furnishes an ironic contrast to the United States, where the Supreme Court has been rather reluctant to become involved in tax policy issues at the federal level, despite its activism in many other areas of the law. The Court has, however, been quite active in the area of restrictions on state tax legislation that flow from the Constitution, given their importance for the federal state. Most other countries where courts have the power to strike down unconstitutional legislation have generally shied away from invoking open-ended principles, such as equality, in the tax area, but have sometimes relied on relatively more formal criteria, particularly those involving competence to legislate, to strike down tax laws.[64]

[64]The Constitutional Court of Guatemala read a provision of the income tax law as taxing an item of income twice and struck it down as violating a constitutional prohibition against double taxation. Cases No. 39-88 and 40-88, Corte de Constitucionalidad, *in* Leyes y Reglamentos de la Reforma Tributaria 83, 91-92 (Luis Emilio Barrios Pérez ed., 1989). *See also* Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

F. Charters of Taxpayer Rights

Some countries have provided charters or declarations of taxpayer rights. These have taken various forms. Sometimes, they have been issued by the tax authorities. Such documents are generally declarative of existing law, without independent legal force. In other cases, there is an article of the administration law entitled "Rights of the Taxpayer,"[65] or there may be a bill entitled "Taxpayer Bill of Rights," which enacts amendments to the rules of tax procedure.[66] In this event, the rules have the same legal force as other provisions of the administration law. The main effect of these charters is to prohibit arbitrary practices by the tax administration against taxpayers.

In 1984, the Charter of Rights and Freedoms was established in Canada, and the rights of the taxpayer are summarized in the Declaration of Taxpayer Rights.[67] The tax authorities must act in accordance with the provisions of the tax law. If the action is not authorized under the tax law, it is invalid. If the action is authorized by the law, a taxpayer can challenge its constitutionality. As a result, taxpayers have sought protection under the law of privacy[68] Section 231(3)(b) of the Income Tax Act, as it then was, authorized the Minister to require a lawyer to produce files relating to his client "within such reasonable time as may be stipulated" in a registered letter. In *In re* Joseph et al. and Minister of National Revenue, 20 D.L.R.4th 577 (1985), the Minister required the lawyer to produce the information "without delay." The court held that the Minister had no power to demand information to be produced without delay, which means immediately. *Id.* at 585. Parliament did not mean immediately when using "reasonable time." Tax authorities must give the lawyer some time to consider whether to produce the information because of the solicitor-client privilege protection. and the right against illegal search and seizure.[69]

[65]This is common in countries of the former Soviet Union. *E.g.,* KAZ TC art. 142.

[66]*E.g.,* Omnibus Taxpayer Bill of Rights Act, Title VI, Subtitle J, Pub. L. No. 100-647, 102 Stat. 3730 (1988) (USA) (codified as amended at 5 U.S.C. § 504 and scattered sections of 26 U.S.C.).

[67]Revenue Canada Taxation, Declaration of Taxpayer Rights (1984), *reprinted in* Vern Krishna, The Fundamentals of Canadian Income Tax 29 (4th ed. 1993).

[68]*See In re* James Richardson & Sons, Ltd. et al. and Minister of National Revenue, 9 D.L.R.4th 1 (1984), where the taxpayer sought protection under the law of privacy. Section 231(3) of the Canadian Income Tax Act, as it then was, gave the tax authorities the power to demand from any person any information "for any purposes related to the administration or enforcement" of the act. The tax authorities relied on this provision and required this company, which is a commodities futures market broker, to reveal the names and addresses of its customers for purposes of doing a feasibility study before introducing a new regulation on information reporting. The tax authorities guaranteed confidentiality of the data during the study. Neither the company nor any of its customers were under investigation at the time. The company refused to turn over the information and challenged the power of the tax authorities at court. The Supreme Court of Canada held that "a requirement of information under § 231(3) could only be made where the Minister was conducting a genuine and serious inquiry into the tax liability of specific persons." *Id.* at 1 (quoting case summary).

[69]When a tax official is conducting an inspection or audit in a taxpayer's residence or business premise, the official must obtain consent from the taxpayer except where a search warrant is issued by a judge. In considering whether to issue a search warrant, the judge must be convinced that there is evidence of

In Belgium, a taxpayer's charter[70] was voted in 1986, after the power of criminal investigation in tax fraud cases was transferred from the tax administration to the public prosecutor. The main effect of the taxpayer's charter was to prohibit tax officials from cooperating with the public prosecutor's office in criminal investigations, thereby also discovering unreported taxable income. In addition, the reporting of instances of tax fraud by the tax administration to the prosecutor's office became subject to a clearance by a high ranking official of the central tax administration.

In France, the tax administration established a taxpayer's charter (*charte du contribuable*) by way of administrative practice.[71] In this document, the taxpayer's rights in case of an audit were stated. In 1987, the tax laws were amended to require the tax administration to provide the taxpayer with a copy of the charter before conducting an audit and conferring legal force on the provisions of the charter.[72] If the tax administration fails to communicate the taxpayer's rights contained in the taxpayer's charter, the audit is invalid.[73]

G. International Agreements

The authority of the state to legislate in tax matters may be limited by international treaties and agreements. These include (1) bilateral tax conventions, (2) multilateral treaties establishing free trade areas, (3) agreements related to the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO); and (4) the Articles of Agreement of the IMF.[74] Depending on their scope, bilateral tax conventions may include specific limitations on the state's power to levy income taxes, payroll taxes, and estate and gift taxes on nonresidents. Treaties establishing free trade areas like the European Union or the North American Free Trade Area (NAFTA) restrict

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violation of the tax law committed by the taxpayer. The search warrant must also describe the premises to be searched. Otherwise, the search is illegal, and the documents seized will be illegal evidence, which cannot be used in a court of law.

[70]Law of Aug. 4, 1986, B.S. 11.408 (Aug. 20, 1986).

[71]*Note sur la charte du contribuable vérifié* (June 19, 1975).

[72]*See* FRA LPF art. L. 10.

[73]*See* Thierry Lambert, Contrôle fiscal: Droit et pratique ¶¶ 523, 524 (1991).

[74]Subject to certain exceptions, Sections 2(*a*) and 3 of Article VIII of the IMF's Articles of Agreement prohibit IMF members from imposing restrictions on payments and transfers for current international transactions, or from engaging in multiple currency practices or discriminatory currency arrangements. These provisions prohibit the authorities of member countries from imposing some types of tax measures through their exchange systems. For example, the imposition by a member country of a tax on the purchase or sale of foreign exchange will give rise to a multiple currency practice (Article VIII, Section 3) if the tax exceeds 2 percent of the amount purchased or sold. Moreover, a restriction on payments and transfers for current international transactions (Article VIII, Section 2(*a*)) will arise if the authorities of a member country, before permitting a nonresident to transfer abroad the proceeds of current international transactions (e.g., profits and dividends), require the nonresident to pay outstanding taxes that are not related to the amount to be transferred. *See generally* International Monetary Fund, Selected Decisions and Selected Documents of the International Monetary Fund 354, 366-68 (20th issue 1995).

the ability to levy tariffs, frequently provide rules for indirect taxation, and may also provide income taxation rules. While typically not as important, other bilateral and multilateral treaties may also be relevant to some aspects of taxation. For example, treaties of friendship, commerce, and navigation usually have antidiscrimination clauses, which may restrict the state's income tax treatment of nonresidents.

A special application of the nondiscrimination principle has been made in several cases before the European Court of Justice. The Treaty of European Union prohibits discrimination on the basis of nationality in the areas of free movement of workers and the freedom to provide services,[75] the freedom of business establishment,[76] and the free movement of capital.[77] The European Court of Justice has held that even when the tax law makes distinctions that are generally considered to be relevant to such law, such as the distinction between resident and nonresident taxpayers, these distinctions violate the nondiscrimination principle if their application restricts basic freedoms.[78]

In Case C–175/88, Biehl v. Administration des contributions du grande-duché de Luxembourg, 1990 E.C.R. 177, the Court of Justice held that a Luxembourg tax law violated the nondiscrimination rule because taxpayers who during the tax year moved abroad were denied the right to claim a refund on the excess withholding tax on wages when their annual tax liability on Luxembourg-source income, because of the move, fell below the amount of taxes on salary that had been withheld during their stay in Luxembourg. The court was of the opinion that this disadvantage would hit nonresidents much more often than residents and, therefore, constituted a violation of art. 48 of the treaty.

In Case C–279/93, Finanzamt Köln-Alstadt v. Schumacker, 1995 E.C.R. 225, the Court of Justice held that tax law may make a distinction between resident and nonresident taxpayers. However, for example, if both categories are basically under the same circumstances, when a nonresident earns 90 percent of his income in another member state, then resident and nonresident taxpayers should be treated identically. In particular, a nonresident taxpayer should benefit from the same refunds on progressive income taxes as a resident taxpayer.

The same principle of nondiscrimination has been held to apply to international movements of goods, so that goods originating in a foreign country may not be subject to

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[75]*See* Treaty Establishing the European Economic Community [EEC Treaty] arts. 48, 58.

[76]*See id.* art. 52.

[77]*See id.* arts. 73b–73g.

[78]In Case 270/83, Commission v. France, 1986 E.C.R. 285, the Court of Justice of the European Communities held that France discriminated against French branches of nonresident EU companies because it denied a tax credit on French-source dividends paid to such branch offices. The argument of the French Government, that it was justified in making an internationally accepted distinction between resident and nonresident taxpayers, was dismissed by the court.

higher taxation than that applied to domestic goods.[79] Here, the European Court of Justice has held that even though the criteria used for distinctions in the tax law were not discriminatory in themselves, because they did not specifically refer to the foreign origin of goods, any criterion resulting in de facto restrictions on the entry of foreign goods violates the nondiscrimination principle.[80] In Case 171/78, Commission v. Denmark, 1980 E.C.R. 447, the Court of Justice held that a lower excise tax on aquavit (the Danish national drink) than on whisky and gin constituted a violation of the nondiscrimination principle, when in fact the largest part of aquavit was manufactured domestically, while whisky and gin were mainly imported. The fact that the tax rule did not make a specific distinction between imported goods and domestically manufactured goods was considered to be irrelevant.

Such a position on nondiscrimination clearly restricts a country's power to make tax laws and should be kept in mind by those countries planning to enter any kind of customs union or common market organization.

The European Convention on Human Rights is an example of another international agreement that limits legislative power, including taxing power. Article 1 of the first protocol to the Convention protects the right to property, but explicitly allows states a considerable measure of discretion with respect to taxation. As a consequence, the European Commission on Human Rights has been reluctant to strike down tax legislation as violative of the Convention; this has occurred only in a case where a tax infringed on the right to religious freedom.[81]

The Convention also provides for procedural rules with respect to the burden of proof and the right of defense in court cases. These provisions have thus far received only limited application in tax cases, chiefly where the case was in the nature of a criminal proceeding. But the European Court on Human Rights has recently ruled that they were applicable to administrative tax penalties, which were to be, from that point of view, assimilated to criminal penalties.[82] Several Western European countries are debating whether to extend all the legal guarantees for the defense in a criminal case to cases of administrative litigation.

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[79]*See* The General Agreement on Tariffs and Trade art. 3, ¶ 2 (1986); EEC Treaty art. 95; Const. art. 1, § 10 (USA).

[80]In Case 433/85, Feldain v. Directeur des services fiscaux du département du Haut-Rhin, 1987 E.C.R. 3521, a French law imposing a progressive motor vehicle tax, depending on the horsepower of the car, was held to violate the non-discrimination principle, because the progressivity of the rate scale, although couched in general terms, was structured in such a way that only foreign cars were subject to the highest tax brackets of the rate scale, resulting in a considerable tax advantage for French domestic luxury cars.

[81]*See* Guy Gest, *La Convention et l'action des autorités fiscales,* 17 Droit et pratique du commerce international 546, 551 (1991).

[82]Case 3/1993/398/476, Benjenoun v. France of Feb. 24, 1994, série A, No. 284. *See* Guy Gest et al., *Convention europeénne des droits de l'homme et fiscalité— Bilan et perspectives*, Les petites affiches, No. 80 (1994).

III. Interpretation of Tax Laws

A. General Considerations

Like other laws, tax laws are general legal prescriptions. However, a legal rule cannot typically foresee all conditions of its implementation, so that ongoing interpretation (and frequently revision) of tax law is essential to its application. Occasionally, constitutions may provide for interpretation by the legislature itself.[83]

Under art. 67 of the Constitution of the People's Republic of China, the Standing Committee of the National People's Congress has the power to interpret the constitution and other national statutes. This means that authoritative interpretation of laws, including tax laws, is in the first place the work of the legislator. However, the Chinese tax legislator has not made frequent use of this power. Article 89(18) of the constitution allows a delegation of this power to lower agencies. In this way, the constitutional provision is used to grant regulatory power to the Ministry of Finance and to the State Administration of Taxation to issue interpretive regulations of the tax laws, as is the practice in many countries of the Organization for Economic Cooperation and Development (OECD). The legislature may achieve a similar effect by amending an existing law, with or without retroactive effect. Such action by the legislature is common when the legislature wants to reverse the effect of the interpretation of a statute by a court.

Because in most countries implementation of tax laws belongs to the executive branch, the interpretation of tax law falls first to the executive branch, which issues regulations, decrees, circulars, and general rulings ("executive rules"). It also will apply law and interpretation to individual cases through individual rulings and decisions. However, executive rules must be in accord with constitutional and statutory law. Review of these rules is undertaken by independent courts. In addition to reviewing executive rules, courts interpret the tax law and apply it in specific disputes between the taxpayer and the tax administration. This means that the final interpretation of tax laws belongs to the judiciary.

The style in which courts interpret tax law will depend to a large extent on the way in which they interpret statutes in general. Statutory interpretation is a complex topic a full discussion of which is beyond the scope of this book. The style of statutory interpretation differs substantially from jurisdiction to jurisdiction.[84] For example, courts differ on whether they even admit that an issue of interpretation exists or that there is

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[83] *E.g.,* Const. art. 205(1) (HND); Decreto No. 115 of Nov. 4, 1966, Gaceta No. 19,011 (HND); HND IR art. 24; Const. art. 58(3) (KGZ). In Belgium, parliament historically had the power to make interpretive laws. *See* Law of Aug. 4, 1832 on the Organization of the Supreme Court (Cour de cassation), arts. 23–24, 1832 Pasinomie 469 (abolished by the law of July 7, 1865)(BEL).

[84] *See* Interpreting Statutes: A Comparative Study (D. Neil MacCormick & Robert S. Summers eds., 1991).

more than one possible way to read the statute.[85] They also differ on methods for ascertaining the intent of the legislature in enacting the statute, such as in their use of *travaux préparatoires* (legislative history). A general distinction can be made between common law countries and civil law countries. Courts in common law countries tend to pay close attention to the facts and exercise more freedom in their legal reasoning. Courts in civil law countries tend to take greater interest in the exact wording of the applicable rule and are generally more strict in their legal reasoning. While the style of interpreting tax statutes is influenced by the general approach to statutory interpretation, tax law presents some special considerations.

Everywhere in the world, even in common law countries, tax law has largely become a phenomenon of statutes and regulations. Oddly enough, the most detailed and elaborate statutory provisions are to be found in common law countries, such as Australia, Canada, and the United States. As a consequence, the application of the statutory rule is the basis for interpretation in common law as well as in civil law countries.

In all Western legal systems, the courts apply a specific method of legal reasoning, based on a systematization of facts and legal rules, in order to arrive at the concrete application of the tax law in the individual case. This type of legal reasoning is not peculiar to tax law, but common to all forms of statutory interpretation. Its objective is to answer the specific question whether a tax is due from a specific taxpayer, by applying one or more rules to the facts that are thought to be relevant. The facts are often not raw physical facts but legally constructed facts, such as a company, a sales contract, or an inheritance. Legal reasoning selects and orders these facts, so that they become susceptible to the application of tax rules. The legal rules to be applied are also to be selected from a variety of norms. Again, legal reasoning selects and orders these norms, so as to arrive at a concrete application of the tax law. The objective of this process is to arrive at a clear result (i.e. a tax is due or not due). The objective is not to achieve reconciliation of the taxpayer with the position of the tax administration.

Two competing principles are of overriding importance in the interpretation of tax law. The principle of legality (under which no tax can be imposed except on the basis of law) can be interpreted as providing that a court should not extend the words of a taxing statute to impose a tax in circumstances where the language of the law does not clearly impose it.[86] This is the basic argument in favor of a literal interpretation of tax laws.[87] However, if tax laws are interpreted rather literally, taxpayers can often arrange their affairs so as to avoid taxation. The countervailing principle therefore is that in enacting a tax law the legislature intends that it be effective, that is, that it not be circumventable through artificial maneuvers. Moreover, the principle of equality would call for

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[85]*See id.*

[86]*See* Gould v. Gould, 245 U.S. 151 (1917).

[87]*See, e.g.,* MacCormick & Summers, *supra* note 84, at 201, 346.

interpreting the statute so as to tax equally taxpayers in the same economic circumstances. The tension between these two approaches to interpreting tax laws has been resolved in different ways by courts in different countries; the review of country practice below focuses on this issue. In addition, the variety of tax cases has raised many issues of statutory interpretation that arise with tax laws as with other statutes and that cannot easily be summarized in such a brief discussion.

The basic questions with respect to the interpretation of tax laws considered below are therefore (1) whether tax laws should be interpreted strictly or in a wider sense by the teleological or analogical method, (2) whether the legal form of a transaction should take precedence over the substance of the transaction, and (3) whether tax laws should be subject to a kind of "economic" interpretation, which would not be applicable in other areas of law. These are partially overlapping questions and are answered differently by the case law of various countries.[88]

B. France

As a general rule, in the French tradition, tax laws are interpreted strictly. This is a consequence of the legality principle laid down in article 34 of the Constitution. A clear text cannot be interpreted beyond the literal meaning intended by the legislator.[89] Yet, the Cour de cassation and the Conseil d'Etat, the two highest courts to deal with tax cases, do not entirely share the same position on strict interpretation. The Conseil d'Etat, which deals with the majority of the more modern taxes (personal and corporate income tax and VAT), tends to have a more flexible attitude toward the interpretation of tax laws.[90] However, even under the traditional rule of strict interpretation of tax laws, the French courts have always recognized the authority of the tax administration to submit evidence about the real nature of the transaction, so that it should be requalified for tax purposes.[91] At about the same time, French courts developed the theory of abuse of law in civil law.[92] In general terms, this means that a person does not have the right to exercise the person's rights (e.g., property rights) in an abusive manner so as to injure others. This

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[88]For Canada, *see* Brian J. Arnold, *Canadian Federal Court of Appeal Rejects Purposive Statutory Interpretation,* 12 Tax Notes Int'l 382 (1996).

[89]"Tax laws should be interpreted strictly, and any doubt about the meaning of these laws should be resolved in favor of the taxpayer." 1 Demante, Principes de l'enregistrement No. 9 (1897) (ed. trans.).

[90]*See* Judgment of July 8, 1992, Conseil d'Etat, 1992 Recueil des décisions [arrêts] du Conseil d'Etat [Lebon], No. 88734, at 284; *see also* older cases cited in Jean-Jacques Bienvenu, Droit fiscal Nos. 52-54 (1987).

[91]This is the theory of "simulation," or sham. *See* Judgment of Feb. 15, 1854, Cour de cassation (civile), 1854 Recueil Dalloz périodique et critique [D.P.] I 51; Judgment of Dec. 11, 1860, Cour de cassation (civile), 1861 D.P. I 25; Judgment of Aug. 20, 1867, Cour de cassation (civile), 1867 D.P. I 337.

[92]*See* Judgment of May 2, 1855, Colmar, 56 D.P. II 9; Judgment of Dec. 2, 1871, Paris, 1873 D.P. II 185; Judgment of Nov. 22, 1889, Órleans, 91 D.P. II 120.

revolutionary theory would much later play an important role in tax cases in other countries.[93]

C. Belgium

Belgium has a long tradition of strict and literal intepretation of tax laws. This is based on the principle of legality enshrined in the constitution: no tax is due unless imposed by a law, and the burden of proof for establishing that a tax is due lies with the tax administration. The quintessence of the Belgian jurisprudence on taxation has been laid down in a decision of the Cour de cassation[94] in which the court stated that a taxpayer is allowed to choose the "lesser taxed way,"[95] and that for the application of the tax laws a legal construction engaged in by a taxpayer will stand, even if the form of the construction is unusual, provided the taxpayer subscribes to all legal consequences of the taxpayer's construction. The holding of the court was based on the view that the legal system as a whole is consistent and that if the taxpayer took all the legal consequences of the taxpayer's acts, the tax administration also had to recognize the tax consequences. The court held specifically that in tax law, there was no room for a priciple of "economic reality."[96] Generally, it also has been held that there is no room for the application of abuse of law or *fraus legis* in the area of taxation. This jurisprudence stands for a high degree of legal security for the taxpayer. However, as tax planning became more aggressive, political pressure built up to introduce statutory antiavoidance rules and, in 1993, a general antiavoidance provision was enacted in the Income Tax Code.[97]

Yet the Belgian courts, like the French courts, applied the doctrine of "simulation" to some more traditional areas of taxation, such as gift and inheritance taxes. There is simulation when the legal act or instrument that is invoked by the parties against the tax administration does not correspond to the underlying legal relationship for which the parties have aimed. For example, a gift subject to substantial consideration to the benefit of the donor or a third party may be requalified as a sale.[98] A transfer of immovable property to a newly established company in exchange for shares, immediately followed

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[93]*See* discussion under *Abus de droit* in Encyclopédie juridique, 1 Répertoire de droit civil 28 (Dalloz 1951); *see also infra* sec. III(E) for the discussion of interpretation of tax law in the Netherlands.

[94]Judgment of June 26, 1961, Cour de cassation, 1961 Pasicrisie Belge [Pas. Bel.] I, 1082.

[95]*La voie la moins imposée; De minst belaste weg.*

[96]*See* Judgment of Feb. 27, 1987, Cour de cassation, 1987 Pas. Bel. I, No. 387, at 777.

[97]*See* BEL CIR art. 344 (permitting the tax administration to set aside any legal qualification of an act or a transaction by a taxpayer, when the purpose of such act or transaction was tax avoidance, unless the taxpayer can show a legitimate business purpose).

[98]*See* Judgment of Dec. 6, 1883, Leuven, Recueil général de l'enregistrement et du notariat [Rec. Gén. Enr. Not.] 10.272; Judgment of Jan. 4, 1900, Brussels, Rec. Gén. Enr. Not. 13.221; Judgment of March 3, 1912, Brussels, Rec. Gén. Enr. Not. 15.129.

by the sale of the shares to a third party, has been requalified as a transfer of the real property itself to the third party.[99]

D. Germany

Germany is an example of a country where the legislator and the courts have over time interfered with each other regarding the interpretation of tax laws. Already in 1919, when the general tax law (*Reichsabgabenordnung*) was introduced, it provided that the tax laws had to be interpreted in accordance with the economic interpretation;[100] the language was broadened in the *Steueranpassungsgesetz* of 1934.[101] The objective of introducing economic interpretation of the tax law as a guiding principle of interpretation was to get rid of the excessively restrictive interpretation of the tax law on the basis of concepts and categories of civil law.[102] Particularly between the two world wars, the *Reichsfinanzhof* was keen on furthering a wide interpretation of tax law. Economic interpretation became an instrument in extending the tax law to fill gaps and loopholes by analogical interpretation.[103]

The use of economic interpretation as a guiding principle in the interpretation of tax law has gradually been abandoned by the Federal Tax Court of Appeal and the pre-eminence of the use of civil law concepts in tax law interpretation has been re-established.[104] At the same time, the German Constitutional Court has been less clear in its decision on strict or extensive interpretation of tax law. Sometimes, it has spoken out in favor of strict interpretation and against the economic interpretation of tax law;[105] at other times, however, the same court has decided in favor of "judicial development of the

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[99]*See* Judgment of Dec. 19, 1962, Brussels, Rec. Gén. Enr. Not. 20.640; Judgment of Mar. 26, 1905, Gent, Rec. Gén. Enr. Not. 20.895.

[100]*See* DEU Reichsabgabenordnung of 1919 § 4. *Cf.* ARG Law 11,683. ("In the interpretation of this statute purpose and economic meaning ought to be considered." (ed. trans.))

[101]DEU Steueranpassungsgesetz § 1/II (according to which the interpretation of the tax law had to consider "the social viewpoint, the purpose, and the economic significance of the tax laws and the development of the (economic) relationships" (ed. trans.)).

[102]In Germany, this narrow and literal interpretation was called *Begriffsjurisprudenz* (conceptual jurisprudence) and subject to attack by the end of the nineteenth century. *See* Karl Larenz, Methodenlehre der Rechtswissenschaft (1983).

[103]*See* 4 Reichsfinanzhof Entscheidungen 243, 252; 6 Reichsfinanzhof Entscheidungen 292, 298.

[104]*See* Bundesfinanzhof, 1969 Bundessteuerblatt II 736, 737; Bundesfinanzhof, 1976 Bundessteuerblatt II 246.

[105]"*...das Steuerrecht wird von der Idee der „primären Entscheidung des Gesetzgebers über die Steuerwürdigkeit bestimmter generell bezeichneter Sachverhalte" getragen und lebt dementsprechend „aus dem Diktum des Gesetzgebers.*" Judgment of Jan. 24, 1962, BVerfG, 13 BVerfGE, No. 32, at 318, 328 ("tax law is based on the idea of the 'primary decision of the legislator concerning the tax treatment of specific generally defined circumstances' and therefore draws breath 'from the statement of the legislator'" (ed. trans.)).

law."[106] When the new general tax law was adopted in 1977, the general "economic meaning" clause in the *Steueranpassungsgesetz* was not renewed.[107] At the same time, a few specific and one general antiabuse clauses were introduced so as to give the courts more leeway in the interpretation of tax law, particularly in cases of abuse of legal construction.[108]

E. The Netherlands

Like France and Germany, the Netherlands at an early stage adopted a general antiavoidance provision.[109] However, for quite a long time, this statutory provision on the interpretation of tax law did not influence court decisions because, at about the same time, the Supreme Court introduced the *fraus legis* doctrine into tax law.[110] According to this doctrine, any legal construction resulting in a factual situation that is effectively subject to tax should be similarly taxed if so required by the purpose of the tax law. Originally, the legal construction was set aside under the *fraus legis* doctrine only when tax minimization was the exclusive reason for the legal construction.[111] Gradually, however, the case law developed the doctrine that the legal form of the transaction would be set aside when the tax motive was the dominant or decisive reason for the transaction.[112] Whether the tax motive is the dominant reason for the transaction is determined not by the subjective intent of the taxpayer, but by objective facts to be evaluated by the judge. It means that if the taxpayer has objective nontax reasons for the transaction, it will stand the test of *fraus legis*. In this way, the Dutch courts still maintain the right of the taxpayer to arrange his or her affairs in such a way as to

[106]"*Der finanzgerichtlichen Rechtsprechung ist es insbesondere nicht von vornherein verwehrt, im Wege der Rechtsfortbildung veränderten wirtschaftlichen Situationen Rechnung zu tragen . . .*" Judgment of Mar. 12, 1985, BVerG, 69 BVerfGE, No. 12, at 188, 203 ("Judicial decisions in fiscal law are not prohibited from giving significance to changed economic circumstances by way of development of the law ..." (ed. trans.)).

[107]According to Tipke, this was because it was considered unnecessary, the approach of *Begriffsjurisprudenz* (*see* note 100 *supra*) having been abandoned. *See* 3 Tipke, *supra* note 53, at 1239. DEU AO §§ 40–42 does contain a few specific antiavoidance provisions, some of which may be interpreted as the continuance of economic interpretation. These provisions, however, have a clear legal meaning.

[108]*See* discussion of antiabuse legislation *infra* sec. III(I).

[109]This provision, called *Bevordering van de richtige heffing,* was later incorporated in the General Tax Law. *See* NLD AWR art. 31.

[110]*See* Judgment of May 26, 1926, Hoge Raad [HR], 1926 Nederlandse Jurisprudentie [N.J.] 723. The Swiss courts have applied an interpretation of tax law that is very similar to the Dutch theory of *fraus legis*. There is an abuse of law when the legal form of a transaction is unusual, it was entered into with the intent of obtaining a tax benefit, and the benefit must effectively have been realized. *See* Jean-Marc Rivier, Droit fiscal suisse: L'imposition du revenu et de la fortune 61 (1980); Ernst Höhn, Steuerrecht 17 (1972).

[111]*See* Judgment of July 22, 1982, HR, 1982 Beslissingen Nederlandse Belastingrechtspraak [B.N.B.] 242.

[112]*See* Judgment of July 11, 1990, HR, 1990 B.N.B. 293.

minimize tax liability, provided that the validity of the legal form is well established.[113] The *fraus legis* doctrine has been considered more than adequate to permit the courts to strike down artificial legal constructions, so that in 1987 the Minister of Finance decided to render the statutory antiavoidance provision inoperative, although it is still on the statute books.

F. United Kingdom

The U.K. tax system has no general statutory antiavoidance provision. Interpretation of tax statutes used to be controlled by the case *IRC v. Duke of Westminster*, where the court stated:

> Every man is entitled if he can to order his affairs so as the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.[114]

This is generally considered to be the leading case for literal and strict interpretation, although the latter principle had already been formulated as follows in an earlier case:

> [I]n a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.[115]

However, in 1981, *W.T. Ramsay Ltd. v. Internal Revenue Commissioner* was decided.[116] In this case, the House of Lords struck down a tax- planning device on the basis that it was entitled to look at the overall result of several transactions and need not give tax effect to every single transaction.

> [T]he fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by

[113]*See* Judgment of Dec. 19, 1990, HR, 1990 B.N.B. 121. A more recent case is discussed *in* Dick Hofland & Kees van Raad, *Dutch Consolidated Income That Erodes Interest Payment to Foreign Parent Company Is Not an Abuse of Law,* 11 Tax Notes Int'l 1143 (1995).

[114]Commissioners of Inland Revenue v. Duke of Westminster, 1936 App. Cas. 1, 19, 19 T.C. 490. For a comparative study of the interpretation of tax laws in France and the United Kingdom, *see* Stefan Frommel, *United Kingdom Tax Law and Abuse of Rights*, Intertax 54 (1991/92); *L'abus de droit en droit fiscal britannique*, Revenue internationale de droit comparé 585 (1991) (same paper in French).

[115]Cape Brandy Syndicate v. Inland Revenue Commisioners, [1921] 1 K.B. 64, 71, 132 T.C. 358, 366.

[116][1981] 1 All E.R. 865.

> considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately.[117]

This doctrine was further developed in *Furniss v. Dawson*, in which the step- transaction doctrine and the commercial purpose doctrine were formulated as follows:

> The formulation, therefore, involves two findings of fact: first whether there was a preordained series of transactions, ie [sic] a single composite transaction; second, whether that transaction contained steps which were inserted without any commercial or business purpose apart from a tax advantage.[118]

More recently, the House of Lords has limited the scope of the business purpose doctrine and the step-transaction doctrine in a series of cases.[119] The court decided that where two courses of action are open to the taxpayer and are actively considered by him, the Government could not deprive him of the tax benefit of one of the alternatives.

> It is one thing for the court to treat as a fiscal nullity a purely artificial step which will inexorably be followed by one or more others so as to achieve the desired end result. It is quite another for the court to treat as a fiscal nullity a step which had a commercial purpose in addition to tax avoidance and which in reality at the time it was taken might not have been followed by the other steps.[120]

This decision was confirmed a few years later, together with associated cases, and Lord Jauncey succinctly stated the position of the House of Lords on tax avoidance:

> I conclude my analysis of the three cases by emphasizing that the *Ramsay* principle is a principle of construction, that it does not entitle the courts to legislate at large against specific acts of tax avoidance where Parliament has not done so and that at the end of the day the question will always be whether the event or combination of events relied on amount to a chargeable transaction or give rise to allowable relief within the meaning of the relevant statutory provisions.[121]

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[117]Furniss v. Dawson, [1984] 1 All E.R. 530, 532 (comments of Lord Fraser of Tullybelton on the *Ramsay* case).

[118]*Id.* at 543.

[119]*See* Craven v. White, IRC v. Bowater, Baylis v. Gregory, [1988] 3 All E.R. 495 (1988).

[120]Craven v. White, [1985] 3 All E.R. 125, 155.

[121]Craven v. White, [1988] 3 All E.R. 495, 542.

Now, the question is how long it will take before the Inland Revenue will decide that statutory antiavoidance measures are in order, as has been the case in Canada and Australia.[122]

G. Australia

In Australia, interpretation of the tax laws was for a long time dominated by literal and restrictive interpretation along the lines of *IRC v. Duke of Westminster* in the United Kingdom. While the British courts have been gradually taking a more flexible position on interpretation of tax law, the Australian courts persisted in their literal interpretation, thereby extending the doctrine of *Duke of Westminster* to all kinds of modern and complicated tax planning schemes, and implementing in fact a policy that favored the taxpayer. In *Investment and Merchant Finance Corp. Ltd.*, this literal and strict interpretation was based implicitly on the principle of legality:

> It is, of course, true that it is because company dividends are rebatable under s.46 that dividend-stripping is so attractive, and, if it be thought that this is a practice which should be checked, it is to that section that Parliament may choose to direct some of its attention. It is not for the courts, however, to depart from Parliament's clear statement....[123]

In 1976, the Privy Council decided under New Zealand tax law the following:

> [I]t is not the economic results sought to be obtained by making the expenditure that is determinative of whether the expenditure is deductible or not; it is the legal rights enforceable by the taxpayer that he acquires in return for making it.[124]

Chief Justice Barwick, who has been held responsible for the extent to which the High Court developed the strict interpretation of tax laws, stated his opinion as follows:

> It is for the Parliament to specify, and to do so, in my opinion, as far as language will permit, with unambiguous clarity, the circumstances which will attract an obligation on the part of the citizen to pay tax. The function of the court is to interpret and apply the language in which Parliament has specified those circumstances. The court is to do so by determining the meaning of the words employed by Parliament according to the intention of Parliament which is discoverable from the language used by the Parliament. It is not for

[122] *See infra* sec. III(G).

[123] Investment and Merchant Finance Corp. Ltd. v. Federal Commissioner of Taxation, 125 C.L.R. 249, 265 (1971); *see also* Curran v. Federal Commissioner of Taxation, 131 C.L.R. 409 (1974); South Australian Battery Makers Proprietary Ltd. v. Federal Commisioner of Taxation, 140 C.L.R. 645 (1978).

[124] Europa Oil v. Internal Revenue Commissioner, [1976] 1 All E.R. 503, 508 (Lord Diplock).

> the court to mould or to attempt to mould the language of the statute so as to produce some result which it might be thought the Parliament may have intended to achieve, though not expressed in the actual language employed.[125]

Although the Australian income tax law contained a wide general antiavoidance and antiabuse provision,[126] consecutive court cases by strict and literal interpretation of the tax law gradually whittled away the scope of that provision.[127] In 1981, the court reversed its stand on literal interpretation and agreed to extend the scope of a statutory provision, although that wider scope was not within the literal meaning of the statute.[128] By that time, however, there had been a political reaction and Parliament had inserted a range of general and specific antiavoidance provisions into the Income Tax Assessment Act, culminating in the adoption in 1981 of a new general antiavoidance rule.[129]

H. United States

Although the Internal Revenue Code contains a limited provision allowing the Commissioner to deny tax benefits from an acquisition, the principal purpose of which is tax avoidance,[130] it does not contain a general provision on interpretation of tax law by the courts. Over time, the courts have developed a doctrine allowing them to set aside certain legal constructions that do not have a "business purpose."[131] When a legal construction has as its clear purpose the avoidance of income tax and does not at the same time involve some economic substance, it can be set aside by the courts as having no effect for tax purposes and replaced by another characterization of the underlying factual situation. Starting with the *Gregory* case, the courts have developed several judicial doctrines, such as constructive income or ownership,[132] continuity of business enterprise,[133] and the step-transaction doctrine. The step-transaction doctrine allows a

[125]Federal Commissioner of Taxation v. Westraders Proprietary Ltd., 144 C.L.R. 55, 59 (1979–80).

[126]AUS ITAA § 260, which was replaced in 1981 by more comprehensive and at the same time more specific antiabuse legislation. *See infra* sec. III(I).

[127]*See* W.P. Keighery Proprietary Ltd. v. Federal Commissioner of Taxation, 100 C.L.R. 66, 92 *et seq.* (1956–57); Cecil Bros. Proprietary Ltd. v. Federal Commissioner of Taxation, 111 C.L.R. 430, 441 (1962–64); Mullens v. Federal Commissioner of Taxation, 135 C.L.R. 290, 302 (1975–76).

[128]*See* Cooper Brooks (Wollongong) Proprietary Ltd. v. Federal Commissioner of Taxation, 147 C.L.R. 297 (1980–81).

[129]AUS ITAA Part IVA, §§ 177A–G ("Schemes to Reduce Income Tax"). *See infra* text accompanying note 149.

[130]*See* USA IRC § 269.

[131]Gregory v. Helvering, 69 F.2d 809 (2d Cir. 1934), *aff'd,* 293 U.S. 465 (1935).

[132]*See* Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 9.02 (6th ed. 1994).

[133]*See* Standard Realization Co. v. Commissioner, 10 T.C. 708 (1948); Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965).

court to decompose a transaction into several distinct steps, or to take several separate transactions together, in order to ascertain whether each of the individual steps, or the overall complex transaction, meets the requirements to benefit from certain effects under the tax law.[134] The precise methods of applying these doctrines are complex and continually evolving.[135]

The issues in applying the substance-over-form approach in U.S. tax case law have been summarized well by Bittker & Eustice:

> One of the persistent problems of income taxation, as in other branches of law, is the extent to which legal consequences should turn on the substance of a transaction rather than on the transaction's form. It is easy to say that substance should control, but, in practice, form usually has some substantive consequences. If two transactions differ in form, they probably are not identical as to substance. Even so, they may be sufficiently similar to warrant identical tax treatment. . . .
>
> The foregoing judicial principles and statutory provisions, which often overlap in practice, are useful deterrents to tax-avoidance schemes of varying scope and ingenuity. Forcing transactions heavily freighted with tax motives to withstand judicial analysis in the context of these broad principles and provisions, vague and uncertain in application though they may be, is more salutary than uncompromising literalism in applying the statutory system for taxing corporations and shareholders.[136]

The often broad way in which U.S. tax courts interpret the tax law should be contrasted with the very close style of legal drafting used in the Internal Revenue Code and which prima facie obliges the courts to make decisions on very narrow rules. In spite of this, U.S. courts stick to their judicial doctrines, probably because of the common law tradition of legal analysis, where interpreting facts and rules with common sense plays an important role.

I. Antiabuse Legislation

Closely connected with the problems of interpretation of tax laws are statutory measures introduced to provide general rules for the application of tax legislation in situations where taxpayers structure transactions in a peculiar legal form so as to obtain a tax benefit unintended by the tax law. Tax laws being general prescriptions, it is

[134]*See* West Coast Marketing Corp. v. Commissioner, 46 T.C. 32 (1966); American Potash & Chemical Co. v. United States, 399 F.2d 194 (U.S. Ct. Cl.), *motion denied,* 402 F.2d 1000 (Ct. Cl. 1968); King Enterprises, Inc. v. United States, 418 F.2d 511 (U.S. Ct. Cl. 1969), *later proceeding* 190 Ct. Cl. 947 (1970).

[135]For a discussion of tests for application of the step-transaction doctrine in reorganizations, *see* McDonald's Restaurant of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1981).

[136]Bittker & Eustice, *supra* note 132, ¶¶ 1.05[2][b], 1.O5[3][d] (footnote omitted).

inevitable that the legislator cannot foresee all situations in a rapidly changing world, thereby leaving gaps and loopholes in any tax law.[137] Also, in many cases, the tax law allows the taxpayer a choice between different legal alternatives to reach factual objectives that are identical or very similar, but with different tax consequences. Depending on the legal choice made by the taxpayer, the same factual objective will result in a lower or higher tax burden. The two basically related questions raised here for the application and interpretation of the tax law are (1) what are the respective roles of the legislator and the courts in filling the gaps and loopholes, and (2) should the tax law attach different tax consequences to different legal situations that result in the same or a very similar factual situation?

The answer to these two questions may be clearer if the so-called antiabuse legislation is considered in the wider context of tax evasion and tax avoidance. In practically all developed tax systems, a distinction is made between tax evasion and tax avoidance. Tax evasion or tax fraud[138] is an offense against the tax laws that is punishable by criminal sanctions. It consists of clear violations of the tax laws, such as fabricating false accounts or other documents, keeping parallel accounts, not reporting income, or smuggling or dissimulating goods or assets. The tax consequences of these acts can of course be corrected by the tax administration, but in addition these acts may give rise to criminal sanctions. The statutory measures taken to combat such violations of the tax law are generally not considered to be antiabuse measures.

Tax avoidance, on the other hand, is a behavior by the taxpayer that is aimed at reducing tax liability, but that does not constitute a criminal offense. The distinction between tax avoidance and tax evasion is critical, although sometimes confused, particularly by nonlawyers. Such confusion may be understandable in an economic or moral context, but it is basically wrong in a legal context of administration and implementation of tax law. In principle, most countries recognize the right of the taxpayer to arrange his or her affairs in such a way as to pay less tax.[139] The problem is

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[137]Loopholes can also result from a disorderly legislative process. Sometimes chaotic amendments are made at the last minute without an opportunity to consider all their ramifactions and make the necessary adjustments.

[138]To avoid any confusion in terminology, it should be noted that "tax evasion" is translated in French as *fraude fiscale* and in German as *Steuerhinterziehung*, whereas "tax avoidance" is respectively translated as *évasion fiscale* and *Steuerumgehung*.

[139]For the United Kingdom, Commissioners of Inland Revenue v. Duke of Westminster, 1936 App. Cas. 1, 19 (Lord Tomlin comments, "[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be"); for the United States, Gregory v. Helvering, 69 F.2d 809, 810 (1934)(Judge Learned Hand stating, "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."), *aff'd,* 293 U.S. 465 (1935); for Australia, Jaques v. Federal Commissioner of Taxation, 34 C.L.R. 328, 362 (1924)(Judge Starke wrote, "[t]here is nothing wrong in companies and shareholders entering, if they can, into transactions for the purpose of avoiding, or relieving them of taxation . . ."); for Belgium, Judgment of June 6, 1961, Cour de cassation, 1961 Pas. Bel. I 1082, 1089 ("considering that there is neither a prohibited fabrication with respect to the fisc, nor one which constitutes fraud, when the parties, in order to benefit from a more favorable tax regime, taking

that the lesser tax burden may result from a legal construction or transaction that uses a gap or a loophole in the law to place the taxpayer outside the reach of the tax law or within the reach of a statutory provision providing for a lesser tax burden, or from a legal construction or transaction to which the tax law attaches a lesser tax liability than to another legal construction or transaction with similar factual results. It is clear that on the basis of considerations of economic efficiency (taxing similar economic situations the same way) and of fiscal justice (taxing similar factual situations the same way), there are good reasons to disregard the tax consequences of the legal construction or transaction and to close the gaps and loopholes, subjecting similar situations to the same tax burden. Therefore in some countries some constructions or transactions that constitute tax avoidance, although not being a criminal offense, are not recognized for tax purposes either by the courts, or by general or specific antiabuse provisions.

In addition to tax evasion and tax avoidance, there is an activity that can be called tax minimization, which can be defined as behavior that is legally effective in reducing tax liability. It can consist in factual behavior by which taxes are avoided such as not consuming certain products (not smoking tobacco or not drinking alcoholic beverages) subject to tax or not earning certain types of income.[140] This factual avoidance of the tax burden is considered as perfectly legal and is not subject to statutory antiavoidance measures. According to Rivier, it consists of "using a lacuna intended by the legislator or the freedom allowed by the law to create a factual situation different from that contemplated by the law, whose consequences for the taxpayer are likewise different from those envisaged by the text of the law."[141] By contrast, tax avoidance typically consists not of factual, but of legal behavior, that is, molding factual situations in legal forms that bear less tax than other legal forms. The difficult question is whether a particular instance of such behavior is considered tax avoidance or tax minimization.

The question is whether the refusal to recognize the effectiveness for tax purposes of a legal construction is a task for the legislator or for the courts. The arguments against the courts doing this job are largely based on the principle of legality and the role of the courts vis-à-vis the legislator.[142] The doctrine of the separation of powers holds that it is not for the judiciary to legislate. Therefore, when the clear wording of the tax law fails to tax certain situations, thereby leaving gaps and loopholes, even when reasonably and as a matter of tax policy these situations should be taxed, the courts will shy away from imposing a tax when there is no formal legal basis for doing so. Strangely enough, the same courts may fill the gaps and loopholes left by the legislator in other areas of the law. The reason is that for taxes, many countries have an explicit or implicit constitutional

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advantage of the freedom of contract and without violating any legal obligation, establish legal acts all of the consequences of which they accept, even if the form that they give them is not the most usual one" (ed. trans.)).

[140]Tax minimization is known as *Steuervermeidung* in German and *Belastingbesparing* in Dutch.

[141]Rivier, *supra* note 110, at 60–61 (ed. trans.).

[142]*See supra* sec. III(A).

provision limiting the authority to tax in a similar way as the authority to impose criminal penalties: no taxation without legal basis. This supposes for an effective implementation of the tax law an all-knowing and infallible legislator who, in reality, does not exist.

With respect to extending the reach of the tax law to legal constructions and transactions having a factual effect similar to situations subject to a heavier tax, many jurisdictions will allow the tax administration to recharacterize a legal construction or transaction, provided it can show that the legal elements for such different characterization exist, but will refuse a recharacterization for tax purposes when only a similarity in fact exists. In more simple terms, this is stated as the problem of the opposition between substance and form. The attitude of the courts again presupposes that the tax consequences attached to each legal construction or transaction are the adequate tax reply to the factual situation covered by the construction or transaction; that is, it presupposes an infallible inner consistency of the law so that each legal form is always the adequate translation of the underlying substance. That unique quality of the legal rule is of course absent in many cases.

The ways in which the courts of various countries have dealt with these problems have been discussed above.[143] In some countries, the legislator has judged it necessary to take legislative action in the form of general or specific antiabuse provisions to remedy the courts' failure to interpret the law in such a way as to cut off abuse. The general antiabuse provisions, on the one hand, call on the courts to apply an extensive or economic interpretation of the tax law and to disregard legal constructions and transactions when they have an artificial flavor. Specific antiabuse provisions, on the other hand, which can be found in nearly all developed tax systems, are aimed at closing particular gaps and loopholes.

It should be noted that there is no clear relationship between the way courts interpret tax law (strictly vs. extensively) and the presence or absence of general antiabuse provisions. Several countries operate their tax system without general antiabuse provisions: Belgium (until 1993), Italy, Sweden (1992-95), Switzerland, United Kingdom, and United States. Except for the United States, in most of these countries, tax law is interpreted in a strict or literal way. The combination of case law and specific antiabuse provisions is apparently held to be adequate in administering the tax system. A second group of countries does have general antiabuse clauses in their tax legislation with rather different results. The most prominent examples are Australia, Austria, France, Germany, the Netherlands, and Spain.[144]

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[143] *See supra* sec. III(A–H).

[144] Belgium (BEL CIR art. 344, as amended in 1993) and Canada (CAN ITA § 245, introduced in 1988) also have general antiabuse provisions, but they are too recent to be able to evaluate their impact on interpretation of tax laws by the courts. Sweden abolished the general antiavoidance provision in 1992 and reintroduced it in 1995.

The original Australian antiavoidance rule provides that contracts are void for tax purposes if they were made in order to alter the incidence of the income tax, or to defeat, evade, or avoid any liability under the Income Tax Assessment Act.[145] Although the wording of this section was very broad, in the general climate of literal and strict interpretation that was dominating the interpretation of tax law by the Australian courts,[146] the scope of the section was systematically whittled down through the application of the "freedom of choice" doctrine to a narrow rule that became very difficult to apply.[147]

By 1980, it became clear that the existing Australian setup of general and specific antiavoidance clauses and literal or strict court interpretation was not working.[148] In 1981, section 260 was amended to apply only to schemes entered into prior to May 27, 1981, and a whole new set of antiabuse rules applicable to arrangements entered into or after that date was introduced as Part IVA ("Schemes to Reduce Income Tax").[149] Basically, Part IVA provides that when there is a "scheme" as defined in the statute, the Commissioner has discretionary power to deny a tax benefit or disallow a deduction, which would have been obtained through the scheme, when such scheme satisfies eight conditions set forth in the statute.[150]

"This Part applies to any scheme...where...(a) a taxpayer (in this section referred to as the "relevant taxpayer") has obtained...a tax benefit in connection with the scheme; and

(b) having regard to——

(i) the manner in which the scheme was entered into or carried out;

(ii) the form and substance of the scheme;

(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

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[145]*See* AUS ITAA § 260, which became inoperative after May 27, 1981, when the new antiabuse provisions of ITAA Part IVA took effect.

[146]*See supra* sec. III(G).

[147]*See* W.P. Keighery Proprietary Ltd. v. Federal Commissioner of Taxation, 100 C.L.R. 66, 92 (1957)("Whatever difficulties there may be in interpreting s. 260, one thing at least is clear: the section intends only to protect the general provisions of the Act from frustration, and not to deny taxpayers any right of choice between alternatives which the Act itself lays open to them."); Cecil Bros. Proprietary Ltd. v. Federal Commissioner of Taxation, 111 C.L.R. 430, 441 (1964)("Indeed, s. 260 does not authorize the Commissioner to do anything; it avoids as against the Commissioner arrangements, etc. as specified and so leaves him to assess taxable income and tax on the facts as they appear when the avoided arrangements, etc. are disregarded."); Mullens v. Federal Commissioner of Taxation, 135 C.L.R. 290 (1976).

[148]*See* Federal Commissioner of Taxation v. Westraders Proprietary Ltd., 144 C.L.R. 55 (1980).

[149]AUS ITAA §§ 177A–177G.

[150]AUS ITAA § 177D provides:

> (iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
> (v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
> (vi) any change in financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
> (vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and
> (viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi),

> it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers)."

The crucial question in applying the act is what constitutes a "scheme." In section 177A(3) and 177D, a scheme is defined as any unilateral scheme, plan, proposal, action, course of action, or course of conduct entered into or carried out for the purpose of enabling the relevant taxpayer or other taxpayers to obtain a tax benefit in connection with that scheme. Contrary to general antiabuse provisions in Europe and even in Canada, the Australian provision follows a very complicated and technically difficult style of drafting.

The first case involving these provisions to reach the High Court of Australia was *Federal Commissioner of Taxation v. Peabody*.[151] The decision illustrates the complexity of a general antiabuse provision because it had to identify the "tax benefit," "the scheme," and "the relevant or other taxpayer." In this particular case, the taxpayer won on the basis that the Commissioner had allocated the revenue to the wrong taxpayer. The Commissioner also lost the second case brought under this provision on the basis that the dominant purpose of the scheme involved was to make an investment and not to obtain a tax benefit, even though the scheme resulted in earning income that was exempt from tax.[152]

At the same time that the new general antiabuse provisions were inserted in the Income Tax Assessment Act, Australia amended its Acts Interpretation Act to promote a purposive interpretation of legislation, particularly tax law. The new section reads as follows:

> In the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object.[153]

The combined effect of the changes to the Acts Interpretation Act, the application of the general antiabuse provision of the income tax law, and changes in the composition of the High Court led to a shift from literal to purposive interpretation of income tax legislation.[154]

French tax law contains two general instruments to combat tax avoidance: a provision on the "abuse of tax law"[155] and the court doctrine of the "abnormal management act,"[156] which does not have a direct statutory basis.

The main characteristics of the "abuse of tax law" provision are that a transaction is subject to sanction only when a specific procedure is followed and, according to the courts, when the transaction has been set up *exclusively* for tax avoidance purposes. This provision covers transactions where the real legal transaction is hidden by an apparent

[151]Federal Commissioner of Taxation v. Peabody, 181 C.L.R. 359 (1994).

[152]*See* Lee Burns & Richard Vann, *Australian Court Considers Source of Interest Income and International Application of the General Anti-Avoidance Provision,* 11 Tax Notes Int'l 1631 (1995).

[153]Acts Interpretation Act, 1901, as amended, 1901 Austl. Acts 2, § 15AA(1). Sec. 15AB of the Act also contains rules with respect to the extrinsic materials that should be taken into consideration for the interpretation of an act. *See infra* ch. 3, sec. III(C) for discussion of Interpretation Acts.

[154]*See* Cooper Brooks (Wollongong) Proprietary Ltd. v. Commissioner on Taxation, 147 C.L.R. 297 (1981).

[155]*See* FRA LPF art. L. 64 to L. 64 B (prohibiting *abus de droit*). This provision was introduced for indirect taxes by an act of July 13, 1925, and for income taxes by an act of Jan. 13, 1941. Act No. 87-502 of July 8, 1987, introduced an optional ruling procedure (known as *rescrit*) for its application.

[156]*Acte de gestion anormale.*

legal transaction (*simulation*),[157] as well as, according to case law,[158] transactions entered into exclusively to obtain a tax benefit (*fraude à la loi*). Because the burden of proof is on the tax administration and the condition of the exclusive tax avoidance motive is difficult to prove, this weapon is seldom used by the tax administration. The French tax administration is now pushing for an amendment to the statute, so as to apply the abuse of law provision in cases where the tax avoidance motive is the dominant reason and not necessarily the exclusive reason for the transaction.

The abnormal management act doctrine has no specific statutory basis, but has been entirely developed by the courts.[159] It is based on the theory that a business taxpayer cannot engage in any activity that is contrary to the taxpayer's business interest because the purpose of the business is to make a profit. This does not mean that the taxpayer has the obligation to maximize business income under all circumstances, but it allows the tax administration to intervene in situations in which the taxpayer reduces taxable income, by acts against the taxpayer's business interests, in order to transfer income to another taxpayer who is exempt or who is taxed at a lower rate. Because the burden of proof is less onerous than under the "abuse of tax law" provision and because there is no specific procedure, the tax administration prefers this court doctrine to combat abuses of taxpayers.[160] The application of the abnormal management act doctrine is not subject to any special procedure. In most cases, it presents problems of fact and not of law, so that it is to be distinguished from the "abuse of tax law" provision of the code of tax procedure. However, the same transaction can reduce a taxpayer's income by an act against the taxpayer's business interests, while at the same time having been entered into exclusively for tax avoidance purposes. In such a case, both antiabuse instruments would be applicable.

Germany introduced quite early[161] a provision in its general tax laws obliging the courts to follow the economic interpretation of the tax law.[162] Gradually, however, the Court of Tax Appeals shifted its interpretation to a more traditional stance, giving predominance to concepts of civil law over tax concepts, so that the taxpayer would be in a position to make a choice between different legal forms of a transaction to minimize the

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[157]*See* FRA LPF art. L. 64 (stating "*les actes qui dissimulent la portée véritable d'un contrat ou d'une convention...*").

[158]Judgment of June 10, 1981, No. 19,079, Conseil d'État, Lebon 248; Judgment of Apr. 19, 1988, No. 86.19079, Cour de cassation, Chambre commerciale, Revue de jurisprudence fiscale 1989, No. 2, at 47. *See also* Cyrille David et al., Les grands arrêts de la jurisprudence fiscale, *Thème 9,* 106 *et seq.* (2d ed. 1991).

[159]*See* Judgment of Apr. 14, 1976, Conseil d'Etat, 1976 Lebon, No. 97.260, at 202; Judgment of Apr. 30, 1980, Conseil d'Etat, 1980 Lebon, No. 16.253, at 206.

[160]*See* commentary and cases cited in David et al., *supra* note 158, at 328 *et seq*.

[161]*See* Reichsabgabenordnung of 1919 § 4; Steueranpassungsgesetz of 1934 § I/II.

[162]*Die wirtschaftliche Betrachtungsweise. See supra* discussion on court interpretation in Germany, sec. III(D).

taxpayer's tax burden.[163] Also, in the German tax doctrine, the economic interpretation was not considered specific for tax law, but was a general kind of teleological interpretation.[164] When the new General Tax Law was introduced in 1977, the mandatory economic interpretation method of tax laws was abandoned and replaced by several antiabuse provisions.[165]

The new provisions are contained in DEU AO sections 40 through 42, of which section 42 is the most important for the interpretation of tax law. AO section 40 establishes the rule that transactions will be taxed whether they are legal or not. The effect of this section is to tax profits from illegal activities, like gambling, drug trafficking, and so on, so as to avoid a situation in which illegal activities would benefit from a tax exemption.[166] It is important to note that deductions for expenses are also allowed, even when incurring such expenses would constitute an illegal activity.[167] AO section 41 subjects to tax transactions that are legally invalid for nontax purposes under civil or commercial law when the economic substance of the transaction is maintained in spite of its legal nullity. It also disregards sham transactions.[168] A sham transaction exists when the parties agree that the transaction should have no legal effect or when one legal transaction is used to hide another legal transaction. Both sections base taxation on the economic or, more generally, the factual substance of a transaction, without regard to its illegality, nullity, or legally fictitious character. In this sense, both sections can be considered a continuance of the economic application of tax law.

The most important general antiabuse clause is contained in AO section 42, providing that tax cannot be avoided by "abuse of legal constructions."[169] When abuse of a legal construction is established, the tax claim will be based on the legal form of the transaction that is appropriate to the legal factual situation. An abuse is considered to exist when the legal form of the transaction or construction used by the taxpayer is not appropriate to the factual *economic* situation. The key word in this provision is "appropriate."[170] It requires that the factual consequences of a transaction be more or less consistent with its legal form. The abuse consists of the choice of a legal form that is inappropriate for the economic relationship in order to avoid taxes.[171] The legal form of a

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[163]*See* Decision of Bundesfinanzhof, 1967 Bundessteuerblatt II 781, 782.

[164]*See* 3 Tipke, *supra* note 53, at 1289.

[165]Austrian law still requires the true economic content of a transaction to be given effect in precedence to its outward appearance. *See* AUT BAO § 21.

[166]In some countries, this rule has been established through case law. *E.g.,* James v. United States, 366 U.S. 213 (1961).

[167]*See* 3 Tipke, *supra* note 53, at 1322–23.

[168]*Scheingeschäfte or Scheinhandlungen.*

[169]DEU AO § 42 (ed. trans.).

[170]*Angemessen.*

[171]3 Tipke, *supra* note 53, at 1336.

transaction will be considered inappropriate when reasonable persons—in order to achieve a specific economic relationship and, in particular, a specific economic goal—would not choose a particular legal form because they would consider it inadequate.[172] The specific characteristic of the German law is that it requires some consistency between the legal form and the economic content of a transaction. In many other tax systems, it suffices to have a business purpose, even if the legal form in which this business purpose is achieved is not entirely appropriate. If a transaction has no business purpose at all, it may be assumed that the legal form is inappropriate and that there is abuse of a legal construction. Generally speaking, for a legal transaction to be effective for tax purposes, it will require (1) a business purpose, and (2) an adequate legal form to achieve the business objectives of the taxpayer. It is clear that when there are several adequate legal forms to achieve these business objectives, the section will not be applicable when the taxpayer chooses the legal form that minimizes the taxpayer's tax burden.

In the Netherlands, a general antiabuse provision was introduced in the general tax law in 1925. Since 1959, it provides that a legal transaction that does not have as its purpose a significant change in the factual circumstances or that would not have occurred but for the fact that it eliminates or reduces the tax liability shall not be taken into account; that is, when the exclusive purpose of a transaction is to minimize the tax burden, it is subject to correction for tax purposes.[173] In the Dutch tax literature, this provision is known as "correct taxation."[174] The tax inspector who wants to apply the procedure of "correct taxation" has to ask for specific advance approval from the Minister of Finance. Given the judicial development of the *fraus legis* doctrine, the statutory provision has been of limited importance.[175]

In Spain, the abuse of law doctrine is based on article 6.4 of the Civil Code, which was adopted in 1974.[176] This concept of civil law was also used for tax purposes, because although the General Tax Law referred in article 24, paragraph 2 to "abuse of law,"[177] there was no clear definition of abuse of law in the tax code.[178] In 1979, this provision

[172]*Id.* at 1337.

[173]*See* NLD AWR art. 31.

[174]"*Richtige heffing.*" *See* for a more ample report, A. Nooteboom, *Netherlands,* LXVIIIa Cahiers de droit fiscal international 545 (1983).

[175]*See supra* sec. III(E).

[176]Codigo Civil art. 6, ¶ 4 (ESP)(stating "acts concluded within the scope of the text of a rule which pursue a result prohibited by the legal regulation or contrary to it, shall be considered as executed as a fraud on the law and shall not thwart the proper application of the norm that was sought to be avoided" (ed. trans.)).

[177]ESP LGT art. 24, ¶ 2 (providing, in part, "to avoid fraud on the law it will be understood, for purposes of the previous paragraph, that there is not an extension of the taxable event in the case of taxation of actions realized for the proven purpose of evading the tax, as long as they produce a result equivalent to that derived from the taxable event" (ed. trans.)).

[178]For a full discussion of the abuse of law provisions in Spain, *see* Escuela de Inspección Financiera y Tributaria, Ministerio de Economia y Hacienda, Compendio de Derecho Tributario Español 79–88 (4th ed. 1984).

was implemented by a decree establishing a special procedure for the application of the concept of abuse of law.[179] As in France, this procedure is to be followed when a taxpayer is notified that the taxpayer is accused of abuse of law. The burden of proof is with the tax administration. In addition, article 25 of the Spanish tax code provides that taxes should be levied in accordance with the real legal or economic nature of the taxable event.[180] When the taxable event consists of a legal transaction, it will be characterized for tax purposes in accordance with its "true legal nature," regardless of the form of the transaction. When the taxable event is determined by economic concepts, it will be characterized in accordance with "effective economic relationships." Both provisions seem to indicate a strong bias in favor of economic interpretation of tax law and of substance over legal form.

However, article 24–1 of the General Tax Law contains an explicit prohibition of extensive interpretation of tax law and interpretation by analogy beyond the strict meaning of the words. The resulting legal framework of the antiabuse provisions in Spain is at least confusing, and there is great debate about the exact meaning of the provisions. As a result, these contradictory legal prescriptions have driven the High Court to very divergent applications of tax laws.[181] Recently, article 24 on abuse of law has been amended.[182] Under the amended language, reference to economic or social interpretation has been eliminated. Taxes will be due on the basis of the "legal nature" of the taxable event. The new Spanish law establishes the "legal reality" of transactions as the sole legal basis for taxation, as opposed to economic or social reality.

J. Specific Antiabuse Provisions

In addition to general antiabuse rules, the tax laws of most countries contain specific antiabuse provisions.[183] The approach of the specific provisions is different from the general antiabuse provisions, because in many cases they do not focus on application or interpretation of tax law, but simply mechanically deny certain tax benefits under certain conditions. Their goal is to prevent avoidance or abuse of specific rules in the tax code. It is impossible to make an inventory of all the rules that vary from country to country; some examples are listed below.

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[179] Real Decreto [Royal Decree] 1.919/1979 of June 29, 1979, por el que se regula el procedimiento especial de declaración de fraude de Ley en materia tributaria, Boletin Oficial del Estado de 6 de agosto.

[180] *See* ESP LGT art. 25, ¶ 1 (providing "*[e]l impuesto se exigirá con arreglo a la verdadera naturaleza jurídica o económica del hecho imponible*").

[181] *See* Judgment of Apr. 5, 1982, Repertorio de Jurisprudencia 1982, No. 1972; Judgment of Mar. 5, 1988, R.J. No. 1649; Judgment of May 3, 1988, R.J. 1988,, No. 3763.

[182] *See* Law of July 20, 1995; LGT ESP arts. 24, 25, 28.2.

[183] A full discussion of these rules can be found in the relevant chapters of the material tax law throughout the book. Provisions of an intermediate nature are also possible, for example, a denial of deductions incurred in a contract lacking a real economic purpose. *See* Daniel Deak, *New Anti-Avoidance Legislation Enacted in Hungary,* 12 Tax Notes Int'l 446 (1996).

Most countries have the following antiavoidance rules in the domestic area: (1) limitation of deductions for entertainment and traveling expenses; (2) rules on taxation of accrued as opposed to effectively paid interest; (3) rules on arm's-length dealing between related taxpayers, or between taxable and tax-exempt taxpayers; (4) rules against dividend stripping; (5) limitations on tax loss carryovers from one taxpayer to another; and (6) limitations on loss deductions by partners and shareholders in companies not subject to corporate income tax.

In the international context, the following rules are common: (1) rules on dealing at arm's length in international transactions; (2) rules on thin capitalization; (3) rules against the transfer abroad of income-generating assets without payment of tax; (4) rules on controlled foreign corporations; (5) rules limiting the effects of physical emigration of taxpayers; (6) rules limiting tax benefits for income sourced in tax havens; and (7) rules limiting deductions of expenses and losses in corporate headquarters or branches of foreign companies.

K. Conclusion

This brief survey shows that the problems of tax avoidance and the issues of substance over form are truly universal, although there are variations in each tax system. Basically, there have been two broad alternative legislative and judicial approaches in the countries surveyed. Courts have interpreted tax laws either in a strict and literal way or in a more flexible way that takes into account the economic and social objectives of the tax laws. The way in which courts interpret tax laws will of course depend on the way courts interpret laws in general and on whether over time they have developed special doctrines for the interpretation of tax laws. Because of limits to what courts can or are willing to do to combat tax avoidance by interpreting the tax laws, many legislatures have resorted to the enactment of antiavoidance provisions.

The survey of the general antiabuse and antiavoidance provisions shows that they are a mixed blessing. The best and most consistent results seem to have been achieved in countries that do have a general antiabuse provision on the statute books, but one that is very sparsely used by the tax administration, because the courts have developed a reasonable—and not too strict or literal—approach to the interpretation of tax law.[184] Very close is the situation in which there is no general antiabuse provision, but in which the courts have developed a general antiabuse doctrine, like the business purpose test.[185] A second-best solution provides for a general antiabuse provision on the statute books, which is sometimes used by the tax administration under strict and narrow conditions imposed by law.[186] In Spain, however, there was the problem of the contradiction between the statutory provision on narrow interpretation of tax law and the general

[184]*E.g.,* Germany, the Netherlands. *See supra* secs. III(D), (E), (I).

[185]*E.g.,* United States. *See supra* sec. III(H).

[186]*E.g.,* France, Spain. *See supra* sec. III(I).

antiabuse provision, which has recently been addressed by legislation introducing the concept of the legal nature of the transaction.[187] The worst scenario, apparently, is the historic Australian experience in which frequent reliance by the tax administration on a general antiabuse provision is combined with strict and literal interpretation of tax law by the courts.

These experiences suggest that for countries that do not have a long court tradition, a general antiabuse provision should be combined with intense education of judges on how to develop legal reasoning and on how to make a reasonable application of the rule of law in general and the rule of tax law in particular. For countries that do have a long court tradition, the solution is simpler: when court interpretation is flexible, no general antiabuse provisions are needed; however, when court interpretation is strict, it may be preferable to work on the education of judges rather than to introduce a general antiabuse provision.

Finally, an increase in aggressive tax planning and resulting tax avoidance have been caused in part by the increasing complication of tax laws and by the growing burden of taxation. This is an imperative reason for drafting simple tax laws, leaving few options to the taxpayer and reducing to an absolute minimum the possibilities for tax arbitrage between the various options. In the end, the justice of a tax system is better served by simple rules that do not make too many distinctions, but that can be applied effectively, than by rules that try to take into account the very different relative positions of various taxpayers, but that can be avoided by taxpayers rich enough to pay for good tax advice.

IV. Distribution of Tax Law Making Power Between the Legislative and the Executive Branches of Government

One of the most perplexing problems that tax officials in developing and transition countries face is in determining the proper role for executive rules to interpret and implement tax laws. It is clear that the legislature is responsible for passing the law, but what is the proper scope for administrative interpretation? Additional questions arise regarding the level of detail to be provided; the type of document to be issued; the name to be given to the document; the organization to issue the document (tax administration, minister of finance, cabinet); the effective date, time, and party to issue the document; and the legal effect to be given to the executive rule.

These questions can be difficult to answer because there are substantial differences in practices from country to country. Moreover, the basic rules governing the legality of permitted practice are often elastic. The legal effect to be assigned to a particular type of executive rule depends on the country's general constitutional and administrative law, doctrines of legislative interpretation developed by courts or enacted

[187] *See supra* note 179.

in law, and specific provisions in tax laws that may prescribe the legal effect of particular types of administrative acts.

Not only is there considerable variation on these matters from country to country, but even within the legal tradition of a particular country, it may be difficult to determine the legal effect that courts give to administrative pronouncements. This is because standards for statutory interpretation and the scope of judicial review of administrative action are often quite elusive. Even when courts can agree on general principles, the application of those principles to particular cases can be controversial.

A. Distinction Between Executive and Legislative Functions of Government

Democracies generally subscribe to the doctrine of the separation of powers, according to which there are three independent branches of government: the legislative, the executive, and the judicial.[188] Under the general distinction between the legislative and the executive functions of government, lawmaking, in the sense of establishing the general rules that control behavior in the society, is the privilege of the legislative branch (parliament), while the implementation and the administration of the laws pertain to the executive branch. In many countries, the power of the executive branch to implement the laws by government ordinance or decree is based on a general delegation of power in the constitution to implement any law approved by parliament.[189] In other countries, the delegation of power must be specifically provided for in the law or is limited in the constitution itself.[190] As an exception to this principle, some constitutions assign to the executive branch the power to make law by decree without the consent of parliament, usually strictly limiting this power in scope or in time or permitting it only when a state of emergency or specific authorization by the legislature exists.[191]

The distinction between lawmaking and administration is not always clear-cut, because administration necessarily involves an element of discretion in interpreting the law. In addition, the administrative branch may be authorized to issue norms with greater or lesser legally binding force in order to carry out the law.

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[188]*See* Charles-Louis Montesquieu, De l'esprit des lois 142 (Garnier Frères 1869); John Locke, Of Civil Government, Book II, 190–92 (1924). *But cf.* W.E. Butler, Soviet Law 41 (2d ed. 1988) ("The concept of separation of powers has been emphatically rejected in Soviet constitutional theory and jurisprudence.").

[189]*E.g.,* Grondwet [constitution] art. 108 (BEL); Const. art. 37 (FRA); Grondwet [constitution] art. 89 (NLD); Const. art. 201 (PRT).

[190]*E.g.,* GG art. 80 (DEU); Grundloven [Constitution] art. 17 (NOR); Const. art. 82 (ESP); Regeringsformen [Constitution], chap. 8, arts. 7–12 (SWE).

[191]*See, e.g.,* Const. arts. 38, 92 (FRA). The French Constitution also provides in art. 37 for a general power to make regulations on matters that are not within the scope of lawmaking under art. 34. This means that regulations can be made by the executive under art. 37 without the explicit delegation of authority by a law. *See also* Grundlov [constitution] § 23 (DNK); Const. art. 86 (ESP).

Administrative acts with the greatest legal force are referred to as regulations. (They may also be referred to as orders, decrees, rules, or ordinances.) The relevant minister or the cabinet of ministers may be authorized directly under the constitution to issue regulations to carry out the laws, or tax laws may delegate authority to issue regulations. As long as a regulation is not contrary to the statute, it has the force of law, which means that it is binding on both the taxpayer and the state. Regulations are typically used to fill in gaps and details that are not dealt with in the statute, although they may also fashion rules out of whole cloth when so authorized.

The division of responsibility between laws and regulations varies greatly from country to country, because traditions of administrative law differ among countries. It is therefore important to design tax laws to fit within the country's scheme of administrative law. In some countries, very short statutes and detailed regulations are routinely written;[192] in other countries, the constitution may leave a very narrow scope for regulations, thereby requiring all necessary details to be put into the statute.[193]

B. Delegation of Power to Make Tax Laws in the Continental European Tradition

In the European continental tradition, the executive branch has the power to establish rules for the implementation or administration of tax laws by way of regulation, provided that the statute approved by parliament contains sufficiently specific rules defining the essential elements of the tax.[194] This means that the act of parliament must

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[192]For example, the former Soviet Union. *See* Butler, *supra* note 188, at 44–45.

[193]The Constitution of Guatemala prohibits tax regulations from modifying the statutory liability to pay tax and confines them to procedural issues. Art. 239 provides:

> The provisions, hierarchically inferior to the law, which contradict or twist the sense of the legal provisions regulating the bases of tax collection, are 'ipso jure' void. Regulatory provisions cannot modify said bases and will provide specific rules for the administrative collection of taxes and establish the procedures facilitating their collection.

[194]For example, under art. 34 of the French Constitution, "the basis, the rate and the methods of collecting taxes of all types" must be determined by an act of Parliament. *See* VII Constitutions of the Countries of the World (Albert P. Blaustein & Gisbert H. Flanz eds., 1988). Art. 37 provides that "[m]atters other than those that fall within the domain of law shall be of a regulatory character." *Id.* Accordingly, matters such as administration and procedure may be dealt with by regulation. *See* Loïc Philip, Droit fiscal constitutionnel 29 (1990). Moreover, while a strict reading of art. 34 would require all rules concerning the basis, rate, and methods of collecting taxes to be enacted by Parliament, leaving no room for regulations, given the impracticality of such an approach, the French courts have recognized that while the basic rules of taxation must be contained in the law, regulations may provide for the application of these rules. *See id.* at 30; *see also* Judgment No. 86-223 of Dec. 29, 1986, Con. const., 1987 J.C.P. II, No. 20903. On the limitations of tax law making powers, *see* Judgment of Oct. 12, 1983, Con. const., 1985 Recueil Dalloz-Sirey, Jurisprudence, Informations rapides 351; Judgment of May 23, 1984, Conseil d'Etat, 1984 Lebon 188. Thus, while in principle there is a constitutional limitation on what may be provided in regulations, as opposed to laws, as a matter of practice, many rules of taxation are provided by regulation. The Code général des impôts (CGI) does not specifically authorize regulations, since this is unnecessary under the constitutional system. The French regulations are published in a companion volume to the CGI and are about equal in length to the Code.

contain the rules defining the taxpayer, taxable events, tax base, tax rates, and rules for the collection of tax.[195] This power of the executive branch of government to execute or implement the tax laws is based on a general or specific delegation of power in the constitution. Tax regulations issued under such delegation of power are limited to the implementation of the law itself and are valid only within the limits of those laws. What can be determined by executive decree are matters of detail, procedure, and administration.[196] A regulation that extended the scope of the tax law, changed its conditions, or altered the meaning of the law would have to be declared illegal and inapplicable by the courts.[197] The tax administration will be bound by the regulations issued by the executive branch, as long as they have not been declared illegal by a court. In many cases, there will be specific delegation of powers in the tax law, but such specific delegation of power does not add anything to the delegated power of the executive branch of government if a general or specific delegation of such power already exists in the constitution.

In exceptional and very limited circumstances, the legislator may give a full delegation of power to the executive branch to establish tax laws or essential elements of tax laws by decree. Such delegation of power may be specifically provided for in the constitution[198] or in the constitutional doctrine.[199] In such cases, the law containing the delegation often requires post factum ratification of the decree by an act of parliament.[200]

C. Delegation of Tax Law Making Powers in Common Law Countries

The power of administrative agencies to make law is viewed somewhat differently in common law countries such as the United States, the United Kingdom, and Canada. Unlike in continental Europe, there is generally no constitutional delegation of tax law making power to the executive branch of government. Rather, such delegation is

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[195]*See* GG art. 80 (DEU). On the basis of this constitutonal provision, a regulation (Durchführungsverordnung) has been issued for practically all the major taxes. *See also* Judgment of Mar. 5, 1958, BVerfG, 7 BVerfGE, No. 36, at 282, 301 (DEU)("Art. 80 of the Constitution is intended to force the legislator itself to set the rules that are decisive for the regulation of an area, and to the extent that details are left to the executive, to determine their direction and extent, in such a way that the possible contents of the regulations can be foreseen" (ed. trans.)).

[196]For instance, the models of tax forms to be filed and the annexes to be joined, the tax rules that are specific to a certain industry in applying a tax, schedules for depreciation and stock valuation, rules specifying evidence for certain business expenses, specific accounting requirements for tax purposes, implementing rules for tax registration, and rules containing filing requirements.

[197]*E.g.,* Sentencia de la Sección Cuarta, Sala de lo Contencioso Administrativo del Consejo de Estado (Aug. 26, 1994)(COL)(finding a decree invalid because it contradicted the statute).

[198]*See* Grundlov [Constitution] § 23 (DNK); Const. arts. 36, 38 (FRA); Const. art. 86 (ESP).

[199]This is the case in Belgium, where the Constitution does not provide specific delegation of powers in tax matters.

[200]A case in point is the determination of VAT rates in Belgium. VAT rates can be determined by government decree, provided that at the end of the calendar year, the decree is ratified by parliament.

by statute. For example, in the United States, the Treasury Department issues tax regulations, in conformity with general provisions of administrative law (embodied in part in the Administrative Procedure Act),[201] and under the explicit general delegation of authority in the IRC to issue regulations implementing the tax laws.[202] In addition, specific provisions of the IRC grant authority to issue regulations. For example, IRC section 7872 grants the Treasury Secretary authority to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section." In allowing regulations to carry out the *purposes* of the section, this language is broader than the general language in section 7805. However, the specific delegation of regulations authority is confusing, because it is either superfluous or casts doubt on the general delegation of authority in section 7805.

Under the Administrative Procedure Act, regulations are divided into interpretive and legislative regulations, although the distinction between them is not always clear. IRC section 7805 provides sufficient authority for the Secretary of the Treasury to issue regulations interpreting the provisions of the IRC. These will be upheld as valid by a court if they are not inconsistent with the statute. Under broader grants of authority to issue legislative regulations, the regulations may set forth rules that go beyond interpreting the statute. An example is IRC section 385, which authorizes regulations distinguishing between stock and indebtedness, requiring only that the Secretary take certain factors into account. Therefore, as long as statutory authority for a regulation exists, U.S. administrative law does contemplate lawmaking by an administrative agency within the framework of a statute.

The U.S. tax regulations are the most voluminous in the world. Fortunately for those who must consult them, they are numbered according to the sections of the Internal Revenue Code to which they correspond. For example, Treasury Regulation Section 1.117-1 is the first regulations section corresponding to IRC section 117; section 1.117-2 is the second section, and so forth. Most sections are quite lengthy and are subdivided according to a system similar to that used to subdivide sections of the U.S. Code.

Similarly, in the United Kingdom, the executive branch may issue such delegated legislation as it is authorized to do by act of Parliament.[203] The power to make laws is vested in Parliament. However, nothing prevents Parliament from delegating this power, in other words, authorizing governmental bodies to make law by administrative order and

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[201] 5 U.S.C. § 551 *et seq.* (USA).

[202] Section 7805(a) of the U.S. Internal Revenue Code provides that "the Secretary shall prescribe all needful rules and regulations for the enforcement of this title...." The authority for Canadian Income Tax Regulations follows basically the same pattern as that of the United States. Section 221(1)(j) of the Canadian Income Tax Act (CAN ITA) gives broad powers to make regulations "generally to carry out the purposes and the provisions of the Act." However, regulations that are inconsistent with the provisions of the Act will not be applied by the courts. *See* Charos v. Minister of National Revenue, 62 Dominion Tax Cases [D.T.C.] 273 (1962). Regulations are published in the Canada Gazette. CAN ITA § 221(2).

[203] *See generally* H.W.R. Wade, Administrative Law 733–47 (5th ed. 1982).

even to amend acts of Parliament if so authorized.[204] Delegated legislation must be within the scope of the delegated power; otherwise, it can be struck down by the courts.[205] There is no single name in the United Kingdom for delegated legislation (e.g., regulations, rules, orders), although they are published in a uniform series of statutory instruments.[206] In the tax area, there are voluminous regulations, although their text is not as long as that of the laws themselves (about 1 1/2 volumes of statutory instruments to 3 1/2 volumes of laws). This is partly due to the extensive use of schedules to the laws, which often contain what would otherwise be in regulations. In contrast to the tax regulations of the United States, which are arranged according to the arrangement of sections of the statute, the various U.K. regulations stand alone, which obscures their relation to the statute.

D. Administrative Commentaries, Interpretations, and Statements of Practice

In addition to executive decrees and regulations, most tax administrations in continental European countries issue administrative commentaries, instructions (which may relate to specific tax forms or be published separately), guidance to their own staff, and circular letters.[207] Such administrative commentaries or instructions are binding only on the administration for which they are intended. They are not binding on the taxpayers or the courts. There are several cases in which the courts have specifically rejected the interpretation of the tax law made by the tax administration in such administrative commentaries or instructions.[208]

The U.K. Inland Revenue issues "statements of revenue practice." These are of great importance for the practical administration of the tax system, although they do not have the force of law. Statements of revenue practice generally are interpretations of the tax law by the tax administration. They also include "extra-statutory concessions." These are written almost in legislative form, although they do not have the same formal status as a statute in the sense that the tax administration does not have a binding obligation to apply them. However, development of administrative case law suggests that the Inland Revenue would not be authorized to deny such a concession to a taxpayer, because such a denial would constitute a breach of duty to act fairly between different

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[204] *See id.* at 738–39.

[205] *See id.* at 748.

[206] *See id.* at 735–36, 741.

[207] *E.g.,* Verwaltungsanordnungen in Germany. In France, the tax administration publishes instructions and circular letters; these are binding on it. It also publishes annually an explanatory treatise, the *Précis de fiscalité*; unlike administrative commentaries and interpretations in circular letters or instructions, the *Précis de fiscalité* is not binding on the French tax administration.

[208] For Belgium, Judgment of Nov. 22, 1949, Cour de cassation, 1950 Pas. Bel. I 182, 1949-50 Algemeen Fiscaal Tijdschrift 258; for Canada, Stickel v. Minister of National Revenue, 72 D.T.C. 6178 (1972) and Canadian Pacific Ltd. v. the Queen, 76 D.T.C. 6120 (1976); for Germany, Judgment of May 31, 1988, BVerfG, 78 BVerfGE, No. 20, at 214, 227; for Spain, Escuela de Inspección Financiera y Tributaria, *supra* note 178, at 57.

taxpayers.[209] The ostensible purpose of these concessions is to deal with hardships that are minor or transitory, although in fact they can be more significant.

Revenue Canada issues interpretation bulletins stating its views on how to interpret and apply particular provisions of the tax laws. These administrative bulletins have no legal force, but Revenue Canada, in most cases, follows its own interpretation bulletins. Thus, if a taxpayer also follows them, the tax authorities cannot challenge the taxpayer's position. If a taxpayer disagrees, the taxpayer can challenge the position of the tax authorities in court.

In the United States, the Internal Revenue Service issues a steady stream of revenue rulings, instructions, and other releases on how it believes the tax laws should be applied. These administrative pronouncements are not binding on the taxpayer, but, until they are withdrawn, they are binding on the lower tax officials.

E. Administrative Rulings

Administrative rulings are an important instrument in the implementation of tax law.[210] Some countries, like Australia, Canada, the Netherlands, the United Kingdom, and the United States, have a long tradition of advance rulings. This means that the tax administration will issue a binding application of the tax law to the facts presented by the taxpayer on the condition that the taxpayer give a full and fair representation of all the relevant facts. Such rulings are effective in avoiding conflict and litigation by establishing in advance an authoritative interpretation of the tax law, so that the taxpayer has full security in the way the tax law will work out in a specific situation.

In allowing the tax administration to issue rulings, the following basic questions should be kept in mind: (1) Is the effect of the ruling limited to the taxpayer who requested the ruling, or can other taxpayers also rely on the ruling? (2) Is the ruling regularly published or not? (3) Are there public and private rulings? (4) Which administrative ranks of tax officials have authority to issue a ruling? (5) Are ruling decisions decentralized at the local level or are they centralized at a higher level or issued by a special unit of the tax administration? (6) What is the exact procedure for requesting a ruling and for deciding on and issuing a ruling? (6) What are the conditions under which the tax administration can change its position under a ruling?

In some countries, like the Netherlands, the power of the tax administration goes even further in that the tax inspector can grant a private ruling for a taxpayer by which he or she grants certain concessions. This type of ruling gives enormous flexibility to the application of tax law and permits the establishment of private tax concessions that are

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[209] *See* Butterworths U.K. Tax Guide 1990-91, ¶ 1:33 (John Tiley ed., 9th ed. 1990).

[210] *See generally* International Fiscal Association, Advance Rulings: Practice and Legality (1994); Jason Chang et al., *Private Income Tax Rulings: A Comparative Study,* 10 Tax Notes Int'l 738 (1995).

not published by way of general rule. Such power can be granted only to tax officials who show great restraint and discipline and are immune from corruption.

In other countries, however, the tax administration cannot issue binding advance rulings. The absence of the power to grant advance rulings has to do with a general view of the role of the tax administration and the role of the tax law and is closely linked to the principle of legality of the tax law and public order, according to which the tax law must be applied strictly and no agreements can be made on its application.[211]

Sweden has a unique system for advance rulings, whereby these are issued not by the tax administration but by an independent council.[212] Decisions of the council can be appealed. "After more than 40 years of Swedish experience with advance rulings, it is quite clear that the cases of advanced rulings being appealed against to the Supreme Administrative Court have delivered an extremely important part of our case law, perhaps the majority of leading cases, and proven of particular value in making court testing, especially of new legislation, possible early enough as to be of real guidance from the outset."[213]

France has a specific system of preliminary agreement, which should be distinguished from the ruling system.[214] It makes certain tax benefits dependent upon the preliminary fulfillment of certain conditions that are reviewed by an agency other than the tax administration. These preliminary agreements can be found, for instance, with tax benefits granted within the framework of economic development of the regions or the economic restructuring of certain industries. The conditions of economic development or restructuring realized by the taxpayer will be evaluated to see whether the taxpayer meets the requirements for the tax benefit.

Finally, specified tax treatment of a transaction may be conditional upon preliminary approval by the tax administration.[215] Such a preliminary approval is often used to guarantee that the taxpayer will not abuse the transaction for purposes of tax evasion or tax avoidance. A requirement of preliminary approval may be particularly appropriate for types of transactions that are rare and that, in the absence of an approval requirement, would need complex statutory provisions. In a certain sense, this is a

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[211] *See supra* note 14; Rivier, *supra* note 110, at 302.

[212] SWE AAR.

[213] Leif Mutén, communication to editor (1995).

[214] *See* Gambier & Mercier, *supra* note 45, at §§ 2260–70 (*les agréments fiscaux*). A similar procedure is applicable in the United States with respect to certain tax benefits, for example, the historic rehabilitation tax credit, which is based on approval of a project by the Interior Department. *See* USA IRC § 47(c)(2)(C).

[215] *See, e.g.,* USA IRC § 367(a)(1981) (transfer to foreign corporation is taxable event unless the Secretary issues a ruling pursuant to a ruling request filed within 183 days after the beginning of the transfer). In 1984, the requirement to obtain a ruling was repealed.

mandatory preliminary ruling. In particular, tax administrations that are not strongly equipped may be tempted to exercise this type of control on taxpayers. However, precisely because such preliminary agreements are often used by weak tax administrations, they can result in corruption and should therefore be implemented only with caution.

V. Division of Tax Powers Between the Central and Local Governments

The allocation of fiscal powers between different levels of government is a complex problem meriting a whole book. Here, a brief overview of the main legal issues is provided.

A. Classification of Tax Powers

Tax law making powers can be divided in different ways. First, a distinction can be made between various types of taxes: income taxes, wealth taxes, turnover taxes, excise and consumption taxes, and so on. The power of taxation with respect to one particular category of tax is often fully reserved for one specific level of government.

A second distinction can be made with respect to the basic elements of any tax. The structure of any tax consists of several elements: the subjects of the tax or the type of taxpayers, the tax base, the tax rate, and the tax procedure. Theoretically, it is possible to reserve the power to legislate with respect to one element of taxation for one level of government (e.g., tax base and rate) and another element for another level of government (e.g., tax procedure).

Finally, a distinction can be made between the levels of implementation of a tax. As explained above, legislative power can be reserved for one branch of government, while administrative implementation is reserved for another. This is a traditional distinction that can be made for any type of lawmaking power. However, the distinction between lawmaking power and administrative implementation may also be made between different levels of government (e.g., central and regional or local government). In such a case, it is necessary to specify which level of government exercises general lawmaking power, and which levels of government exercise various administrative powers of implementation at various hierarchical ranks—for example, executive decrees, regulations, rulings, and instructions.

B. Leading Principles in the Distribution of Tax Power

1. Federal vs. a Centralized State

The most important factor that determines the distribution of tax law making powers among the various levels of government is whether the state is federal or centralized. In referring to federal and centralized states, it is important to remember that these are simplifications and that the constitutional reality of any particular country may defy easy categorization.

In a centralized state, there are usually only two significant levels of government: the central government and the local government. Intermediate levels of government can exist, but they are usually politically and fiscally unimportant. A federal state is characterized by the fact that in addition to the central and local levels of government, there is a strong intermediate level of government in the form of autonomous or independent regions or states. In several European countries, there is a tendency toward the constitution of a federal state. Formerly centralized states, such as Belgium, France, Italy, Spain, and even the United Kingdom, are all in varying degrees in the process of organizing political and fiscal power at the intermediate level of government. For example, Belgium and Spain have become federal states similar to Austria and Germany. Yet, examples of fairly centralized states continue to exist—Denmark, Ireland, the Netherlands, Portugal, and Sweden.

2. Economic and Monetary Union in a Federal State

Within a federal state with a market economy, the preservation of economic and monetary union is a basic element in determining at what level of government certain taxes should be levied.

An economic and monetary union in a free market presupposes a minimum degree of economic cohesion and uniformity. This in turn requires that certain taxes be levied only by the central government. An obvious example is customs duty. If regional governments have the power to levy customs duties, they can obstruct the flow of goods between regions. The first rule of an economic and monetary union is that all taxes related to the import or export of goods are levied by a central authority or at least levied in accordance with rules that are the same for all the component states belonging to the union.[216] Other taxes that affect interregional commerce must be levied in a manner that will not unduly impede such commerce.

3. Relation Between Revenue and Expenditure

Another important principle in the distribution of tax law making powers is the balance between revenue and expenditure. A certain overall equivalence between the amount of taxes that can be raised autonomously by local governments[217] and the volume of public outlays for which they are responsible is indispensable. This equivalence between taxing power and spending power is an indicator of the true degree of autonomy of local governments.

[216]The classical example is the European Union, which has a common customs system, although the common rules are administrated by independent national customs administrations.

[217]The term "local" government includes regional levels of government.

Of course, the constitutional setup can be organized in such a way that a local government does not raise its own revenue but is subsidized by grants from a higher level of government; that is, the federal government raises the revenue and transfers the funds to local governments. This mechanism is often used in federal states to transfer funds from richer regions to poorer regions.[218] The system of financing through grants, in which different governments are responsible for raising revenue and spending it, can lead to problems.

In a system of financing local government through grants, it is difficult to maintain true autonomy of local government. On the one hand, unconditional or unlimited grants can lead to irresponsible behavior by local governments, which will be inclined to spend at the expense of the central government. On the other hand, if the grants are subject to conditions set by the central government, the latter can choke off completely the autonomy of the local governments by imposing strict conditions on these grants or by restricting their amounts.

Besides the democratic substance of the tax system, budgetary principles call for a rough balance between taxing and spending powers: such balance reflects the true allocation of costs of government functions. In a system of financing local governments with unconditional grants, the burden of cost for the operation of a specific level of government is not reflected at the level of government that is spending. Therefore, it will be more difficult to determine the real operating cost of that level of government.

4. Distribution of Tax Law Making Power with Respect to Certain Elements of the Tax

In many cases, full legislative power for all elements of a tax is not vested in one particular level of government, but distributed over several levels of government. This is often the case when the revenue raised from a particular tax is shared by two or more levels of government.

The most frequent model is one in which the central government retains control over the determination of the subjects of taxation, the tax base, and the procedural rules, but the power to fix rates is shared with other levels of government. This model exists in several European countries and in Japan, whereby a surcharge of one or more national taxes is levied to benefit local governments.[219]

In some cases, besides the power to set the rates, part of the legislative power with respect to the tax base also belongs to regional or local governments. In other cases,

[218] *See, e.g.,* for Germany, the *Bundesfinanzausgleich* [Federal equalization of finances] in art. 107 of the Constitution. The United States had so-called revenue-sharing provisions for a time, but they have been dropped. State and Local Fiscal Assistance Act, Pub. L. No. 92-512, Title I, 86 Stat. 919 (1972).

[219] *See* International Tax Program, Harvard Law School, World Tax Series: Taxation in Italy 65–66 (1964); Hiromitsu Ishi, The Japanese Tax System 256–59 (1993).

simultaneous and full parallel taxing power on the same tax is held by federal and regional levels of government. Examples of this situation are not so common because the coexistence of two levels of legislative power over the same tax is a constant source of conflict. In Belgium, for example, the tax on estimated rental income from real estate is distributed among no fewer than four levels of government: the central state, the regions, the provinces, and the local municipalities. The central state determines the general rules for the tax base and includes this income in the tax base of the progressive income tax. The regions set a separate flat rate on the tax base as determined by the central state, but have the power to introduce certain exemptions from the tax base and to allow certain reductions of the amount of regional tax due. Finally, the provinces and the local municipalities are entitled to a surcharge on the amount of tax levied by the regions without any change of the tax base.

In Germany, the Federal Government theoretically shares its tax law making power with the state governments.[220] This parallel power is limited, however, by another constitutional provision stating that the state governments lose their lawmaking power when the Federal Government has legislated in a tax area.[221] In Canada, income tax is imposed on individuals and corporations under the Federal Income Tax Act. The provinces have the power to levy income tax on both individuals and corporations; generally, this power is exercised by setting a provincial rate of tax to be applied to the tax base established by the federal act, the tax being collected by the federal administration. Exceptions are Quebec, which has its own income tax law, and Alberta and Ontario, which have their own corporate income taxes.[222]

In the United States, the states theoretically have full taxing power, except for customs duties.[223] This taxing power is subject to some constitutional limitations, the most important of which is the interstate commerce clause,[224] which prohibits the states from obstructing interstate commerce by restrictions in the tax laws. States can therefore provide their own definition of taxable income, although in practice the federal definition is the starting point and the deviations from it are relatively limited in scope in most states. Tax rates differ from state to state, and some states do not even have an income tax. As a result of this parallel taxing power, conflicts on tax jurisdiction may arise between the federal and the state level, as well as among the states themselves. In Switzerland, the confederation and the cantons effectively share tax law making power

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[220]*Konkurrierende Gesetzgebung* (concurrent lawmaking). *See* GG art. 105/2 (DEU).

[221]*Id.* art. 72/2 No. 3.

[222]*See* the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, S.C., ch. F-8 (1993).

[223]*See* Const. art. 1, § 10 (USA).

[224]*Id.* art. 1, § 8, cl. 3.

for direct taxes on income and wealth.[225] Conflicts between certain types of tax legislation are solved by harmonization of the conflicting tax rules.[226]

Another example of this setup is the way in which customs duties are administered in the European Union. All the rules with respect to the subjects of taxation, the determination of the base, and the rates are determined by EU law. The tax administration and procedure (i.e., tax returns, control measures, tax protests, and litigation) are administered in accordance with the national law of the member states.

5. Distribution of Tax Law Making Power According to the Level of Implementation of the Tax

Finally, it is possible to distribute tax law making power in accordance with the level of implementation of the tax. In this model, the general rules with respect to the subject of the tax, the tax base, and rates are fixed at the central level of government, while the more concrete details of the implementation of the tax are left to lower levels of government. For example, in Germany, regional tax authorities administer major federal tax laws for the account of the federal treasury.[227] Another example of this model can be found in the way the VAT and certain aspects of corporate income tax are implemented in the EU.

The VAT has been introduced in the EU by way of directive.[228] A directive is a legislative act issued by the Council of Ministers of all the member states, who decide by unanimous vote (in tax matters) to introduce certain tax rules. In this case, the basic rules determining the subject of taxation, the tax base, and part of the rules of procedure and administration (not the rates) have been determined by directive, leaving certain options to member countries. Each of the member states then implements the VAT through national laws. Disputes may arise when taxpayers argue that the national laws are inconsistent with the directive.[229]

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[225]*See* Const. art. 41 *ter* (CHE); International Tax Program, Harvard Law School, World Tax Series: Taxation in Switzerland 140–42, 165–69 (1976).

[226]*See* Const. art. 42 *quinquies* (CHE) (*cited by* Rivier, *supra* note 110, at 42–43); *see also* Ernst Höhn, *supra* note 110, at 34.

[227]*See* GG art. 108 (DEU). On the basis of this article, regional tax authorities administer the personal and corporate income tax, the business tax (*Gewerbesteuer*), the VAT, and inheritance and gift taxes, as well as the road tax. *See* 3 K. Tipke, *supra* note 53, at 1130.

[228]Sixth Council Directive 77/388 of May 17, 1977, on the Harmonisation of Laws of Member States Relating to Turnover Tax—Common System of Value Added Tax Uniform Basis of Assessment, 1977 O.J. (L 145) 1; Second Council Directive 67/228 of Apr. 11, 1967, on the Harmonisation of Legislation of Member States Concerning Turnover Taxes—Structure and Procedures for Application of the Common System of Value Added Tax, 1967 O.J. (L 71) 1303; First Council Directive 67/227 of Apr. 11, 1967, on the Harmonisation of Legislation of Member States Concerning Turnover Taxes, 1967 O.J. (L 71) 1301.

[229]*See* Case C-35/90, Commission v. Spain, 1991 E.C.R. 5073; Case C-31/89, Commission v. Spain, 1990 E.C.R. 2139; Case C-120/88, Commission v. Italy, 1991 E.C.R. 621; Case 50/87, Commission v. France,

The same pattern is emerging in the EU with respect to the corporate income tax. Certain requirements with respect to the treatment of corporate reorganizations and intercorporate dividends, which particularly affect corporate groups with members in more than one state, have been imposed by directive.[230] Further, in a report on the harmonization of the corporate income tax, a committee of independent experts advised the European Commission to set certain minimum rules with respect to tax rates and tax bases beyond which member states should not go.[231] Within the outer limits established by these minimum rules, member states would retain full taxing power.

6. Deduction or Credit for Regional and Local Taxes

An important question in the distribution of revenue between various levels of government is whether a local tax is deductible from the tax base determined by the central government or whether it can be credited against the amount of tax due to the central government.

If a tax levied by a regional or local government can be credited without limit against a tax levied by the central government, the lower government, by increasing its taxes, can completely wipe out the tax revenue of the central government. An example of this is the tax on estimated rental income from real estate in Belgium. The regional, provincial, and local taxes on estimated rental income can be credited against the progressive personal income tax levied by the central government; that is, the amount of tax due to the lower governments is deducted from the amount of tax due to the central government and only the balance has to be paid. To prevent the regional and local governments from reducing the central government's revenue by increasing their taxes, the central government has set a limit on the amount of tax that can be credited at 12.5 percent of the tax base.

A similar problem arises when local taxes are deductible in determining the base of a tax levied by the central government. Recent examples of this are environmental taxes, such as taxes on litter or the use of water, levied by regional or local authorities that are deducted from the corporate income tax base. As the local tax burden increases, the tax base for the central government is reduced.

1988 E.C.R. 4797; Case 122/87, Commission v. Italy, 1988 E.C.R. 2685; Case 249/84, Ministère Public and Ministry of Finance v. Profant, 1985 E.C.R. 3237.

[230]*See* Council Directive 90/434 of July 23, 1990 on the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States, 1990 O.J. (L 225) 1; Council Directive 90/435 of July 23, 1990 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, 1990 O.J. (L 225) 6.

[231]Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation (1992).

7. Distribution of Tax Law Making Powers in a Centralized State

The distribution of tax law making powers in most centralized states is fairly simple because there are only two significant levels of government: central and local. The local government in most cases is too small to administer any of the important taxes, so the power to impose the most important taxes rests with the central government.

In a typical centralized state, all major modern taxes are levied by the central government. All aspects of legislative power over these taxes rest with the central government, and local governments are not involved in their implementation or administration. Allocation of revenue to local government is typically governed by a law on local finance.[232]

The problem in such centralized states is that local governments may not have adequate taxing power. While it is not possible to make a complete inventory of taxes levied by local governments, some patterns of taxation do emerge. Local governments in many Western European countries are typically financed by surcharges on personal or corporate income tax, surcharges on national road taxes, taxes on real estate, and taxes on business activity. There is often a ceiling on the amount of local surcharge to be levied. Taxes on the estimated value of real estate, on rented rooms or hotel rooms in tourist sites, or on second residences are categorized as taxes on real estate. Taxes on personnel or equipment used in the exercise of a business, taxes on business offices or the authorization to open a local business, or taxes on turnover or on the exercise of a business are categorized as taxes related to a business or professional activity. Finally, taxes such as those on the collection of refuse and litter, sewer connections, and the delivery of passports and public certificates relate to services provided by the local administration.

As the financial needs of local governments grow, the proliferation of all types of taxes increases the tax burden and can make the local tax "system" incomprehensible and obscure. Therefore, it is preferable to reserve a few major sources of revenue such as surcharges on personal and corporate income tax for local governments, so that they are not obliged to raise taxes arbitrarily.

8. Distribution of Tax Law Making Power in a Federal State

The distribution of tax law making power in a federal state is much more complex than in a centralized state because there is at least one additional level of government (the regional government) large enough to administer a major modern tax system. In a federal system, the question is how to distribute tax law making power with respect to major taxes while maintaining economic and monetary union. In a federal state, both the federal government and the states often have full power to raise important taxes, such as

[232]*See* Nieuwe Gemeentwet [New Law on Local Government], Koninklijk Besluit [King's Decree] of June 24, 1988, B.S. 12.465 (Sept. 3, 1988)(BEL).

corporate and individual income tax and sales taxes. A single corporation may be liable to corporate income tax in all the states in which it does business. This raises the risk that either (1) the various states in which the corporation operates will each seek to tax more than their appropriate share of the corporation's income, thereby leading to multiple taxation of the same income, or (2) the corporation will take advantage of the different tax rules operating in each of the states to arrange its affairs so that much of its income escapes taxation.

The problems involved in limitating the taxing authority of regional governments are beyond the scope of this book.[233] In countries where regional governments enjoy fiscal autonomy, there is usually substantial litigation concerning these limitations.

[233] *See generally,* for Belgium, A. Alen, Treatise on Belgian Constitutional Law 256–62 (1992); for Switzerland, World Tax Series: Taxation in Switzerland, *supra* note 225, at 103–106; for the United States, 1 Jerome R. Hellerstein & Walter Hellerstein, State Taxation, chs. 4, 5 (2d ed. 1993).

3

Drafting Tax Legislation

Victor Thuronyi

> In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.
>
> —Learned Hand, The Spirit of Liberty.

I. Introduction

Drafting tax laws is a subspecialty of legislative drafting in general.[1] This chapter does not attempt a comprehensive treatment but serves as an introduction, focusing on questions that have been of particular concern in drafting tax laws. The focus is on drafting technique, other matters relating to drafting being considered elsewhere in the book.[2] In addition, the chapter is limited to considerations that apply generally,

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[1]For more general treatments, *see* Lawrence E. Filson, The Legislative Drafter's Desk Reference (1992); Robert J. Martineau, Drafting Legislation and Rules in Plain English (1991); David Renton, The Preparation of Legislation: Report of a Committee Appointed by the Lord President of the Council, 1975, Cmnd 6053; G.C. Thornton, Legislative Drafting (3rd ed. 1987); Elmer A. Driedger, The Composition of Legislation (1957); Reed Dickerson, Legislative Drafting (1977); S. Namasivayam, The Drafting of Legislation (1967)(U.K.-style drafting, with particular emphasis on Ghana and Ceylon); Louis Philippe Pigeon, Drafting and Interpreting Legislation (1988)(focus on Canada and Quebec in particular, but much of discussion is of general interest); Law-Making and Development: Formulating Policies and Drafting Legislation (Seyoum Haregot ed., 1987) (collection of essays on the role of legislation, legislative drafting, and related topics, with special emphasis on developing countries); V.C.R.A.C. Crabbe, Legislative Drafting (1993) (focus on Commonwealth practice; appendix contains Canadian guidelines on preparation of legislation); William Dale, Legislative Drafting: A New Approach (1977) (comparative study of methods in France, Germany, Sweden, and the United Kingdom). The best (and funniest) short piece on drafting I have read is Ward Hussey, Homily on Drafting Style (as yet unpublished).

[2]For example, discussion of the drafting process and legislative process in general in ch. 1, the legal framework in ch. 2, and drafting problems that relate to specific taxes throughout the book.

regardless of language or jurisdiction. Because languages and local drafting styles differ, the approach to drafting a tax law will vary widely from country to country.

Those who draft tax legislation in developing or transition countries usually are not subspecialists in this area (i.e., lawyers who have specialized in legislative drafting and in particular in the drafting of tax legislation). Local officials responsible for drafting typically are tax experts in the ministry of finance, and are not often lawyers or specialists in drafting. Foreign advisors who assist them can be lawyers, accountants, or economists with a background in taxation, but do not usually have an expertise in legislative drafting. Therefore, this chapter explores some of the lessons that can be learned from specialists in legislative drafting.

The effectiveness of a tax law is enhanced if its words are meaningful, intelligible, well thought out, and well organized. Many tax laws do not come close to meeting these criteria. The tax laws of countries with established and sophisticated systems can be particularly impenetrable, as qualifications and exceptions have been heaped on top of existing rules. In this sense, those working in developing and transition countries have an opportunity to produce better laws than exist in developed countries. Poor drafting often leads to substantial problems in implementation of a new tax law that could have been avoided. A goal of this chapter is to encourage those involved in the tax legislative process to devote greater attention to drafting technique.

The discussion in this chapter is organized according to the criteria for a well-drafted law. I have identified these as understandability, organization, effectiveness, and integration. Understandability refers to making the law easier to read and follow. Organization refers to both the internal organization of the law and its coordination with other tax laws. Effectiveness relates to the law's ability to enable the desired policy to be implemented. Finally, integration refers to the consistency of the law with the legal system and drafting style of the country. These criteria are, of course, interrelated and somewhat overlapping. Organization is important for understandability, and all the criteria contribute to the effectiveness of the law.

In the most general terms, the tax laws should be drafted so as to best fulfill their role in the tax system, which is to specify such matters as how much each taxpayer is liable to pay and what the taxpayer's rights and obligations are.

A well-drafted tax law spells out with precision the matters that are within its scope. But precision is not enough. A law should not be precise at the expense of being complicated and impossible to understand. The easier a tax law is to understand, the lower will be the compliance costs, both for taxpayers and for tax administrators. It is particularly important that a tax law be easy to apply (compared with other public law, for example, a law governing the generation of toxic waste or one governing building codes) because the tax law applies to nearly every physical and legal person in the country with respect to countless transactions every day. The fact that tax law must be applicable to so many transactions in an efficient manner has an important influence on how the law must be drafted. In particular, there is little room for sloppiness. Finally, a tax law must be effective in achieving the policy goals of the legislator, both in terms of the amount of revenue to be raised—with an eye to equity, efficiency, and simplicity—and the items and persons to be taxed. Good drafting goes hand in hand with the specification of policy.

These criteria sometimes conflict. For example, a simple statute may be rejected as inequitable, because it does not recognize the differences in situation of different taxpayers. A statute that provides too much certainty may conflict with the goals of equity and revenue raising (because the certainty can be exploited by tax planners). In many cases, however, there is no conflict; complexity that is merely the result of bad drafting can be eliminated while at the same time providing greater certainty and a clearer articulation of the policy.

II. Understandability

A. Brevity

The shorter the statute, the less effort will be required to understand it, and the lower compliance burdens will be. Elegance, brevity, and clarity of expression are therefore to be sought. Every word in a statute should have a definite purpose and no unnecessary word should be used.[3] In addition to being easier to understand, a more elegant statement often better articulates the policy of the law. For example, on reviewing an initial draft of a statute, the drafter might notice that several rules, perhaps located in different parts of the statute, could be combined into one general rule which covers what previously appeared as unconnected details. (This is one example of the close interrelationship between the development of policy and the process of drafting.)

The prescription for brevity does not necessarily mean that a shorter statute is better than a longer one. It may be determined that certain details need to go into the statute, and it takes additional words to express these details. Moreover, the expression of an idea in so few words that it becomes cryptic and understandable only after careful study also constitutes an extreme to be avoided. The point is simply that no word should be included if it does not serve a function.

How long the optimum law would be for a particular tax is an interesting philosophical question and an important one in drafting a new law. Whatever the answer in the abstract, much more important is the local situation. The local officials who will be working with the new law must make it their own. The constraint in terms of length is often how much can be absorbed by those who will be using the law. Because taxation suitable for a market economy is a recent phenomenon in transition countries, the length of the tax laws in such countries can be expected to increase as their experience with taxation grows. One implication is that the tax legislative process for these countries has only just begun.

[3]Drieger, *supra* note 1, at xxii.

B. Transparency

A statute is transparent if it easily allows the reader to understand the rationale of the rules.

One way of achieving transparency is to begin a law by stating its purpose.[4] If the statement is very general, it is not helpful. On the other hand, a very general statement can do little harm. (E.g., an income tax law might begin: "This law levies a tax on income.") If the statement is made more specific and operational, then it could serve a function by indicating the overall legislative purpose so as to facilitate interpretation of ambiguous provisions. In the case of some legislation, this might be helpful. For example, a piece of environmental legislation might stipulate that the purpose of the legislation is to eliminate pollution wherever technically feasible, regardless of the cost, or it might provide the opposite, that the statute should not be construed as requiring measures to be taken whose costs are disproportionate to the environmental benefits. Either philosophy, if articulated by the legislature, would give guidance to the courts as to the legislative intent.

In the tax area, however, it may be dangerous to make an overriding general statement of the legislative purpose, because the courts may interpret the provisions of the statute in light of this stated purpose and may be misled in doing so. It is difficult to avoid a misleading statement of purpose, because tax laws are highly technical and, in some cases, artificial. For example, person *X* might be denied a deduction because that is an administratively more feasible approach than taxing person *Y* on the payment received from person *X*.[5] The result is that person *Y* is not taxed on the payment and person *X* is denied a deduction which should be available under general principles. This would hardly square with a general statement to the effect that "each taxpayer shall pay tax on the taxpayer's net economic income." Not only do the tax laws contain artificial provisions, but they are also prey to competing policy goals. Some deductions are allowed because they accurately reflect net income; others because of a legislative purpose to encourage a particular activity; in some cases, motives for providing a deduction are mixed. Because of the disparate and competing policies behind tax legislation, it becomes difficult to describe the general purpose of the law in operational terms. Tax laws therefore have generally not included a statement of purpose. Recently, however, in New Zealand, legislation has been introduced that states the purpose of the income tax act and provides an underlying framework for the income tax.[6] If adopted, it will be interesting to see how this works.

Instead of stating the law's purpose, the law could begin with an exposition of its basic mechanics, that is, identification of the taxpayers, tax base, and location of

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[4]*See, e.g.*, 16 U.S.C. § 1531(b) (USA) (purposes of Endangered Species Act). *See generally* Dickerson, *supra* note 1, at 107–108; Renton, *supra* note 1, at 30, 62–63.

[5]*See* vol. 2, ch. 14 (discussion of different ways of taxing fringe benefits).

[6]*See* Adrian Sawyer, *New Zealand Introduces New Core Provisions Bill,* 12 Tax Notes Int'l 539 (1996).

provisions containing the rates. This would be more modest than attempting to state the purpose of the law, but it would at least allow the reader to see the basic structure of the law at the beginning. Whether this approach is suitable in a particular case will depend on local drafting style.

C. Avoiding Legalistic Language

Advocates of "plain language" drafting recommend avoiding legalistic language, so as to make the law easier to understand.[7] Where legalisms are verbose or obscure, they can make comprehension more difficult, and they should be eliminated if possible. For example, artificial terms with meanings defined in the tax law should be used sparingly, as their use will often be confusing to a reader who is not thoroughly familiar with the statute. On the other hand, the use of legal terms or other terms of art can make the statute precise and shorter, where these words have a technical meaning or a meaning determined by legal rules outside the tax law. For example, concepts such as corporation, partnership, employee, contract, mortgage, or lien may be well defined by laws outside the tax laws, and it is appropriate to use these words rather than simpler words that might be more understandable to laypersons. It is sometimes appropriate, however, to adopt a modified meaning for tax purposes.[8] One should therefore not hesitate to use technical terms where appropriate, even if a layperson might as a result have greater difficulty in understanding the statute. While it is nice if portions of the tax laws are comprehensible to nonlawyers (or even to non–tax lawyers), and the law should be so drafted if precision is not sacrificed, comprehensibility to the layperson should not be an absolute requirement in an area as technical as tax law.[9] A tightly drafted statute can be translated to the layperson in the form of instructions.

D. Numbering of Sections[10]

Most countries have adopted the practice of numbering the sections of a statute sequentially, that is, 1, 2, 3, and so on.[11] While this is fine for a statute that will never be changed, most tax laws are amended frequently. Amendments create problems for sequential numbering. Either amendments have to be placed at the end of the statute, in which case they are not in the logically appropriate place, or they can be inserted in the appropriate place but the sections of the statute have to be renumbered, or they can be inserted under a hybrid alphanumerical designation. Except where legislation is

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[7]*See* Martineau, *supra* note 1, at 90–92.

[8]*See infra* sec. V(C).

[9]*But see* Martineau, *supra* note 1, at 91 (legislation should be drafted so that it can be understood by a person of average intelligence). The taxpayer's contact with the law itself may be minimal. Most people will rely on explanations of the law issued by the tax authorities, and considerable care should go into writing such explanations. These should be written in language understandable by laypersons. *See also* Renton, *supra* note 1, at 112–13.

[10]"Section" is used in this chapter to refer to the basic unit of a statute. In some countries, particularly in the civil law tradition, "article" or "paragraph" is used.

[11]*See, e.g.*, Thornton, *supra* note 1, at 59–60.

completely overhauled, renumbering is confusing and should be avoided because references to section numbers in other laws, in legal documents, in judicial decisions, in regulations, and in articles and other descriptive materials become incorrect.

Renumbering can be avoided by inserting new sections between the existing sections. However, this can lead to bizarre and confusing designations for sections.[12] The solution adopted in the U.S. Code (one title of which is the Internal Revenue Code) is nonsequential numbering. The approach is to leave a gap in section numbering between each division of the statute. If new sections are added, they can be named by using the unused section numbers. For example, the first group of sections might run from 1 to 14, and the next group begin with section 20. One might object to this on philosophical grounds (the section called 20 is not the twentieth section, but only the fifteenth), but section designations like "238 *bis*" seem equally objectionable to me (how can there be a first section 238 and a second section 238?). If tradition can be overcome, nonsequential numbering offers an advantage.[13]

E. Section Headings

In many countries, sections do not have section headings,[14] but are simply designated by numbers.[15] The use of section headings makes it much easier to read and understand the law; moreover, it acts as a discipline for the drafter. If the drafter cannot think of a good heading for a section, it may be because the section contains disparate subject matter, which would best be broken into more than one section. Recent legislation in a number of transition countries now contains section headings.[16]KAZ TC.

If a decision is made to use section headings, the question arises whether headings for subdivisions of a section should also be used. For example, in the U.S. Internal Revenue Code, not only does each section have a heading, but each subsection and

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[12]For example, the following articles exist in the FRA CGI: art. 235 *ter* EA (which comes after art. 235 *ter* E), and art. 235 *ter* H *quater* (which, obviously, comes right before art. 235 *ter* HA, which would, presumably, if it had been enacted after art. 235 *ter* H *quater*, have been called art. 235 *ter* H *quinquies*). So far, the Parliament has not found the need to insert an article between art. 235 *ter* HA and art. 235 *ter* HB, or, what would be even worse, an article between art. 235 *ter* H *ter* and art. 235 *ter* H *quater*.

[13]It is not a perfect solution, in the sense that assigning the unused article numbers to new articles might place the new articles in an order that is not quite logical. Often, however, new articles will be appropriately located in the places where gaps are left, since they will be in the nature of special rules, which are appropriately placed at the end of a group of related articles.

[14]In the U.K. tradition, the term used is marginal notes, and these are, as the name implies, placed in the margin, except in New Zealand and Canada, where they follow the section number as a heading. *See, e.g.,* CAN ITA. *See also* Thornton, *supra* note 1, at 125–28.

[15]*E.g.*, France, Germany, and Spain. In such countries, however, parts of a statute (they may be called title, part, chapter, and the like) do typically have headings. *E.g.,* FRA CGI.

[16]For example, section headings are used in many of the recently adopted tax laws of Estonia. *See, e.g.,* EST LOT; EST IT; EST VAT; EST LND; EST GAM. Section headings are also used in some of the Russian and Latvian tax laws, as well as in the new Kazak code. *See, e.g.,* RUS IT; RUS PT; LVA TF; LVA EIT; LVA ET;

paragraph does too. This may be appropriate in a situation, such as for the U.S. Code, where even the subdivisions of a section are lengthy. In a more sparse drafting style, the use of headings for subdivisions of articles would lead to clutter. A cluttered statute being more difficult for the reader to digest, there comes a point in the subdivision of a statute where the use of headings should stop. In most cases, my preference would be to do this at the level of the section, but the matter should be decided in light of the characteristics of the statute being drafted and of the country's drafting style.

Where section headings (or marginal notes) are used, the question of their legal effect should be considered; that is, to what extent should or will courts rely on the section heading in construing the statute?[17] It is generally best to keep the headings short (one to four words); this makes it clear that the heading will not capture all the nuances of the section it heads.

F. Sentence Structure

Long, complex sentences should generally be avoided, since they impede understanding (in some cases, however, a lengthy sentence can express an overall thought more succinctly than shorter sentences). Some drafting traditions follow the opposite approach and actually encourage the use of longer sentences. In the U.K. tradition, a section may not contain more than one sentence unless broken down into separate subsections.[18] Drafters can and do, however, get around this rule by creating run-on sentences using conjunctions or semicolons. Horribly long sentences result. The rule against more than one sentence in a subdivision makes little sense. Often, a rule is best expressed using more than one sentence, and it is easier to understand the rule if these sentences are located in a single subdivision. If the goal is elegance and comprehensibility, the U.K. rule should be abandoned. However, tradition sometimes dies hard, and it is possible, although not ideal,[19] to work within the constraints of the U.K. rule in jurisdictions which adhere to it.

Another question of sentence structure is whether a sentence should be broken down by numbering and indenting its logical components. This has been called "paragraphing."[20] Paragraphing is to be recommended on two closely related grounds: it is a means of removing ambiguity, and it makes sentences easier to read. Paragraphing reveals the logical structure of a sentence at a glance; it divides the sentence into

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[17]*See* Thornton, *supra* note 1, at 123–24, 127.

[18]*See* Renton, *supra* note 1, at 64; Thornton, *supra* note 1, at 57. This tradition is followed in various countries of the Commonwealth, such as Canada and Australia.

[19]Run-on sentences can be avoided by dividing them into several subsections. However, this leads to less than ideal clarity of organization of sections, since sections are as a consequence broken down into too many subsections. For example, it might be ideal to divide a particular section into three subsections, since the section contains three main thoughts. Each of these subsections might consist of two sentences. But if this is prohibited, then the alternative is to divide the section up into six subsections of one sentence each. In this case, the benefits of breaking out the section into its three main thoughts are lost. An example of a statute drafted under the one-sentence rule, but where the sentences have been kept fairly short, is LSO IT.

[20]*See* Renton, *supra* note 1, at 64–65; Thornton, *supra* note 1, at 57.

elements which can more readily be comprehended one at a time and shows graphically the relationship between these elements.

For example, consider the following sentence:

The property income derived—
(a) from a foreign source; or
(b) from the disposal of an investment or asset generating foreign-source income
by an expatriate taxpayer is exempt from income tax.[21]

Paragraphing in this sentence makes clear that the condition in the flush language ("by an expatriate taxpayer") applies to both items (a) and (b). It also allows specification on a self-contained basis of each of the elements of the sentence and allows the reader to quickly grasp the nature of the rule. If the paragraphing were removed, the sentence would possibly be ambiguous and would be more difficult to follow.

Paragraphing has its detriments, however. It makes the statute seem complex and abstract, where it might be easier to digest if the numbering and indentations were removed. This is especially the case when multiple tiers of subdivisions are used. Perhaps the most extreme example of this is the U.S. Internal Revenue Code, which regularly subdivides individual sections into several layers. Paragraphing should therefore not be overused, and the number of tiers of subdivision should be limited (more than two tiers are rarely necessary).

Where sections of a statute are divided, it is desirable to adopt a uniform style for division, thereby allowing for easy identification and reference to subdivisions of a section.[22] A contrast to this is the division style of the tax code of France, which is inconsistent. In some cases, articles are divided into paragraphs which are not numbered (i.e., there is just indentation).[23] In other cases, the first division of an article is numbered according to Roman numerals,[24] and in other cases, it is numbered with Arabic numbers.[25]

III. Organization

A. General Issues

[21]LSO IT § 24.

[22]For example, in the Internal Revenue Code (and more generally, in the U.S. Code), sections are divided into subsections (designated by lowercase letters), then into paragraphs (Arabic numbers), subparagraphs (uppercase letters), clauses (lowercase Roman numerals), and sub-clauses (uppercase Roman numbers). Correspondingly, there is a uniform designation of groupings of sections in the U.S. Code. The U.S. Code is divided into titles, subtitles, chapters, subchapters, parts, and subparts.

[23]*E.g.*, FRA CGI art. 223J.

[24]*E.g.,* FRA CGI art. 238 *bis* HA.

[25]*E.g.,* FRA CGI art. 223 L.

Logical organization of a statute aids comprehension. If the statute is well organized, it is also easier to determine where one needs to look for the answer to a particular question, and which portions of the statute can be ignored by a particular taxpayer. Each tax law contains the same key elements (taxpayers, rates, tax base, procedure, and administration), and understanding is improved if all the tax laws of a particular country follow the same order in respect of these elements. Foreign advisors in particular should consult the local practice in this respect.

Organization requires grouping together provisions on the same topic. Moreover, each subdivision of the statute, including individual sections, should be constructed in an order that facilitates comprehension. Usually, this means stating the general rule first and following it with exceptions and special rules for particular cases.

Proper organization is as important for the drafter as it is for the reader of the statute. The organization of a statute is like the framing of a house. Organizing rules helps the drafter think them through. If the drafter is forced to think about where in the statute a particular section should go, then he or she will think more carefully about its function, which will help in understanding and formulating the rule. It might occur to the drafter, for example, that what started as a rather particular rule should be rewritten as a more general rule which goes elsewhere in the statute. Grouping rules together also helps the drafter figure out whether any pieces are missing.

There are many examples of bad organization.[26] One is the failure to divide a long statute into parts, thereby forcing the reader to hunt through the entire statute in search of the relevant provisions. Another example, which is typical of the U.K. tradition, is the use of schedules. For example, there are 31 schedules to the Income and Corporation Taxes Act 1988 (U.K.). While it may seem commendable to relegate detailed provisions to a schedule in order to make the statute easier to read, the result is simply bad organization.[27] Detailed provisions should either be in the appropriate place in the statute, or, if they are elaborations of general statutory rules, could be placed in regulations which are subordinate to those rules. The failure to integrate schedules with the statute not only makes the statute more difficult to follow, but also tends to undermine its logical integrity. A tightly drafted tax statute contains many explicit or implicit[28] cross-references. The logical interrelations among its provisions are intricate. If some of these are removed to a schedule, there is a danger that they will not be adequately integrated into the logical structure of the rest of the statute, particularly once there are amendments.

B. Use of Code

[26]*E.g.,* AUS ITAA.

[27]*But see* Renton, *supra* note 1, at 68–69. There may be political or parliamentary reasons for the use of schedules, where they can be changed by a process different from statutory amendment; this makes their use understandable, but does not remove the criticism that they make the statute more difficult to follow.

[28]"Implicit cross-reference" means the use of a term whose meaning is specified elsewhere in the statute.

A few countries have organized their tax laws into a single code.[29] The use of a code facilitates the elimination of duplicative provisions. For example, without a code, definitions or administrative provisions might be repeated in separate laws or, even worse, might differ in two different tax laws because of historical accident.[30] Consolidating common provisions into a code facilitates their rationalization, since it forces one to think about what the general rule should be. Putting all the tax laws into one code also facilitates compliance, because taxpayers know that they have all the tax laws in front of them when dealing with a particular problem. In the absence of a code, people can waste time searching for tax laws in an effort to ensure that they have a complete set. This function of a code—gathering all the tax laws into one document—is an important benefit and argues in favor of using a code if at all possible.

Organization of all the tax laws into a single code is consistent with the civil law tradition. Some scholars in this tradition hold that only the general rules of taxation should be embodied in a code, with the more specific and ephemeral rules contained in specific tax laws, which can be expected to be changed more frequently.[31] Whatever is included in a code, in the tax area the use of codes does not correlate with whether a country has a civil or common law system. While France has a tax code, many other civil law countries do not. And even though the United States is a common law country, it does have a code.

C. Organization of Tax Laws in the Absence of a Code

The above considerations suggest that it is desirable to place all tax laws in a code. However, this might not be possible in a particular country, since it would require consensus on a substantial legislative project of codification. Where a code is not used, it is possible, albeit with some effort and discipline, to achieve virtually the same result by carefully organizing the separate tax laws, making sure they fit together properly, using cross-references where appropriate to eliminate duplicative provisions, and collecting provisions of general application into one law. In many countries, the tax laws are well organized, despite not being formally embodied in a code. For example, in Germany, the *Abgabenordnung* (Fiscal Statute) contains many of the provisions that apply to the tax

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[29]For example, Cameroon, Colombia, Côte d'Ivoire, France, Gabon, Kazakstan, Madagascar, Mali, Togo, and the United States. Even in countries where a code is used, there are some tax provisions, usually of very narrow application, which have not been included in the code. For example, in the United States provisions that allow a deduction from taxable income for federal income tax purposes for amounts deposited in a capital construction fund for merchant marine vessels are contained in the Merchant Marine Act, 46 U.S.C. § 1161, not in the Internal Revenue Code.

[30]Use of a code does not, however, guarantee that duplicative provisions will be eliminated. For example, the Internal Revenue Code contains numerous definitions of "related person," with little policy justification for such multiplicity. It is not enough to put the tax laws into a code; one must also "think code," in the sense of consolidating detailed provisions into a smaller number of more general rules.

[31]*See* José M. Martín & Guillermo F. Rodriguez, Derecho Tributario General (1986). This approach is followed by a number of Latin American countries. *See infra* note 32; 1 Carlos Fonrouge, Derecho Financiero 41, 48–63 (Susana Navarrine & Rubén Asorey rev. 1993).

laws generally; a number of other countries follow a similar approach of placing general rules into one law.[32] This avoids repetitive or inconsistent rules for different taxes.

Where all the tax laws are contained in one code, amendments are automatically consolidated into it, since they take the form of adding sections to it or repealing or replacing the language to be changed. This type of amendment is called a "textual amendment," since it is an amendment of the text of the previous law. It is desirable to make amendments in this manner, since otherwise a series of non-textual amendments makes it difficult to ascertain precisely what the law is, often necessitating a tedious task of ex post consolidation of amendments.[33] One advantage of a code is that it encourages the legislature to make textual amendments.[34]

There is no hard and fast rule as to how many tax laws there should be. The same arguments that favor a code also suggest that the fewer tax laws the better, although one can in principle achieve close to the same result with more tax laws, as long as they are carefully coordinated. For example, Germany has two income tax laws, one for corporations and one for individuals, but the corporate income tax law is much shorter and incorporates much of the individual income tax law by reference.[35] In practice, however, such coordination is difficult to achieve with a multiplicity of laws; coordination is more likely to occur if several tax laws are merged into one.

Particularly problematic is the inclusion of provisions relating to a particular tax in more than one piece of legislation, together with nontax provisions, as often happens for example when tax provisions are contained in foreign investment laws or laws designed to regulate particular industries. The interaction of the various rules for a particular tax is apt to be neglected when they are spread over more than one law.

IV. Effectiveness

[32]*See, e.g.,* BEL CIR; AUT BAO; ESP LGT; RUS TS; EST LOT; CHL CT; ECU CT; PER CT; DOM CT; CHN TA; KOR BNTA; BRA CTN; MEX CF.

[33]*See* Renton, *supra* note 1, at 32, 76–84. The Renton Committee considered it desirable to proceed by textual amendment wherever possible, but found that "there will be many circumstances in which the amendment of fiscal legislation by the textual amendment method will not be practicable." *Id.* at 117. It is, however, difficult to see what these circumstances are. All amendments to tax law in the United States and many other countries are textual, so it is evidently possible to proceed this way. The failure to do so ultimately leads to a mess. The United Kingdom has been moving toward a more consolidated approach in recent years. For example, most of the laws relating to income taxation have been consolidated into the Income and Corporation Taxes Act 1988, and many amendments are now being made as amendments to specific sections of this act.

[34]Again, the use of a code does not guarantee this result. For example, in the United States some tax provisions are "off code" where they are considered to be of such narrow application as not to be of general interest.

[35]*See, e.g.,* DEU KStG §§ 7, 8. A similar approach is followed in several other countries. *See also* NLD Vpb.; ESP IS.

The fundamental test of whether a tax law is drafted properly is if it implements the desired policy in an effective manner. In trying to make sure during the drafting process that the law will be effective, it is necessary to reflect on the policy and on the anticipated implementation of the law, including its interpretation in regulations and by the courts, and on how taxpayers and tax administrators will act in applying the law.

A. Relation Between Policy and Drafting

To properly manage the drafting of tax legislation, it is important to understand the relation between policy formulation and drafting. It is, of course, necessary to make some tentative general decisions about the policy to be implemented before sitting down to draft specific legislative language. Yet in substantial ways policy does not precede drafting, the two being developed concurrently. In the first place, policy shifts as the political process of producing a tax bill unfolds. Initial responsibility for producing a draft bill might lie in a department of the ministry of finance. Often, governmental process calls for producing a complete draft even before the minister makes certain policy decisions. Changes in policy may then be made at several stages, as a tax bill undergoes consideration by the government and then by the legislature. Policy decisions can be changed up to the last point when a bill is finally adopted as law. Second, it is impossible to decide whether a policy is wise without considering the text of the bill. The drafting process involves a constant refinement of the policy decisions. This is because drafting forces the policy to be specified more and more precisely. As this specification takes place through the consideration of tentative legislative language, numerous questions arise for the consideration of those who are responsible for the setting of policy. If certain tentative policy decisions are made before drafting begins, the drafter must thoroughly understand not only what those decisions are, but the reasons behind them. Only by fully understanding the policy choices and the reasons for making them can the drafter propose legislative language to accomplish the policy. In the end, there is only the language of the law. Policy may still exist, in the sense of what various individuals may intend or hope for the bill to accomplish, but the state of mind of various individuals does not become the law. Tax policy in an objective sense subsists only in the language of the law. Therefore, the drafting process can be seen as the development of tax policy, which is inchoate at the beginning of the drafting process and fully realized only at the end of the process. It would therefore be more accurate to say that while tentative decisions as to the general direction of a draft bill must be made before specific language can be drafted, at that point the language of the draft and the policy behind it typically proceed hand in hand through the process until the final language is adopted.

B. Anticipating Application and Interpretation

During the drafting process, consideration should be constantly given as to whether the statute is complete. To be effective, the statute should set forth all the rules needed to determine tax liability, or should provide authority for regulations that will contain these rules. To achieve this, the drafters must try to imagine all possible situations in which the statute will be applied. As part of this exercise, the drafters would do well to consult the accumulated experience of other countries and identify the issues that have come up in applying particular kinds of provisions. A choice must be made as to (1) whether rules go into the statute or into regulations[36] and (2) what level of detail is appropriate. Both choices may appropriately be made differently in different countries and for different kinds of issues.

Another aspect of thinking about how the law will be interpreted and applied is to be on the lookout for ambiguity. Unnecessary ambiguity should be eliminated. Given that language is inherently ambiguous, it is impossible to eliminate all ambiguity. It is appropriate to take a practical view here and to eliminate ambiguity that would be of concern to a judge attempting to interpret the tax law. In some cases, a degree of ambiguity is desirable, since it provides flexibility for the tax administration to respond to unanticipated cases. For example, in drafting an income tax, one could list all the types of deductible business expenses. This would provide certainty, but not enough flexibility. It is better to provide a general rule, such as that all expenses incurred in the realization of income subject to tax are deductible, with specified limitations. Such a rule involves some ambiguity, but on balance is preferable to a rule that attempts to list all allowable deductions, since it accomplishes the goal of taxing net income.

More generally, in drafting it is important to anticipate the administrative or judicial resolution of disputes between taxpayers and the tax authorities. For example, suppose that it is decided to allow an income tax deduction for business entertainment expenses only if the expenses are reasonable in amount. If the statute is drafted in these terms, the drafters should consider who is going to decide whether an expense is reasonable. Will this be determined according to guidelines provided by regulations, will it be left to the judgment of individual auditors, or will it be left to the courts? If the drafters focus on these questions of procedure, alternatives for how to draft the statute might occur to them. For example, instead of using a concept of reasonableness, the statute could deny deductions for entertainment in excess of specified limits or could deny a fixed percentage of entertainment deductions or could deny this deduction altogether. Each of these alternatives is progressively simpler from the point of view of tax administration and progressively harsher for taxpayers. A policy choice must therefore be made. This is another example of how policy choices are generated and facilitated by the drafting process.

C. Drafting for a Judicial Audience

Just as any piece of writing is modified to cater to its audience, the manner in which laws are drafted should take into account how courts are expected to interpret them.[37] For example, the Renton Committee distinguished in general terms between the civil and common law systems.[38] It found that under the civil law system, legislation tends to be drafted in the form of broad statements of principle, with the application of these principles to particular cases being left to the judgment of the court. Classic civil

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[36]*See infra* sec. IV(D).

[37]*See* ch. 2, sec. III.

[38]*See* Renton, *supra* note 1, at 51–55.

law drafting practices "a deliberate restraint in the proliferation of detailed rules."[39] In contrast, common law drafting tends to be much more detailed, trying to cover each possible case, with the court taking a correspondingly narrower reading of particular provisions of a statute.

Of course, these characterizations of the judicial and corresponding statutory style in the civil and common law systems are only ideal types, and practice in particular countries and with respect to particular types of legislation may vary.[40] Tax laws in civil law countries are often rather detailed. Moreover, the level of detail can vary depending on the legislature's attitude about delegating its lawmaking authority. In any legal tradition, the tax law itself could be drafted in very broad terms, as long as there is a broad delegation of authority to issue detailed regulations. Whether a legislature wishes to do this is often a political question, and also depends on tradition and the framework of administrative law.[41]

In addition to the question of the level of detail of a statute, in common law jurisdictions, it is important to be aware of judicial decisions on taxation, as many important principles are governed by a "common law" of taxation.[42] This is less likely to be the case in civil law countries, or when the legislature has made an attempt to codify the tax laws. Even in a country like the United States, which has a code, an extensive common law of taxation has grown up under the guise of interpreting the provisions of the statute. Congress can always override judicial decisions, but U.S. courts tend to stick to the doctrines they have developed absent a clear congressional statement that they must be abandoned in a particular area.

The interpretation of law by courts can itself be governed by rules set forth in legislation. Commonwealth countries have developed a tradition of interpretation acts, which provide definitions of commonly used terms, and may contain other clauses relating to the interpretation of laws.[43] In the United States, similar provisions are found in Title I of the U.S. Code. An analogy in civil law countries is found in the portion of the civil code containing general provisions on the application of laws, although these tend to be less detailed than the interpretation acts of the Commonwealth.[44] With respect to tax legislation in particular, guidelines of interpretation for the courts are sometimes included in the tax laws.[45]

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[39]*Id.* at 51.

[40]The Renton Committee provides a historical perspective on statutory detail in England, with the older statutes in laconic Latin ceding in the Middle Ages to verbosity, perhaps due to the use of conveyancers to draft legislation. *See id.* at 5.

[41]*See infra* sec. IV(D).

[42]*See* Barry Pinson, *Pinson on Revenue Law* 3 (1981).

[43]*See* Thornton, *supra* note 1, at 87–93.

[44]*See, e.g.,* Code civil arts. 1–6 (FRA).

[45]*See supra* ch. 2, sec. III.

D. Relation Between Statute, Regulations, and Other Explanatory Material

Because tax legislation is often difficult to understand, new tax laws are often accompanied by explanatory documents of various kinds, which provide legislators, tax officials, and taxpayers with an understanding of their purpose and intended operation. To ensure effectiveness, statutes should be drafted with a view to what will go into these documents. It is not usually considered appropriate to try to provide all the necessary details of tax legislation in the statute. To do so would make the statute unduly lengthy and difficult to understand. Moreover, because one cannot foresee all the situations in which tax laws will be applied, all the details cannot be worked out at the time the statute is enacted. Finally, even if the drafters of the statute had in front of them the detailed rules needed to implement the statute, they might choose to leave these rules to be promulgated by the administrative branch, since administrative rules can be modified more easily than the statute.

Categories of explanatory materials may be called different things in different countries, but here are some examples:

Issuer	Type of document
Legislature	Committee report, report of hearings, explanatory memorandum, reports of debate
Executive branch	Message accompanying legislation introduced in parliament
Minister or cabinet	Regulation, order, decree, rule, ordinance
Tax administration	Commentary on tax legislation, public ruling, private ruling, instructions, circular

These different documents may all be helpful to taxpayers and tax administrators in understanding the law, but they differ in their legal effect. Some have the force of law, some have persuasive authority, some have little binding legal effect.[46]

There is no hard and fast rule as to which provisions should go into the law and which into the regulations. Which provisions are viewed as essential ones that must go into the law depends on the practice in the particular country and on politics—how much power over detail the legislature is willing to delegate. There is also the problem of time: legislative drafting is a laborious exercise, and there is a limit to how much detail can be drafted within the time limit for enactment. Neither can one easily prescribe in advance how much total legislative and regulatory text there should be in order to give guidance to taxpayers without smothering them in detail. It is usually best to expand the mass of regulations little by little as needed. Leaving matters to regulations can also be a political

[46]*See supra* ch. 2, sec. IV.

tactic; it may be difficult to reach consensus on particular points, and leaving these points to regulations can facilitate passage of a bill.

There are alternatives to issuing detailed regulations. One alternative is to provide no written rules governing details, allowing the broad principles of the statute to speak for themselves. Another is to provide that certain rules of the statute apply only where the tax authorities have given their approval in the particular case. This is a useful technique in the case of rules that govern what is expected to be a small number of cases. Instead of spelling out the rules for these cases in advance, it may be easier to proceed on an ad hoc basis.

Another alternative to regulations is for the tax administration to issue commentaries on the law. These can take varied forms. For example, in the United States, the Internal Revenue Service issues revenue rulings, dealing with the application of the law in certain situations (to be distinguished from rulings issued to particular taxpayers). Revenue Canada issues interpretation bulletins. The tax authorities of most countries issue instructions on how to fill out the tax forms. In practice, these may be the only material consulted by the majority of taxpayers. While their legal significance may be minimal, their practical importance cannot be overstated. The U.K. tax authorities issue "extra-statutory concessions," explanatory booklets, and statements of practice.[47] The French tax administration publishes a book called *Précis de fiscalité*, which is a treatise nearing 2,000 pages in length covering all the rules of taxation.[48] These commentaries have varied legal effect; they are often binding on the tax authorities, but not on the taxpayer. Even if such administrative interpretations are not legally binding on taxpayers, for all practical purposes if they are not directly contrary to the statute taxpayers will often follow them.

Advance guidance on interpretation of the statute can also be provided in documents that are issued contemporaneously with consideration of the legislation, for example, in the form of an explanatory memorandum submitted by the government or in the form of a committee report (i.e., the report of the legislative committee considering the bill). The extent to which the courts will consider legislative history in construing the bill differs in different legal systems.[49] In U.K.-based systems, the matter can be dealt with in an acts interpretation act[50] or in the particular statute itself.[51] As a practical matter, legislative history can play an important role, even if judicial doctrine does not assign it

[47]*See* B. Pinson, *supra* note 42, at 3.

[48]Statement in text is based on the 1994 edition, which is approximately 2,000 pages long. It is not binding on the tax administration. *See supra* ch. 2, note 206.

[49]*See supra* ch. 2, sec. III.

[50]For example, sec. 19 of the Interpretation Act of Ghana provided "for the purpose of ascertaining the mischief and defect which an enactment was made to cure and as an aid to the construction of the enactment a court may have regard to ... any memorandum published by authority in reference to the enactment or to the Bill,..." *quoted in* Namasivayam, *supra* note 1, at 2.

[51]*E.g.,* LSO IT § 3(2).("In interpreting this Act, regard should be had to the Explanatory Memorandum accompanying the Act.")

much legal force. Therefore, consideration should be given to preparing a detailed explanatory memorandum to accompany tax legislation, if acceptable as a matter of local practice.

It is important to be aware of the country's administrative law and practice with respect to delegated legislation. While we have reviewed in general terms the practice of several countries, there are many variations, and each country has its unique practices. These may pose real obstacles to what can be done in regulations. For example, there may be a practice or requirement in the law that regulations have to be issued contemporaneously with passage of the legislation (or within a specified period of time). The drafter should become aware of any such constraints in advance. Where it is important for a rule to have binding legal force, then it may be necessary to include it in the statute if administrative practice does not readily allow it to be included in another legally binding norm. Inclusion of rules in the statute is also necessary if the statute is to operate at once, before regulations can be issued.

Attention should also be paid as to how to provide in the statute for regulatory authority. This depends on the country's administrative law. Often a tax statute will contain a general authority for regulations. Even where this authority is provided, there are often additional grants of authority to write regulations to implement particular provisions of the statute. Multiplication of authority for regulations should be avoided on grounds of simplicity, but there is some excuse for special grants of authority where regulations that are legislative in character are called for, that is, where the regulations are providing rules out of whole cloth rather than filling in the details of rules provided in the statute. The distinction between legislative and interpretative regulations is not, however, always clear.

Finally, because regulations are not issued all at once, there is a problem of organization. The text of regulations or administrative commentaries is often longer than that of the law. This makes it all the more important to arrange them logically, so that the reader can immediately turn to the relevant portions. Where the law is logically arranged, it makes sense to arrange the regulations in the same way. The method adopted by the United States, whereby the regulations are named according to the section numbers of the statute, makes it easy to find the regulations that correspond to any particular statutory text. The approach of the *Précis de fiscalité*—a treatise summarizing the rules for all the taxes in France—is also user-friendly (it is well-organized and has an extensive table of contents and index).

V. Integration

It is important to ensure that a new tax law is fully integrated into the rest of the legal system. Not only does the drafter need to be aware of the obvious issues of possible unconstitutionality, but also more subtle questions of conformity with local drafting style and language as well as the legal system in general need to be considered to enhance the acceptability, understandability, and effectiveness of the law.

A. Local Drafting Style

Apart from general principles of good drafting, tax statutes must be drafted in the context of the style of legislative drafting in the country in question. Different countries have developed their own drafting practices. The officials of some countries may be willing to make changes if convinced that the result would be a better statute. Others may be wedded to their traditions and reluctant to change even if the result would be more efficient or more elegant. There is much to be said for tradition in drafting style. A country's laws should be consistent in appearance and style so as to facilitate understanding and interpretation of the laws and maintain the dignity of the legislative process. Therefore, to draft tax laws differently, the officials responsible for legislative drafting in a country might have to make a more universal change, which may require more convincing. Those drafting tax laws must do their best within these constraints. Unless a country's officials decide to make a change in their drafting style, the drafter must follow that style.[52]

B. Gender-Neutral Language

In recent years, there has been increasing awareness of the desirability of using language that does not reflect discrimination based on gender. The issue depends on the grammatical peculiarities of the language in question, as well as on the evolution of the language and its culture. In English, it has become common to avoid exclusive use of the masculine gender to refer to an antecedent of indefinite gender and to avoid nouns denoting a particular gender where an indefinite gender is intended. To the extent called for by the language and culture of the country in question, the drafter should take care that usage of words is precise and nondiscriminatory.

C. Relation Between Tax Law and Other Legislation

The context of nontax regulatory and private law is also important for the drafting of tax laws. The tax law must often refer to provisions of economic law, such as the definition of different types of business organization. Accounting norms and principles found outside the tax laws can be critical to their operation.[53] The tax law is fundamentally based on legal relations determined by nontax legislation, primarily private law.[54] If this legislation is nonexistent or is in a confused state, it is difficult to draft a good tax law.[55]

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[52]*See* Martineau, *supra* note 1, at 121. In some countries, there is no uniform drafting style; in this case, it may be possible to justify a more modern approach by finding local precedents or by showing that the local style admits to variation.

[53]*See* vol. 2, ch. 16, appendix.

[54]Mostly in civil law countries, law is generally classified as either public law or private law, the former having to do with the state and the latter governing relations among persons (such as property and family relationships). Private law would include what in common law systems is known as the law of contracts, torts, property, and family law. For a discussion of the distinction between public and private law, *see* 2 International Encyclopedia of Comparative Law, ch. 2, Structure and Divisions of the Law (R. David ed.).

Some nontax regulatory legislation is important for the effective functioning of the tax laws, for example, legislation requiring the registration of company shares and other securities (i.e., prohibiting issuance in bearer form), legislation limiting the scope of bank secrecy, legislation governing the integrity of the civil service, and legislation providing effective civil and criminal procedure.

There is a tendency, particularly in civil law countries, for the law to be seen as a consistent whole. Concepts defined by the civil law therefore need not necessarily be redefined in the tax law. One problem arises because a term may not have an unambiguous meaning in the civil law;[56] problems can also arise—whether in a civil or common law system—when a term is defined with reference to its meaning in another statute.[57] There may, however, be a good reason for the meaning of a term for tax purposes to differ from the ordinary meaning. For example, the concept of "employee" may be well defined in the labor law, but the tax definition of an employee may appropriately be broader.[58] Similarly, the tax law may tax as a separate entity an economic unit that does not have independent legal personality under the civil law, or conversely may provide for flow-through treatment of an entity that is a separate person under the civil code. In some cases it is also necessary to disregard the civil law forms chosen by the parties in order to minimize their tax liability.[59] Where it is desired in the tax law to use a term with a broader meaning than in the civil law, there are two

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For a discussion of the relation between private law and tax law, *see* Sture Bergström, *Private Law and Tax Law*, 23 Scandinavian Studies in Law 31 (1979); 1 Klaus Tipke, Die Steuerrechtsordnung 89–104 (1993).

[55]For example, in several countries of the former Soviet Union, as well as in countries of Eastern Europe, it has not been clear whether certain enterprises are legal persons under civil law. Tax legislation often uses the term "legal person" in defining taxpayers, and any uncertainty about the meaning of the term can therefore lead to difficulties in the implementation of the law. Before the split-up of the Soviet Union, the uncertainty arose in discussions about whether an "enterprise" was of necessity a legal person. *See* M.S. Braginskii, *Legal Regulation of Entrepreneurship in the Russian Federation*, 19 Rev. Central and East Eur. L. 365, 377 (1993). Laws on entrepreneurship were passed with different wordings in various countries. For example, in Latvia the Law on Entrepreneurial Activity (1990) *reprinted in* Joint Publication Research Service, Regional Economic Issues JPRS–UEA–90–043 (Dec. 11, 1990), art. 7, states that "the legal capacity of an enterprise arises at the moment of its registration...." This suggests to some that an enterprise is necessarily a legal person. But the Latvian Law on Partnerships, art. 1, states "a partnership is not a legal entity." The Law on Enterprises in the Republic of Kazakstan (1991, as amended to 1993), *reprinted in* Foreign Investment and Privatisation in Kazakhstan: Collected Legislation 103 (W.E. Butler trans., 1993), art. 1, states "an enterprise is an autonomous subject with the rights of a juridical person ..." And further, in art. 5(2): "An enterprise shall be considered to be created and shall acquire the rights of a juridical person from the date of the State registration thereof." Under provisions such as these, the status of partnerships, associations, sole proprietorships, and branches of foreign companies can be unclear or subject to doubt. (The situation may have been clarified in Kazakstan with the adoption of a new civil code in late 1994.) Under such circumstances, it is irresponsible for a drafter of tax legislation to use the term "legal person" as if it were perfectly clear which type of enterprise is a juridical person and which is not. Instead, it may be necessary to fashion a definition of this term, or an alternative term such as "enterprise" which will apply for tax purposes, pending resolution of the uncertainties in the civil law.

[56]*See, e.g.,* Bergström, *supra* note 54.

[57]*See* Thornton, *supra* note 1, at 110–16.

[58]*See infra* sec. V(D)(2).

[59]*See supra* ch. 2, sec. III(I).

alternatives. One is to use the same term as that used in civil law, but to provide a special definition in tax law. For example, the term "employee" can be used in the income tax law, but defined to include persons who are not employees under the civil law. This approach can, however, be confusing, particularly to someone who does not read carefully all the definitions. An alternative is to use a different term in the tax law, where the intended meaning is different from that in the civil law. The disadvantage of this, however, can be that the term used might sound artificial or be cumbersome. Neither approach may be fully satisfactory.

D. Specific Problems of Terminology

Certain terms whose meaning is defined in the civil law are used pervasively in tax laws of different kinds and must be used or defined with care. Some examples are the following.

1. Legal Person

In most civil law countries, business entities (companies, partnerships of various kinds) are generally legal persons. In countries such as France, Spain, and those with similar civil codes, the various forms of *sociétés* or *sociedades* generally are legal persons. There are, however, some business arrangements that do not give rise to a legal person and that are characterized by a splitting of the income from the business venture among the parties.[60]

The situation is different in Germany. Under the German civil code, *Personengesellschaften* (partnerships of persons) are not legal persons, while *Kapitalgesellschaften* (capital companies) are legal persons. This distinction in fact may not make very much practical difference for purposes of the civil law for reasons that need not be gone into here.[61] But it means that given the formal distinction, and the fact that *Personengesellschaften* include important forms of commercial partnerships, references in the tax law to "legal persons" will not include *Kommanditgesellschaften* (limited partnerships) or *Offene Handelsgesellschaften* (general partnerships).[62] In Germany and other countries where partnerships are not legal persons,[63] it is necessary, where appropriate, to define taxpayers as including legal persons and certain other entities that are not legal persons.

In some countries, the status of an entity for tax purposes is determined not by the civil law but by the tax law. Thus, in the United States, whether an entity is treated as a corporation is determined by rules under the tax code.[64] A similar problem comes up

[60] *See, e.g.,* Code civil art. 1871 (FRA) (*société en participation*).

[61] *See* Handelsgesetzbuch arts. 124, 161 (DEU).

[62] *See* DEU KStG § 1(1)(4).

[63] *See* vol. 2, ch. 21.

[64] *See* USA IRC § 7701.

where the status of a foreign entity is in question. Usually, the determination is made not according to whether the entity has the status of a legal person under the law of its home jurisdiction, but according to what its status would be in the jurisdiction in question. This should be specified.

2. Employee

Whether an individual has the status of employee or independent contractor can have importance for tax purposes. In common law countries, the distinction is typically made according to the criteria of common law. This looks to the degree of control that the employer has. In civil law countries, the determination is made according to the status of the relationship generally determined under the labor code.[65] In both civil and common law jurisdictions, employees will not include directors of companies, public officials, and certain other persons whom one would wish to treat as employees for tax purposes. These should also be defined as employees for purposes of the tax law.[66]

3. Property

Legal systems differ in their concepts and classification of property.[67] Usually, different kinds of property do not need to be defined separately in the tax laws, as their meaning will be given in the civil law. But care should be taken. "Real" property (in common law jurisdictions) has a similar but not identical meaning to "immovable" property in civil law jurisdictions. Some civil codes have peculiarities. For example, the Russian civil code defines immovable property as including airplanes and businesses.[68] In such cases, it may be necessary to separately define immovable property in the tax laws as excluding this type of property.[69] Similar care should be taken in using concepts such as tangible property, intangible property, and fixed assets. In countries with codified accounting norms, categories of assets and liabilities relevant for tax purposes are often defined in these norms.

E. Use of Models

Recent years have seen the publication of the Basic World Tax Code, authored by two American lawyers who have also worked extensively abroad, and the Draft of a Tax Code for Middle and Eastern European States, authored by a German tax professor and

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[65] *See, e.g.,* Code du travail art. L 121-1 (FRA).

[66] *See, e.g.,* FRA CGI arts. 80, 80 *ter*. The issue is discussed in greater detail *infra* ch. 11 and in vol. 2, ch. 14.

[67] For a historical introduction, *see* Boudewijn Bouckaert, *What is Property?,* 13 Harv. J. L. & Publ. Pol'y 775 (1990); 1 Vinding Kruse, The Right of Property (1939).

[68] Civil code arts. 130(1), 132 (RUS); civil code arts. 117, 119 (KAZ).

[69] *E.g.*, KAZ TC art. 5(16).

commissioned by the German Ministry of Finance.[70] A model tax code (general tax law) was published in the 1960s, intended primarily for Latin American countries.[71] Other unpublished model tax laws are in various stages of development. The IMF's Legal Department has prepared a number of draft model laws for use in its technical assistance work; these are revised on an ongoing basis as experience with them suggests improvements. Some of this model legislation is geared to a particular country or legal or linguistic tradition; some is intended to be used on a wider basis.

Model legislation is extremely useful as a starting point for drafting. Given the complexity of tax legislation and the wealth of experience with tax laws in many countries, it would be foolish for a drafter to attempt to reinvent the wheel. On the other hand, the complexity of the laws of countries with well-developed tax systems is so great that it is inappropriate to use them as a model without a considerable degree of pruning and revision. The various model tax laws tend to be derived from the legislation of particular countries, although a considerable amount of distillation may have taken place.

Proper use of a model in drafting legislation for a specific country involves the realization that considerable adaptation, if not wholesale revision, of the language of the model will likely be required in order to meet the particular needs of the country in question. A model can only be a starting point. As long as the limitations of any model are borne in mind, a model can be a useful, even essential, tool in drafting.

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[70]Ward Hussey & Donald Lubick, Basic World Tax Code and Commentary: 1996 Edition (1995); Joachim Lang, Entwurf eines Steuergesetzbuchs für mittel- und osteuropäische Staaten (Bundesministerium der Finanzen 1992).

[71]Organization of American States, Modelo de Código Tributario (1967). In addition, the Inter-American Center of Tax Administrators has planned to publish a model tax code in 1996.

4

Law of Tax Administration and Procedure

Richard K. Gordon

> The Ruler should act like a bee which collects honey without causing pain to the plant.
>
> —*Mahabharata*

Tax administration law covers an enormous number of issues. An essay which attempted to cover each issue in detail would run on for volumes, rather than pages. To keep the discussion at a reasonable length, this chapter offers only an introduction to some of the issues involved. Where there is little theoretical controversy, the chapter only outlines the issues and provides discussion of a basic nature.

The result is a chapter that, like Gaul, is divided into three parts. The first part consists of a relatively general discussion of the nature of the law of tax administration and procedure and how it relates to other laws.

The second part consists primarily of a checklist of those elements that should be included in a tax administration law, except for matters concerning tax compliance, which are covered in the third part. The discussion in the second part is more limited, primarily because, at least concerning most of these points, there is little debate of a theoretical nature which would profit by additional exposition here. This checklist offers an introduction to the fundamental mechanics of the law for those who might not be completely familiar with tax procedure.

The third part discusses compliance. The part begins by discussing how substantive tax laws should be drafted to further compliance goals. It next addresses the question of taxpayer sanctions, how they work, and what is required to make them effective. Much of the current research into sanctions has suggested some counterintuitive conclusions, conclusions which are often largely at odds with sanctions extant in many tax laws. For this reason, this part includes a relatively detailed discussion of these issues.

Note: Victor Thuronyi, Melinda Milenkovich, Milka Casanegra de Jantscher, U.I. Dharmawansa, V.S. Rekhi, Reinier Kraakman, Ward Hussey, Leif Mutén, and Pamela Sak each provided extremely helpful comments and corrections.

I. Structure of Tax Administration Law

A. Organizing Principles of Tax Administration Law

It is a frequently heard complaint that tax administration laws are complex, confusing, and arbitrary. To some degree this is probably unavoidable. Administration of a tax system must cover an enormous and diverse number of rules. Unlike the substantive laws of taxation, there is no basic "principle" of administration. In contrast, an income tax law, a property tax law, or a VAT law each have unifying themes. While each may include some complex definitions, simplifications, or exceptions to these themes, there are at least a limited number of principles, typically related, around which the law can be structured and to which both policy analysts and drafters can return when creating the law.

In contrast, it is not easy to encapsule a few guiding themes for a tax administration law. There are a number of very broad principles which should apply in each administrative rule, such as fairness and efficiency, but these do not really help much in guiding substantive design. In some ways, tax administration law is constituted by a hotchpotch of rules, some related, some not very closely related, some expressing clear policy, and some based rather largely on arbitrary considerations. This is due to the fact that tax administration law is first and foremost the elucidation of a bureaucracy. Public administration, in and of itself, is not easily determined by reference to a small number of principles. Instead, it is much more a question of designing acceptable answers for myriad practical bureaucratic problems.[1]

Nevertheless, some order can be brought to the organization of tax administration law. Three organizing principles can be identified: organization according to function, temporal organization, and organization by legal category. In combination, the three can make for a coherent legal structure that corresponds to the bureaucracy and procedure with which the tax administration law deals.

1. Functional Categories

It is not surprising that the most important way in which the better tax administration laws are organized mirrors the way in which tax authorities themselves are, or at least should be, organized. In other words, the laws are primarily organized around the different bureaucratic functions necessary for the administration of a tax system. For this reason, this essay will refer to this form of organization as "functional."[2] Sections in tax administration laws corresponding to functional categories cover regulations and rulings, record keeping and returns, audits and

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[1]Interestingly enough, Freud described the borderline between psychosis and neurosis as when the mind acts like a bureaucracy. Sigmund Freud, An Outline of Psychoanalysis 48 (1911).

[2]For a tax administration, the opposite of functional organization is organization according to substantive taxes. While many tax administrations are organized in this way, the general trend is toward a functional organization. *See* Aldo Schlemenson, *Organizational Structure and Human Resources in Tax Administration*, *in* Improving Tax Administration in Developing Countries 343 (Richard M. Bird & Milka Casanegra de Jantscher eds., 1992). *See also* Richard M. Bird & Milka Casanegra de Jantscher, *The Reform of Tax Administration*, *in id.* 1, 9.

investigations, dispute settlement, recovery of monies owed to the government, internal investigations, and taxpayer ombudsperson.[3]

Functional organization of tax administration law makes it easier for the taxation authority, as well as for other government officials involved in the taxation process, to follow and interpret the law. Each department in the taxation authority can concentrate primarily on a single part or parts of the law.[4] Of equal importance, while organizing by function may initially appear to reflect the world of tax administration from the viewpoint of the bureaucracy, so doing also automatically reflects administration from the taxpayer's perspective as well. The taxpayer's involvement in each aspect of tax administration can largely be described by her or his interaction with different departments of the taxation authority. Therefore, organizing tax administration law in functional groups also helps the taxpayer better understand the rules and the process.

2. Temporal Organization

The quality of making the law easier to understand for the taxpayer as well as for the administration can be accentuated if the functional categories are themselves organized so that they follow in logical, temporal sequence. Temporal organization for the law of tax procedure makes sense because tax procedure inevitably follows a time sequence, given that each tax obligation is based on a tax period, with a subsequent possibility of the redetermination of tax, appeal of the redetermination, and ultimate determination of tax liability for the period. A temporal organization would mean that the law should begin with those rules concerning the elucidation of the law (regulations and rulings), followed by the incurring of a liability by a taxpayer (which would typically require the taxpayer to secure an identification number, keep records, and file returns), and then continue through each step through remittance of tax (or information), enduring an audit, disputing the assessment decision, and suffering a collection action. While not every taxpayer would be involved in each possible step in administration, both taxpayers and administrators would know to skip over intervening possibilities until the next relevant issue was reached. In the process, both would be reminded of those possibilities.

3. Legal Categories

Some rules, which represent a common legal category, cut across both functional and temporal lines. They cannot easily be organized on a temporal basis because they apply at a number of possible temporal steps. These are best placed together, usually at the beginning and

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[3]For example, The United Kingdom's Taxes Management Act includes statutory subdivisions on returns, assessment and claims, dispute settlement, recovery of monies owed, and penalties for tax offenses. *See* GBR TMA §§ 7–12, 29–43, 48–56, 60–70, 93–106. The U.S. Code, in Subtitle F on procedure and administration, includes sections on returns, assessment, collection, dispute resolution, tax offenses and penalties, and taxpayer ombudsperson. *See* USA IRC §§ 6001–7873. Belgium's code includes sections on returns, audits and investigation, assessment, dispute settlement, and penalties. *See* BEL CIR arts. 297–463.

[4]An additional functional category sometimes found in tax administration laws, one which forms the necessary precursor to the creation of the administrative bureaucracy, provides for the creation of the tax administration itself. However, in some jurisdictions the rules concerning the creation of departments or administrative authorities may be found in a separate law. *See, e.g.,* DEU FVG.

the end of a tax administration law. Among the most important of these categories are definitions that apply to terms found generally throughout the law, the legal rights of taxpayers,[5] penalties (both civil and criminal) for a taxpayer's failure to comply with her or his obligations, penalties for a failure on the part of the administration to comply with its obligations, and interest (due both to government on underpayment and the taxpayer on overpayment).[6]

There is no organizational imperative to collect the relevant rules in such categories separate and apart from functional divisions. For example, every right, as well as each liability for any penalty or interest, whether relating to taxpayers or to the administration, with few exceptions arises only in the context of a rule described in a functional category. In the broadest sense, the rights of a taxpayer can be understood to include not only what is normally thought of as "rights" (e.g., the right to secrecy, the right to representation), but also essentially everything that is not specifically required of her or him (e.g., the right *not* to keep unnecessary records, or the right *not* to have a levy enforced on her or him for monies not lawfully due). Similarly, both penalties and interest, whether owed by taxpayer or government, can be understood to arise wherever among the rules in the functional categories the obligation arises (e.g., a penalty for failure to keep records, a penalty for requiring the taxpayer to keep unnecessary records, a penalty for failure to submit to a lawful levy, or a penalty for forcing submission to an unlawful one, and interest due on any underpayment or overpayment).

There are important benefits to collecting certain general definitions, taxpayer rights, interest, and penalties in separate categories. By and large, the rights, interest, and penalties included in separate categories are those which are broadly applicable throughout much or all of the administrative process. Therefore, rather than repeating each, it is easier to put them in one place and to make clear that they refer to more than one aspect of the administration law. There are also general rules applicable to all penalties (e.g., a reasonable cause exception) that can usefully be grouped with the specific penalty rules. Also, placing certain definitions, taxpayer rights, interest, and penalties into separate sections makes it more likely that the design and therefore the application of each will be more uniform.

B. Interrelation of Tax Administration Law with Other Laws

1. Nontax Law

Tax administration law is intimately connected with various laws (including the state constitution) not specific to taxation. For example, laws concerning the operation of the executive branch may affect the structure and function of the tax administration.[7] Administrative

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[5]*See* the discussion of who or what constitutes a taxpayer, *infra* sec. II(B).

[6]*See, e.g.,* KAZ TC arts. 142, 161–63 (articles regarding taxpayer rights, penalties for overdue tax payments, fines for late filing of returns, penalty for understatement of taxes, current payments, and objects of taxation); FRA CGI arts. 1725–56 *septies* (articles regarding penalties); GBR TMA §§ 86–106 (sections on interest on overdue tax and tax penalties).

[7]*See, e.g.,* Grundgesetz arts. 104a–115 (DEU) [hereinafter GG]; 5 U.S.C. §§ 101–306 (USA).

law may affect how regulations and rulings are issued.[8] The civil procedure code may have considerable relevance to numerous aspects of tax administration, including rights to notice of government action, rights to counsel during proceedings, procedures for dispute settlement in civil courts (including the application of civil fines and of appeals), and rules concerning the recovery of debts.[9] Criminal procedure rules typically govern the application of criminal penalties in the tax area.[10]

As a general rule, unless there is a specific and compelling reason, it is probably best not to provide special rules only for tax matters. William of Occam, the great thirteenth-century English natural philosopher, admonished "[d]o not multiply entities unnecessarily."[11] To do so makes things more complicated than they need to be. Where rules relevant to tax procedure are contained in other laws, it may be beneficial to make cross-references to these laws in the text of the tax administration law. In certain cases it may be preferable to modify existing law to fit the unique problems inherent in tax administration. Where possible, it is probably best to make clear what nontax rule is being modified, and to limit the modification to the minimum necessary to effect the specific tax administration purpose.[12]

2. Substantive Tax Law

There is no clear line separating substantive tax law and tax administration law. There are a number of ways of drawing the line, however. One would be to include in the law of administration any rule that is primarily administrative in nature. Another would be to put into each substantive tax law the administrative rules that are peculiar to that tax, and to put in the general administrative law any rule that applies to more than one type of tax. Most jurisdictions apply a mix of both.[13]

3. Location of Tax Administration Law

The practice of countries differs greatly in terms of where the tax administration provisions are located. In some countries, each substantive tax law contains all the provisions

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[8]*See, e.g.,* the Administrative Procedure Act, 5 U.S.C. §§ 551–83 (USA) [hereinafter APA]; and the Verwaltungs-verfahrensgesetz (DEU).

[9]*See, e.g.,* Code of Civil Procedure §§ 166–213a, 511–44, 803–71 (DEU) (procedure for service of process, appeals, and execution levied on movable property and real property); Code of Civil Procedure arts. 411–20, 542–60, 651–94 (FRA) (procedure regarding representation, notice, and appeals).

[10]*See infra* sec. III(C)(6).

[11]William of Occam, *Quodlibeta Septem* (1320), *quoted in* John Bartlett, Familiar Quotations 143 (15th ed. 1980). This is the original statement of Occam's Razor.

[12]Examples of such provisions are included in the tax laws of the United States, France, and Germany; these codes include sections regarding tax liens and seizure of the taxpayer's property. *See* USA IRC §§ 6321–27, 6331–44; FRA CGI arts. 1920–29 *septies*; DEU AO §§ 281–308.

[13]For instance, in Australia provisions regarding returns and assessments are contained in the Income Tax Assessment Act, while in the United Kingdom such provisions are included in the Taxes Management Act. *See* AUS ITAA §§ 161–77; GBR TMA §§ 7–18, 29–40. Provisions regarding assessment are also contained in Germany's income tax law. *See* DEU EStG §§ 25–28.

necessary for its administration. In countries which organize all their tax laws into one code, the tax administration provisions can be one or more titles of this code. Yet other countries have what may be called a tax administration law or a general law on taxation. The tax administration provisions may also be contained in more than one law. For example, there may be a law on the tax system, which contains many of the general rules of procedure, and a law on the state tax service, which primarily governs the organization of the state tax service, but also deals with some of its powers as against the taxpayer.[14] The last approach can be confusing, particularly if the same matters are dealt with in both laws.[15]

II. Matters to Be Included in a Tax Administration Law

A. Compilation and Publication of All Tax Laws

All legislation concerning taxation, including tax laws, regulations, administrative interpretations, and court decisions, should be compiled and generally made available. Unless this issue is already covered elsewhere, the law on tax administration and procedure should so require. The greater the availability of such information, the easier it is for taxpayers, tax administrators, and adjudicators to research the law and to make sure that they have uncovered all the relevant information on any particular subject.

B. Definitions of General Applicability

There is considerable difference among different legal traditions as to the desirability of definition sections in statutes or as to their appropriate scope. For example, legislation based on the U.K. tradition often includes monumental definition sections, while statutes based on the French civil code tradition often have no definition sections at all.[16] However, where appropriate to the particular legislative tradition, definitions of general applicability can be of considerable use to avoid confusion in interpreting the law.

Among the most important definitions is that of "taxpayer." Any reference to a taxpayer in a law on administration and procedure should, unless otherwise indicated, include any physical or legal person who is required under the tax administration laws to collect or remit tax (plus any related interest or penalties) or information. The definition of taxpayer would, therefore, include both third-party withholding agents and those physical persons who are responsible for effecting the collection or remission of tax or information owed by legal persons. An acceptable alternative, which is followed by some laws, is to make a terminological distinction between taxpayers and such persons as withholding agents, who are responsible for paying the taxes of another.[17] If such a distinction is made, then care should be taken to draft the

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[14]*E.g.,* RUS TS; RUS STS.

[15]In Australia, for example, the Taxation Administration Act 1953 and the Crimes (Taxation Offenses) Act 1980 both concern themselves with tax offenses. *See* AUS TAA §§ 8B–8Z; AUS CTO.

[16]*See* GBR ICTA § 831 *et seq*.; AUS ITAA § 6 *et seq*.; FRA CGI; CIV CGI.

[17]*See, e.g.,* VEN COT §§ 19-29. French tax law draws a distinction between a *contribuable* (taxpayer) and a *redevable*. The former is the person in whose name the tax obligation is legally established; the latter is a person

law so that both taxpayers and responsible persons are subject to the relevant procedural requirements of the law.

Which other definitions might be included in a definition section would depend on the particular legal terminology in use in the particular jurisdiction. Some examples are discussed in chapter 3, section V(D).

C. Regulations and Rulings

In many jurisdictions, administrative regulations and rulings are an important instrument in interpreting tax law. Depending on the jurisdiction and its legal traditions, rulings can be of general application or can apply only to specific taxpayers, and they can apply prospectively or retrospectively. In the case of rulings of specific application, they can be issued in advance of a transaction or following the transaction. The treatment of these matters in a number of jurisdictions is discussed in chapter 2, sections VI(D) and (E). What follows is an outline of what might be considered appropriate to include in a tax administration law in a typical jurisdiction.

1. Regulations and Rulings of General Applicability

The government should solicit outside comment and obtain a broad range of opinion by holding public hearings on proposed regulations. Persons could testify orally or submit written testimony. The opportunity for all parties to be heard will assist the government in uncovering beforehand any unintended benefits or hardships its proposed action will produce. Hearings are required in some countries by a law on administrative procedure.[18] In the absence of a similar law, the matter can be addressed specifically by the tax administration law.

In general, the tax authority should be bound by its regulations and rulings of general applicability. Of course, the tax authority must be permitted to reverse a position when necessary, but this should normally be done only on a prospective basis.[19]

2. Rulings of Specific Application

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from whom the law may authorize the tax authorities to require payment of the tax obligation (e.g., a withholding agent or a person jointly liable for payment of the tax). *See* Gilbert Tixier and Guy Gest, Droit Fiscal 222–23 (3rd ed. 1981). Confusingly, however, the term *redevable* is also used in a meaning synonymous with that of "taxpayer," in the cases of taxes such as the VAT, the wealth tax, and the *taxe professionelle. See* Précis de fiscalité ¶¶ 2000, 4890, 6176 (1994); FRA CGI Titre II, ch. I, sec. VI ("*Redevables de la taxe*").

[18]For example, in the United States, the Administrative Procedure Act [APA] applies to any "authority of the Government of the United States" which is not Congress, the courts, or a military authority. 5 U.S.C. § 551(1) (USA). Under the APA, the Treasury Department may issue regulations and rulings relating to internal revenue laws only after publication of a notice of proposed rulemaking, followed by public hearings. *Id.* § 553. A failure to comply would result in the regulation being invalid. *See* American Standard, Inc. v. United States, 602 F.2d 256 (Ct. Cl. 1979).

[19]For further discussion of this issue, *see supra* ch. 2, sec. (IV)(D).

Although the legal traditions of some jurisdictions restrict their use, there is considerable benefit to having a procedure whereby rulings of specific application may be issued at the request of a taxpayer.[20] These rulings typically are based on fact patterns presented to the taxation authority.[21] In jurisdictions such as the United States, such rulings are limited only to the taxpayer in question and cannot be used as precedent by any other taxpayer.[22] To ensure accuracy and fairness in rulings, all rulings should probably be approved by a central rulings office or by another appropriate higher-level authority.[23]

The authority to issue legally binding rulings should be specified in the law, and the procedure specified either in the law or in delegated legislation.

D. Returns and Record Keeping

1. Returns

With respect to income tax and some other taxes, many jurisdictions have systems where the taxation authority assesses the amount of tax due based on information provided to it, usually by the taxpayer. However, efficiency concerns are increasingly motivating jurisdictions to adopt self-assessment systems, where the taxpayer determines tax owed. With regard to income taxes, self-assessment systems do not necessarily require that each individual prepare a return and determine tax owed, as several types of income can be taxed through final withholding taxes. If some taxpayers, say, small businesses, cannot currently be relied upon to determine their own tax, self-assessment for income tax can be introduced in stages, starting with larger enterprises and extended to others as they gain the necessary skills.

Whether a self-assessment system is in effect or not, the taxpayer must provide essential information to the taxation authority in the tax return so that it can either determine the amount of tax owed or check on the taxpayer's calculations.

Tax returns must spell out in detail the information required of the taxpayer. In a self-assessment system, the information will be in the form of a series of steps that the taxpayer must undertake in calculating the tax. The accompanying instructions to the return should provide comprehensive guidelines for filling out the return, taking the taxpayer logically from one line of the form to the next.

The general rules relating to returns (e.g., who is required to sign the return and procedures for extending the time to file) can be contained in the general tax administration law.[24] The specific tax laws should specify the deadline for filing and who is required to file.[25]

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[20]*See, e.g.,* Treas. Reg. § 601.210(a), (e) (as amended in 1983) (USA). *See also* ch. 2, sec. IV(E).

[21]*See* Treas. Reg. § 601.201(a)(2) (USA).

[22]*See id.* § 601.201(l).

[23] *See, e.g., id.* § 601.201(a)(2).

[24]*See, e.g.,* DEU AO §§ 149–53.

[25]*See, e.g.,* DEU EStG §§ 25, 1; DEU KStG § 49.

2. Information Returns

An information return is a declaration by a person who, though not necessarily liable to withhold tax, has economic information about one or more potential taxpayers.[26] The law must give broad powers to the tax administration to establish a filing requirement for information returns and to define the format to be used.[27]

3. Conditioning a Tax Benefit on Identification of the Payee

The law could require that in order to obtain certain tax deductions or credits that are triggered by a payment, a taxpayer must identify the payee. By identifying the payee, the taxpayer provides the tax administration with valuable information that can be used in auditing the payee. Because it relates to the determination of the tax base for a specific tax, this type of rule is generally included in the specific tax laws.[28]

4. Record Keeping

The law or regulations should specify taxpayers' obligations to keep books of account and other records necessary for determining tax liability.[29] These would include the content and form of invoices, what taxpayers must use them, and under what circumstances.

E. Audits and Investigations

1. Relationship between the Taxation Authority and Investigative Agencies

Many, if not most, jurisdictions have found it appropriate to segregate the civil functions of tax administration from the enforcement of criminal law, so that procedural protections for citizens are not undermined. The tax administration should not, for the purpose of civil tax investigations, rely on search powers given to the police. The tax administration's search powers should be specified in the tax administration law, subject to constitutional constraints.[30]

It is common for countries to provide a separation between the functions of civil and criminal investigation. Once the tax authorities have determined that there appears to be sufficient evidence of criminal behavior, the case should be turned over to the public prosecutor, and the procedures for criminal investigation should be applied from that point on.

2. Access to Third-Party Records and the Power to Issue Summonses

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[26]*See, e.g.,* USA IRC §§ 6041, 6041A, 6042, 6044, 6045, 6049.

[27]*See id.*

[28]For example, a VAT input credit is typically allowed only if the taxpayer has an invoice from the supplier.

[29]*See, e.g.,* USA IRC § 6001; CAN ITA § 230; DEU AO §§ 140–48.

[30]*See, e.g.,* USA IRC § 7608; GBR TMA § 20C; CAN ITA § 231.3.

The tax administration should have access to the records of anyone who has financial dealings with taxpayers and who can provide relevant information on taxpayers' income and the accuracy of their tax declarations and books and records.[31]

3. Indirect Methods of Assessment

The law should specifically authorize the tax administration to use alternative methods to establish or verify the amount due, whether the tax involved is income, VAT, or another tax.[32] The taxation authority should be permitted to use these alternative forms whenever the taxpayer fails to provide the records otherwise required in a complete and accurate form.

F. Dispute Settlement

1. Compromises

To further efficiency, throughout the dispute-settlement process the tax authority should be allowed discretion to settle issues of controversy with the taxpayer.[33] The tax authority should consider the likelihood that the authority would prevail in an adjudication and the costs of pursuing the authority's position. The authority should also have the discretion to reduce civil penalties, but not interest due.

2. Payment of Tax During Dispute

Countries differ on whether taxpayers are required to pay any tax subject to dispute in order to pursue a dispute.[34] Some consider it unfair to impose such a requirement. Others impose it to discourage frivolous disputes. An intermediate position would be to allow tax authorities or the court to waive the requirement on a case-by-case basis. Another possibility is to require payment of a portion of the tax (e.g., 50 percent).

3. Disputes Within the Taxation Authority

Disputes between tax authority and taxpayer must be resolved in as fair, timely, and efficient a manner as possible. A single method of resolving disputes, from registration of taxpayer disagreement with an assessment up to resolution of a final appeal, is preferable.

The first forum for dispute settlement should be with the taxation authority officials who first issued the assessment. The taxpayer should be given the opportunity, within a limited

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[31]*See, e.g.,* USA IRC § 7609; CAN ITA § 231.2.

[32]*See infra* ch. 12.

[33]For example, U.S. law permits the IRS to "compromise any civil or criminal case arising under the internal revenue laws prior to reference to the Department of Justice for prosecution or defense." USA IRC § 7122; *see also* Treas. Reg. § 301.7122-1 (as amended in 1960) (USA).

[34]In the United Kingdom, France, and Germany, payment may be suspended when the assessment is under appeal, while in Italy suspension of payment is not permitted. Organization for Economic Cooperation and Development, Taxpayers' Rights and Obligations: A Survey of the Legal Situation in OECD Countries 99 (1990).

prescribed time, to disagree with the assessment, either in writing, in person, or both.[35] If the assessing official or officials agree with the taxpayer on any point, a new assessment can be issued.[36] This assessment should be reviewed by a superior official.

If a dispute continues, the taxpayer should have the opportunity, within a prescribed period of time, to appeal to a special administrative appeals board. To ensure impartiality, this unit should be completely independent of other divisions of the taxation authority. It could report to someone outside of the tax administration authority, perhaps the general counsel (chief lawyer) of the finance ministry.[37]

4. Tax Adjudications

If agreement is not reached, the taxpayer should have the opportunity, within a prescribed period of time, to appeal to a court. Some jurisdictions allow appeal to the ordinary courts. These are typically not well suited to adjudicate tax matters, so consideration should be given to establishing a special tax court.[38] Depending on the legal traditions of the jurisdiction, this tax court can be set up inside or outside the regular court system. Also depending on the particular legal traditions of the jurisdiction, judges on the court might include both tax professionals and laypersons. The tax court would then hear evidence from both the taxpayer and the tax administration and would reach a decision in a trial-like setting. However, the regular rules of evidence need not necessarily be applicable to the tax court. In addition, experts other than lawyers or advocates, such as accountants, might be permitted to represent taxpayers before the tax court.[39]

In some jurisdictions, appeal is to a court specializing in appeals from administrative decisions, although not specializing in tax cases.[40]

Both the taxpayer and the tax administration should be permitted to appeal a decision of the tax court, ordinary court, or administrative court to a court of appeal.[41] Such appeals should be based only, or at least primarily, on matters of law, not of fact.

5. Procedures in Tax Adjudications

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[35]In the United Kingdom, the taxpayer may, in writing, appeal a tax assessment within 30 days after the date of notice of the assessment. GBR TMA § 31.

[36]*See id.* § 32.

[37]*See infra* sec. II(K)(9) concerning taxpayer rights to appeal.

[38]*See, e.g.,* USA IRC §§ 7441–75.

[39]*See id.* § 7452; *see also infra* ch. 5.

[40]For example, in France, general principles of administrative law require that the legality of an administrative decision can always be reviewed by an administrative judge. *See* Judgment of Feb. 7, 1947, Conseil d'État, 1947 Recueil des arrêts du Conseil d'État [Lebon], no. 79128, at 50. Such decisions are then themselves appealable to the Conseil d'État. *See* Judgment of Oct. 19, 1962 Conseil d'État, 1962 Lebon, no. 58502, at 552.

[41]*See, e.g., id. See also* USA IRC § 7482.

An adjudicative proceeding should minimize surprise and give taxpayers every opportunity to know of and rebut the case against them. First, each party should fully inform the other regarding what issues are contested.[42] Both parties should exchange all relevant documents within an adequate time period before the adjudication.

Depending on the jurisdiction, rules of discovery may vary depending on the stage of adjudication and the nature of the particular forum. For example, in the United States, discovery rules vary depending on whether the case is before an administrative officer at the Internal Revenue Service, the Tax Court, the Court of Claims, or the District Court. At the administrative level, the general disclosure provisions of the Administrative Procedure Act allow the taxpayer to request information in her or his file, unless that information falls within a number of exceptions, including internal communications and information relating to a law enforcement action.[43] Discovery is more limited in the Tax Court than the Claims Court, and more limited in the Claims Court than in the District Court, each of which has its own rules of procedure.[44] The Administrative Procedure Act also entitles the taxpayer to a copy of any testimony given during the case.[45] Absent fraud or an attempt to conceal, any document not exchanged within this time period should be barred from consideration during the procedure.

6. Burden of Proof in Tax Adjudications

In an administrative or judicial proceeding that involves a civil tax issue, the taxpayer should generally have the burden of proof. In some jurisdictions, as a general matter the burden of proof lies with the party normally in possession of the relevant evidence.[46] In tax matters, this party is typically, but not always, the taxpayer. For example, the tax department would have the burden of proof in matters such as comparable gross profits ratios. However, it may be preferable to state explicitly that the burden lies with the taxpayer, except in such instances where the tax department has sole access to the necessary evidence. Absent such instances, there should also be a presumption that an assessment issued by the tax department is correct. The

[42]For example, in the United States, a written report [called a Revenue Agent's Report or RAR] concerning the proposed changes to the taxpayer's return, including explanations, is prepared after each examination. *See* Internal Revenue Manual 4237, Report Writing Guide for Income Tax Examining Officers § 231, MT 4237–17 (Apr. 23, 1987) (Basic Report), *cited in* Michael I. Saltzman, IRS Practice and Procedure ¶ 8.06[8] n.121 (2nd. ed. 1991). Such a report is beneficial to both the taxpayer and to the tax administration. If the case is not settled, the Appeals Office prepares a memorandum discussing its decision. *Id.* ¶ 9.05[3]. The taxpayer may obtain a copy of this memo under the Freedom of Information Act. *Id.* n.5.

[43]*See* 5 U.S.C. § 552(b)(5), (b)(7) (USA).

[44]*See* Tax Ct. R. Prac. & Proc. 70(a)(1) (USA); Cl. Ct. R. 26 (USA); Fed. R. Civ. P. 26 (USA).

[45]5 U.S.C. § 555(c) (USA).

[46]For example, under French administrative law, each party must prove its case based upon the materials available on file with the court. However, a failure to reply, whether to the rapporteur or to the tax authority, allows the court to draw the inference that the party in default has no case to make in answer to the question. The effect is that the burden of proof shifts to the party who has the materials. *See* Judgment of May 28, 1954, Conseil d'État, 1954 Lebon, nos. 28238, 28493, 28524, 30237, 30256, at 308.

taxpayer then has the burden of rebutting this presumption by demonstrating the inaccuracy of the assessment.[47]

G. Recovery

A basic choice must be made as to whether tax debts are to be collected under the same procedures as for all other debts against the government, or for civil judgments generally, or whether special rules should apply in the tax area. Whatever the decision, some reference may be made to nontax laws, such as the civil procedure code, the civil code, or other laws governing the sale of property in satisfaction of a judgment, and some of the provisions described below may not in all cases need to be repeated in the tax laws.

1. Tax Liens

The law should provide that a tax assessment is a charge or lien that constitutes a security interest in the taxpayer's property in favor of the government. The lien should be against all property and rights to property, whether movable or immovable, belonging to the taxpayer as of the date of assessment or subsequently acquired during the existence of the lien.[48]

2. Seizure of Property

In the case of taxpayers who fail to pay, the law should provide for the seizure of property so that the proceeds from the sale can be applied to their tax liability.[49]

3. Sale of Seized Property

With the exception of negotiable instruments such as currency or marketable securities, the law should require seized property to be sold at public auction.[50]

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[47]For example, in the United States, under the decision of the Supreme Court in Welch v. Helvering, 290 U.S. 111, 115 (1933), the assessment of the Internal Revenue Service is presumed to be correct. Rule 301 of the Federal Rules of Evidence states that "In all civil actions...a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption...." The taxpayer has the burden of proving the assessment wrong. Helvering v. Taylor, 293 U.S. 507, 514 (1935).

[48]*See, e.g.,* USA IRC § 6321.

[49]*See, e.g.,* GBR TMA § 61; DEU AO § 281.

[50]For example, in the United Kingdom, if the taxpayer does not pay the sum due within five days of the seizure of property, the seized property will be sold at public auction to pay sums owed. GBR TMA § 61(4), (5). Provisions for public auction of seized property are also contained in the tax laws of Germany and the United States. *See* DEU AO § 298; USA IRC §§ 6335, 6336.

4. Recovery of Debts Owed the Taxpayer by Third Parties

The law should allow the government to reach persons who might owe money to the delinquent taxpayer, such as employers or creditors.[51] The law should provide for the seizure of such property through a notice of seizure upon the third party and a requirement that the third party pay over to the government the amount owed to the taxpayer.

5. Installment Payment Arrangements

The law should authorize the tax authorities to enter into an agreement with a taxpayer, which would allow the taxpayer to pay the tax over time, in cases where the taxpayer cannot pay the amount of assessed tax immediately.[52] The extension of time to pay the tax should not affect the accrual of interest on unpaid amounts.

6. Receivership

If it is necessary to seize a business for nonpayment of tax, the tax administration should have the right to ask the court to appoint a receiver for the purpose of administering the business and paying the taxes.

7. Property Transferred Without Full Consideration

The government should be given a security interest in any property that was fraudulently conveyed for less than fair consideration. Such provisions are often found in civil or commercial codes, and apply generally to all creditors.[53]

8. Compromise and Write-Offs

The law should permit tax officials to write off uncollectible accounts and to enter into a compromise with a taxpayer whereby part of the tax liability is canceled.[54]

H. Internal Investigations

Provisions should be made in the law for an internal investigations department within the tax administration. The goal of this department should be to ensure that the tax authority acts fairly and honestly. The internal investigations department could, like the administrative appeals

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[51]*See, e.g.,* DEU AO § 309.

[52]For example, the U.S. Code authorizes the IRS to enter into a written agreement with the taxpayer allowing the taxpayer to make payment in installments if such agreement would facilitate collection of the tax owed. USA IRC § 6159. *See also* GBR ICTA § 5(2) which in certain cases permits the taxpayer to satisfy her or his tax liability in two equal installments.

[53]*See, e.g.*, Code of Civil Procedure art. 1167 (FRA); Mass. Ann. Laws ch. 109A (Law. Co-op. 1995); Bankruptcy Code, 11 U.S.C. § 548 (USA).

[54]*See, e.g.,* USA IRC § 7122.

board, report to someone outside the tax administration authority, perhaps the general counsel of the finance ministry.

I. Taxpayer Ombudsperson

Some countries have established a department of the taxpayer ombudsperson. The role of the ombudsperson would be to assist taxpayers in solving complaints about the tax authority.[55] Although this department could be set up within the tax authority, in order to ensure that it is not overly influenced by other personnel in the authority, it should perhaps report directly to the authority's head.

J. Interest

Interest must be assessed on every late payment of tax[56] or penalty,[57] as well as on every payment due from the treasury to the taxpayer. It should be stressed that interest is not the same as a penalty due for noncompliance. Interest reflects the time value of money and should therefore never be waived or subject to compromise. An interest rate which reflects the full cost of money, including inflation, should be specified, typically by reference to the central bank discount rate, a rate on treasury obligations, or the like.[58] To discourage "borrowing from the government," and to encourage the settling of disputes, the interest rate should exceed the basic rate given debtors in the economy. In part because the government is presumably a better credit risk than a defaulting taxpayer, it may be appropriate to provide a lower rate of interest on overpayments than on underpayments.[59]

K. Taxpayer Rights

Provisions guaranteeing procedural protections to taxpayers can be gathered into a separate section of the tax administration law, or included in the appropriate places in a law organized on temporal or functional lines.[60]New Zealand's Statement of Principles (1986), and the United Kingdom's Taxpayer Charter (1986). OECD, *supra* note 34, at 70. *See also* ch. 2, sec. II(F). This section would collect these taxpayer rights common to all tax laws in a single place, either in the tax administration law or the basic law. At the commencement of any

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[55]Countries with an office of Ombudsperson include Australia, Austria, Denmark, France, and the United States; Canada, Germany, Italy, and Japan are among the countries without an Ombudsperson. *See* OECD *supra* note 34, at 20, 76–77. *See also* USA IRC § 7811.

[56]*See generally* DEU AO §§ 233–39 (provisions regarding assessment of interest including when interest payments are assessed and how they are calculated).

[57]*See* USA IRC § 6601(e).

[58]For example, in the United States, the rate is determined using the rate on treasury obligations. *See id.* §§ 6621, 1274(d).

[59]For example, in the United States the overpayment rate bears an interest rate 1 percentage point lower than the underpayment rate. *Id.* § 6621(a)(1), (a)(2).

[60]Some countries even have official documents outlining the taxpayer's rights; examples of such documents include Canada's Declaration of Taxpayer Rights (1985), France's Charte du contribuable (1987),

assessment or audit, the tax department should deliver a comprehensive description to taxpayers of their rights. However, these rights need not be unique to tax administration. Wherever possible, they should be accorded with other procedural rights guaranteed under law. A list might include some or all of the following rights.

1. Confidentiality

Taxpayers should have the right to have their personal financial information accorded the greatest possible confidentiality within the taxation authority.[61] This confidentiality should be breached only (1) during criminal investigations, when criminal investigators outside the taxation authority must view the information, (2) when so required during adjudication of a controversy, when an adjudicator must view the information, and (3) in certain other cases provided by law (e.g., disclosure of information pursuant to a treaty to the competent authority of a foreign government).

2. Notice

Taxpayers should have the right to be notified of an assessment, a decision on an adjudication, or of any collection action against the taxpayer's assets.[62] The exception is the jeopardy assessment, where there is an imminent danger of the taxpayer disposing of the asset.[63]

3. Reasonable Audits

Taxpayers should have the right to have audits held at a reasonable time, in a reasonable place, and within reasonable limits.[64]

4. Explanation

Taxpayers should have the right to an explanation of why their tax is being assessed the way it is and to an explanation of the reasons for a decision by an adjudicator.[65]

5. Counsel

Taxpayers should have the right during any dealings with the tax authority to be represented by a qualified professional.[66]

6. Record

[61] *See, e.g.,* DEU AO § 30; USA IRC § 6103.

[62] *See, e.g.,* DEU AO § 122; USA IRC §§ 6323, 6331(d), 6335.

[63] *See* USA IRC § 6331(d)(3).

[64] *See id.* § 7605.

[65] *See supra* note 42.

[66] In the United States, this right is guaranteed under the APA (USA).

Taxpayers should have the right to record their meetings with the tax authority and to have all adjudications recorded.[67]

7. Discovery

Taxpayers should have the right to advance access to the government's evidence in the case of an adjudication.[68]

8. Hearing

Taxpayers should have the right to a hearing before a decision is taken on an adjudication.[69]

9. Appeal

Taxpayers should have the right to an independent administrative appeal and a final judicial appeal.[70]

10. Limitations

There should be a limitation on the period during which an assessment may be made.[71] However, this limitation should be waived in the event of fraud on the part of the taxpayer.[72] The relevant rules should be specified in the tax administration law.

III. Taxpayer Compliance and Sanctions

Both substantive and procedural tax laws should always be directed toward improving taxpayer compliance. It is generally agreed that improving taxpayer compliance has many aspects to it, including making the law fair and equitable, easy to comply with, and difficult to evade. Another important aspect of improving compliance is the provision of effective sanctions for failure to comply. Typically, sanctions can be of a civil or a criminal nature, and most jurisdictions provide for both, although in some jurisdictions criminal sanctions would be included in a separate criminal code.

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[67] *See, e.g.,* USA IRC § 7521.

[68] *See supra* sec. II(F)(5).

[69] *See* USA IRC § 7458.

[70] *See supra* sec. II(F)(4).

[71] *See* GBR TMA § 34 (assessment of tax generally may not be made later than six years after the chargeable period); USA IRC § 6501(a) (assessment of tax made within three years after tax return was filed).

[72] In the United Kingdom, if tax was not paid due to the taxpayer's fraudulent or negligent conduct, assessment may be made within twenty years of the chargeable period. GBR TMA § 36(1). If a U.S. taxpayer files a fraudulent return, files no return, or in any other way willfully attempts to evade tax, assessment may be made at any time. USA IRC § 6501(c)(1), (c)(2).

However, there is much dispute as to what factors contribute most effectively to taxpayer compliance. Perhaps the most contentious area of controversy lies in the nature and function of both civil and criminal sanctions. Considerable variation exists with regard to the design of 65 sanctions among different jurisdictions. However, social scientists have made considerable progress in understanding the various aspects of compliance, and most particularly how sanctions work. Such information has made it possible to reach tentative conclusions as to preferred ways of designing them.

A. Existing Research into Compliance Issues

There is a large (and growing) amount of literature on taxpayer compliance, much of it focused on a single type of tax, for example, income, VAT, property, customs, and so on. This discussion will, where possible, consider some principles applicable to all of the above, but by and large most of the citations to research will be from studies on income tax compliance. The reasons for this focus are varied; principally, however, it is that the majority of studies have been done in the United States, and the income tax is the most important and most studied tax there.

Much empirical research has been done on sanctions and income tax compliance in the developed world, and, as suggested, the body of literature on compliance in the United States in particular is quite substantial.[73] Unfortunately, while some theoretical and anecdotal work on compliance has been done in the developing world, there is little empirical work to guide policy planners. Therefore, if one is to use empirical research as a guide to designing rules for developing countries, it is necessary to rely excessively on studies from developed countries as a guide.[74]

In addition, unfortunately, much research into taxpayer compliance even in developed countries like the United States has been of rather dubious empirical value. Studies have tended to two different types: those undertaken using official taxpayer data and those using self-administered questionnaires, although some studies have also used national accounts data. Unfortunately, taxpayer data are often incomplete and can rarely distinguish very well among types of compliance and noncompliance, while self-reporting is often inaccurate. In-depth interviewing and participant observation, while probably the most accurate way of learning about taxpayer behavior, is also the most difficult to undertake.[75] It may be that anecdotal evidence is the best that can be hoped for regarding many taxpayer compliance issues.

However, even though much of the social science work done may not really be terribly conclusive, the analysis can be helpful in thinking about the issues. Both theoretical and

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[73]Much of the pre-1990 taxpayer compliance research has been summarized and reviewed in two indispensable volumes: 1 Taxpayer Compliance (Jeffrey A. Roth et al. eds., 1989) and 2 Taxpayer Compliance (Jeffrey A. Roth & John T. Scholz eds., 1989).

[74]"Despite the huge economic literature on tax evasion, which fundamentally focuses on the appropriate role and implementation of penalties ... there seems to be no empirical study of penalty design and effectiveness in developing countries. What studies do exist, mostly for the United States, appear to be both model- and country-specific ... and cannot easily be generalized to the quite different circumstances of developing countries." Bird & Casanegra, *supra* note 2, at 5 n.8 (citations omitted).

[75]*See* the discussion of this issue in Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance in* 2 Taxpayer Compliance, *supra* note 73, at 47, 64–66.

empirical studies in the general area of legal compliance, and the specific subcategory of taxpayer compliance, can give indications as to what the issues are and what might work, even if they cannot prove what might work beyond a reasonable doubt. Also, if one relies on social science research only as a general guide to understanding, it becomes easier to apply insights learned from such studies in developed countries to the different circumstances of developing countries.

Successfully developing rules that improve compliance requires at the outset two steps. First, a taxonomy of compliance needs to be developed, so that the relevant issues can be identified. Second, as the issues are identified, theories have to be formulated that can be tested against experience and that can then be used to create tax compliance principles. How the principles are implemented can be guided by specific examples, but the design of laws in a particular jurisdiction is likely to be sui generis, based upon the unique characteristics of that jurisdiction. For this reason, it is helpful to be able to return to the principles and their analysis as a guide for how to proceed.

B. Design of the Substantive Tax Law

Many taxonomies of tax compliance are reported in the scholarly literature. The most important breakdown is probably between unwilling and willing. First looking at the unwilling, people can fail to comply because (i) they do not know how, (ii) it takes too much effort to do so, or (iii) it is too expensive to do so.[76] Related to this distinction is the ease with which a law may be avoided or evaded. A law that is easy to comply with may also be relatively difficult not to comply with. The most successful law will be one where these two properties coincide in a single law. In either case, it is the underlying substantive law of taxpayer obligations that must be designed so as to make compliance easy and noncompliance difficult.

The first and most obvious technique of filling both criteria is to reduce the total number of people who must make tax calculations, file returns, or pay money to the government. For administration of a value- added tax, this can mean restricting the collection of tax only to those who have a turnover of a certain size. For property taxes, it can mean using exemptions for properties of certain types or sizes.

For administration of an income tax, for example, it can mean exempting people below a certain income level from paying the tax and having as much tax as possible collected through a withholding system or pay-as-you-earn (PAYE) system. Withholding and PAYE form one of the central aspects of the administration of any income tax system. They can reduce significantly the actions that must be taken by taxpayers and reduce the number of persons who must

[76]Terms often used by writers on the topic include "unknowing noncompliance," "lazy evasion," or "lazy noncompliance." Taxpayer Compliance, *supra* note 73, at 20. Other different, but essentially redundant terms, are also used. *See* the reviews of the literature in Kidder & McEwen, *supra* note 75, at 50–62. Some rules may be particularly difficult to comply with. For example, in the United States, a special task force of the Internal Revenue Service singled out the complexity of the estimated tax rules which "frustrate[] taxpayers, particularly individuals, to the extent that penalties *are an acceptable alternative to compliance* (emphasis added)." Commissioner's Executive Task Force, Report on Civil Tax Penalties 15 (Feb. 27, 1989).

ultimately file tax declarations.[77] In these instances, an intermediary, usually the person who employs the individual taxpayer or the person who makes periodic payments to the taxpayer, determines the tax and pays it.[78] That intermediary can also typically advise the taxpayer as to the applicable rules.

As a by-product of having intermediaries compute, withhold, and remit tax, the interaction between individual physical taxpayers and the administration and the associated paperwork are reduced. This is in effect a reduction in the cost of compliance for those taxpayers who have their obligations fulfilled, or intermediated, by others.[79] Success is reflected in less work for the individual taxpayer and a reduction in the total number of individual taxpayer declarations that need to be filed. Of course, in these instances, the intermediary also becomes a taxpayer; withholding or PAYE becomes a separate obligation enforceable by law.[80]

One of the frequently repeated dogmas of tax administration is that "legal simplification" also reduces the costs of taxpayer compliance.[81] A simple tax law may fulfill the twin requirements of being easy to obey and hard to disobey because it both allows the taxpayer, or taxpayer intermediary, to know more easily what is expected of him or her and also reduces its manipulability, thereby reducing the possibilities of tax avoidance.[82] Complexity, and the chance to avoid tax obligations, can come from a number of sources. Inconsistency within the coverage of the law certainly can be one. Exceptions or special rules that provide for reduced obligations in certain circumstances not only add complexity, but they also create an incentive for taxpayers to try and fit into those circumstances. The converse is also true: the more special circumstances where taxpayers have increased obligations, the more those circumstances will be avoided. However, when one considers policy justifications for particular taxes, legal simplification can turn out not to be a very simple task.

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[77]Besides making it easier for a taxpayer to comply, withholding also makes it more difficult for a taxpayer not to comply. *See* vol. 2, chs. 14, 15. This was also the conclusion of the United States Internal Revenue Service Commissioner's Task Force on Civil Tax Penalties. Commissioner's Executive Task Force, *supra* note 76, at 37–42.

[78]For example, banks can be required not only to withhold and remit taxes on periodic payments, such as interest, but may also prepare and file declarations for income other than payments made by the bank itself. *See* Carlos A. Silvani & Alberto H.J. Radano, *Tax Administration Reform in Bolivia and Uruguay*, *in* Improving Tax Administration in Developing Countries, *supra* note 2, at 19, 29, 54–56; Charles E. McClure, Jr. & Santiago Pardo R., *Improving the Administration of the Colombian Income Tax, 1986–88*, *in id.* 124, 132. Of course, without a self-assessment system, some of the effort of preparing tax declarations and computing liability can be shifted to the administration. However, given the limited amount of administrative resources in developing countries, this hardly seems to be a wise idea.

[79]This also has the effect of shifting costs to those intermediaries. *See* Jaime Vázquez-Caro, *Comments*, *in* Improving Tax Administration in Developing Countries, *supra* note 2, at 145, 150.

[80]See the discussion of the definition of the term "taxpayer" *supra* sec. II(B).

[81]*See, e.g.,* Henry J. Aaron & Harvey Galper, Assessing Tax Reform 42–44 (1985). Their call for legal simplification has been quoted often in tax compliance literature.

[82]Joel Slemrod discusses these issues in *Complexity, Compliance Costs, and Tax Evasion*, *in* 2 Taxpayer Compliance, *supra* note 73, at 156, 157–74. Of course, not all avoidance (or the organizing of one's affairs so as to reduce obligations without also evading) constitutes a compliance problem. Administration is concerned only with avoidance that results in a reduction in normative (or "correct") taxpayer obligations.

What constitutes simplicity and consistency in a tax law, at least with regard to tax avoidance opportunities, will depend on the policies behind the specific type of tax involved. The more that obligations can be designed to treat taxpayers and circumstances alike, the more consistent will be the law, and the fewer special circumstances will result. Second, in treating taxpayers and circumstances as alike as possible, the fewer and the more internally consistent the principles of such treatment, the better. With like treatment and limited and consistent principles, and language clearly reflecting those principles, interpretation of rules should be easier. The opportunity to avoid tax obligations would be reduced.

Unfortunately, these general principles can be very difficult to effect in practice. In fact, rules designed to make withholding and PAYE easier may frequently violate these principles, as do special provisions designed for administrative ease, such as exempt amounts and schedular withholding in the income tax. However, such complications and inconsistencies in tax rules should be approved only where there is a net administrative benefit.[83] While there may be no set of rules of thumb to decide when this will be the case, this should be the explicit goal of the drafters of substantive tax laws. It would generally be wise for the drafters of substantive tax laws to consult with tax administration experts to ensure such a result.

C. Sanctions

1. Purpose of Sanctions

Sanctions are perhaps one of the most overrelied-upon, and poorly understood, tools for enhancing tax compliance.[84] Sanctions can also have more than one purpose. First, the most important component of sanctions is their ability to deter unwanted behavior, so as to bring about greater compliance.[85] Therefore, sanctions should be applied only to behavior that is reasonably capable of being deterred. Second, sanctions must be fair under the general jurisprudential criteria in effect in a particular jurisdiction. Under the jurisprudential principles of most jurisdictions, this means that sanctions should apply only when the sanctioned person is somehow at fault and should not be unduly harsh or disproportional, or imposed in violation of principles of due process. When the principles of deterrence and fault are combined, this leaves a general principle that faultless or reasonable behavior by taxpayers, even if it results in an underpayment of tax, should not be punished by sanctions. Only negligent or unreasonable behavior resulting in an underpayment should result in sanctions.[86]

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[83] *See generally* Richard K. Gordon, *Tax Administration Concerns in the Reform of Substantive Personal Income Tax Law in Emerging Economies*, 46 Bulletin for International Fiscal Documentation 163 (1992).

[84] Sanctions can be divided into types using a number of different criteria: civil and criminal, fines and imprisonment, per violation or per amount of tax forgone, or culpability of violation.

[85] There are two basic types of compliance failures: failures to provide accurate information when due and failures to remit the correct amount of money when due. The former (information) is important to the administration only in that it allows the latter (money) to be properly computed and remitted. Nevertheless, it can sometimes be easier to identify and assess a failure to provide information necessary for the proper remittance of tax simply by reference to the actual failure itself, rather than by attempting to put a money value on it.

[86] In the United States, for example, failure to file a return or to pay tax will result in sanctions unless such failure is due to reasonable cause and not willful neglect. *See* USA IRC § 6651(a)(1), (a)(2). In Belgium, if the taxpayer fails

In addition to their deterrence component, sanctions also may have an important financial component. Financial sanctions may raise revenue, while prison sentences may increase expenditures. Financial sanctions may even be designed in such a way that they cover the tax administration's expenses in pursuing a case, from investigation through final collection. Fines may also be designed to reduce administrative costs by encouraging the early settlement of disputes between administration and taxpayer.[87] This principle may appear to be self-evident. However, there are a number of jurisdictions, particularly among transition economies, where the principle is not followed under current law.[88]

In countries where government resources are extremely limited, these financial aspects of sanctions policy may be especially central, and the financial costs and benefits are of serious legitimate concern. However, in most instances, it will be difficult to fashion appropriate sanctions that fulfill both deterrence and other goals. Deterring behavior—which includes "encouraging" certain behaviors, such as the efficient settlement of disputes, or the remedying of violations, such as the failure to file or the failure to pay—should determine the design and severity of sanctions; the raising of revenues should be left to the taxes themselves.

Both financial and penal sanctions may also be designed to punish, not for the purpose of directly affecting the behavior of the person punished, but for the purpose of retribution or to indicate that society seriously disapproves of particular behaviors. As will be discussed below, the severity of sanctions may play a role in affecting people's attitudes toward the particular crime. For these two reasons, certain taxpayer activities which are viewed as particularly heinous, such as intentional evasion through fraud, are usually punished more harshly than less serious avoidance or error. Some jurisdictions punish such heinous behavior through both the civil system (e.g., increased fines for fraud) and the criminal system (additional fines and even prison terms for fraud).[89]

Although rarely discussed, another goal of sanctions policy should be not to cause (or worsen) other problems, that is, those outside of the direct realm of tax administration. In at least two important instances, this goal will suggest that sanctions should be relatively limited in degree. This will be discussed at greater length below.

2. Operation of Deterrence

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to file a return or files an incomplete or inexact return, he will be sanctioned. However, in the absence of bad faith, the taxpayer's sanction may be waived. BEL CIR art. 444.

[87]Tax codes encourage the taxpayer to pay her or his taxes by having the amount of the fine increase the longer the taxpayer withholds payment. *See* USA IRC § 6651(a)(1), (a)(2); GBR TMA § 93; BEL CIR art. 414; FRA CGI art. 1727.

[88]For example, the laws of both the Russian Federation and Kazakstan impose 100 percent penalties for understatement of tax, regardless of whether the taxpayer was at fault. RUS TS art. 13; KAZ TC art. 163.

[89]Penalties for such crimes as willful tax evasion or fraud may include monetary fines or imprisonment or both. *See* USA IRC §§ 7201–16. Willful tax evasion, for example, is considered a felony in the United States and is punishable by a fine of up to $100,000 or imprisonment of up to five years or both, along with the costs of prosecution. *Id.* § 7201.

Leaving aside for the moment some of the subsidiary issues, the principal goal of sanctions is based on a simple premise—the threat of punishment deters unwanted behavior. If the likely punishment is sufficient to outweigh the prospect of gain, a rational person will not undertake the activity that will result in that likely punishment.[90] Even this most basic of statements of deterrence function depends on two important assumptions. The first is that it is possible to determine and create a likely punishment that appropriately outweighs the prospect of gain. The second is that people will act in a way that is measurably and understandably rational.

For a likely punishment to be accurately determined by an individual, she or he first must understand both what choices he or she has and what any possible adverse consequences of any choice will be. Only in such cases can the individual weigh the risks of detection and its consequences against the expected benefits of violation. Rational choice economists might state this as an equation: the taxpayer will commit evasion if the benefit the taxpayer receives is greater than the total punishment provided for violation multiplied by the likelihood of punishment.[91]

Rational choice theory does not simply mean that people are "rational" in the sense that they act in accordance with a single set of norms, for example, that they are profit maximizers.[92] People may act differently in response to a like set of circumstances and still act rationally; this is because they have different preferences or private utilities. Part of the individual's private utility function may be unrelated to specific statutory sanctions, such as informal sanctions of the community or individual preferences for obeying all laws or only certain laws.[93] However, looking first at the effect of official, state-sponsored sanctions, the private utility function of one individual is still likely to vary from that of another. In other words, to achieve a like effect, deterrents would have to vary from individual to individual precisely because individual utility

[90]Jeremy Bentham, the father of English utilitarianism, saw the choices between possible modes as based on a calculation of risks of pain and pleasure. This view is still a basic premise of most discussion of deterrence. *See* Johannes Andenaes, *Does Punishment Deter Crime?* 11 Crim. L. Q. 76, 79 (1968).

[91]The legal scholar and economist Steven Shavell describes the equation as one of the magnitude and probability of harm versus the magnitude of benefit. Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 Colum. L. Rev. 1232, 1236–38 (1985). A general discussion of rational choice theory in the context of taxpayer compliance can be found in Alfred Blumstein, *Models for Structuring Taxpayer Compliance*, *in* Income Tax Compliance: A Report of the ABA Section of Taxation, International Conference on Income Tax Compliance 159, 160–61 (Phillip Sawicki ed., 1983). This was also the conclusion of the United States Internal Revenue Service Commissioner's Task Force on Civil Tax Penalties, *supra* note 76, at 13–14.

[92]Most analyses of economic crimes do assume that criminals are principally profit maximizers. *See, e.g.*, the discussion in Michael Gerken & William R. Gove, *Deterrence: Some Theoretical Considerations*, 9 Law & Society Rev. 497, 497 (1975). With the exception of tax protesters, it is probably a good guess that tax evaders are almost always doing so to maximize monetary profit. Therefore, the differences in individual utility functions might be relatively less than among other criminals, and sanctions might be relatively easier to design. *See generally* Robert V. Stover & Don W. Brown, *Understanding Compliance and Noncompliance with Law: The Contributions of Utility Theory*, 56 Social Science Quarterly 363, 374–75 (1975). Unfortunately, as discussed below, even this simplification turns out to be unlikely.

[93]These two specific issues are addressed in greater detail at the text accompanying notes 120–24.

functions differ.[94] For example, some taxpayers may have a greater preference for money now (say, through tax evasion) over later (say, when taxes and fines are finally due) than do other taxpayers.

The reasons for these different utility functions may be relatively more "objective" or "subjective." For example, some taxpayers may be poor or spendthrift and may be relatively indifferent to monetary sanctions because they are judgment-proof (i.e., immune from a money judgment because of insolvency, lack of property within the jurisdiction, or other reasons).[95] Others may simply prefer to live for the moment. That would mean that even if a sanction were certain to be applied and the cost were (in present value terms) greater than the amount initially saved, some taxpayers might still choose to evade, and yet could still be acting rationally.

Therefore, first, with regard to poor or judgment-proof taxpayers, there should be provisions in the law that allow debts to the government resulting from monetary sanctions to remain in effect even in the event of bankruptcy. Second, for both these taxpayers and those who are, for other reasons, indifferent to monetary sanctions, the most effective deterrent might be prison rather than fines. Therefore, while jurisprudential rules concerning the imposition of prison terms may restrict their application only to cases of criminal fraud, they may in certain circumstances act as a deterrent to these taxpayers. How these general policy conclusions might be implemented in a statute are discussed below.

However, other taxpayers might care very much about monetary sanctions, while still others, perhaps because of the lack of social stigma in their particular community, care little about prison sentences. It would be impracticable, and would presumably violate the principle of equality before the law, to provide completely individualized sanctions.[96] It would also probably violate the principle of equality if sanctions were designed to be infinitely strong so as to deter those least able to be deterred.[97] Therefore, for rational choice theory to be implemented in the design of sanctions, general rules must be created that are reasonable in the particular jurisprudential setting and that provide the greatest average deterrence. This would include the full panoply of monetary sanctions applied as effectively as possible, plus (in certain cases) non-monetary sanctions such as prison terms.

Even allowing for some differences in individual utility functions, basic rational choice theory suggests that if sanctions are to work, they must be severe enough, and their chance of application be likely enough, that the product of these two exceeds the benefits of

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[94]To maximize social utility, the severity of sanctions against a particular behavior would have to increase as a particular individual's utility (in that behavior) increases. Samuel Kramer, *An Economic Analysis of Criminal Attempt: Marginal Deterrence and the Optimal Structure of Sanctions*, 81 J. Crim. L. & Criminology 398, 399 (1990).

[95]Or, as Professor Shavell so succinctly puts it, "it is impossible to deter a person with no assets by the threat of monetary sanctions." Shavell, *supra* note 91, at 1237. This means that monetary sanctions can rarely be enough to act as a sufficient general deterrent to undesired behavior.

[96]*See supra* ch. 2, sec. II(A). This issue is also emphasized in the United States Internal Revenue Service Commissioner's Task Force on Civil Tax Penalties. *See supra* note 76, at 13.

[97]It would also probably be counterproductive. *See* the discussion concerning possibly counterproductive aspects of relatively high penalties *infra* at text accompanying notes 114–17.

noncompliance for a sufficiently high proportion of the members of the target group. One direct corollary is that an increase in the perception of likelihood of being caught and punished results in an increase in the deterrence effect. This has been observed in the United States as a matter of general compliance with laws.[98] It has also been observed repeatedly in studies of tax compliance.[99]

The perception of likelihood of suffering sanctions depends on a number of factors, the first being the actual risk. That in turn will depend on (i) the ease of detecting noncompliance, (ii) the ease of proving noncompliance, and (iii) the administrative effort put into detection and proof.[100] Again, not surprisingly, tax studies in the United States have repeatedly shown that the easier it is to cheat and to hide the cheating, the more cheating will occur.[101] Any perceived risk is likely to differ from the actual risk and will depend on objective factors, such as how well the actual risk is publicized, and subjective factors, such as how well risk is processed and internalized by the taxpayer. Again not surprisingly, studies show that taxpayers who perceive higher probabilities of being subjected to legal sanctions are more likely to comply.[102]

Some research has suggested a number of less obvious refinements to the proposition that people are more likely to cheat if it is less likely that they will be caught. While rational choice theory may suggest that a reduction in probability of detection and punishment can be offset by an increase in severity of sanctions, there is considerable evidence that people are not very good at analyzing probabilities.[103] The first consequence of this fact is what criminologists refer to as the "tipping" effect.

Criminologists working in developed countries have found that within a given group of people there is a critical level of probability of punishment before which a marked deterrent effect is seen.[104] That point at which the likelihood of punishment "tips" into a compliance effect may not, in fact probably will not, fit with actual probabilities. As a general proposition, tipping seems to occur because people often tend to discount low probability events. It has been

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[98]A brief survey of some of the literature in the American context can be found in Scott H. Decker & Carol W. Kohfeld, *Certainty, Severity, and the Probability of Crime: A Logistic Analysis*, 19 Policy Studies Journal 2, 3–6 (1990).

[99]Some examples of research confirming this point include Robert Mason & Lyle D. Calvin, *A Study of Admitted Income Tax Evasion*, 13 Law & Society Rev. 73, 85, 87 (1978); Harold G. Grasmick & Donald E. Green, *Legal Punishment, Social Disapproval, and Internalization as Inhibitors of Illegal Behavior*, 71 J. Crim. L. & Criminology 325, 327 (1980).

[100]Many of these studies, each of which is concerned with income tax compliance in the United States, are summarized in 1 Taxpayer Compliance, *supra* note 73, at 97–110.

[101]*See id.* 27, 30, 88, 97, 107–10; Steven Klepper & Daniel Nagin, *The Anatomy of Tax Evasion*, 5 Journal of Law, Economics & Organization 1 (1989).

[102]*See* 1 Taxpayer Compliance, *supra* note 73, at 100.

[103]This is not terribly surprising when considering the popularity of lotteries. It is not just a question of whether some people are risk-averse while others are not, but a more general, systemic inability to judge risk accurately.

[104]This is discussed in Charles R. Tittle & Alan R. Rowe, *Certainty of Arrest and Crime Rates: A Further Test of the Deterrence Hypothesis*, 52 Social Forces 455, 456, 458 (1974). The article looked at general crime rates in the U.S. state of Florida.

suggested, but not proved, that there may be a general tendency for people to think relatively more rationally about economic crimes than about other types of crime and, perhaps, that such rationality increases as the person's income increases.[105] Therefore, one might conclude that, at least with regard to other types of crime, tax evasion might have a lower tipping point. Further, as a general matter the tipping point for a particular individual is perhaps likely to be lower (in other words, the individual is more likely to comply) if that individual's wealth or income is relatively greater. Because the wealthier, or those with higher incomes, are more likely to owe more in tax, one might also conclude that the tipping point would often be inversely proportional (again, meaning that the individual would be more likely to comply) to increases in the amount of potential evasion. Nevertheless, this thesis does not suggest, at least in any absolute sense, where that tipping point would be.

The point at which a taxpayer would perceive that the probability of being caught is high enough that he or she would begin to comply may be influenced by different factors that would increase the taxpayer's awareness of punishment certainty.[106] This is because the tipping thesis depends on taxpayer awareness of the likelihood of punishment, and not just upon actual probability of punishment.[107] If taxpayers incorrectly believe that evasion is relatively common but is still not punished, the result could be tipping points higher than if the truth were better known. Another related point has to do with the percentage of people in the population who regularly comply or fail to comply. If a person violates a rule and is not caught, he or she may be more likely to commit another violation.[108] And, if many have this experience, they will be able to relate their success at evasion to larger sections of the population, resulting in a greater perception of the lack of consequences for failure to follow the law. The effects of perceived common evasion, plus one's own positive experiences of evasion, would both raise the tipping point and thereby reduce the effectiveness of sanctions.

There are a number of practical lessons to be learned from this analysis. First, in those areas of tax administration where there is sufficient successful detection of noncompliance and application of sanctions to exceed a tipping point, there could be considerable benefit in publicizing such detection and application of sanctions. Tax administrations can publish data on the number of taxpayers caught (or possibly even their names) and the sanctions applied. Active promulgation of such information should have a positive effect on future compliance.[109]

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[105]*See generally* Philip J. Cook, *The Economics of Criminal Sanctions*, *in* Sanctions and Rewards in the Legal System: A Multidisciplinary Approach 50, 54 (Martin L. Friedland ed., 1989).

[106]For example, smaller groups with a high level of group communication may have an earlier tipping point and perhaps an increased tipping effect. Don W. Brown, *Arrest Rates and Crime Rates: When Does a Tipping Effect Occur?* 57 Social Forces 671, 680 (1978).

[107]There is a dearth of research into tipping and tipping points in tax compliance, even in the literature concerning income tax compliance in the United States. However, there is some. *See* the review in 1 Taxpayer Compliance, *supra* note 73, at 111.

[108]*See* the discussion in Raymond Paternoster et al., *Perceived Risk and Social Control: Do Sanctions Really Deter?* 17 Law & Society Rev. 457, 458 (1983).

[109]Depending on the jurisdiction, publication of the names of those taxpayers who are subjected to sanctions may raise issues of taxpayer confidentiality. For example, the U.S. Internal Revenue Service may only disclose to the general public a taxpayer's name and assessed penalties when a compromise is reached with the taxpayer before the case is referred to the Justice Department for prosecution. USA IRC § 6103(k)(1).

However, in areas where it is clear that a tipping point has not been reached, it would actually be counterproductive for a tax administration to advertise its relative ineffectiveness. In such instances, until detection of noncompliance and application of sanctions are sufficiently high, the tax administration should not publicize its efforts. For example, it may be possible that the application of sanctions to VAT noncompliers, or to those who do not comply with income tax withholding requirements, may be much higher than to those who do not comply with income tax rules for self-employment income. In such a case, it might be wise not to publicize the tax administration's experience with self-employment compliance.

In making such determinations, however, the tax administration should recall that rates of detection of noncompliance and application of sanctions, and of tipping points, can vary among different populations. Therefore, for example, it may be that tax administration efforts may be more substantial, and more successful, among the wealthiest income tax payers. If so, publicity about successes in this subgroup could be beneficial in improving compliance among members of the subgroup.

Therefore, the tax administration should have the ability to collect the necessary information required to determine both rates of detection of noncompliance and subsequent implementation of sanctions as well as likely estimates for tipping points. It should also have both the authority and the means to publicize this information selectively.

It may seem obvious that increasing detection of noncompliance, and of applying sanctions to the noncompliant, would raise the likelihood that the tipping point would be exceeded. However, increasing the perceived likelihood of the imposition of sanctions may result in effects that, although rational, are counter to the standard deterrence effect hypothesized by rational choice theory. At his or her tipping point, the taxpayer assumes that the risk of detection is sufficient to assume that he or she will be subject to sanctions. At this point, the sanctions need be just severe enough for the taxpayer to comply.

But if the taxpayer can take effective evasive action, he or she might be able to reduce the (self-perceived) probability of suffering from sanctions. Such action can include additional tax evasion or measures to hide the evasion. As the likelihood of being caught increases, either because of the nature of the substantive law (hard to avoid or evade) or of effective administration (more work in fighting avoidance and evasion), certain taxpayers may actually be driven into even greater acts of avoidance or evasion. Only if the taxpayer's evasive action is unlikely to be successful, or if the cost of the action to the taxpayer is likely to exceed the taxes saved, will the taxpayer comply.[110]

[110]If the taxpayer is uncertain as to the effectiveness of future evasive action, taxpayer costs will increase, in that uncertainty of success increases costs, while return remains the same. *See* James Alm et al., *Institutional Uncertainty and Taxpayer Compliance*, 82 American Econ. Rev. 1018, 1018–20 (1992). The author's understanding of these issues was greatly enhanced by a number of discussions with Professor Reinier Kraakman of the Harvard Law School.

Putting more resources into effective tax administration may cost the exchequer money that could be spent better elsewhere.[111] However, it is also important to remember that more avoidance or evasion on the part of taxpayers carries a number of welfare costs. Both legal strategies for avoidance and illegal actions to evade are likely to have negative effects on resource allocation.[112] Therefore, even if net revenues (amounts collected minus costs in collection) were to increase with additional sanctions, there could be a net welfare loss to the economy in general, because of the changed nature of noncompliance.[113] Increasing the likelihood of being caught and subjected to sanctions works best if the taxpayer cannot easily take evasive action.

Although it is probably important for the perceived probability of being caught to be sufficiently high for there to be any deterrence effect from sanctions, there is not much evidence to suggest that compliance varies directly with the degree of severity of the sanctions. There has been an inconclusive debate among criminologists over why this is the case, although there is no clear evidence to suggest that the conclusion is wrong.[114] There are theories that people simply do not act rationally or that the theory of rationality must be correct and the data wrong.[115] Some criminologists have suggested that while the severity of formal sanctions in economic crimes like tax compliance may have little deterrence effect, informal sanctions may have greater effect.[116] However, increasing the severity of sanctions may also result in evasive action, under the same mechanism as that described previously regarding increased certainty.

The albeit insufficient empirical evidence might suggest that because an increase in severity does not change the point at which taxpayers become really afraid of being caught, it is unlikely to improve their compliance. However, such an increase in severity might nevertheless inspire them to take some extra precautions in their avoidance and evasion to ensure that they do not suffer those increased penalties. In fact, increasing the severity of sanctions without

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[111]Despite the statements of some revenue authorities to the contrary, most have accepted that the goal of tax administrators is not to maximize net take, but to maximize total welfare. *See* Richard Goode, *Some Economic Aspects of Tax Administration*, 28 IMF Staff Papers 249 (1981).

[112]*See* Jonathan Skinner & Joel Slemrod, *An Economic Perspective on Tax Evasion*, 38 Nat'l Tax J. 345, 350 (1985).

[113]There are other possible effects. As taxpayers take greater evasive action, they may be inspired to commit even greater crimes. Also, if one method of avoidance or evasion becomes too difficult, they may abandon it but turn to others. *See* the discussion with regard to general deterrence theory in Jeffrey Grogger, *Certainty vs. Severity of Punishment*, 29 Economic Inquiry 279 (1991).

[114]*See* the survey of data in Decker & Kohfeld, *supra* note 98; *see also* the discussion in the context of tax compliance in Steven Klepper & Daniel Nagin, *The Criminal Deterrence Literature: Implications for Research on Taxpayer Compliance*, in 2 Taxpayer Compliance, *supra* note 73, at 126, 135–36, 143–44.

[115]*See, e.g.,* Harold G. Grasmick & George J. Bryjak, *The Deterrent Effect of Perceived Severity of Punishment*, 59 Social Forces 471, 472, 475 (1980). They state that "the conclusion directly challenges the basic premise of deterrence theory that man is a rational actor." *Id.* at 472. They then go on to posit that this conclusion cannot *not* be correct, and that the data or analysis leading to the conclusion must be wrong. *Id.* at 473. Some might argue that this places theory above empiricism, an assertion that most scientists, at least since Newton, would fault.

[116]*See infra* text accompanying notes 120–21.

increasing their certainty to a tipping point would probably only have the detrimental effect of creating more avoidance and evasion, with the ensuing general loss to welfare.[117]

An additional cost of very high sanctions is that their imposition may well be unfair.[118] The sanctions, if disproportionate to the offense, would also be unfair. They would be unfair in their application if they reached only a small number of violators, since the violators who were caught would be much worse off than those who were not.[119] In tax administrations prone to corruption (including both the taking of bribes and the use of administrative powers against political opponents of the regime), the existence of unduly severe but not universally applied sanctions can constitute a dangerous weapon in the hands of corrupt officials. The general conclusion is it is better to deal with noncompliance by imposing moderate sanctions more frequently than by having draconian sanctions that are rarely applied.

While fines and imprisonment may be the principal statutory responses to taxpayer noncompliance, they are not the only sanctions that figure in a taxpayer's rational choice calculus. Criminologists have recognized that the informal sanctions of social disapproval from peers have, in certain populations and for certain types of crime, also deterred criminal acts.[120] In many cases, the cultural climate regarding compliance may be even more important than the legal sanctions themselves. This may tend to be the case more with wealthier or more socially prominent subgroups, where social status is important and where social ostracism for criminal activity is more likely. Officers of prominent corporations, for example, may be particularly affected.[121]

While the literature on the subject is not completely convincing, the argument is powerful enough to suggest that it may be beneficial to make public the names of wealthy, powerful, or influential taxpayers who are punished for noncompliance. As discussed earlier, taxpayer confidentiality is an important right. However, once a taxpayer is actually sanctioned, any reason for protecting the name of the taxpayer is considerably weaker. Of course, if government in general or the tax system in particular is seen as corrupt or unfair, failure to pay may not be perceived as bad, and publicizing the names of those who did not pay would not result in social ostracism and greater deterrence.

Social ostracism is likely to increase with the relative heinousness of the crime. A study done for the U.S. Internal Revenue Service suggested that tax noncompliance, particularly tax

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[117]There may also be a form of substitution effect where taxpayer compliance improves in those areas where a violation might draw the administrator's attention, but whose savings are less than those where certainty has not reached a tipping point. *See* the discussions of substitution effects in Michael J. Graetz et al., *The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement*, 2 Journal of Law, Economics, and Organization 1 (1986); Klepper & Nagin, *supra* note 101, at 18–20.

[118]Also, it is often the case that the greater the severity of sanctions, the less likely that they will be fully applied. *See* Vito Tanzi & Parthasarathi Shome, *A Primer on Tax Evasion*, 40 IMF Staff Papers 807, 812 (1993).

[119]This point was also emphasized in U.S. Internal Revenue Service Commissioner's Executive Task Force on Civil Tax Penalties, *supra* note 76, at 13.

[120]*See* Grasmick & Green, *supra* note 99, at 327–29.

[121]*See* Sally S. Simpson & Christopher S. Koper, *Deterring Corporate Crime*, 30 Criminology 347, 367 (1992).

evasion, might have less social stigma attached to it because the public often perceives it to be a "victimless crime."[122] This attitude may vary depending on who commits the crime. Experiences in places as diverse as New York State and India suggest popular support for government enforcement against the wealthy or powerful.[123] Presumably, the more the public understands tax evasion as a crime of moral turpitude, or one that injures the public at large, the greater the effect of social ostracism against tax evaders. Therefore, it may make sense for the tax administration to publicize adverse effects of tax noncompliance on other taxpayers, such as a general increase in tax liability for those taxpayers who do not comply. Again, if government in general or the tax system in particular is clearly corrupt or unfair, no amount of publicity is likely to change the public's perception of these problems.

People also have propensities to obey laws for reasons other than the likelihood of punishment.[124] Not surprisingly, social scientists have suggested that people are likely to follow rules that they feel have a strong moral justification.[125] A large number of studies suggest that people who support the government in general and the tax laws in particular are more likely to comply with tax laws. If such morals are widely found within a group, then individual moral influences and the informal sanctions of the group are likely to coincide, reinforcing each other.

These individual and group views of morality can be affected by the existence of official sanctions. If a particular legal structure is viewed as legitimate by the target population, and as a general matter the severity of sanctions increases with the severity of crimes, then statutory sanctions may influence both personal and group views.[126] There may also be other ways for the government to influence people's propensity to obey the laws, from improving the perception of its own legitimacy to improving the perception of the legitimacy of particular laws. Wherever possible, these ways should be explored.

Another problem with increasing sanctions without increasing their certainty is that people may begin to view the system of tax administration as arbitrary and unfair. This problem can be magnified if sanctions are perceived to be enforced primarily against political enemies of the government in power. In addition, if sanctions are enforced largely against the less wealthy

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[122]*See* Yankelovich, Skelley & White, Inc., *Taxpayer Attitudes Study: Final Report* (Public Opinion Survey Prepared for the Public Affairs Division, Internal Revenue Service, 1984). The study seems to suggest that perhaps large-scale evasion would not be seen as a "victimless crime."

[123]The Leona Helmsley case in New York, where a wealthy hotel heiress was prosecuted for tax evasion, generated considerable support for the state tax administration. In India, arrests for tax evasion of major industrialists have also been popular. *See* Richard K. Gordon, Jr., *Income Tax Compliance and Sanctions in Developing Countries*, *in* Taxation in Developing Countries 455, 461 (Richard M. Bird & Oliver Oldman eds., 4th ed. 1990).

[124]Scholars may disagree as to whether the existence of personal morality is part and parcel of rational choice theory or describes another theory of human interaction. Some, for example, contrast rational choice models with "psychiatric models" of moral inhibitions or internalized norms. Andenaes, *supra* note 90, at 78–79. However, one can also include morality and internalized norms as aspects of individual utility functions. The important issue, however, is that people do not act solely to maximize dollar profit.

[125]That is, to avoid doing things wrong that are in themselves, as opposed to wrong because prohibited. *See* James J. Teevan Jr., *Subjective Perception of Deterrence (Continued)*, 13 Journal of Research in Crime & Delinquency 155, 157 (1976).

[126]*See* Gerken & Gove, *supra* note 92, at 502.

and powerful, or if the powerful and wealthy are known to escape sanctions, the public's perception of the justice inherent in the legal system can be substantially weakened. This could reduce compliance even further.[127]

3. Design of Civil Sanctions

a. Deterrence

As noted previously, in general, civil sanctions should be designed with two purposes in mind: (i) to deter certain unwanted behavior and encourage desirable behavior, and (ii) to punish other, more heinous behavior. Looking first to the question of general deterrence, sanctions that are easily understood by taxpayers, and that are therefore easily applied and determined, are more certain in their outcome and more likely to affect a taxpayer's behavior, given that person's utility function.[128] Also, sanctions that are easily applied and determined are likely to take fewer administrative resources and are less likely to be subject to arbitrariness. Therefore, as a general principle, financial sanctions should be imposed as automatically as possible. Perhaps the most effective way to do this is to assess a general deterrence penalty, calculated as a percentage of the amount involved, for negligent or unreasonable failure either to (i) report the correct amount of income (or other tax base) on the return or to (ii) pay tax when due.[129] Of course, a judgment will always be required to determine whether a failure is based on negligence. However, the degree of judgment required can be constrained. For example, there can be a presumption that a failure to pay an amount due is unreasonable and that the taxpayer has the burden of proving reasonableness.[130]

In addition to being easier to apply and determine, assessing penalties on the basis of the amount of underpayment makes sense within the logic of deterrence theory. As discussed previously, a penalty designed to deter should, within the constraints of tipping points and the irrationality of humans, raise the average cost of noncompliance so that it exceeds any average savings from noncompliance. Because the literature suggests little additional compliance as sanctions increase, there is likely to be little benefit to increasing formal sanctions beyond this point. In fact, greater sanctions may only increase avoidance and evasion activities, resulting in no greater overall tax compliance and perhaps in a net loss of social welfare to the economy at large. A monetary sanction should then be equal to an appropriate percentage of the benefit of noncompliance, although what percentage is "appropriate" is not always clear. In some instances it may be appropriate to apply flat-rate penalties. These instances are discussed below.

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[127]*See* Gordon, *supra* note 123, at 462. *See also* Virendra Singh Rekhi, Notes on Legal Methods of Combating Corruption: Lessons from the Indian Experience (November 15, 1995) (on file with the Legal Department, International Monetary Fund).

[128]*See* Commissioner's Executive Task Force, *supra* note 76, at 13–15.

[129]*See* USA IRC § 6651(a); BEL CIR art. 444; DEU AO § 152. *See also* Commissioner's Executive Task Force, *supra* note 76, at 67–68.

[130]Upon failure to pay tax, the U.S. Code presumes that the failure to pay is unreasonable; a fine will be imposed unless the taxpayer can show that such failure was due to reasonable cause. USA IRC § 6651(a)(2).

As discussed earlier, the tax administration should publicize rates of detection of noncompliance and implementation of sanctions whenever such rates are above a tipping point for that particular noncompliance. The tipping point should be measured within a particular identifiable subgroup of taxpayers. When appropriate, the deterrence effect of social ostracism may be exercised by publicizing the names of taxpayers who have been punished for noncompliance. Finally, the tax administration should undertake, where appropriate, public information campaigns to emphasize the injuries suffered by complying taxpayers when others fail to comply.

b. Encouraging Resolution of Disputes

There are two ways to reduce or eliminate the incentive to drag out settlement of a tax dispute. The first is to require the taxpayer to pay all disputed amounts and penalties at the outset. The second is not to require payment at the outset, but instead to charge interest on both until they are paid. In the former case, the possibility that the taxpayer will later run out of resources to pay is reduced. However, if the administration is mistaken, such a rule can unfairly force the taxpayer to borrow substantial amounts, perhaps at high interest rates, and put the taxpayer in financial jeopardy, even if the administration must eventually pay interest to the taxpayer on overpayment. In extreme cases, the taxpayer may not only be unable to borrow the needed amounts, but may be unable to contest the assessment at all.

These problems are exacerbated by the fact that government and taxpayer are likely to have different credit ratings, meaning that risk premia are likely to be higher for the taxpayer as borrower than for the government as borrower. Even if the taxpayer receives interest on an overpaid amount, the interest may be much lower than what the taxpayer must pay on funds borrowed to make an initial payment of the amount in dispute. Another problem with regard to risk premia exists if the taxpayer is allowed to defer payment until the end of the dispute process. Unless interest is charged based upon the least creditworthy taxpayers, it will benefit those taxpayers to "borrow" from the government.

Different jurisdictions have reacted to this conundrum in different ways. Some require payment before any dispute settlement can begin, while others do not. Interest rates on overpayment and underpayment also differ among jurisdictions.[131] One possible compromise is to allow an impartial adjudicator to determine whether the taxpayer is required to pay. Taxpayers can then be encouraged to pay earlier by setting relatively high rates of interest on overpayments and overpayments.

Another way to encourage the settlement of disputes is to reduce the penalty if early settlement is reached. For example, the penalty could be reduced by 50 percent if agreement is reached during the administrative stage and by 25 percent during the first litigation stage.[132]

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[131]In almost all of the OECD countries, the one exception being New Zealand, interest is imposed if the taxpayer does not pay his or her taxes on time. OECD, *supra* note 34, at 18–19, 62–66 (1990). Most of the OECD countries also compensate the taxpayer for overpayment with interest. *Id.* at 20, 83–84.

[132]The Colombian tax law is an example of such a system. In Colombia, "[i]f the taxpayer agrees to settle at the time of the initial field audit by the tax authorities, the penalty is 20 percent . . . of the underpayment. If a formal demand for supplementary payment made by the tax administration is accepted by the taxpayer before the case goes

c. Punishment

To punish particularly heinous behavior, an additional civil penalty can be charged for underpayment attributed to willful evasion, fraud, or reckless indifference.[133] This penalty can be determined as a percentage of the portion of the underpayment that is due to such willful evasion, fraud, or reckless indifference.

d. Flat-Rate Penalties

Although sanctions should in general be fixed as a percentage of the deficiency, in some instances it may be desirable to fashion penalties in an even easier, more predictable, and more automatic way than assessing a percentage against the amount of underpayment of tax. This will be the case when there is at best an indirect connection between an action and an underpayment of tax. For example, flat amounts can be charged for each instance of failure or error and can include a flat penalty for failure to file a required document (tax return, information return) or for filing certain documents incorrectly (information returns).[134]

4. Severity of Civil Sanctions

Perhaps the most important lesson to be found in the research literature on sanctions is that they are ineffective unless taxpayers believe that there is sufficient likelihood that they will be caught and that the sanctions will actually be applied. As noted earlier, the most important activity that a tax administration can undertake to ensure the voluntary payment of taxes is to ensure that noncompliance is readily discovered, that the discovery results in the application of sanctions, and that the public is made aware of the difficulty of escaping noncompliance detection. These measures will lower the tipping point, resulting in greater compliance behavior by more taxpayers. In short, the most effective sanction is not the sanction per se, but the rate of enforcement. As a general matter, therefore, those tax laws that are relatively easy for the tax administration to check or audit (meaning also that they are hard to avoid or evade) will have the greatest potential for compliance. Such laws are also likely to be the easiest for the taxpayer to comply with.[135]

For tax laws that are harder for the tax administration to audit, it will be more difficult to ensure a low tipping point. However, unless the tipping point is low enough, increasing sanctions is unlikely to result in a decrease in evasion. The risk that greater sanctions may result

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to court, the penalty is 40 percent. If the taxpayer agrees to the increased assessment after the case goes to court, but before the final judicial determination of liability, the sanction is 80 percent." McLure & Pardo, *supra* note 78, at 136. Thus, Colombian tax laws encourage settlement of disputes.

[133]*See* USA IRC §§ 7201-202 (willful tax evasion and failure to collect or pay tax are felonies); DEU AO § 370(3)1 (penalty for tax evasion is increased if committed out of gross self-interest and is of a large scale).

[134]*See, e.g.,* USA IRC § 7203 (penalty imposed for willful failure to file a tax return); FRA CGI art. 1725 (penalty imposed for failing to file required documents). Similar points were raised in the United States Internal Revenue Service Commissioner's Executive Task Force on Civil Tax Penalties. *See supra* note 76, at 15, 42–43.

[135]*See also* Rekhi, *supra* note 127.

in a net loss of social welfare is more substantial when the law is more difficult to enforce and when additional avoidance and evasion behavior is more likely to be successful. In addition, if the tax administration appears to be punishing relatively few noncompliers with very harsh sanctions, the law will be perceived as arbitrary, as well as a vehicle for politically motivated prosecutions. Therefore, regardless of whether the particular tax law is easy or difficult to administer, sanctions need not be substantial. Sanctions that are already established at significant levels should not be increased in severity as compliance decreases, although this approach may seem counterintuitive.

It is difficult to determine both the actual tipping points for particular populations and the chances of being caught and forced to pay. It is even less likely that these determinations can be made for different types of avoidance or for different population subgroups. It can be said, however, that the exact percentage of the amount of underpayment that should be charged would vary from jurisdiction to jurisdiction, although the variation should not be too substantial. Also, the difficulty of determining these factors when combined with the benefits of uniformity suggests that penalties should be uniform for all taxes. The most important point, however, is that efforts should focus on making compliance with the laws easier, making avoidance easier to detect, improving tax administration enforcement efforts, and, when those efforts are successful, publicizing those efforts.

The size of the penalties would vary from jurisdiction to jurisdiction depending upon the factors discussed above. However, in most cases, penalties should probably not exceed 25 percent of the amount of underpayment for negligence or 50 percent for intentional underpayment.[136]

In the case of additional civil penalties for the more heinous activities of evasion, the additional goal of punishment comes into play. The level of such sanctions should first be based on the legal traditions of punishment viewed as desirable in the particular jurisdiction. However, this starting point should be adjusted to take into account the adverse affects previously discussed of having particularly high sanctions. However, it is unlikely that a civil penalty for fraud should exceed 100 percent of the amount of underpayment.[137]

5. Rules to Increase the Effectiveness of Civil Sanctions

Because of the economic nature of tax noncompliance, monetary sanctions are not always effective deterrents. One example is where the noncomplier is "judgment proof," meaning the taxpayer has no resources to pay any amount due, including underpaid tax, interest, and any monetary sanction. First, legal rules should provide that the government has appropriate priority over other creditors. In particular, bankruptcy laws should be drafted so that tax liabilities are not extinguished in the bankruptcy of a physical person and that tax liabilities are given priority

[136]For example, the U.S. Internal Revenue Service Commissioner's Executive Task Force on Civil Tax Penalties concluded that the civil penalty for underpayment owing to negligence (i.e., no reasonable care) should be 20 percent, with a *de minimis* rule, while the penalty for intentionally underpaying (although without fraud) should be 50 percent. *Supra* note 76, at 67–68.

[137]For example, the U.S. Internal Revenue Service Commissioner's Executive Task Force on Civil Tax Penalties concluded that the civil penalty for underpayment due to fraud should be 100 percent. *Id*. at 68.

in the reorganization or winding up of a legal person.[138] Second, there must be legal rules that allow the taxation authority automatically to secure liens against the taxpayer's unsecured assets, to garnish wages, and to levy property. Also needed are rules against the conveyancing of assets to others in order to avoid government claims.

Although the rules of priority, bankruptcy, lien, attachment, execution, and fraudulent conveyancing are designed to protect the government's claim, there may still be instances where the taxpayer is relatively judgment proof. Some have suggested that in these instances nonfinancial penalties, such as prison terms, should be added. However, most legal systems would not tolerate the imposition of prison terms for civil offenses.[139] Civil sanctions could, however, include the temporary suspension of certain privileges, such as to practice as a chartered accountant. Some jurisdictions revoke business or other licenses from delinquent taxpayers.[140] Revoking such privileges, while acting as a deterrent, may actually reduce the ability of the taxpayer to pay off his or her government debt and may have the undesired effect of damaging the economy, and increasing unemployment, by essentially prohibiting a business from operating.

It may make sense to allow such nonmonetary sanctions to be applied only after a taxpayer fails in good faith to make payments under a payment plan. The taxation authority can increase the effectiveness of informal sanctions by publicizing tax violations. Such informal sanctions would apply to all delinquent taxpayers, but may have particular importance for those debtors who are judgment proof. Sanctions are also ineffective when someone other than the noncomplier will step in and pay the fine, for example, when legal persons, such as companies, are taxpayers. The physical persons who undertake the execution of the tax law liabilities of legal persons may not be subject to an adequate financial sanction if only the legal person, and therefore the legal person's owners, suffers. Therefore, financial sanctions must be addressed not only to the legal person, but also to the physical person. If the physical person is indemnified against any sanctions by the legal person or by others, the sanction will also not work.

These problems can be at least partially addressed by including a "responsible physical person" penalty. Such a penalty would make those physical persons who are responsible for collecting and paying taxes for legal persons liable for failure. Jurisdictions that have such responsible person penalties usually restrict them to certain types of noncompliance. In the United States, for example, such a penalty exists only for the failure to withhold the appropriate amount of taxes on payments to third parties and on failure to pay the withholding over to the government. The "penalty" for such failure is equal to the amount of underwithholding or underpayment; the responsible persons are jointly and severally liable, along with the legal person.[141] However, responsible persons are not penalized for failure to pay income tax amounts due. This is probably

[138]*See, e.g.,* Bankruptcy Code, 11 U.S.C. §§ 507(a)(7), 523(a)(1) (USA).

[139]No OECD country provides for prison terms for civil tax offenses. *See* OECD, *supra* note 34, at 19. While in most countries imprisonment is one possible sanction for tax crimes, it is very rarely imposed.

[140]For example, in the United States and the United Kingdom, tax deficiencies may result in a loss of privileges, including the ability of attorneys and accountants to practice their trade. *Id.* at 19, 67–69.

[141]USA IRC §§ 3402, 3403, 3505, 3509, 6672; *see also* AUS ITAA §§ 222AOA–222AOD.

due to the fact that, as discussed previously, withholding rules are very simple to implement and failure to withhold can be attributed clearly to a limited number of people.

The same cannot be said for the determination of income tax liability. Other taxes, such as VAT and excises, may also be easy enough to implement, so that a failure to collect and remit these taxes could also subject the responsible person to penalty. A 100 percent responsible person penalty suggests that the purpose of the penalty is not simply to extend deterrence to the physical person in charge, but perhaps also to help collect the amount of underpaid tax when the legal person is judgment proof. In the United States, the responsible person penalty makes any person required to pay tax over to the IRS liable for the tax.[142] Because the taxes chosen for such a penalty are easy to determine and collect, and easy for the tax administration to check or audit, the tipping point for the deterrence effect can be made fairly low, which means that sanctions would be more likely to be effective and high sanctions would be less likely to have additional negative welfare effects through increased avoidance and evasion behavior. The nature of these taxes also suggests that high penalties are not necessary. Therefore, the total amount of tax collected from all responsible persons through this penalty should not exceed 100 percent of the tax due, plus interest and other applicable penalties.[143]

6. Criminal Offenses by Taxpayers

Fraud or evasion is usually considered a crime,[144] but it is often a difficult crime to prove. Some countries have therefore set forth other acts that may be part of a scheme of fraud, but that, in themselves, constitute crimes and that may be easier to prove than a fraudulent scheme. The punishment for these crimes is usually less than the punishment for fraud. If the taxpayer is convicted of fraud, these other crimes should not apply. These crimes include submitting false documents and interference with tax administration through libel, slander, or other means designed to influence official action either positively or negatively.[145]

Criminal offenses would be in addition to civil penalties. They can be subject to flat fines and even to terms in jail. However, as with all penalties, high criminal penalties may only result in taxpayers' taking greater care to disguise their fraud.[146] Depending on the country's legal tradition, the provisions imposing a criminal penalty could be included in the tax administration law or in the criminal code. Wherever located, the general rules of criminal procedure should apply.

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[142]USA IRC § 6672.

[143]This is the case in the United States; while the IRS may assess 100 percent penalties against all responsible persons, it may enforce such assessments only until it has collected an amount equal to the tax liability. Gens v. United States, 615 F.2d 1335 (Ct. Cl. 1980).

[144]*See, e.g.,* USA IRC §§ 7201, 7202.

[145]For example, in the United States, the Internal Revenue Code includes the following acts as crimes punishable by fines and prison: making fraudulent statements in a tax return or information return, making fraudulent statements under penalty of perjury, and removing or concealing information with intent to defraud. USA IRC §§ 7204–7207.

[146]*See* discussion *supra* sec. III(C)(2).

7. Tax Administrator Penalties

Unless the matter is governed adequately in the other laws, special civil and criminal penalties can be applied for tax administrators. They can include civil penalties for negligent failure to follow accepted procedures or to respect taxpayer rights. Depending on the jurisdiction, these penalties could be imposed as damages based on taxpayer suits as part of (or an addition to) the general law of civil liabilities. Permitting taxpayer suits in these cases could act as a substantial deterrent to corrupt behavior on the part of officials. Criminal behavior of tax administrators may already be penalized under the criminal code.[147] Some laws also provide for criminal penalties for private income tax preparers who disclose confidential taxpayer information.[148]

[147]For example, in the United States, the Internal Revenue Code includes the following acts as crimes punishable by fines and prison: numerous acts by revenue officers or agents, including extortion, bribery, conspiracy to defraud, and failure to report the illegal acts of others. USA IRC § 7214. The Internal Revenue Code supplies a cross-reference to a penalty provided in the U.S. criminal law relating to officers of the United States who trade in public funds, debts, or property. *Id.* § 7214(c).

[148]*See, e.g., id.* § 7216.

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Regulation of Tax Professionals

Victor Thuronyi and Frans Vanistendael

Bad ethics drive out good.
—Adapted from Gresham's Law.

It would be difficult to have a well-functioning tax system without tax advisors. Because most taxpayers are not familiar with the intricacies of the tax laws, tax advisors are needed so that taxpayers can fulfill their complicated tax obligations. As informed members of the public, tax advisors also provide input to the formulation of legislation and regulations.

By counseling taxpayers on how to comply with their legal obligations, tax advisors serve an important public interest; the state has an interest in fostering and protecting this role. The role of tax advisors, however, differs from that of the tax authorities in that their primary loyalty is to their client, not to the state. An important function of the regulation of tax advisors is to help strike an appropriate balance between loyalty to the system and loyalty to the client.

Regulation also has the goal of protecting clients from unscrupulous or ncompetent tax advisors. Here, the regulatory interest of the state is similar to that in other areas of consumer protection. The danger is that such regulation might serve instead to protect the economic interests of those permitted to act as tax advisors, or might strangle the free exercise of the profession by creating undue bureaucratic control.

This chapter reviews the regulation of tax advisors in different countries. Such a review is multifaceted, for several reasons. First, different countries have adopted rather different regulatory approaches. Second, tax advice is typically given by different types of professionals —lawyers, accountants, auditors and others—each of which may be subject to independent regulation of its profession. Third, "tax advice" covers a multitude of different activities, which can be performed by professionals with different qualifications and which may call for different regulatory approaches. Fourth, tax advisors do not operate purely domestically, and a different regulatory approach may be appropriate, for example, for foreign tax advisors who render advice within a country, perhaps to a largely foreign-based clientele. Finally, the role of tax advisors cannot properly be viewed in isolation from a country's culture and its legal and economic system. Therefore, approaches that may work in one country may not be appropriate for another.

Note: Rick Krever contributed to the writing of this chapter. The authors are grateful to Bernard Wolfman for his comments.

Because of the practical importance of tax advisors for the functioning of the tax system, it is important that the system of tax legislation provide an underpinning for their role, whatever regulatory approach is adopted in a particular country. At a minimum, the law should spell out the taxpayer's right to use a representative and the consequences of that use. Whether it is appropriate to go beyond this and provide more detailed regulation is a matter to be decided in light of the circumstances of the country concerned and the stage of development of the tax advisory profession in that country. In most transition countries, there are very few tax advisors. This is due to the youth of the tax system as a whole and to the fact that there has not been time for professional education and experience. In part because of the paucity of tax advisors, taxes in these countries are often designed so as to minimize the number of taxpayers who must take positive action with respect to their tax affairs, for example, through the use of final withholding taxes and registration thresholds. Detailed regulation of tax advisors would not seem to be a top priority for transition countries, compared with other areas where the tax system needs development. Nevertheless, several transition countries (e.g., China, Poland, and the Slovak Republic) have undertaken such regulation.

I. Basic Policy Considerations in Regulating Tax Advisors

A. Balance of Supply and Demand

Regulating a profession by imposing conditions for admission inevitably reduces the supply of potential professionals. Whenever a service industry is regulated, a rough balance between supply and demand for professional services should be maintained. Therefore, in any proposal to regulate a professional service, like tax advice, it is of crucial importance to know in advance how many people can be admitted to the profession immediately or within a short period of time, given the regulations contemplated. The standards of experience and education that are set in the regulation will to a large extent determine the volume of the supply of tax advisors. Flexible transitional measures may also have a major impact on the balance between supply and demand for tax services.

On the demand side, an analysis should be made of what type of professionals will be required by what type of taxpayer. For example, there is a huge difference in qualification requirements between a tax lawyer able to take complicated cases in court and a person able to prepare simple returns for small rural businesses. The demand for tax advisors will depend, among other things, on the development of the economy and the legal system and on requirements imposed on taxpayers (e.g., how many taxpayers are required to file returns). On the supply side, the major constraint in many countries is likely to be the availability of proper training.

The necessity of providing a rough balance between supply and demand for tax advice is of decisive importance in deciding (1) whether or not to regulate the profession, and (2) how to regulate the profession and more specifically what the qualifications should be for admission to the profession and whether the profession should be granted a monopoly on some or all aspects of tax practice.

The most burning political question concerns granting a monopoly for the exercise of the profession. From the point of view of the tax profession, a monopoly may be highly desirable. However, it is the general interest and not the interest of the profession that should decide this issue. The general interest is best served by high-quality service at a low price. A monopoly is supposed to exclude incompetence and low quality but tends to result in higher prices and may in certain circumstances result in corruption (e.g., there can be corruption in terms of entry to the profession). Moreover, a monopoly cannot fully exclude incompetent advice. If incompetent advisors can make it into the monopoly, and are able to keep competent advisors out, then a monopoly offers a lower quality of advice than a regime of free competition. Quality standards can also be fostered by regulatory measures that do not create a monopoly.

A monopoly for tax advice is also difficult to enforce. A great deal of tax advice is generated by the activities of professions such as accountants (internal audit), auditors (external audit), lawyers (advising on business transactions, tax litigation), notaries (conveyancing), real estate agents, and customs agents. Each of these activities can in its own right involve some form of tax advice. Establishing a monopoly for tax advisors will not exclude all these professionals from offering tax advice. This means that establishment of a monopoly is not likely to be very effective in achieving the desired policy goals.

Moreover, an alternative means is available for providing consumers access to a regulated profession. The profession can be regulated and its title protected by law (which means that an individual who is not duly accredited is not allowed to use the title of tax advisor), but without giving members of the profession a monopoly on tax advice. Under such a scheme, consumers would have the choice of obtaining tax advice from an accredited tax advisor or of consulting another professional. This solution maintains competition between rival professions in the market for tax advice, while at the same time setting adequate quality standards for the profession of tax advisors. It is one possibility among the alternative approaches to regulation discussed in section III of this chapter.

B. Maintenance of Quality Standards

Maintenance of quality standards does not necessarily involve a legally imposed regulatory scheme. For example, in the Netherlands there are two strong private organizations that impose strict rules on their members.[1] Although there is no official recognition of these private organizations, the Ministry of Finance considers them to be representative partners in dealing with problems of the tax profession. These organizations police the quality of their members and accordingly offer the public a choice about whom to consult on tax matters. Their private status gives them flexibility in setting professional standards. However, such a situation, whereby a private organization imposes quality standards on its members, requires time and tradition to develop. This model would probably be difficult to follow in most countries in transition.

[1]These are *de Nederlandse Orde van Belastingadviseurs (NOB)* [The Dutch Order of Tax Advisors] and *de Nederlandse Federatie van Belastingconsulenten (NFB)* [The Dutch Federation of Tax Consultants].

Many developing and transition countries that decide to regulate tax practitioners may choose to determine professional requirements by law rather than by relying on private organizations, unless these are well developed. The question of the professional qualifications required for admission is a difficult one, because the profession is in practice exercised at very different quality levels, ranging from quite simple to highly sophisticated. In setting educational and professional standards, one should also take into account a country's educational and professional tradition.

In the United Kingdom, for instance, professional education of lawyers and accountants traditionally took the form of on-the-job training, while the role of universities and other institutions of formal education was rather limited. This may be related to the English tradition of professional education in which solicitors and barristers traditionally learned their trade at the Inns of Chancery and the Inns of Court in London rather than in universities. In more recent years, however, the norm in the United Kingdom has become a university degree. In setting standards for admission, a country having a similar tradition of on-the-job training could put more emphasis on professional experience than on university degrees. Countries with a strong tradition of academic education in law or other relevant disciplines (e.g., accounting) can rely more on degrees in setting standards for admission.

Keeping in mind the basic requirement of a balance between supply and demand for tax advice, limitations on resources for training and education are likely to constitute the major bottleneck in the supply of tax advisors in developing and transition countries. To avoid such bottlenecks, any regulation should avoid exclusive channels of access to the profession. When the main requirement is professional experience, the law regulating the profession should not give the profession exclusive control over quality standards, but should share this control with the government, enabling the latter to keep channels of access open. When the main requirement is a diploma or degree, the law should provide that the government can organize official examinations for candidates without the degree, requiring the same level of competence as the examinations organized by universities and other institutions of higher learning.

A model of the latter approach can be found in the Eighth European Directive of April 10, 1984,[2] regulating admission to the auditing profession. This directive requires candidates to have a university-level education and practical training.[3] This theoretical education can be provided either by universities or other institutes of higher learning or by the profession itself. The same holds for practical training. The important thing is that the directive provides for alternative channels of access (universities or the profession). The directive is also flexible in that it does not require the applicant to take courses and lectures. The only requirement is that the applicant present a theoretical examination on a minimum number of courses and proof of practical training.[4] The applicant has the choice between a university or other school of higher learning, or an examination board organized by the state. This is not to suggest that degree requirements

[2]Council Directive 84/253, 1984 O.J. (L 126) 20.

[3]*Id.* art. 4.

[4]*Id.* arts. 4, 5, 8.

for tax advisors should all be set at the university level: a multilayered approach may be more advisable.[5]

Finally, in implementing a regulatory scheme that involves professional standards, it may be necessary to provide for a transitional period during which access to the profession is permitted on the basis of an examination, in a few areas that are essential to tax practice, such as general principles of tax law, substantive law of major taxes—such as income tax (individual and corporate) and value-added tax or turnover taxes—tax procedure and company law, and accountancy, without any formal requirement of prior education (except basic secondary education). The exact program could be detailed by regulation. Examinations could be organized by universities or other institutions of higher learning, or by educational centers of the tax administration that organize the training of tax officials.

C. Conflicting Loyalties of Tax Advisors

The development of appropriate regulation of tax advisors must recognize the dichotomy between the state's interest in raising revenue and in applying its taxation law in a consistent, efficient, and equitable manner and the client's interest in minimizing tax.

Some taxpayers are prepared to violate the law in order to pay less tax. Others wish to act legally but to obtain as much after-tax profit as possible. They will legally seek to do this by exploiting inconsistencies and ambiguities in the tax legislation. Where different tax consequences follow two different forms of a transaction, the taxpayer will, if properly advised, often adopt the form that incurs the lowest tax burden. Similarly, if two types of transaction bear different tax burdens, the taxpayer can be expected to characterize the transaction employed by the taxpayer as one qualifying for the lower tax burden. And, finally, where there is some ambiguity in the application of the statute, the taxpayer will seek to interpret the ambiguous wording in the most advantageous way possible.

In addition, a taxpayer may consult an advisor to make sure that a particular transaction or business structure does not result in unfavorable tax treatment or to learn how to comply with tax legislation.

An underlying question is the extent to which, in different circumstances, the tax consultant must act in the interests of the state or the client if the interests of the two parties diverge. This question should be borne in mind in considering the various functions that a tax advisor can perform. The basic rule in most countries is that the private tax advisor must act in complete independence from the tax administration. The tax advisor must of course respect all legal obligations that flow from the tax law, but his or her primary loyalty lies with the client, the taxpayer. For example, the advisor must generally respect client confidences and may not report the client to the tax authorities.[6] This independence results from the general attitude taken toward professional services, such as those of lawyers, physicians, and accountants. This independence may be very valuable, particularly in transition countries, which until recently had

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[5] *See infra* sec. II.

[6] *See infra* sec. I(H).

an experience of interference by public authorities in all areas of public and private life. The loyalty to the client is not, however, unqualified. A tax advisor is not generally permitted, for example, to participate in fraud or to lie to the government.[7]

Some countries have a different emphasis. According to the Japanese Law on Certified Tax Accountants of 1951, the mission of a certified tax accountaint (CTA) is to implement the taxpayer's obligation to pay taxes as stipulated in the law. The CTA must be impartial between the taxpayer and the tax administration and make the CTA's position clear to both parties. The Japanese Ministry of Finance may also disbar or suspend a CTA; some argue that this makes the professional subject to the tax administration to some degree.[8] Similarly, in countries with rules contemplating the certification of a tax return by a professional, the professional on his or her personal responsibility certifies that the return is in compliance with the law, thereby placing the tax advisor in a position of some independence vis-à-vis the client.[9]

Closely tied to the question of loyalty is the question of whether tax officials may practice as tax advisors. This question is particularly crucial in transition countries because the tax administration may constitute the only reservoir of professional expertise for private practice. Regardless of the circumstances, the basic rule should be that an official of the tax administration is prohibited from engaging in any form of private tax practice while in government employment.[10] The reason for this incompatibility between public and private tax practice is that it is impossible to serve two masters at the same time. There would be a clear conflict of interest between loyalty to the tax administration on the one hand and loyalty to the client on the other.

This incompatibility should not be confused with the duty of the tax official to help some kinds of taxpayers file their tax returns. In many countries the tax administration opens its offices to taxpayers who are illiterate, low-income, or elderly. The taxpayer must be aware that the tax official is acting in the exercise of the official's public office in providing this service. These services can be provided for small taxpayers with simple tax returns reporting fixed salaries or pensions. They should not be open to taxpayers with important sources of revenue, because in such instances they could easily result in corruption.

Another question is whether a tax official can enter into private tax practice after leaving the tax administration. Tax officials often resign from their official duties to accept lucrative consulting jobs in the private sector. Basically, this should be permitted in developing and transition countries. However, to avoid a massive flight from the tax administration into private practice, after the tax officials have completed their professional training in the tax

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[7] *See* Bernard Wolfman et al., Standards of Tax Practice § 403.2 (3rd ed. 1995).

[8] *See* Masayoshi Hanaki, Japanese Certified Tax Accountant System (paper presented at International Seminar, Beijing, Apr. 1994).

[9] *See infra* sec. IV(A).

[10] *See, e.g.,* 31 C.F.R. § 0.735-20, -21(b), -39 (1994) (USA) (Treas. Dept. employees may not engage in outside employment involving a conflict of interest; federal employees may not act as attorney or agent of a party in a case before a court or agency where the government is an opposing party).

administration, a minimum number of years in public service could be imposed.[11] Finally, and in order to avoid a conflict of interest, a former tax official should be prohibited from dealing as a private advisor with files with which the official has been in contact directly or indirectly while working for the tax administration.[12]

D. Relationship Between Tax Consulting and the Legal and Accounting Professions

The variety of functions performed by tax consultants overlaps the responsibilities ordinarily carried out by other professionals, chiefly lawyers and accountants. Thus, it is impossible to consider the regulation of tax consultants without considering how the legal and accounting professions are regulated, the extent to which these professions are guaranteed monopolies in practicing in their respective areas, and the extent to which tax consulting activities are considered the practice of law or the practice of accounting.

In almost all jurisdictions, controls are placed on who is entitled to practice law or accountancy. The controls usually work in conjunction with measures that provide for the establishment and recognition of independent, self-governing professional bodies that are responsible, among other things, for establishing the prerequisites for admission to practice in the profession, the continuing education and other conditions for continuing qualification, and the disciplining of members of the profession with respect to breaches of their professional responsibilities. Legislation imposing criminal sanctions is often used to enforce the professional monopolies and restrict practice to persons who meet the requirements of the state and of the relevant professional body.

The boundaries between legal advice, accounting advice, and advice that is neither legal nor accounting are inherently unclear in the tax area. All advice about tax *law* can be characterized as legal advice. Jurisdictions vary in the extent to which they give a monopoly on the provision of legal advice to lawyers and on how they define the monopoly. In countries such as the United States and France, which restrict the provision of legal advice to lawyers, there can be disputes about the extent to which the provision of tax advice by nonlawyers is the unauthorized practice of law. In Germany (and other countries with analogous regulatory schemes), the situation is more complicated, because there is a legally created monopoly on both the practice of law and on the practice of tax advice, so that the lawyers' monopoly must make exceptions to take into account the competing monopoly of the tax advisors, and vice versa. No jurisdiction, however, has provided that only lawyers may give tax advice, because so many other professionals deal with tax matters.[13]

Because legal, accounting, and tax services are so closely connected, it is desirable to approximate certain professional rules in the three professions. If those professional rules were very different, competition between the three professions could be distorted. The areas in which

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[11]This could take the form of a promise that is not legally binding, a contract with a damages clause, or a legally imposed period prohibiting private practice for a certain time if the minimum length of service is not satisfied.

[12]*See* 18 U.S.C. § 207 (USA); Treas. Dept. Circ. No. 230, § 10.26 (USA) [hereinafter Circular 230]. In Germany, there is also a three-year waiting period before a former tax official may represent a client whose tax matters the official dealt with. *See* DEU StBerG § 61.

[13]*See infra* sec. II.

professional rules should be approximated include the following: (i) permissibility of advertising, (ii) rules for professional liability, (iii) the parallel activities that are compatible with the exercise of the profession, (iv) whether a person can become a member of more than one profession and which profession would then control professional and ethical standards, (v) whether a legal person can become a member of the profession, (vi) fees, (vii) privileged information, and (viii) ethics, for instance, conflicts of interest, limitations on holding financial interests in clients, and procedures for a client to consult another professional.

The difficulty of segregating legal and accounting advice from tax advice and from business and financial planning advice does not arise with respect to other functions performed by tax consultants where the nature of the service is easy to identify, namely, the preparation of tax returns and the representation of a taxpayer in contacts with revenue authorities or before an appeals board or court. The relative clarity of these latter functions probably explains to a large degree why, as explained further below, in some jurisdictions[14] efforts to supervise and regulate tax consultants concentrate on these responsibilities.

E. Admission of Legal Persons to the Profession

The development of rules allowing or disallowing tax advisors to operate through different business forms will depend in part on the conceptual model underlying the profession to which the advisor belongs. Two competing models have emerged—the traditional concept of a liberal profession as it has been developed in continental Europe and the more modern Anglo-American concept of a profession providing intellectual services through entities such as the big accounting or law firms. In the former concept, the person of the practitioner takes a central position and the practitioner's personal qualities determine the quality of his or her professional practice. In the latter, the organization and its techniques and procedures are crucial, and the person of the practitioner is of secondary importance because the practitioner's quality is determined by the working procedures of the organization. These two alternatives are not mutually exclusive because systems permitting practice by legal persons also allow practice by individuals.

If legal persons are admitted to practice as such, two basic issues arise, one with respect to the professional quality and responsibility of the individuals working for the organization and another with respect to the independence of the organization from its clients and the rules with respect to conflicts of interest and other matters of professional ethics.

Preservation of the virtues of personal professional responsibility and quality of the services provided are good reasons for not admitting legal persons to the exercise of the profession. The argument that admission of legal persons is necessary for the buildup of large organizations is not valid. The existence of major European and American law firms that have several hundreds of lawyers and thousands of employees, and that are not admitted to practice as an organization, is sufficient to refute this argument.

[14]*See infra* secs. II(D–F), III.

However, some countries (such as France and Germany) have chosen to admit legal persons to practice.[15] Under such a system, a major policy question is the extent to which a director, partner, shareholder, or employee is required to be an individual member of the profession with all rights, privileges, and responsibilities related to that status. In the extreme case, one could have a firm with only one individual being a member of the profession and all other partners and employees not being members. It is clear that certain minimum standards should be fixed as to the level in the organization at which individuals must be members of the profession.

Closely tied to this question is that of corporate control. If a firm is admitted to the profession, it is important to know who will control it. If bankers, industrialists, and shopkeepers can exercise control of a tax consulting firm, it will be very difficult to enforce the standards of ethics and independence of the profession because no banker, industrialist, or shopkeeper is bound by such standards. Again, if one takes the independence and ethics of the profession seriously, it would seem that the minimum rule ought to be that control over all professional decisions must be in the hands of persons who, as individuals, are members of the profession and subject to its ethical rules. This may require a majority of the outstanding capital and of the votes in the general meeting of shareholders and even exclusive representation on the board and other bodies of the legal person.[16]

The admittance of legal persons to the profession also raises some secondary questions, namely, how ethical rules can be enforced against a legal person and how the legal person can participate in the life of the profession (voting rights in the general meeting of the professional association, representation on its executive board, etc.).

F. Regulation of International Tax Consulting Services

Those countries that leave the tax profession largely unregulated do not face a problem in dealing with foreign practitioners. Where a country seeks to establish a monopoly on tax practice, however, problems arise in applying the regulations to tax consulting services that cross borders.

Consideration of the tax implications of international transactions and investments will inevitably involve consideration of local tax laws and the tax laws of the jurisdiction in which the other party to the transaction or investment is resident. In the case of multinational corporations, it is likely that the tax implications in many jurisdictions, where various branches of the company are resident, will have to be taken into account before the details of a transaction can be finalized.

Persons qualified to provide advice on domestic taxation are unlikely to have sufficient knowledge of relevant foreign tax systems to advise on all aspects of the foreign law. To obtain that information, a taxpayer will quite likely require the advice of a foreign tax consultant. The qualifications required of (and supervision of) foreign tax consultants will depend on how the

[15]*See* DEU StBerG §§ 3(1)1, 49, 72, 74; Loi No. 90-1258 of Dec. 31, 1990, relative à l'exercice sous forme de sociétés des professions libérales soumises à un statut législatif ou réglementaire ou dont le titre est protégé, J.O. Jan. 5, 1991 (FRA) [hereinafter Loi No. 90-1258]. The Slovak Republic has changed its rules to prevent limited liability companies from providing tax consultancy services. *See* Alzbeta Bobáková, *LLCs Can No Longer Provide Tax Services in Slovakia,* 11 Tax Notes Int'l 32 (1995). The law regulating tax advisors is SVK TAL.

[16]*See* DEU StBerG §§ 50, 50a; Loi No. 90-1258, *supra* note 15, arts. 5–13.

advice is provided. The advice can be sought directly by a taxpayer in the country or through a tax consultant practicing in the country. In both cases, the advice can be sought in a number of ways, such as asking an expert abroad to provide advice; arranging for a foreign advisor to visit the country for a brief period; using a foreign expert who is resident in the country; or having the tax analysis be done in another country where a multinational is based or has operations.

Pragmatic considerations suggest it is difficult to regulate the provision of this sort of advice. Excessive regulation might result in simply pushing businesses to seek tax advice offshore. It should also be taken into consideration that foreign tax advisors are likely to bring international technical expert knowledge to the tax profession that a country may very much need to participate in international economic transactions. A pragmatic solution strongly suggests *not* to establish a monopoly for tax advice, or at least not to establish a monopoly on international and foreign tax practice, so as to leave foreign tax experts free to practice in the international area and in the domestic tax area of their country of origin.

Moreover, jurisdictions that are part of a common market area may face legal constraints in imposing restrictions on freedom of establishment and the freedom to provide cross-border services that discriminate against foreign nationals.[17] A foreign professional who has been qualified abroad may wish to practice in the country without having fulfilled all the in-country educational requirements normally required of domestic individuals who wish to become licensed. If certain aspects of tax practice are restricted to persons with given qualifications, this problem can be dealt with by providing for a simplified procedure for foreign practitioners to qualify to practice in the country in recognition of the fact that they have already had to become qualified abroad.[18]

When foreign members of a regulated profession are allowed to practice in a country, an important question arises as to which will be the competent disciplinary authority: the authority of the territory in which the activity has been exercised or that of the territory in which the professional was admitted to practice. This question has not yet received a final answer. It is clear that international law firms and accounting firms would prefer disciplinary authority to rest with the competent authority of the country in which the professional has been admitted to practice. They are familiar with those rules, and application of those rules would provide legal security, which may be necessary to convince an international tax advisor to practice in a country that is otherwise unknown to him or her.

On the other hand, a country may want to subject foreign members of a regulated profession allowed to practice in the country to the same professional rules as its own national professionals. Different professional rules may distort competition to the disadvantage of domestic professionals.

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[17] *See supra* ch. 2, sec. II(G).

[18] *See, e.g.,* DEU StBerG § 36(3) (simplified procedure for citizens of other EU states).

G. Provision of Tax Services by Employees

Any regulatory scheme should take account of the fact that the major portion of tax services to corporations is provided not by outside advisors but by employees. The regulatory interest in controlling what employees can do is weak, since presumably the employer can exercise the control desired. Generally, employees are free to provide tax services to their employer without any state control over their qualifications, except in cases involving representation of the employer before a court,[19] and they may be exempted from requirements that apply to independent tax advisors.[20] In drafting a regulatory scheme, the supply and demand implications of service rendering by employees should be taken into account. Moreover, it should be clearly specified which activities can be undertaken without government control. A regulatory scheme that is restrictive and leads to a scarcity of available advisors will create pressure for corporations to do their tax work internally rather than to retain outside advisors.

H. Privileged Communications and Work Product

In many countries, professionals rendering tax advice enjoy professional privilege under which documents furnished to, and communications with, a tax advisor may be exempt from disclosure to the government.[21] Usually, the rules in this area follow the general rules of privilege. Communications to lawyers may be eligible for privilege, but communications to accountants or tax advisors who are not lawyers are generally not. Not all communications to lawyers are privileged; thus, privilege generally extends only to communications in confidence for the purpose of obtaining legal advice. Financial documents, however, furnished to a lawyer for the purpose of tax return preparation might not be privileged because they have not been prepared by the client for the purpose of confidential communication to the attorney.[22] Communications made to an attorney for the purpose of return preparation might not be privileged because the preparation of tax returns does not constitute rendering legal advice.[23] On the other hand, the taxpayer's attorney's work product (e.g., notes analyzing the taxpayer's case) may be immune from disclosure to the tax authorities.[24] The U.S. Supreme Court has not, however, extended the attorney work product doctrine to accountants.[25]

Where privilege is available with respect to some professions, but not with respect to tax advisors generally, there is a distortion of competition between tax advisors who are members of different professions, since taxpayers may prefer an advisor to whom communications are

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[19]*See, e.g.,* Circular 230, *supra* note 12, § 10.7(c).

[20]*E.g.,* Finance Act 1995 § 172(1) (IRL)(employee not subject to rule described *infra* note 30).

[21]This is known in some countries as professional secret (in France, *secret professionnel*, *see* Décret No. 91-117 of Nov. 27, 1991, organisant la profession d'avocat, J.O. Nov. 28, 1991, and in Germany, *Berufsgeheimnis, see* DEU AO § 102(1)3(b)). For discussion of professional privilege in the tax area in the United States, *see* Wolfman et al., *supra* note 7, at § 306.4.4.1; Michael Saltzman, IRS Practice and Procedure ¶ 13.11 (2d ed. 1991).

[22]*See* Colton v. United States, 306 F.2d 633 (2d Cir. 1962).

[23]*See In re* Schroeder, 842 F.2d 1223 (11th Cir. 1987).

[24]*See* Hickman v. Taylor, 329 U.S. 495 (1947); Upjohn Co. v. United States, 449 U.S. 383 (1981).

[25]*See* United States v. Arthur Young & Co., 465 U.S. 805 (1984).

protected by privilege. On this basis, some of the distinctions that are drawn between different professions in the recognition of privilege can be faulted.[26]

Many tax administrations are opposed to professional privilege for communications to tax consultants, because it would impede the efficiency of tax audits. Obtaining information about the client's tax affairs from an advisor can be a particularly useful tool for the tax administration, because the tax advisor may have analyzed the client's situation and identified points of weakness in positions the client has taken.[27]

The question of privilege comes up where the government seeks to obtain documents or testimony from the tax advisor. A related, but distinct, issue is the advisor's responsibility to keep client confidences; that is, are there any circumstances under which the advisor is permitted or required to report the client's misconduct to the tax authorities? The general obligation to maintain client confidences is imposed by the general professional standards that govern the practice of lawyers and accountants. A duty to maintain confidentiality may also apply to tax advisors who are not lawyers or accountants if these are regulated.[28]

As a general matter, the practitioner may not reveal client confidences to the government. For example, if a client commits tax fraud, a practitioner representing the client in an audit who learns of the fraud from the client may not inform the tax authorities. Instead, the practitioner may be required by professional standards of practice to advise the client to inform the tax authorities of the fraud. If the client refuses to do so, then the practitioner may be required to cease representing the client, if continuing to do so would make the practitioner a party to the fraud.[29] Ireland has recently amended its tax law to require an advisor to a company who becomes aware of certain tax offenses committed by the company to first ask the company to report the situation to the tax authorities.[30] If the company refuses to do so, then the advisor is required to cease working for the company as auditor or as tax advisor for a period of three years.[31] If the advisor who is required to resign is an auditor, the advisor must notify the company of his or her resignation and send a copy of the notice of resignation to the tax

[26]*See, e.g.,* Nancy Loube, *Attorney-Client Privilege in the Context of Section 6662,* 10 Tax Notes Int'l 2103 (1995).

[27]For example, in United States v. Arthur Young & Co., 465 U.S. 807 (1984), the IRS sought the tax accrual workpapers of the taxpayer's accountant through an administrative summons. Tax accrual workpapers are the independent auditor's papers used in the process of determining the adequacy of the corporation's reserve account for contingent tax liabilities. "Tax accrual workpapers also contain an overall evaluation of the sufficiency of the corporation's reserve for contingent tax liabilities, including an item-by-item analysis of the corporation's potential exposure to additional liability. In short, tax accrual workpapers pinpoint the 'soft spots' on a corporation's tax return by highlighting those areas in which the corporate taxpayer has taken a position that may, at some later date, require the payment of additional taxes." *Id.* at 813.

[28]*See* Wolfman et al., *supra* note 7, § 403.1.1; USA IRC § 7216.

[29]*See* Wolfman et al., *supra* note 7, § 403.2.2.

[30]Finance Act 1995 § 172(2) (IRL).

[31]*Id.* § 172(2)(b).

authorities.[32] An exception is provided for a person assisting or advising the company in preparation for legal proceedings.[33]

II. Tailoring Regulation to Functions of Tax Advisors

The resolution of the interests of the state and of the taxpayer requires a multifaceted response in light of the fact that the category "tax consultants" encompasses persons with quite different roles and responsibilities. For example, in situations such as those of a lawyer defending a client against criminal prosecution, it is appropriate for the advisor to act with total loyalty to the client, subject only to the ethical principles that apply to lawyers (such as the duty not to lie to a tribunal). In other cases, such as where the tax advisor assists in planning transactions, it is not appropriate for the advisor to act as aggressively as possible in the client's interest.[34] A preliminary step in regulating tax consultants, therefore, is to identify the different types of consultants and consulting activities and consider each separately in the context of alternative regulation models. This section reviews the different functions that are typically performed by tax advisors, and how considerations for regulation might differ for each.

A. Tax Planning

Tax advice, because it can be approached from different angles, is part of a much wider package of legal and economic services, including auditing, accounting, financial, legal, and management services. Tax problems can arise not only from the company's accounts and records, but also from legal obligations flowing from company law, securities regulation, bankruptcy law, and so on. Therefore, it is important to recognize that many different kinds of professionals will deal with tax problems as a natural extension of their nontax activities. In countries with complex tax laws, virtually every business or financial transaction may call for review of its tax implications. Advice on tax planning can therefore arise in quite different contexts and be given by different professionals not just by tax specialists.

B. Advice Ancillary to Financial and Other Services

Tax advice is also provided by some ordinary business enterprises like banks, insurance companies, brokerages, and real estate companies as a service ancillary to their main business. For example, life insurance products may be eligible for special tax treatment, which insurance brokers will explain to clients. The same will be true for many financial products. The advice given here will typically be very narrow in scope, focusing on the tax treatment of the financial product being sold. These business enterprises cannot be compared to independent professions and should not be regulated like independent professions, provided that their tax services remain truly ancillary to other economic activities. In Western Europe, the financial services industry

[32] *Id.* § 172(3).

[33] *See id.* § 172(2)(b); *See also* Miriam H. O'Brien, *Ireland: Parliament Passes Finance Act 1995 With Controversial Reporting Obligation for Tax Advisors,* 10 Tax Notes Int'l 1955 (1995).

[34] *See* Wolfman et al., *supra* note 7, §§ 501-505.

has recently been seeking to enter the market for tax services, thereby raising the question of whether those activities should be regulated the same way as the independent professions.

C. Preparation and Auditing of Commercial Accounts

A primary function of commercial accounts is to provide financial information to the owners and creditors of a business. Commercial considerations have led to the imposition of standards and controls on persons preparing or auditing commercial accounts. In most cases, the qualifications for preparing accounts are less severe than those for the independent professionals who audit accounts (certified public accountants). While the commercial accounts may be of great importance in the determination of tax liability,[35] there is usually no regulation by the tax authorities of persons preparing commercial accounts.

D. Preparation of Tax Returns

Countries with a system of licensed tax professionals will typically stipulate that only persons who are licensed as return preparers may prepare a return for remuneration. Even when a country does not want to regulate the tax profession or tax advice as such, it may wish to have certain controls on the persons who prepare and file tax returns on a taxpayer's behalf. The minimal rule may be that when the taxpayer does not personally prepare the tax return, the person who prepares the return has to identify himself or herself. This allows the taxpayer to hire anyone to prepare the return, but it also permits the tax administration to keep track of professionals engaged in the business of preparing returns and to impose penalties where called for.

In any scheme that imposes requirements or restrictions on return preparers, it will be necessary to identify who is a preparer. In most cases it is easy to identify the preparer. However, in the case of complex returns, many people may contribute to the preparation of a return. In these cases, a person furnishing substantial information or advice that is an input to the preparation of the return may appropriately be considered a return preparer. Of course, under this rule, it is possible that many persons will be considered preparers with respect to a single return. For some purposes, one can provide special rules limiting the number of preparers (e.g., one could provide that only the principal preparer must sign the return).

E. Representation of Taxpayer Before the Tax Administration

A tax advisor representing a taxpayer before the tax authorities acts as an advocate. Because of the skills required, there are often restrictions as to who can act in this capacity, and the rules typically differ depending on the procedural formality that the proceedings take. When the profession is regulated, it is generally provided that the tax advisor may represent the taxpayer before the tax authorities. Generally, this right of representation is shared with other professions, such as lawyers and accountants. Representation can take place to obtain a ruling; in connection with audits or investigations, before or after assessment; and before administrative tribunals or tax boards.

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[35]*See* vol. 2, ch. 16.

F. Representation Before the Courts

In some countries, all tax litigation is decided by the civil courts, rather than by administrative courts. In countries where administrative tribunals initially hear a case, depending on the rules of tax procedure, appeals in tax litigation are most often decided by the civil courts, while tax fraud and tax evasion belong to the competence of the criminal courts.

Representation of taxpayers before the civil or the criminal courts is generally reserved exclusively to lawyers. The argument in favor of restricting appearances in courts (or administrative tribunals with procedural rules similar to those of courts) to lawyers is that professionals who may be tax experts but are not litigation experts may not be qualified to serve their client in such a setting. However, in countries where there is a comprehensive regulation of the tax profession, tax advisors may also be permitted to represent taxpayers in litigation before the civil courts. In such cases, specific competence in legal or tax procedure is most often required. Representation of taxpayers in criminal cases is the exclusive competence of lawyers in most countries.

Where nonlawyers are allowed to represent taxpayers, they are often required to be licensed by the tribunal and must take an examination for this purpose.[36] Particularly if the number of lawyers available to take tax cases is inadequate, this kind of licensing might be a solution to providing professional representation for taxpayers.

III. Approaches to Regulation

The extent of regulation of the tax profession differs substantially from country to country. Three general approaches can be identified. The first, exemplified by Austria, China, Germany, and Japan,[37] establishes a regulated professional monopoly for tax practice (similar to the professional monopoly that lawyers enjoy in many countries for legal practice) that is shared in most cases with other regulated professions such as lawyers and accountants. The second, exemplified by the United States, does not establish a monopoly for tax advice or return preparation, but does restrict certain representational activity to licensed practitioners and members of other regulated professions and involves a well-developed regulatory framework. The third, which most countries follow, involves an essentially unregulated tax profession that coexists with regulated professions such as lawyers and accountants. However, the regulations applicable to these professions do not deal specifically with the provision of tax services. Within these three general approaches, there are differences in detail in different countries' approach to the tax profession.

A. Full Regulation: the German Model

[36] *See, e.g.,* U.S. Tax Court Rule 200(a), 60 T.C. 1152 (1973).

[37] *See* Law on Certified Tax Accountants of 1951 (JPN); State Administration of Taxation, Interim Measures on Tax Agents (Sep. 16, 1994) (CHN); DEU StBerG.

In Germany, the Tax Consultancy Law[38] comprehensively regulates the provision of tax advice. Article 2 provides that assistance in tax matters on a commercial basis may be provided only by persons who are authorized to do so by the law. Under article 3, those who are generally competent to give tax advice are licensed tax advisors, lawyers, accountants, and auditors. Thus, a person who is licensed as a lawyer or an accountant need not obtain a special license for tax practice, but no other person may generally give tax advice without a license. The seriousness of this general restriction of tax practice is underscored by article 4, which lists in detail the limited situations in which nonlicensed persons may provide tax advice.[39] To become a licensed tax advisor, an individual must follow a program of courses and take an examination. A separate regulation provides a schedule of allowable fees.[40]

B. Partial Regulation: the U.S. Model

Like Germany, the United States regulates tax practice.[41] The scope of this regulation is, however, much less extensive than in Germany in that anyone, even someone with no professional training or qualifications, is allowed to give tax advice[42] or to prepare a return for someone else. A person preparing a return is, however, required to sign it as preparer. This requirement allows penalties to be imposed, if warranted. It also makes the return preparer take responsibility for the return, which is important in and of itself. Finally, by keeping track of persons signing as return preparers, the tax authorities can detect whether returns with particular problems are originating from particular preparers. In the United States, as part of signing the return, the preparer must list the name of the firm, his or her social security number (which is used as the tax identification number), and the employer identification number (i.e., the tax identification number) of the firm. The use of identification numbers enables the tax authorities to keep track of return preparers with greater certainty.

Other types of representation before the Internal Revenue Service are restricted to persons who are attorneys, certified public accountants, or enrolled agents.[43] Enrolled agents are regulated by the Treasury Department; they are generally required to take an examination and may be disbarred for misconduct. A person who is not otherwise eligible to practice before the IRS but who has prepared a return that is being audited may represent the taxpayer in the audit

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[38]DEU StBerG.

[39]For example, to list only 3 of the 13 cases listed in article 4, patent lawyers are allowed to give tax advice within the scope of their work as patent lawyers, employers are allowed to render assistance to their employees in matters concerning taxation of wages, and administrators of property may give advice with respect to the property they administer. *Id.* § 4(2), (10), (8).

[40]*See Steuerberatergebührenverordnung reprinted in* Deutsche Steuergesetze 1992, at 1192 (4th ed. 1992).

[41]*See, e.g.,* Circular 230, *supra* note 12.

[42]However, if the rendering of tax advice is considered to be legal advice, then it may constitute the unauthorized practice of law (and therefore be prohibited) if done by someone who is not an active member of the bar. Because the practice of law is regulated by each state, this is a matter that is not regulated by the federal tax authorities.

[43]*See* Circular 230, *supra* note 12, § 10.3. Enrolled agents must generally either pass an examination or be a former IRS employee with sufficient experience. *Id.* § 10.4. To remain in good standing, enrolled agents must satisfy continuing professional education requirements. *Id.* § 10.6. A similar regulatory scheme applies in Israel. *See* ISR IT §§ 236–236H.

proceedings (but not before the Appeals Office).[44] Before the Tax Court, a taxpayer may be represented by an attorney or by someone who has been admitted to practice before the court by taking an examination.[45] Nonattorneys cannot represent taxpayers in other courts that hear tax cases.

Another country with partial regulation of tax practitioners is Australia, where only lawyers and tax agents are allowed to prepare returns for remuneration; thus, accountants must be registered as tax agents in order to carry out such work.[46] Taxpayers may deduct fees for tax advice only if the advice is furnished by a registered tax agent or by a barrister or a solicitor.[47] A recent policy review in Australia conducted jointly by revenue authorities and professional bodies recommended that qualified accountants who are not tax agents be allowed to charge a tax-deductible fee as well.[48] Overall, the Australian regulatory scheme as it currently stands falls somewhere between the U.S. and the German models in that there is effectively a monopoly provided both on the provision of tax advice and on return preparation, although the regulatory scheme is not as comprehensive as the German.

C. The Model of No Regulation

In many countries, including Belgium, Italy, Portugal, Spain, and the United Kingdom, the provision of tax advice and return preparation is generally unrestricted as to profession. Some countries, however, provide special treatment for certain professionals in certain circumstances.[49]

With the exception of countries following the U.S. or German models, representation before the tax authorities is relatively unrestricted. Most countries allow representation by nonlawyers in administrative proceedings, since these are not based on formal procedure and rules of evidence that might apply in court. Often, the return preparer defends the case.

D. Issues in Regulation of Tax Consultancy

The issues to be dealt with in any regulation of the tax profession depend, of course, on the type of regulation that is to be introduced: full regulation, partial regulation, or no regulation at all. However, even in the third case there may be a need for some rules, to govern cases where the taxpayer is assisted in filing the tax return, or is represented by someone else before the tax administration.

In the model of full regulation the following items should be taken care of:

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[44]*See* Circular 230, *supra* note 12, § 10.7(c)(1)(viii).

[45]*See* USA IRC § 7452; U.S. Tax Court Rule No. 200, 60 T.C. 1152 (1973).

[46]*See* AUS ITAA § 251L(1).

[47]*See id.* § 69(4), (11) (there is also an exception for persons who are exempt from registering as an agent, but this is of limited application).

[48]*See* National Review of Tax Standards for the Tax Profession, Tax Services for the Public 73 (1994).

[49]*See infra* sec. IV.

(1) The question of whether tax consultants should have a monopoly, and the sanctions for violating the monopoly.[50]

(2) When the regulation does not provide a monopoly, it should determine the nature of the advantage of title protection, which titles (e.g., tax advisor, tax consultant, tax lawyer, or tax accountant) are protected, the sanctions for violating this protection of title, and the obligation always to use the title in professional tax practice.

(3) Apart from the advantages of monopoly or title protection, the law should also list any other advantages to be provided, such as facilities in representing taxpayers before the tax administration, in communicating documents and notifications to the tax administration, or obtaining delays for filing or payment, and waiver of penalties.

(4) Regardless of whether there is a monopoly, or only title protection, the regulation should set out which activities are protected under the law: advice, preparation of tax returns, representation before the tax administration, litigation in courts, and services ancillary to these activities.

(5) Regardless of the scope and the nature of the regulation of the profession (monopoly or title protection), exceptions should be made for other professions that are closely connected with tax advice, such as lawyers, accountants, auditors, notaries, real estate agents, and patent advisors for the tax aspects of their field of activities.[51]

(6) The regulation should also specify the educational standards required for admission to the profession.[52] Two things should be regulated: the level of education (university, vocational) and its content (accounting, basic principles of public and private law, major taxes, and the rules of professional ethics). Depending on the level of educational requirements, practical experience may also be required.[53]

(7) Any full regulation of the profession should also contain organizational rules on the creation of an order or an institute, with a seat, a board, a general meeting, membership dues, a list of licensed members, and bylaws.

(8) The supervision of the profession should also be regulated. The choice is between supervision by the tax administration, by a self-governing body (as for the legal and medical professions), or by a body with representatives of the general public (consumer protection agencies) and the tax administration. The way in which the profession is supervised also determines the nature of disciplinary measures and procedures, which should also be spelled out in the professional regulation, as well as rules on the

[50]*See supra* sec. I(A).

[51]*See* DEU StBerG §§ 3, 4.

[52]*See supra* sec. I(B).

[53]For example, in the German model, the duration of practical experience increases as the level of education decreases. *See* DEU StBerG § 36.

relationship between disciplinary law and ordinary civil law (professional liability) and criminal law.

(9) The regulation should stipulate whether legal persons can be admitted as full members of the profession.[54] It should also indicate whether tax advisors can exercise their profession in company form. If legal persons are admitted to practice, secondary questions arise such as the control on the board of directors and the general meeting of shareholders by physical persons licensed to practice, the way legal persons participate in the life of the professional organization (voting rights in the general meeting of the profession, representation in the executive board, membership dues), and the way ethical rules are enforced against legal persons.

(10) Cooperation with other regulated and unregulated professions is also a problem to be dealt with. Conditions for cooperation on an individual basis or within the framework of a legal person should be spelled out, including the question of whether a person can become a member of more than one profession, as well as rules with respect to activities compatible with the exercise of the profession.

(11) The regulation should also deal with tax advice practiced by employees in the service of their employer and tax advice for third parties. This is a specific problem because employees do not have the same guarantees of independence as independent licensed tax advisors.

(12) Full regulations may contain rules on ethical standards with regard to advertising, conflict of interest (particularly when tax advisors collaborate with other professions in the framework of a legal person), and limitations on financial interests in potential clients.

(13) Rules on professional privilege should be set down, when such professional privilege is granted to the tax profession.

(14) Rules on professional liability vis-à-vis customers and rules with respect to the obligation to carry professional insurance should also be spelled out.

(15) Some regulations contain a full schedule of fees.[55]

(16) Last but not least, the regulation should contain transitional measures. These are very important because they will determine the balance between supply and demand during the early stages, when the professional regulation is taking effect. The balance between the flexibility of transitional regulations and the strictness of the final regime should be watched very closely. Too often tax practitioners succumb to the temptation of keeping the door wide open during the transitional regime, setting almost no meaningful standards for admission and slamming it shut after the transitional period, so that the established

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[54] *See supra* sec. I(E).

[55] *See supra* note 40.

professionals are sitting pretty, while young and capable candidates are kept away by insurmountable entry barriers.

In the model of partial regulation, the extent of regulation is of course much more restricted. In the U.S. model, there is no place for an order or an institute, so that all rules with respect to such institutions become irrelevant. Many tax advisors will be governed by disciplinary rules applicable to their professions of law or accounting. Disciplinary rules for those admitted to practice before the tax authorities should be provided for in the regulation, to be enforced by the government. Because there is no monopoly, there are no problems to regulate with respect to the relationship with other professions. Anyone will be allowed to file tax returns and provide tax advice. There is protection of title, in the sense that persons who are not admitted to practice before the tax authority cannot use the title pertaining to those who are. Educational, professional, or other quality standards, including a minimal tax examination, will have to be provided for those admitted to practice before the tax authority. However, because practice in the form of preparing returns or offering tax advice will generally be open, these requirements will not keep out those who wish to practice without formal admission to practice.

Even when there is no regulation for the tax profession at all, there may still be some rules as to preparing tax returns, providing tax advice, and representing taxpayers before the tax administration and the courts. These rules are usually found in the general tax legislation. They deal with questions such as the liability of and sanctions against persons helping or advising the taxpayer in cases of fraud and tax evasion, the legal consequences of the use of outside services to fulfill personal tax obligations, and rules with respect to the question of who has standing to represent a taxpayer before the tax administration, the tax courts, and the courts of tax appeals.

E. Penalties for Practitioners

Whatever the degree of regulation a country wants to introduce for the tax profession, legislation should contain clear, comprehensive rules providing penalties for violations by tax practitioners. Tax practitioners who are lawyers, accountants, or auditors are subject to discipline by the licensing authority of the jurisdiction in which they are licensed to practice. If the behavior of such a professional while acting in a tax matter runs counter to the standards of professional conduct of the jurisdiction, he or she is therefore subject to disciplinary punishment that can range from a reprimand to suspension or disbarment from practicing.

The above-described sanctions may not be tailored to tax practice and are applicable only to practitioners who are also lawyers, accountants, or auditors. Therefore where persons are engaged in tax practice, regardless of whether it is regulated or not, there are typically additional sanctions that are tailored to taxation and that apply to all those engaged in tax practice. These sanctions may be contained in a specific professional regulation, but most often they are part of the general tax law. Typically, these rules will apply in cases of misbehavior, such as filing false returns or aiding a taxpayer in cases of fraud or tax evasion, and provide for criminal sanctions and a prohibition against representing taxpayers before the tax administration. For example, in the United States, the Treasury Department has issued regulations[56] governing practice before the

[56] 31 C.F.R. §§ 10.0–10.101 (USA).

Internal Revenue Service that contain rules for disciplinary proceedings and that allow the Treasury Department to disbar from practice before the IRS persons who violate the rules.

In addition to the specific penalties of suspension and disbarment provided under such regulations, tax laws may provide penalties for tax return preparers and others who engage in tax practice and who commit designated offenses, usually relating to specific tax returns.[57] This type of penalty is similar in structure to penalties applicable to the taxpayer (such as for late filing, late payment, negligence, or fraud) but is imposed directly on the preparer for the preparer's improper conduct. The penalty should not apply if the preparer is not at fault, for example, if the taxpayer fails to provide information to the preparer and the latter does not have reason to believe that the information reflected on the return is false.

For example, in the United States, a penalty applies to a return preparer who fails to sign the return. Code section 6694 imposes a penalty on a person who prepares an income tax return that reflects a position for which there was not a realistic possibility of being sustained and imposes a higher penalty for willful or reckless conduct in preparing a return. Of course, if the tax advisor's conduct is particularly outrageous, so that the advisor is an accomplice in tax evasion, then criminal sanctions may apply.

Regulation may also be accomplished by courts. For example, the rules of the U.S. Tax Court provide ethical standards for those practicing before it.[58]

Those engaged in tax practice who behave negligently may also be liable to their clients or to third parties in a civil action for negligence or breach of contract.[59]

In some countries, the tax advisor is held personally liable to the state for any taxes or penalties due in case of avoidance or evasion.[60] This model is not followed, however, in most countries. Except when the tax advisor himself breaks the law as an accomplice to the tax evasion of a client, the advisor should not be held personally liable for the taxes or penalties imposed on the client. The advisor should be subject only to specific penalties for his or her unlawful behavior.

IV. Legal Consequences of Using Advisors

[57]*See, e.g.,* Wolfman et al., *supra* note 7, §§ 301.1–305.3.

[58]*See* U.S. Tax Court Rule 201, 202, 60 T.C. 1153–54 (1973); U.S. Tax Court Rule 33(b), 85 T.C. 1125–26 (1985); Wolfman et al., *supra* note 7, at § 106.

[59]*See* Wolfman et al., *supra* note 7, at §§ 601–605; Geoffrey Lehmann & Cynthia Coleman, Taxation Law in Australia ¶ 11.74 (3rd ed. 1994).

[60]*See* Mustafa Çamlica, *Compulsory Return Certification and Sworn Fiscal Advisory in Turkey,* 10 Tax Notes Int'l 1584, 1586 (1995) (responsibility of sworn fiscal advisor for tax and penalties in respect of return certified by him or her); Luís F. Ramírez A., *Privatization of Tax Administration, in* Improving Tax Administration in Developing Countries 377, 388 (Richard M. Bird & Milka Casanegra de Jantscher eds. 1992) (in Mexico, accountant who certifies return is liable for penalties).

A. Returns

In some countries, the law encourages or requires the use of qualified professionals in preparing returns on the theory that a return prepared by a professional will be on a sounder footing and less likely to be fraudulent. For example, if an alternative income tax is directed at businesses maintaining questionable (or no) accounts, the law may apply the tax generally and then provide an exception for companies maintaining audited accounts.[61] Most countries do not, however, provide special treatment for returns based on audited books.

In Israel, companies are required to submit income tax returns that are certified by an auditor, as defined in the Auditors Law, and that are adjusted by the auditor for the purposes of the tax.[62] In Turkey, taxpayers above a certain size are required to have their returns certified by a sworn fiscal advisor.[63]

B. Liability for a Tax Advisor's Mistakes

A tax return prepared by a registered tax preparer may give rise to penalties for reasons that are the fault of the tax preparer rather than of the client for whom the return was prepared. For example, the preparer may make errors or omissions that give rise to penalties, file the return late, and so forth. The question arises as to whether the taxpayer should be immune from penalty where the conduct giving rise to the penalty is that of a registered tax preparer.

This problem can be approached in one of three ways:

1. The taxpayer can be liable for penalties but retain the right available under the general law to sue the tax preparer under tort or contract law for recovery of the amounts.

2. The taxpayer can be liable for penalties but be protected by specific legislation that requires tax preparers to indemnify taxpayers.

3. The taxpayer can be excused from penalties arising out of errors or failures by a tax preparer; penalties may also be imposed directly on the tax preparer instead of on the taxpayer.

The rationale for the third approach is that a taxpayer who deliberately seeks professional advice and assistance, among other reasons, to avoid errors or omissions, should not then be penalized because of another person's inadequate performance. This position is strongly supported, perhaps surprisingly, by professional tax preparers in some jurisdictions. Where there is a "reasonable cause" exception to imposition of a penalty, the argument is that in relying on a professional, the taxpayer acted reasonably and therefore should not be penalized.[64]

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[61] *See* SLE IT § 23 (minimum chargeable income provisions do not apply where taxpayer's books of account have been audited by "a reputable firm of Accountants" and the Commissioner has conducted a satisfactory field audit).

[62] *See* ISR IT § 131(c).

[63] *See* Çamlica, *supra* note 60, at 1585.

[64] *See* Saltzman, *supra* note 21, ¶ 7B.06[3][c]. Under U.S. law, the question can be framed as to whether reliance on professional advice constitutes reasonable cause that allows the taxpayer to escape from the penalty. In the case of a

The practical problem that would be encountered if the third approach were adopted is that of evidentiary dispute. It will often not be clear to revenue authorities who was to blame for the problem giving rise to a penalty, and these authorities cannot be expected to investigate and ascertain blame before levying a penalty.

While ordinary contract or tort law may be sufficient to protect a taxpayer if the third option is not considered feasible, a specific statutory remedy may be desirable to avoid any doubt about the matter.[65] Moreover, inclusion of such a measure in the tax legislation could be used as a means of bringing the action within the ambit of the tax litigation system and provide the parties with access to the tax appeal system, where they will encounter tribunals and courts with greater tax expertise and more knowledge about the technical problems that gave rise to the penalties in the first place.

As indicated above, in some cases penalties may be waived when the technical violation of the tax law was due to the fault or negligence of the tax agent. However, in most cases the taxpayer will remain liable to tax and interest. So, for example, if the tax advisor fails to file a tax protest in time, and on account of this negligence the taxpayer is not able to defend the taxpayer's case, the amount of tax assessed will be due from the taxpayer. The fact that the taxpayer used the services of a tax advisor is not an excuse for not filing the protest in time. The taxpayer will have to pay the full amount of tax and recover damages from the tax advisor in a court suit on professional liability. Any other rule would allow the taxpayer to use the tax advisor as an alibi for not playing by the rules of the tax law.

The use of a tax advisor may be seen as an attenuating circumstance, however, when the taxpayer is accused of tax evasion. The fact that the taxpayer used the services of a tax advisor is often seen as an indication that the taxpayer intended to fulfill all the taxpayer's tax obligations in accordance with the law, so that it becomes more difficult for the tax administration to accuse the taxpayer of tax evasion. This presumption is of course valid only when the taxpayer provided all necessary information to the advisor.

C. Facilities for Taxpayers' Use of Tax Advisors

Even when the profession of tax advisors does not have a monopoly on the provision of tax services, the legislator may recognize the advantage of having professionals prepare tax returns, thereby reducing the administrative burden for the tax administration. The regulations may provide for some facilities that are available only to licensed professionals. These may include the following: automatic acceptance of credentials as an attorney for the taxpayer, flexible rules with respect to the filing of tax returns and payment of the taxes due, and informal ways of communication between the tax advisor and the tax administration.

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failure to file a return, the Supreme Court has decided that reliance on an advisor who failed to file cannot be considered reasonable cause. *See also* United States v. Boyle, 469 U.S. 241 (1985).

[65]*E.g.,* AUS ITAA § 251M. For a discussion of problems under this provision, *see* National Review of Standards for the Tax Profession, *supra* note 48, at 91–93. For a discussion of the tax advisor's liability for negligence and criminal liability under Danish law, *see* Anders Vinding Kruse and Jesper Lett, *Civil and Criminal Liability for Advice Pertaining to Issues of Taxation,* 33 Scandinavian Studies in Law 167 (1989).

Appendix A. Organization of Tax Profession in Different Countries[66]

In countries such as Belgium, Italy, the Netherlands, Spain, and the United Kingdom, there are one or more private associations representing tax consultants without formal legal status. In Denmark, Greece, Ireland, Luxembourg, and Portugal, tax advisors are either not organized professionals or are members of other professional organizations, such as accountants, auditors, or lawyers, who also engage in tax activities. Germany and Austria have a profession that is specifically regulated, with associations of tax professionals that are recognized by law. In France, tax advice that constitutes the provision of legal advice is regulated as part of the legal profession.

The following table lists tax professionals for each country discussed:

Tax Professionals in Selected Countries

Australia	lawyer, accountant, tax agent
19Belgium	*conseil fiscal, avocat, reviseur d'entreprise, expert comptable*[67]
Canada	lawyer, accountant
France	*comptable, expert-comptable, avocat*
Germany	*Steuerberater, Rechtsanwalt, Wirtschaftsprüfer, vereidigte Buchprüfer, Steuerbevollmächtigte*
the Netherlands	*belastingadviseur, belastingconsulent, advokaat register accountant*
Italy	*tributaristo, avvocato*
Spain	*asesor fiscal, abogado, economista*
United Kingdom	accountant, tax consultant, taxation practitioner, lawyer
United States	accountant, attorney, enrolled agent

In Australia, tax returns may generally be prepared for remuneration only by a tax agent or a lawyer. Tax agents are defined in legislation and are regulated by a board controlled by the tax authorities. Tax agents and lawyers may also represent taxpayers in administrative disputes, but only lawyers may represent taxpayers in court litigation.

In Belgium, a tax advisor is called *belastingconsulent-conseil fiscal*. This professional designation is not regulated by law, nor does the law regulate who may give tax advice, but there is a private professional organization to which tax advisors typically belong. Tax advice can also be given by lawyers (*advocaten*/*avocats*), notaries (*notarissen*/*notaires*), accountants (*accountants*/*experts-comptables*) or auditors (*bedrijfsrevisoren*/*reviseurs d'entreprises*), the

[66]The discussion is based on Ottmar Thoemmes et al., EG-Recht in der Steuerpraxis (1993); and Wilfried Dann, *Das Leistungsspektrum des Steuerberaters in Europa und seine berufsrechtlichen Grundlagen,* Internationales Steuerrecht 44 (1993).

[67]*Belastingconsulent, belastingadviseur, advocaat, bedrijfsrevisor, accountant.*

latter being analogous to a certified public accountant. All these professions (lawyer, accountant, and auditor) are recognized and regulated by law, but typically the provision of tax services is outside the scope of this regulation. However, anyone may prepare a tax return and represent the taxpayer before the tax administration or in administrative disputes. Tax litigation before the civil courts is limited to lawyers. Except for accountants and auditors, there is incompatibility between some professions; that is, a lawyer cannot be a tax advisor, and a lawyer cannot be an auditor, but both are entitled to provide tax services.

In France, tax advice was traditionally indirectly regulated as part of legal advice in general.[68] The legal profession was divided into *avocats* and *conseils juridiques* (legal advisors). However, legal advisors did not have a monopoly on the provision of legal advice, so that tax services were also provided by notaries (*notaires*), accountants (*comptables, experts-comptables*) and auditors (*commissaires aux comptes*). France also had a specialized certification for tax lawyers: *avocat spécialiste du droit fiscal*. Recently, all legal activities, including litigation, legal advice, and tax advice, were merged into a new profession whose members carry the title of *avocat*.[69] The provision of tax advice that constitutes legal advice is regulated as part of this legal profession. The French regulatory scheme provides for a monopoly on legal advice for people holding a professional degree in law.[70] Legal persons are also admitted to the profession, provided they meet certain conditions, which guarantee that physical persons who are admitted to the profession will control the legal person.[71] The law also sets criteria for obtaining the title of lawyer (*avocat*) that are more stringent than the conditions formerly imposed to practice as a legal advisor.[72] The legal profession is fully organized as a bar, with disciplinary proceedings, professional privilege, and rules of ethical conduct. All the rules that apply to lawyers also apply to tax consultancy insofar as it is a subdivision of legal advice. However, other professions, such as *experts comptables* (chartered accountants), may also provide tax advice, provided that it is in direct relationship to the services (*e.g.,* accountancy) that they provide their clients.[73]

Germany (as well as Austria) is one of the few countries that has a long-established legal organization of the tax consultancy profession. The law provides a monopoly for tax advice and prohibits unauthorized persons from providing tax services that are.[74] The German law extensively regulates services relating to the administration of withholding taxes and social contributions on salaries.[75] It contains provisions for a full professional organization, with

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[68]*See* Loi No. 71-1130 of Dec. 31, 1971, portant réforme de certaines professions judiciaires et juridiques, J.O. Jan. 5, 1972 [hereinafter Loi No. 71-1130].

[69]*See* Loi No. 90-1259 of Dec. 31, 1990, portant réforme de certaines professions judicaires et juridiques, J.O. Jan. 5, 1991 [hereinafter Loi No. 90-1259].

[70]"*Nul ne peut, directement ou par personne interposée, à titre habituel et rémunéré, donner des consultations juridiques ou rédiger des actes sous seing privé, pour autrui: 1 S'il n'est titulaire d'une licence en droit ou d'un titre ou diplôme reconnu comme équivalent par arrêté....*" *Id.* art. 54.

[71]This question is regulated in a separate law. *See* Loi No. 90-1258, *supra* note 15.

[72]*See* Loi No. 90-1259, *supra* note 69, art. 9.

[73]*See id.* art. 59; Décret No. 91-1197 of Nov. 27, 1991, organisant la profession d'avocat, J.O. Nov. 28, 1991.

[74]*See* DEU StBerG §§ 3, 4, 5, 160.

[75]*See* DEU StBerG §§ 13–31.

conditions for admission, quality and educational requirements, admission of legal entities, control of legal entities by physical persons admitted to the profession, disciplinary proceedings, ethical rules, and obligations and rights and privileges of tax consultants.

The Italian term *tributaristi* includes members of several professions: including lawyers, *dottori commercialisti, ragioneri,* and *notarii.* All of these professions are regulated by law, but *tributaristi* can also be tax advisors who are not licensed professionals, because there is no monopoly on tax advice. Representation of taxpayers before the civil courts is limited to lawyers.

In the Netherlands, the profession of tax advisor is not regulated by law. Tax services are provided by a wide range of professions, all of which (except for tax advisors) are regulated by law: lawyers (*advocaten*), notaries (*notarissen*), accountants and auditors (*register accountants*), and tax advisors (*belastingconsulenten* or *belastingadviseurs*). However, the part of their activities that consists in providing tax services is not regulated. There is no incompatibility between the other professions and the tax advisors; that is, a lawyer or an accountant can at the same time be a tax advisor. The situation of tax advisors is unique in that, although the professions are not recognized by law, the two private organizations of tax advisors (NOB and NFB)[76] are so strong and prestigious that it is almost impossible to engage in tax services in the Netherlands without belonging to one of them. Both organizations use high professional standards for admission and strict ethical rules. The NOB requires an academic degree for membership and the NFB requires a rigorous training program with strict examinations.

In Spain, a tax advisor, called *asesor fiscal*, might be a lawyer (*abogado*), accountant (*economista*), or holder of a degree in business (*professor mercantil, intendente mercantil*). Again, the provision of tax advice is not restricted to particular professionals. Anyone can file a tax return for remuneration. However, tax litigation in civil courts is restricted to lawyers.

In the United Kingdom, tax advisors are typically known as accountants, tax consultants, or taxation practitioners, but there is no legal limitation on the general provision of tax advice. More and more solicitors are entering the field of tax advice. In the United Kindgom external auditors, solicitors, and barristers are subject to regulations, but these do not specifically regulate tax advice. Anyone is free to prepare tax returns and to represent taxpayers before the tax administration or the tax commissioner on appeal from assessment. Only barristers can represent a taxpayer before the High Court.

Similarly, in the United States, tax advice may be given by lawyers, accountants, enrolled agents (i.e., those admitted to practice before the IRS), or those without professional certification. There is a kind of factual division of labor whereby ordinary tax returns are prepared by enrolled agents or by unregistered preparers, while more complicated cases are handled by lawyers or accountants.

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[76] *See supra* note 1.

6

Value-Added Tax

David Williams

Not only is the VAT a fairly simple tax, but it is also probably the most popular tax in the world today.

—Mark Bloomfield and Margo Thorning

The concept of value added is not clearcut or easily defined...On the whole, the value-added tax is not nearly as simple a levy as is sometimes argued.

—John F. Due

Note: This chapter was produced in parallel with a draft law (the "Draft Value Added Tax Law of the Republic of Fiscalia," accompanied by a commentary). My thanks for help over several years on this chapter, the related papers, the thinking that lies behind them, and the draft law are due in particular to Victor Thuronyi, Richard Vann, and Robin Adair. Frans Vanistendael gave invaluable comments about Western European laws and detailed comments on the entire text. Thanks are also due to my colleagues and students at the University of London, including particularly Nuala Brice, Adrian Shipwright, Gloria Teixeira, Panit Dhirapharbwongse, Junko Isonako, and Carolina Gratenol.

I. Introduction

A. Adoption of VAT

Value-added tax (VAT) is still a relatively new tax. It was first introduced as a comprehensive national tax 40 years ago in France.[1] Since then, it has been adopted as the main form of indirect taxation by many countries in different parts of the world and at different stages of economic development.[2] In particular, it is a key common form of taxation for the 15 member

[1] The *taxe sur la valeur ajoutée* was introduced in 1954. For a discussion of its antecedents and evolution, *see* 1 Direction générale des impôts, Précis de fiscalité [*généralités*: two pages preceding ¶ 2000] (1994). The current legislation is in *Titre II, Chapitre premier* of the *Code Général des Impôts*. FRA CGI art. 256 *et seq.*

[2] For a thorough survey, *see* Alan Tait, Value-Added Tax: International Practice and Problems (1988). Since 1988, several of the countries that did not then have a VAT have adopted one. None of the states with a VAT described in Tait, *supra*, has repealed it. On the contrary, the general trend has been to increase the rates of VAT and reduce the exceptions.

states of the European Union.[3] It has also been adopted by Japan,[4] China,[5] Canada,[6] Korea,[7] and many other states in Asia, North and South America, and Africa, besides being adopted in almost all the states of Europe[8] and of the former Soviet Union.[9] Further, the process of expansion of the European Union, together with the alignment of the laws of potential candidates for membership, has ensured increasing consistency in the form of VAT operating in Europe.[10] Of

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[3]All EU member states are required to apply the agreed provisions of VAT. The key legislation is found in a series of directives and regulations of the European Union, of which the most important are the First Council Directive 67/227 of Apr. 11, 1967, on the Harmonization of Legislation of Member States Concerning Turnover Taxes, 1971 O.J. (L 71) 1301 [hereinafter the EC First VAT Directive] and the Sixth Council Directive 77/388 of May 17, 1977, on the Harmonization of the Laws of Member States Relating to Turnover Taxes—Common System of Value Added Tax: Uniform Basis of Assessment, 1977 OJ (L 145) 1 [hereinafter the EC Sixth VAT Directive]. For a detailed analysis of this legislation and other relevant aspects of EU law, *see* B.J.M. Terra & Julie Kajus, VAT Legislation of the European Union (1995).

[4] Best termed in English the consumption tax, this tax has a number of special features compared with the tax outlined in this chapter, but it is in essence a tax on value added of the kind discussed here. For a full account in English, *see* Ministry of Finance, An Outline of Japanese Taxes 141-75 (1994). *See also* Alan Schenk, *Japanese Consumption Tax After Six Years: A Unique VAT Matures*, 11 Tax Notes Int'l 1379 (1995).

[5] The People's Republic of China has had a limited form of VAT for some years, but has recently revised and broadened the tax. The current legislation is in Provisional Regulations of the People's Republic of China on Value-Added Tax, adopted by the State Council on Dec. 13, 1993 (CHN VAT), and supplemented by rules for its implementation. Ministry of Finance, Detailed Rules for the Implementation of the Provisional Regulations of the People's Republic of China on Value-Added Tax (Dec. 25, 1993), *reprinted in* Foreign Taxation Administration Department, National Taxation Bureau, A Collection of Tax Laws and Regulations of the People's Republic of China 109 (1994)(in Chinese with English trans.).

[6] The "Goods and Services Tax" (CAN GST) was adopted in 1990 and entered into force on January 1, 1991. It was based on the New Zealand Goods and Services Tax (NZL GST), first adopted in New Zealand in 1985. Major reform of the structure and details of the Canadian tax is currently under consideration.

[7] The tax, translated in English as the value-added tax, was adopted in the Value-Added Tax Law of 1976 (KOR VAT). It broadly follows a simplified version of the form then taken by the VAT in the European Communities (now the European Union).

[8] With the exception of territories of the former Socialist Federal Republic of Yugoslavia, a VAT has now been adopted, or is being considered for adoption, by every state in Europe save some of the smallest. One of the more significant states to adopt a VAT recently is Switzerland, where the population rejected the adoption of the tax at three plebiscites, but agreed to it at a fourth. The Swiss law (French version) is the Ordonnance régissant la taxe sur la valuer ajoutée, of June 22, 1994. The Swiss law broadly follows the form of VAT adopted in the European Union.

[9]The Russian form of VAT (RUS VAT) and those of some of the other countries of the former Soviet Union raise a number of special issues, including relations within the Commonwealth of Independent States. For an analysis of some of these issues, *see* Victoria P. Summers & Emil M. Sunley, *An Analysis of Value-Added Taxes in Russia and Other Countries of the Former Soviet Union,* IMF Working Paper 95/1 (January 1995).

[10]The requirements set out in the directives noted in note 3 *supra* apply to all member states, and candidate members are required to amend their law to conform with it by the time of membership. At the European Council of Ministers conference at Cannes in June 1995, the Council adopted a Commission White Paper laying down terms for convergence toward entry. Preparation of the Associated Countries of Central and Eastern Europe for

the major economies, only the United States and Australia[11] do not have a VAT at the federal level (partly because of problems in introducing the tax in federal states), although both have considered in detail how it might be implemented.

As a result of this rapid and widespread adoption of a VAT, the laws implementing the tax have adopted different terms and forms in different states. Tait has rightly described it as an "unparalleled tax phenomenon."[12] There has therefore been little chance to evolve a settled vocabulary or considered common approach.[13] In particular, there is no international organization with the specific role of supervising the operation of value-added taxes among states in the way that the OECD Fiscal Affairs Committee[14] keeps an eye on double taxation agreements and the International Customs Union (formerly Customs Cooperation Council) coordinates the collection of customs duties. Although the European Commission performs that function within the European Union,[15] and assists elsewhere in Europe,[16] it does not have competence to act globally. Nonetheless, despite varying names and terminology, the VAT has a common core form throughout the world. That is the focus of this chapter.

Integration into the Internal Market of the Union: White Paper Presented by the Commission, COM(95)163 final. It includes detailed steps to bring indirect taxes in line, particularly, with the requirements of the VAT Directives. *Id.* at Annex. In effect, the terms amount to an early adoption of the principles of the EC form of VAT and a staged adjustment of national laws until all EC requirements are met. The guidance applies specifically to Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia but by analogy applies to other European states as well. *Id.* ¶ 1.15.

[11]The tax has been actively considered in both states. In the United States, the American Bar Association produced a detailed report and draft law. *See* Committee on Value Added Tax, Section of Taxation, American Bar Association, Value Added Tax: A Model Statute and Commentary (Alan Schenk reporter, 1989). *See also* 3 U.S. Treasury Department, Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President (1984). In Australia, the tax was discussed at the government level but rejected after lengthy political debate.

[12]Tait, *supra* note 2, at 3.

[13]*See* Ward M. Hussey & Donald C. Lubick, Basic World Tax Code and Commentary: 1996 Edition, at Title II ("Value Added Tax") (1995)(containing a draft VAT law). The Basic World Tax Code follows the U.S. federal style of drafting (although, of course, the United States does not have a VAT), but is based largely on the same principles as the VAT addressed in this chapter.

[14]However, the Fiscal Affairs Committee of the OECD has in recent years taken a role in monitoring some aspects of VAT within its member states and in the states of Central and Eastern Europe and the countries of the former Soviet Union. It also published a thorough survey of the use of the VAT and similar taxes by the member states of the OECD in 1988. Organization for Economic Cooperation and Development, Taxing Consumption (1988). More recently, it has held regular informal VAT workshops for government officials as part of its program of technical support to the states of Central and Eastern Europe and the countries of the former Soviet Union.

[15]VAT is the responsibility of Directorate-General XV of the Commission.

[16]This assistance is provided by officials and consultants through the PHARE and TACIS funds of the EU.

The aim of this chapter is to examine in detail the legal structure required to implement a broad-based VAT and to draw attention to legal problems requiring solution for the efficient introduction of the tax. The discussion is mainly restricted to the invoice-based credit method of the consumption-type VAT. This is by far the most prevalent type of VAT in use, although there are other forms in existence[17] or as a matter of theory. The chapter does not seek to explore the policy behind the VAT or assess its relative merits as a form of taxation.[18]

B. Terminology

The rapid emergence of the VAT, together with the new concepts involved in the tax, has meant that states have had to invent new words to deal with the tax. Inevitably, these terms have proved inconsistent, even among countries that share a common language. Since the terminology used in a VAT law is instrumental in ensuring the effective working of the law, it is most important that the terminology to be used in any law be considered thoroughly.

For that reason, it is important to note the terms used in this chapter and why they have been chosen. The vocabulary is increasingly used in discussions in English. However, there is no standardized English usage, and the text indicates alternatives where they may help to clarify the underlying concepts. It must also be borne in mind that some of these terms do not translate well into other languages. Consequently, variations occur because of the absence of a common vocabulary.

The name "value-added tax" is not a universal term. The term exists in two English forms: "value added tax" and "value-added tax."[19] Both represent a translation of the original French term,[20] and it might be argued that "added value tax" would be the nearest version, but this is not used. Other states use "goods and services tax." As already noted, this chapter uses

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[17]The most important example of another kind of VAT is the accounting method consumption tax adopted in Japan. *See* Ministry of Finance, *supra* note 4, at 141, 170-74. This simple form of the tax emerged from the compromise necessary to meet strong opposition when the tax was introduced. It is based on book entries as well as invoices.

[18]This has been done in Alan Tait's important book, *see* Tait, *supra* note 2. *See also* Sijbren Cnossen, *Key Questions in Considering a Value-added Tax for Central and Eastern European Countries,* 39 IMF Staff Papers 211 (1992); Value Added Taxation in Developing Countries (Malcolm Gillis et al. eds., 1990); Howell H. Zee, *Value-Added Tax, in* Tax Policy Handbook 86 (Parthasarathi Shome ed., 1995). For an introduction to VAT policy, the reader may wish at this point to read sec. II of ch. 7.

[19]The former is the style used in the United Kingdom, GBR VAT, and in the English-language versions of EU legislation. *See supra* note 3. The latter is used by Ireland, South Africa, and in the English translations of the laws of a number of states.

[20]The French name is *taxe sur la valeur ajoutée*. The German name is *Mehrwertsteuer* (added-value tax) or *Umsatzsteuer* (turnover tax), the latter being the formal name of the tax under German law. The Spanish name is *impuesto sobre el valor añadido (valor agregado* in some Latin American countries).

the abbreviation "VAT" throughout.[21] The term VAT is preferred to "goods and services tax" or other names because it most accurately reflects the unique nature of this tax.

One example of a term that causes language problems is "supply." The transactions taxed by a VAT are usually termed "supplies" in English-language texts.[22]directives, *supra* note 3, and in the VAT laws of the United Kingdom, GBR VAT § 1, and Ireland, IRL VAT §§ 3, 5. It is also used in Canada, CAN GST § 123(1); New Zealand, NZL GST § 5; South Africa, ZAF VAT §§ 1(lvii), 9; and other English-speaking states. The problem is partly sidestepped in the Basic World Tax Code draft of Hussey and Lubick, *supra* note 13, which focuses on "taxable transactions." *Id.* §§ 201, 211. However, it also uses the term "supply" throughout. *Id.* § 212(c). *See also* the official English translation of the Bulgarian VAT Act of 1993, which refers to "transactions with goods and services." BGR VAT art. 1. The term used in art. 4(1) of the Japanese Consumption Tax best translates as "transfer." *See* Ministry of Finance, *supra* note 4, at 141. VAT laws in the Russian language typically use the term *oborot* (turnover). RUS VAT arts. 3, 4; KAZ TC art. 54. The term does not translate easily and directly into French, German, Russian, or Spanish. Nor have those languages evolved a single term equivalent to "supply." For example, the French law refers to *les livraisons de biens meubles et les prestations de services*. Consequently, this key term cannot be used in states using those languages. Similar problems are encountered in Japan, where the law refers to "transfers of assets, etc."

A second example is the link between the term "supply" and that of "goods or services." In some laws, the emphasis is separately placed on "supply" and "goods and services," while in others—for reasons just noted—the focus is on "supply of goods" and "supply of services." Again, English usage is not itself entirely consistent,[23] but problems arise in other languages both over this point of linkage and also with the terms "goods and services."[24]

A final example shows language reflecting underlying differences in legal systems. The example is the next phrase in the EC version of the charge to VAT, namely that the tax is imposed on "the supply of goods or services *effected for consideration*."[25] The term "consideration" carries a particular technical meaning in common law states where it forms a

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[21]This abbreviation (or its equivalent in the relevant language) is now also used in some national legislation. *See, e.g.,* the recent U.K. consolidation measure, the Value Added Tax Act, 1994, ch. 23 (GBR VAT)(referring to "VAT" throughout).

[22] This is the term used in the English version of the European Union

[23] Hussey and Lubick, *supra* note 13, talk of "goods or a service." *Id.* § 211(a)(1). Like other English-speaking lawyers, they find it difficult to use the term "a good" despite its prevalent use among economists.

[24] As noted below, the Russian law and other laws similar to it refer to "goods, work, and services" because the term "services" has a narrower meaning in Russian than the concept expressed by the English word. *See* RUS VAT arts. 1, 3.

[25] EC Sixth VAT Directive, *supra* note 3, art. 2(1).

constituent element in the legal formation of a contract.[26] The term does not carry the same significance in states of the civil law tradition and cannot be directly translated. The French term is *effectuées à titre onéreux*.[27] It might be translated better as "against payment."[28] This approach is used in this chapter, although alternative approaches to avoid the term are used in some states.[29]

C. Economic Scope

The unique nature of the VAT is its potential scope in identifying and taxing the economic contribution—or added value—made by any economic operator in connection with any activity of a business or commercial nature. There are several ways in which that result can be achieved, as Tait discusses.[30] This chapter discusses only one, the method often called the invoice-based method, which is the most widely used. It requires the VAT to be identified in respect of each transaction or group of transactions.

The formal principles of this method are set out in the EC First VAT Directive[31] as follows:

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[26] This caused problems in the English courts in the case of *Customs and Excise Commissioners v. Apple and Pear Development Council*, [1984] Simon's Tax Cases [S.T.C.] 296 and [1985] S.T.C. 383, where the lower courts mistakenly focused on the technical English law meaning of the term, but questioned by the House of Lords, [1986] S.T.C. 192, and referred by them to the Court of Justice of the European Communities, which court, [1988] S.T.C. 221, emphasized that the term had common meaning throughout the European Communities (now the EU). The case well illustrates the dangers, emphasized here, of wrong terminology in this tax.

[27] Deuxième Directive 67/228 du Conseil du 11 avril 1967 en matière d'harmonisation des législations des Etats membres relatives aux taxes sur le chiffre d'affaires—Structure et modalités d'application du système commun de taxe sur la valeur ajoutée, art. 2, 1967 J.O. (L 1303) 67, 68; *see also* FRA CGI art. 256; CHE OTVA art. 4.

[28] This is the English-language text used in the (now superseded) Second Council Directive 67/228 of Apr. 11, 1967, on the Harmonisation of Legislation of Member States Concerning turnover Taxes—Structure and Procedures for Application of the Common System of Value Added Tax, art. 2(a), 1967 O.J. (L 71) 1303, as an alternative English equivalent of the French phrase in the text (which did not change between the Second and EC Sixth VAT Directives).

[29] The New Zealand goods and services tax is imposed on supplies "by reference to the value of [the] supply." NZL GST § 8. A similar approach is taken in the Basic World Tax Code. Hussey & Lubick, *supra* note 13, § 221(a). The U.K. legislation links the concepts in a different (and, in the view of this writer, a less satisfactory) way by defining "supply" as including "all forms of supply, *but not anything done otherwise than for a consideration.*" GBR VAT § 5(2)(a)(emphasis added). A difficulty with any such formulation is that some supplies that are not for consideration are taxable—for example, personal use of business assets—requiring a reference to deemed consideration.

[30] Tait, *supra* note 2, at 4–9.

[31] First VAT Directive, *supra* note 3, art. 2 (in part). The EC First VAT Directive provides the framework for the single form of VAT adopted by the European Union. *Id.*

> The principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions that take place in the production and distribution process before the stage at which tax is charged.
>
> On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components.

The following is a simplified example of the operation of the VAT on these principles, involving *X* (who creates an item of household goods from raw materials acquired without costs), *Y* (who runs a shop and buys the goods direct from *X* to sell to the public), and *Z* (the customer who buys the goods for personal use). *X* sells the item to *Y* for 100 (ignoring the VAT), and *Y* sells the item to *Z* for 300. The value added by *X* is therefore 100 and by *Y* is 200. *X* and *Y* are both fully registered for the VAT. The rate of VAT is 10 percent.

> *X* sells the item to *Y* for 100. The sale is subject to VAT at 10 percent, so *X* must add this to the price. *Y* therefore pays 110. *X* must account to the tax authorities for the VAT, 10, keeping a profit of 100. *Y* therefore pays 110 for the item.
>
> *Y* sells the item to *Z* for 300. The sale is subject to VAT at 10 percent, so *Y* must add this to the price. *Z* therefore pays 330. *Y* is entitled to be paid back for the VAT paid out to *X*, so retains 10 of the VAT collected. *Y* must account to the tax authorities for the other 20, keeping a profit of 200. *Y*'s profit remains at 200 because the net cost of *Y* buying from *X* is 100, not 110.
>
> The tax authorities receive 30 in total, 10 from *X* and 20 from *Y*. This reflects the value added by both *X* and *Y*.
>
> Further, assume that *Z* is also a trader registered for VAT and buys the item from *Y* for 300 plus VAT. However, *Z* is unable to sell the goods for a profit, and instead sells them to another private customer, *W*, for 280 plus VAT.
>
> *Z* therefore pays 330 for the item. *Z* sells the item to *W* for 280. The sale is subject to VAT at 10 percent, so *Z* must add this to the price. *W* therefore pays 308. *Z* is entitled to be paid back for the VAT paid out to *Y*, so retains the full 28 VAT collected. Further, *Z* is due a rebate of 2 against other sales. *Z* will therefore claim a rebate of 2 from the tax authorities.

In this example, *X* and *Y* both added value on their sales. *Z* lost value. The tax authorities receive 10 from *X* and 20 from *Y* but must rebate 2 to *Z*. This totals 28 across the transaction as a whole, ensuring that the proper amount of VAT is paid. Note that if *Z* is not allowed a rebate (or, as in some of the countries of the former Soviet Union, if *Z*'s loss is not recognized for VAT purposes), then the tax on the combined transactions is excessive.

D. Territorial Scope

Because the VAT is an indirect tax focusing on the transaction or activity rather than on the economic operator, the primary determination of the territorial scope of the charge to VAT is by reference to the location of a transaction. If the transaction occurs within the state, then it is within the charge to VAT. Attention must also be paid to the person to be charged to VAT on the transaction, to ensure that the amount of VAT due can be enforced and collected. It is therefore necessary to provide rules to determine the identity of the person responsible for payment of the VAT when some element of the transaction being taxed takes place outside the jurisdiction of the state.

There are two conflicting principles on which the territorial scope of a VAT can be based: the *origin principle* and the *destination principle.* As these names suggest, the origin principle charges a transaction, only part of which occurs within the jurisdiction, if the transaction originates or is created within the state, and the destination principle charges the transaction if it is destined for consumption in the state. For example, if goods are exported from state *A* to state *B*, then state *A* will charge the transaction if it has an origin-based VAT, and state *B* will charge if it has a destination-based VAT. For services, it may in practice be harder to determine where the service is provided, or where it is consumed. Subject to that practical problem, an origin-based tax will concentrate on the state of origin of the person supplying the service, while a destination-based tax will charge supplies consumed in the state.

Potential problems of double taxation and absence of taxation arise if these rules clash. For example, assume state *A* has an origin-based VAT and state *B* has a destination-based VAT. Exports from state *A* to state *B* will be taxed in both states. Exports from state *B* to state *A* will not be taxed in either state. The result, in a free market, would be that goods from state *A* would be too expensive to be competitive in the market in state *B*, so only limited exports would occur. However, there would potentially be high levels of exports from state *B* to state *A* because the goods imported from state *B* would be tax free, while locally made goods in state *A* would be subject to tax. In practice, state *A* could not afford this imbalance and would impose a charge on the goods from state *B*—in other words, a destination-based charge, unless the charge is to be a discriminatory border charge. This would avoid the absence of a VAT, but not the double taxation. (An alternative adjustment mechanism, whose implications are beyond the scope of this book, is the exchange rate between the currencies of *A* and *B*.)

To avoid double taxation, states that impose a VAT on imports remove exports from the charge to tax (and conversely, they should exempt imports where exports are taxed). This will also remove double taxation if both states have the same system (whether the origin system or the destination system). The example shows that those sets of rules cannot in themselves deal with a situation where the two states have different approaches to this question.

There is no international agreement determining either that states should follow one of these principles rather than the other or seeking to reach common rules to avoid double taxation (or double exemption from taxation). There is, therefore, no commonly agreed set of answers to these issues.

In practice, however, and with limited exceptions,[32] states have adopted the destination basis as the primary basis. There are some cases where, within a customs union or trading bloc, the origin base is used or has been proposed for adoption,[33] but these practices are limited exceptions to the general approach. In this chapter, we therefore assume that the VAT is to be based on the destination principle. This requires a charge to VAT on all transactions occurring within the state and also on all imports to the state.

To impose tax on both groups of transactions, VAT is normally imposed by two parallel sets of provisions:

(a) provisions imposing VAT on all transactions within the state; and
(b) provisions imposing VAT on all transactions involving imports to the state.

This pattern is adopted in this chapter, and the question of taxation of imports is dealt with separately from the matter of transactions treated as fully within the territorial scope of the tax.

E. Internal Charge to VAT

The common pattern of an invoice-based VAT is that a charge to VAT is imposed on all transactions within the state and within the scope of the VAT. Each taxable person is allowed a deduction against the total VAT charged by the person to take account of any VAT paid by the person on inputs related to transactions within the scope of the VAT.

A transaction within the scope of VAT and on which VAT is imposed is commonly called an *output* and the VAT collected on it is called *output tax.* A transaction made to the person making the output is known as an *input,*[34] and the VAT paid by that person when obtaining the input is an *input tax*. The internal charge to tax, consistent with the principles noted above, is therefore a charge amounting to the output tax received by a person less the input tax paid by that person.

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[32] The main exception is that of Russia and states within the Commonwealth of Independent States, adopting an origin basis. *See* Summers & Sunley, *supra* note 9, at 26 *et seq.*

[33] The European Commission has formally proposed that the European Union change from the present destination basis to a form of origin basis, originally for 1997 for transactions within the EU, although that date has now been deferred. *See* 1990 O.J. (C 176) 8. At present, no consensus exists to take this proposal forward on a general basis.

[34] From the supplier's point of view, it is an output.

The charge to tax must therefore identify on which outputs, and by which persons, output tax must be collected, and what input tax is available as a deduction against that output tax.

The normal approach is to impose output tax on transactions and persons if

(a) the transactions are "supplies of goods and services;"[35]
(b) those supplies are "taxable" and not exempt from VAT;

(c) those taxable supplies are made by a "taxable person," that is, a person within the scope of the charge to VAT; and

(d) the taxable person makes those supplies as part of the person's business activities, and not as part of a hobby or noncommercial activity.

Each aspect of this approach to charging VAT is examined below.[36]

F. Approach to Charging VAT on Imports

States have normally adopted the practice of treating imports of goods separately from imports of services. Imports of goods are identified by the physical entry of the goods. Services cannot be identified in this way. Instead, states have chosen to adopt rules that treat a supply of a service as occurring within a state if the supply meets certain criteria (and not so occurring if it does not). In this way, states have usually avoided the concept of "import of services" by defining or deeming services to be supplied either in the state or outside it (and not "to" it).[37] This is the approach adopted in this discussion.

Having identified imports of goods as a separate occasion for charge, the normal practice of states is to use their customs laws as a vehicle for imposing the VAT on goods that are imported, subject to necessary modifications. The nature of appropriate modifications is discussed below.

G. Principle of Nondiscrimination

[35] The summary adopts the terminology used in this chapter. Note, however, the reservations against any particular set of words already noted above.

[36] *See infra* secs. II–IV.

[37] The distinction is not merely semantic. An import of goods is taxable regardless of the identity of the supplier or person supplied. By contrast, an "import" of services is taxable only if the supplier (or person supplied) is a taxable person. Since there is usually a registration threshold for VAT, a foreign supplier that supplies only services with a low annual value may not be a taxable person. In the case of imported goods, the importer is made liable for the VAT regardless of that person's status. In the cases of services, the person receiving the services may be responsible for the VAT under a reverse charge (*see infra* text accompanying note 89), but registration will still be required for this to be effective.

The existence of separate charges on locally supplied goods and imported goods gives rise to the possibility of discrimination between the two classes of supplies. Most states are obliged by international agreement not to discriminate against supplies by way of import. The primary source of this obligation is Article III of the General Agreement on Tariffs and Trade.[38] The key part of that article provides:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products.

A growing number of states are also under other obligations not to discriminate through their indirect taxes. Sources of such obligations include the terms of customs unions and free trade area agreements,[39] double tax agreements,[40] Article 24 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries contains a provision that is identical to an earlier version (the 1977 version) of the OECD Model Tax Convention. U.N. Dep't of Int'l Economics & Social Affairs, U.N. Model Double Taxation Convention Between Developed and Developing Countries at 39, 207, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980). The only differences with the present OECD provision are drafting changes. Baker, *supra,* at 384. The model form of wording is found widely in individual double taxation conventions, although some states do not adopt it. The United Kingdom recorded a reservation to paragraph 6 in the OECD Model Tax Convention commentary, but no other state has done so. *Id.* at 413. and bilateral trading and investment agreements.[41]are still in force. The modern practice is to negotiate bilateral investment protection agreements. These sometimes include similar clauses. The principle therefore requires some modifications of customs law (which is of its essence a charge designed to discriminate). This is also discussed below.

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[38] Text adopted in 1947. The GATT 1947 (as amended before 1995) along with various protocols, decisions, waivers, and understandings make up the GATT 1994. Therefore, the obligation remains valid. Indeed, its scope is potentially widened to cover some services as well as products (or goods—the terms are effectively interchangeable).

[39]An example is art. 95 of the Treaty Establishing the European Community (and directly operative in all the member states of the EU). This imposes an obligation on all member states not to use internal taxation of products to favor locally produced goods over similar goods from other member states, or so as to cause indirect discrimination of that kind. The article has lead to considerable litigation within the EU and before the European Court of Justice. *See* Stephen Weatherill & Paul Beaumont, EC Law, chs. 6, 14 (1993).

[40] Article 24 of the OECD Model Tax Convention on Income and on Capital of 1992 [hereinafter OECD Model Tax Convention], *reprinted in* Philip Baker, Double Taxation Conventions and International Tax Law (2d ed. 1994), contains a provision prohibiting discrimination between the two states that are parties to the agreement with respect to the nationality of taxpayers. Although most provisions in the OECD Model Tax Convention are confined to direct taxes, art. 24(6) applies this article to all forms of tax. Therefore, it potentially covers the VAT.

[41] The earliest nondiscrimination clauses (usually in the form of national treatment clauses or most-favored-nation clauses) are in treaties of friendship, commerce, and navigation, some of which were first negotiated in the fifteenth century. Many friendship, commerce, and navigation agreements

To ensure that a state complies with these obligations, the structure of its VAT must be nondiscriminatory. This requires that the imposition of VAT on imports of goods or on services originating outside the state must not be in excess of the charge on internal transactions.

II. Taxable Persons

A. Persons Within the Scope of the Law

A person within the scope of VAT is usually described as a taxable person.[42] This terminology avoids the confusion caused in some states by calling such persons "taxpayers." The confusion arises because the taxpayer, in the sense of the person bearing the economic incidence of the tax, is the person receiving a taxable supply. This also applies for calculating the direct tax on a supply. For example, in the case of a supply of property rights on which a royalty is paid, the person supplying the rights is the taxable person for VAT purposes (while the person paying the royalty to the taxable person is in the economic sense the taxpayer), and the taxable person is in both law and practice the taxpayer of any income tax in respect of the receipt of the royalty.

A VAT law should include all legal persons created under the law of the state (or of a foreign country) that engage in economic activities of any kind, as well as all physical persons. The text should be drafted to bring all legal and physical persons potentially within the category of "taxable persons." It may usefully refer to the precise laws of the state under which such persons or entities derive their juridical status.

One problem arising here is whether the law should include partnerships and associations as taxable persons. The extent to which associations and partnerships have juridical personality separate from the individuals who are its members varies from one state to another, and the law

[42] This is the term used in the English-language version of the EC Sixth VAT Directive, *supra* note 3, art. 4. It is also used in the Irish Value-Added Tax Acts, IRL VAT § 8; the Basic World Tax Code, Hussey & Lubick, *supra* note 13, § 213(b); and the Singapore Goods and Services Tax, SGP GST § 8(2). The French term is *un assujetti*, although the term *redevable* is also used. *See* FRA CGI art. 256; CHE OTVA art. 4; *see also supra* ch. 4, note 17. The English term used in Ministry of Finance, *supra* note 4, is "taxpayer." Venezuela is an example of a state with a general tax law (the Organic Tax Code) that lays down general rules about "taxpayers." VEN COT arts. 22–24. It also makes provision for "persons responsible," namely, those who are not taxpayers but who have responsibilities to collect or pay tax under tax legislation. *Id.* at arts. 25–29. Because of this, the Venezuelan Wholesale and Luxury Tax, as the local equivalent of a VAT is called, applies to "taxpayers" as defined in the Organic Tax Code and "persons responsible." VEN IC art. 1; VEN COT arts. 22, 25–28. This leaves the precise personal scope of the VEN IC to be defined by the general tax code. The New Zealand law uses the term "registered person," but makes it clear that a person is to be treated as a registered person if the person is not registered in cases where the person should be registered. NZL GST § 2(1)(defining "registered person" as "a person who is registered or is liable to be registered under this Act"); *see also* GBR VAT § 3(1)("A person is a taxable person for the purposes of this Act while he is, or is required to be, registered under this Act."). Both the United Kingdom and New Zealand have high taxpayer compliance. The term used in this chapter does not assume compliance.

may need to reflect this. In some legal systems, they do not have separate juridical personality.[43] A VAT law may regard an association or partnership as a taxable person separate from the individuals in the association or partnership, although the association does not, for general legal purposes, have separate personality. This is consistent with an intention of excluding from the scope of the tax individuals engaged only in noncommercial activities.

If separate registration of a partnership is provided for, a mechanism should be introduced to give effect to the recognition. This will treat the partnership as making or receiving all relevant supplies and will ignore those supplies as being made by the partners (even though, for other legal purposes, the reverse is the actual legal position).[44]

Some states also allow or require[45] separate branches of a juridical person to be regarded as separate taxable persons (in which case a supply by one branch to another branch is a taxable supply) or allow groups of companies (e.g., a parent company and its subsidiaries) to register together as one taxable person (in which case a supply by one of the companies to another will not be a taxable supply). Where separate branches are treated as separate taxable persons, or groups of companies are treated as one taxable person, some administrative machinery is necessary to recognize the branches and groups.[46]

A VAT law does not usually need to expressly mention foreign legal persons, that is, persons that derive their legal personality from the law of some other state, as with a company registered in a foreign state. However, it is intended that all legal persons be registered for VAT if they conduct within the state activities of the kind and level defined in the law. In practical terms, this means that some branches or permanent establishments are required to apply to be registered, while others are found, following the jurisdictional rules of the state, not to be making supplies of the required level within the state. This problem has some similarities to that of deciding whether a person is a resident for income tax purposes. In most states, for example, a foreign company becomes "resident" and, therefore, within the jurisdiction of the state if it

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[43] For example, in Germany, Latvia, and many common law states. In civil law states, joint ventures may not have separate legal personality. The United Kingdom has an even more complex situation whereby partnerships have legal personality in part of the state (Scotland) but not in the whole state. *See also* ch. 3, sec. V(D); vol. 2, ch. 21.

[44] For a clear example of this kind of provision, *see* NZL GST § 57.

[45] For example, Kazakstan did so before July 1, 1995.

[46] The corporate income tax legislation of many states recognizes the joint treatment of a group of companies for income tax purposes. These laws provide, for example, a definition of the link creating a group (perhaps a 50 percent or 75 percent shareholding by the parent in the subsidiary). They often reflect the accounting convention of the integration of the activities of subsidiary companies into the accounts of the parent. They might be used by analogy for the VAT. Few states, however, recognize registration for separate divisions for direct tax purposes. Separate registration may prove advantageous for VAT purposes by allowing, for example, a split between the taxable activities of a company and nontaxable activities where those separate groups of activities are carried out by different divisions of a company or organization. It will also allow a trading division within a public body to register, while the main body remains unregistered.

establishes a branch, agency, or permanent establishment within the state. There is an agreed definition of "permanent establishment" in article 5 of the OECD Model Tax Convention.[47] A similar approach could be adopted for the VAT.[48]

Governmental bodies at the national, regional, and local level are to be included as taxable persons, in the same way as any other person, if they engage in economic activity. It is appropriate to except from this full rule "the central lawmaking and executive authority of the state," as no useful purpose is served in normal situations by such an inclusion. These institutions rarely engage in business activities. By definition, the main activities of the state legislature and the state's central governmental agencies are sovereign activities of the state and not commercial activities. This is also true of the activities of the judiciary in the state courts. It may be felt appropriate to provide a definition clarifying which of these bodies are expressly excluded from the scope of the VAT. The precise terms used need to be adapted to make sense in the context of the organization of government of the particular state.[49]

B. Excluding Persons with Low Levels of Business Activity

Most states require only some of the many persons active in business within the state to be taxable persons.[50] This is normally achieved by setting a minimum level or threshold of business activity and requiring only those persons with levels of activity above the minimum to be taxable persons. Those with levels of activity below that level are not required to be taxable

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[47] OECD Model Tax Convention, *supra* note 40, art. 5.

[48] The key test for registration is normally whether a taxable person makes supplies of the required level within the state. For that purpose, it does not matter in what form the supplier is present in the state—although in practice it may prove difficult to identify the person who ought to register by reason of a single transaction. Residence is, however, relevant to some supplies of services and for certain procedural purposes (e.g., nonresidents being required to appoint a resident tax representative). One approach that accepts this problem is that of the United Kingdom in providing that "a supply of services shall be treated as made . . . in the United Kingdom if the supplier belongs in the United Kingdom . . . " GBR VAT § 7(10). A supplier of services is treated as "belonging," if there is a business establishment in the country. *Id.* § 9(2). Either a branch or an agency is treated as a business establishment. *Id.* § 9(5)(a). "Branch or agency" is the phrase used in U.K. income tax law instead of "permanent establishment." GBR ICTA § 11. The phrase used in the underlying EU law is "fixed establishment." EC Sixth VAT Directive, *supra* note 3, art. 9. The French term for this is *établissement stable*. FRA CGI art. 259. This is the same term as that used in the French version of the OECD Model Double Tax Convention for "permanent establishment." OECD Model Tax Convention, *supra* note 40, art. 5. It is used directly in the French law, CGI art. 259, and the French version of the Swiss law, OTVA art. 9. It must also be noted that the concept of permanent establishment is not without its own problems. For example, if a business has a permanent establishment within the jurisdiction, is that establishment deemed to supply all supplies made to the jurisdiction by the company, even though they are not made through the permanent establishment? It may be so treated under the "force of attraction" principle, *cf. e.g.,* KAZ TC art. 5, which is, however, rejected by many treaties for income tax purposes.

[49] For the position relating to the diplomatic and consular functions of the state, *see infra* sec. IV(K).

[50] Some states, however, require all legal persons to be registered and have a minimum limit for individuals only. States may also exclude certain kinds of activity (e.g., excluding retailers but taxing wholesalers). This is usually considered problematic and contrary to the spirit of the VAT.

persons, although they are often given the right to voluntarily choose to be taxable persons. The usual measure of business activity is the total turnover of taxable goods and services supplied by the person over a set period.[51]for a set period, the result may be seen to be unfair.

The total to be taken into account for the threshold is the *total taxable supplies* of that person. This means the total of all supplies made by that person that are treated as taxable supplies within the definition of the law. The total does not include supplies exempted from VAT or outside the scope of VAT. This means that a person conducting a business that is largely exempt is outside the scope of the registration provisions if the taxable activities reach a total less than the threshold, although the total economic activity of the business is high.

The precise level of threshold varies widely from one state to another and, within a state, varies from one time to another. There are several reasons for this. Limits vary partly as a reflection of the economic structure of a state. Some states have a comparatively greater number of marginal small businesses involving one person or one family than other states. Even taking account of the differences, in many states self-employed individuals or single families engaged, for example, in subsistence farming or small market trading will contribute little to the collection of VAT. It is also administratively difficult—and therefore expensive—to collect tax from such people. In addition, the exclusion of smaller traders from VAT through the use of a threshold limit is particularly useful at the introduction of the tax, when there are limits on available administrative resources and taxpayer knowledge of the tax is at a minimum.

The law may be drafted to allow the authorities to alter the amount set from time to time, both to ensure that the tax is working properly and, in any event, to ensure that inflation does not have too significant an effect on the practical level of the threshold.[52]as the minimum monthly or annual wage. The threshold then adjusts automatically with that factor.

This discussion assumes that a law has only one registration limit. Some states have more than one limit, for example, a lower limit by reference to the supplies of services or of certain kinds of services, and another, higher limit for the supply of goods.[53] This allows the state

[51] The threshold will need to be defined with some care. There are two bases for definition: actual turnover of taxable supplies over a defined period and estimated turnover over a defined period. The test may be based on past periods (when actual turnover can be used), future periods (when estimates must be used), or a period such as the current calendar year, which is both past and future. An estimate might be based on the amount that it is reasonable to assume or, alternatively, likely that the business will exceed. The advantage of including estimates is that this allows registration to be made mandatory before the threshold is reached. This makes for easier enforcement. However, there will be situations where the estimate proves to be too high, and registration is forced in a case where it was not objectively required. In such a case, if other provisions force a registration to remain

[52] This provision is extremely sensitive in economies with high inflation. In some states that have severe problems with inflation, but that may not have a well-developed index of consumer prices, the practice has been adopted of linking the threshold not to a set sum of money but to an indexed factor, such

[53] This happens in Ireland, where the higher limit applies to traders with at least 90 percent of their taxable turnover deriving from the sale of goods, with the lower threshold (about half the level of the higher threshold) applying to all other taxable persons. IRL VAT § 8(3)(c), (e).

authorities to impose limits that reflect the different proportions of value added involved in providing goods and providing services, although it can do so only by adding another level of complexity. A provision setting more than one threshold will also need to provide a definition of the kinds of supply that count toward the lower level rather than the higher level and to provide for those who make both kinds of supply.

It should be emphasized that the threshold limit applies to all supplies made by one person or by that person's agent for the person. It is possible for a person who is potentially a taxable person to avoid that result by transferring some of the person's activities to another person (who might be under common ownership with the person transferring). States concerned by such practices may adopt provisions requiring that the total of activities in such situations be added together and be deemed to be the activities of one taxpayer.[54]

It must also be clear that, apart from aggregation rules, the threshold applies separately to each taxable person. For example, if *A* and *B*, both being active in business independently, also form a partnership, then the threshold applies separately to the taxable turnover of *A*, of *B*, and of the partnership.

C. A VAT Register

To administer the VAT, it is standard practice to establish a formal state register of those who are registered persons. There must then be a requirement that any person who is, or should be, a taxable person take the necessary action to seek to be registered for the VAT. The law or regulations need to confirm the register and give it official status. Penalties will also be needed to ensure that all those required to do so apply to be registered. Recognizing this requirement, laws sometimes refer to taxable persons as "registered persons" or "persons required to register."[55]

D. VAT Numbers

States sometimes decide to adopt and adapt an existing register, such as the register for companies or a general register of taxpayers, to act as the VAT register. That is for a state to decide, but the register must be capable of generating a unique VAT number for each taxable

[54] An example of this kind of antiavoidance provision is found in the United Kingdom. GBR VAT Sched. 1. This was strengthened considerably by the U.K. Finance Act 1996, sched. 3. The tax authorities can treat a series of separate companies as carrying on one trade so as to require them or one of them to register on behalf of the "group." The Japanese law has a "substantial attribution" rule based on similar rules for the direct taxes under which those who substantially enjoy consideration for transfers are regarded as the entities making the transfers. *See* JPN CTL art. 13; Ministry of Finance, *supra* note 4, at 159. A taxable person manipulating levels of transfer will be within the scope of this provision.

[55] *See supra* note 42.

person,[56] as well as providing the tax authorities with an up-to-date list of those, and only those, who are taxable persons. For reasons of good administration, states with more limited administrative resources find it increasingly attractive that the VAT number be the same as the taxpayer identification number used for income and other taxes. The practice must meet the need to provide all those registered for VAT, whether or not they are income tax payers, with a unique number at the time they are registered for VAT.

The VAT number is used by the tax authorities and by taxable persons themselves to ensure the proper operation of an invoice-based VAT. Every invoice is important to the tax authorities wishing to collect the VAT recorded on it and also to any taxable person paying the VAT recorded on the invoice to ensure deduction of the input tax on the invoice. For this reason, it is necessary to be able to identify the taxable person charging the VAT on the invoice. The law should provide that a taxable person is under a duty to put his, her, or its VAT number on the invoice, so that this can be achieved.

Once a taxable person has been issued a VAT registration number or has had the registration confirmed under a given number, the law should require the person to use that number on all official communications. For example, the number should be indicated on all communications with the tax authorities and perhaps other documents, such as official orders or official stationery.

E. Voluntary Registration

States often allow those who are not required to be registered (because their activities are below the level of the threshold) to register voluntarily. This may be appropriate for many organizations that intend to have a large turnover, but have not yet reached it; incur large expenditure in one year, expecting the income in the next year; or are carrying out business activities at a level that does not reach the registration limit, but that do not wish this information to be known by customers (e.g., younger self-employed providers of services). Voluntary registration also allows those operating just below the threshold level to avoid any competitive disadvantage compared with other operators who are required to be registered.

There is sometimes a danger to the integrity of a tax system in allowing uncontrolled voluntary registration. First, this may allow those who are not in reality engaged in business to register with a view to claiming rebates of input tax when they have no real intention of paying much output tax.[57] Such persons should not be entitled to register unless they are genuinely

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[56] The precise nature of the number used, and its status as a unique registration number for VAT purposes, is particularly important where the registration number is used in international transactions. Best practice will require both that the number identify the taxable person by reference to the state issuing the number and that the number contain a check digit so that routine checks can be made against mistakes and deliberate wrong use of numbers. International identification is provided within the EU by a standard international prefix. The check digit requires that the number be issued or monitored using standard mathematical methods.

[57] Some of the states adopting a VAT in recent years have experienced problems with this kind of fraud.

involved in business, but both practical and legal safeguards are needed to ensure that the tax authorities can control this situation. Failure to control it may result in significant revenue loss. It may be deterred to some extent by placing a minimum period on voluntary registration, as noted below.

A second reason for limiting voluntary registration is that the right to register voluntarily may have the effect of making many more persons "taxable persons" than is administratively appropriate for the state, particularly when a VAT is first introduced and the state has chosen to set a high threshold level.

Provided that the tax authorities can ensure that the integrity of the VAT is safeguarded, economic neutrality will be achieved only if voluntary registration is allowed. A compromise adopted by some states introducing a VAT is to set a minimum activity level for compulsory registration and a lower minimum level for voluntary registration. Where these rules operate, a person can register voluntarily only if the lower minimum is met. This excludes those persons with no real economic activity or whose businesses have not yet started. At the same time, it allows some voluntary registration to control distortions between those just above and those just below the compulsory threshold.

F. Exporters and Persons Engaged in International Activities

Most states provide that there is no VAT on exports.[58]*See supra* sec. I(D). To avoid exporters paying VAT, provision is made for them to claim back any input tax they have paid in making the exports (see below). Therefore, exporters and those in a similar position must be brought onto the register. If they are not on the register, they will not be entitled to claim rebates of input tax, and their activities will be affected. An exporter may not have a level of activity great enough to be above the minimum level requiring registration. Any provision in the law having the effect of excluding voluntary registration must therefore be accompanied by another provision ensuring that exporters are allowed to register regardless of their level of activity.

G. Effect of Nonregistration

A person who is required to register for the VAT is a "taxable person" who is subject to the duty to impose and collect VAT on all supplies whether or not the person is registered. It is important that the law make this clear and not exclude a person from the scope of the law just because of a failure (deliberate or otherwise) on the part of the person to apply for registration. It will also be appropriate to impose penalties on those who should have applied for registration but have failed to do so, as well as to ensure that full powers exist to collect VAT from those persons in respect of all supplies that have taken place (or are assumed or estimated to have taken place) when the person was not registered but should have been registered.[59] However, such a person is

[58] This follows from adoption of the destination basis of taxation.

[59] The amount collected is typically reduced by input tax credits supported by invoices.

not entitled to issue VAT invoices. Hence, the person's customers cannot claim input tax credits in respect of supplies from such a person.

The converse to this position should also be made clear in the law. A person who is not registered for VAT and is not required to be registered is outside the scope of the law. A person outside the scope of the law has no right to claim a rebate for any input tax paid. The person also has no right to impose VAT, or anything purporting to be VAT, on supplies made by the person. To ensure that persons do not abuse this position, two safeguards may be put in place. First, a person who collects or tries to collect VAT while not empowered to do so is made liable to criminal penalties. Second, the VAT law provides powers to collect the sums of money from such a person although the sums are strictly not VAT.[60] A variant on the second provision is to ensure that the overpaid VAT is repaid to the person overpaying.

H. Cancellation of Registration

The law should provide for three situations where VAT registration should be canceled.

The first case is where a person has been registered for VAT properly, but where the registration is no longer appropriate. This will occur where a person was required to register because the person's business activities exceeded the threshold but where, subsequently, the person's level of business activities has declined to below the threshold. If the person is continuing in business, then, if the person so wishes, a voluntary registration may be maintained. However, the person should have the right to deregister. Mechanisms are needed to allow a person to remove the person's name from the register when this occurs.

The second case is where the person has ceased to carry on business activities (or has ceased to qualify for some reason for voluntary registration). If so, the person's name should be removed from the register whether or not the person applies for deregistration. Subject to safeguards for the integrity of the VAT collection process, deregistration should take place when the person ceases to be entitled to register or no longer wishes to be registered.

The third case is where the person has been registered by mistake or by misrepresentation on the part of the person. In these cases, it will usually be appropriate to provide that the person is removed from the register retrospectively to the moment of registration. In other words, the registering authorities can take action so that the person registered wrongly can be treated as if the registration had never occurred.

The charging provisions of the law should deal with VAT liability that arises by reason of a person ceasing to be registered. In addition, the powers of the tax authorities should remain in place notwithstanding the deregistration to deal with such charges.

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[60] The New Zealand law provides the Commissioner of Taxes with the power to collect the tax in these circumstances by an assessment if "[a]ny person, not being a registered person, supplies goods and services and represents that tax is charged on that supply . . ." NZL GST VAT § 27(1).

Safeguards are needed to deal with those who have been registered, but should not have been registered, and for those who appear to be registering properly, but who use registration to obtain large refunds of input tax without later paying in any corresponding output tax. In part, these safeguards may be linked to the grant of refunds for input tax.[61] Some states add further safeguards, for example, preventing a person who has registered voluntarily from deregistering within a set time (perhaps one or two years) of first registering.[62]

J. Continuing a Registration Despite a Change in the Taxable Person

Situations will arise where a person ceases carrying on a business unavoidably. For example, the death, incapacity, or insolvency of an individual or the winding up of a company may mean that the person registered as running a business is no longer running it. The business will usually continue at least for a time to be run by some other person. For example, the trustee in bankruptcy or a receiver for a debtor may run the business in the owner's place, and the personal representatives of a deceased person will often run the business until it can be transferred to some other person. In these cases, states often make provision to treat the registration as continuing notwithstanding the change in identity of the taxable person. Rules might deal similarly with changes in membership of a partnership where the partnership continues to run the business without a break. These provisions should be linked with other provisions preventing a transfer of title in cases of continuing registration from constituting a supply. The rules can be more liberal than the reorganization provisions of the income tax.[63]

III. Supplies of Goods and Services

A. Transactions within the Scope of the Law

A broad-based VAT is designed to bring within its charge every kind of economic transaction, subject to limited exceptions. This is normally achieved by drafting a very broad provision imposing VAT on an extremely wide range of business transactions and then removing by specific exception any transaction that is not to be liable.

Transactions are usually stated to be within the scope of VAT if they are "supplies of goods or services." These terms are given extremely wide meanings that go significantly beyond the usual meanings of "supplies," "goods," and "services" in most languages. The aim is to bring within the charge all economic activity. In particular, the terms need to cover transactions

[61] *See infra* sec. VII(L).

[62] For example, the limit in Japan is two years. JPN CTL art. 9.

[63] I f a reorganization were to be considered a taxable supply, the successor entity would obtain an input tax credit in the same amount. The logic of VAT does not require tax to be imposed in such a situation, as long as the successor continues to be a taxable person. *See also infra* sec. VII(E).

dealing with land or other immovable property and with intellectual property rights. Therefore, the terms should not be limited to the meanings of those terms, for example, in consumer law.

For reasons of linguistic simplicity, all the relevant transactions are termed "supplies" in most English VAT texts. However, there is no one concept of "supply" in many languages.[64] A more formal presentation of the scope of a VAT law might refer to (a) transactions involving the transfer of the legal rights to goods, and (b) other transactions within the scope of VAT but not involving such a transfer.

In actual drafting, one can employ less clumsy expressions than this, as long as the underlying intent is not lost. The discussion will deal with the formal classification.

Besides identifying what transactions are within the scope of the VAT, rules are required to determine where transactions occur, when they occur, and who for the purposes of VAT is carrying out, or treated as carrying out, the transactions.

B. Supplies of Goods

VAT laws usually contain a definition of a "supply of goods" or "goods." It is felt, in the light of the formal presentation above, that the better practice is to offer a definition of a "supply of goods." Again, the definition needs to avoid being too closely related to any definition of a similar concept in the commercial or consumer law of the state. This is because the scope of the VAT rule will usually be wider than the scope of the commercial law. Other rules, such as timing, may also be different. Nonetheless, those defining a "supply of goods" in the VAT context might well gain from reviewing the other definitions within the state of those terms.

A possible definition[65] of a "supply of goods" is a transfer of the right to dispose of tangible movable property or of immovable property other than land.[66]of services, and leasing is

[64] *See supra* sec. I(B).

[65] The EC Sixth VAT Directive defines "supply of goods" as "the transfer of the right to dispose of tangible property as owner." EC Sixth VAT Directive, *supra* note 3, art. 5. This is an English rendering of the French "*le transfert du pouvoir de disposer d'un bien meuble corporel comme un propriétaire*," FRA CGI art. 256, and does not fully convey the civil code technicalities of the French version. The Swiss-French version is "*le pouvoir de disposer économiquement d'un bien en son propre nom.*" CHE OTVA art. 5. The U.K. law does not define "supply" (beyond saying that it includes all forms of supply, GBR VAT § 5(2)(a), a formula also adopted by the New Zealand law, NZL GST § 5(1)), or "goods" (defined in New Zealand, NZL GST § 2(1)) or "supply of goods." The Basic World Tax Code defines supply as "the act of providing a good or service . . ." Hussey & Lubick, *supra* note 13, § 212(c).

[66] Some definitions also expressly exclude "money" from the definition. For example, the New Zealand definition states that "goods" includes "all kinds of personal or real property; but does not include choses in action or money." NZL GST § 2(1). (Chose in action means a right to bring a lawsuit or to recover a sum of money.) This is the widest definition possible in the context of the present form of law. Other forms of property such as intellectual property are therefore not goods. This is, however, an approach made within the context of the common law. Other systems of law do not draw the same distinctions between tangible and intangible property. For example, under the Japanese consumption tax law, the leasing of assets (goods) is treated in the same way as sales of assets and separately from the provision

defined to include transfers of intangible property in assets. *See* Ministry of Finance, *supra* note 4, at 145. The consequence of this form of definition, coupled with a broad definition of services (see sec. D below), is that the transfer of intangible property will be considered a service.

The problem with a general definition of this concept is that there are fundamental differences in approach to the sales of goods in different legal systems, including differences within the European Union between common law states and civil law states. The definition offered here is a compromise between the common law and civil law approaches to property. The definition in a state may need to be aligned more closely with the property laws of that state.

For example, the common law approach identifies property as tangible (items that can be held or touched—usually referred to as goods or products in commercial laws) and intangible (property that cannot be touched, such as legal rights). It also distinguishes between "personal property" (including tangible property that can be owned by individual persons, such as goods) and "real property" (this includes only legal rights of ownership to land and things attached to or inseparable from land). In countries with a civil law tradition, a distinction is drawn between movable property and immovable property on a differing basis (e.g., a building can be treated as separate from the land on which the building stands, and the categories of immovable property may be related more to the physical ability to move the property than to the underlying legal rights). VAT laws may not precisely follow either of these approaches. The objective of the VAT rule is to impose tax on the economic substance of what is occurring (and for which a person receives payment) rather than on its precise legal form.

A "supply of goods" is not constituted merely by a transfer of possession, which is a transfer of the use of goods, not of the goods themselves. A transfer of the use of goods is a supply of services. What constitutes the right to dispose of property depends on the laws of each state. The definition set out above avoids reference to a sale of the goods or the rights of ownership. The intention is to avoid complexities of the commercial laws of a state, such as reservations of title, that may prevent ownership from transferring but that do not prevent all the physical attributes and economic value of ownership from being transferred. Equally, a transaction that has all the attributes of a sale but later turns out to be avoidable for legal reasons does not thereby cease to be a supply, although there may later be a supply back again if the goods are transferred back.

If a transfer of possession (a supply of a service) is followed by a transfer of the title, or rights of ownership, the supply of goods is the supply of those rights and reflects the residual value after taking into account the value of the services already supplied.

No separate definition of "goods" is needed save the explanation in the above definition or its equivalent.[67] The intention is to include in the category of "goods" all those forms of

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[67] For alternative approaches, *see supra* notes 65 and 66; *see also* Hussey & Lubick, *supra* note 13, § 212(a), (c) (defining "goods" as well as "supply"). For a lengthy definition of "supply," *see* NZL GST § 5.

tangible property that are to be within the scope of the tax. Land is often excluded from the definition of goods deliberately for reasons discussed below. Sometimes money is also excluded. This will depend in part on how money is viewed in the property laws of a state (particularly, whether money is regarded as tangible or intangible). In reality, whether or not money is excluded here, all forms of VAT exclude a charge to VAT on transfers of money (or, properly, the use of money) by exemption. Any exclusion of property or transactions from the definition of "supply of goods" will bring it within the definition of "supply of services" set out below, thereby requiring the exclusion to be set forth again.

Many laws also extend the definition of supplies of goods to cover supplies of energy and other kinds of supply that are similar to goods. For example, a supply of electricity is not generally treated under civil or commercial law as a supply of goods, nor is a supply of heat, refrigeration, or air conditioning. However, it is usually regarded as convenient to treat them as supplies of goods to apply the timing and location rules that relate to goods.[68]

C. Land

The reference to "immovable property other than land" is designed to take account of the fact that some states have wider definitions of immovable property than other states. Whatever the scope of the definitions within a state, a sale of land should be excluded from the scope of a supply of goods.[69] "Land" in this context means the rights of a person as the owner to legal title and exclusive possession and control over any part of the surface or subsoil of the territory of the state. The emphasis is on the legal title, not on the actual soil. This may or may not automatically include legal title and possession of any buildings, structures, or equipment fixed to the surface or in the subsoil.[70]

The reference to legal title is based on the assumption that the law of the state provides for the sale of the whole legal interest in land. In a number of states, only limited sales of interests in land can occur and to that extent the comments are not relevant. Another point of difference in the laws dealing with land or immovable property of states is that some states have laws under which a building on land is legally regarded as part of the land, and so cannot be sold

[68] The EC Sixth VAT Directive requires that "[e]lectric current, gas, heat, refrigeration, and the like shall be considered tangible property." EC Sixth VAT Directive, *supra* note 3, art. 5(2).

[69] Compare the New Zealand definition set forth in note 66, *supra*, as one attempt to widen the scope of the tax to cover certain land transactions. For the policy behind the statement, *see* Tait, *supra* note 2, at 61-66, 80-90; *see also* ch. 7 *infra*. It may be noted that the New Zealand law contains a number of exemptions removing certain transactions involving land from the scope of the tax. It was found necessary on more than one occasion after the passage of the act to widen those exemptions, despite the clear policy in New Zealand against such exclusions.

[70] In the preliminary edition of the Basic World Tax Code, Hussey and Lubick catered to this by separately excluding land and "existing buildings" from the definition of "goods." Ward M. Hussey & Donald C. Lubick, Basic World Tax Code and Commentary § 212(b)(2), (3) (1992). Section 212 of the 1996 edition now includes land and buildings. For an explanation of the change of view of the authors, *see* Hussey & Lubick, *supra* note 13, at 289.

separately from that land.[71] In other states, a building can be sold even where the land is not sold or cannot be sold.[72] The suggested definition will have different effects in these different situations. Consideration will need to be given to the adaptation of the law to the situation applying in the state.

Exclusion of land from the definition of goods is for reasons of both principle and practical administration. Some of the arguments from principle are reviewed in the chapter by Cnossen[73] and are not rehearsed here. A practical problem is how best to tax works or buildings on land without also taxing the land. There are several possible solutions to the problem of taxing development (including buildings) and not land. The methods used in OECD states are also reviewed by Cnossen.[74]

If a law adopts the definition set out above, a sale of undeveloped land is never subject to VAT. A sale of land by a private person would not, in any event, be within the scope of the tax, because the sale would not be part of a business activity, and, in many cases, the seller would not be a taxable person. The transfer of an interest in land is not excluded from the scope of VAT by this definition. This is because the transfer of an interest in the land (i.e., a transfer of part of the total ownership of the land) is not the same as a transfer of the land. Instead, most kinds of transfers of interests, such as leases or rights to use land, are exempted under the VAT laws of many states. Short-term leases are subject to VAT. Works done on land, for example, civil engineering work or building work for the owner of land, are not excluded from the scope of VAT by this definition. Therefore, such works are usually subject to VAT.

The result of these definitions can be inconsistency between the VAT treatment of different transactions relating to land. Therefore, the VAT treatment of land needs careful consideration within the context of the landholding laws and practices of the state, with particular regard being given to the position of buildings sold by and to taxable persons for use in a business. For example, many states charge tax on a new industrial or commercial building, although not all those states charge tax on the sale of a building completed before the start of the tax in the state.[75]

D. Supplies of Services

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[71] This applies in states that have adopted English land law.

[72] This applies in many civil law states. It also applies in states, such as those of the former Soviet Union, where land cannot be sold, but a building on the land can be sold.

[73] *See infra* ch. 7.

[74] *See id.*

[75] *See id.* for a further discussion.

A "supply of services" is often defined as any supply within the scope of VAT that is not a supply of goods or a supply of land.[76] This definition, when read with the definition of "supply of goods" means that *any* supply is within the scope of the charge to VAT. If that is so, it may be asked why there is any need to distinguish between "goods" and "services." The answer is that the rules locating a supply of services are different from those for a supply of goods, as are the rules determining when such supplies occur. Further, where VAT is charged at more than one rate, the precise identity of the supply may be critical. Also, the self-supply rules explained below apply to goods but not to services. Finally, a supply of goods across the frontier of a state is an import or export of those goods and is subject to the customs regime of the state. This does not apply to supplies of services. The latter point serves to emphasize that, in cases of doubt, it may be useful to consider the scope of the customs law of the state in considering whether or not something is a "good."

It is therefore not possible[77] to have a supply that is not either a supply of goods or a supply of services, except for supplies of land or money. From this, it is clear that "services" has an extended meaning. It covers the use of all forms of property and also transfers of the right to dispose of intangible property. It also covers negative events, such as refraining from activity or undertaking by covenant or agreement not to do something.[78] Indeed, "services" are supplied whenever value is added because of a transaction that falls within the scope of VAT. A transaction will fall within the scope of VAT under the normal rules if the transaction is a business transaction, if the person making the supply is a taxable person, and if some other person makes a payment for the supply.

VAT laws rarely offer a useful separate definition of "supply."[79] A supply will occur whenever there is some transaction or event involving a taxable person whereby the taxable person receives payment (or consideration) for the effects of that transaction or event. In other words, the concept of value added is reflected by this broad definition. Any narrower definition, and any attempt to place limits on the meaning of "supply" or of "services," would exclude economic activities from the scope of VAT.

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[76] *Est considérée comme prestation de services toute prestation qui ne constitue pas la livraison d'un bien.*" CHE OTVA art. 6(1). In the European Union, "supply of services shall mean any transaction which does not constitute a supply of goods." EC Sixth VAT Directive, *supra* note 3, art. 6(1). Where goods are defined as excluding money, it is appropriate to provide that "services means anything which is not goods or money." *See* NZL GST § 2(1). The Japanese law has no equivalent and relies instead on a comprehensive list of kinds of service.

[77] Save by express provision. For example, the U.K. law provides that the transfer of an ongoing business is a supply, but of neither goods nor services. Special Provisions Order 1995, No. 1268, art. 5(1) (GBR), *reprinted in* Butterworths VAT Handbook 1995, at 451. This is a drafting device to remove that kind of transaction from the scope of VAT, but it does so in a way that defies the logic of the legislation of which it is part.

[78] For example, the EC Sixth VAT Directive includes in the definition of supplies of services "obligations to refrain from an act or to tolerate an act or situation." EC Sixth VAT Directive, *supra* note 3, art. 6(1).

[79] *See supra* the definitions quoted at notes 65 and 76. Some laws, such as the French, provide a series of examples of what is included in delivery and provision, FRA CGI arts. 256–59C; others refer to "transaction" instead. *See, e.g.,* BGR VAT art. 1.

Interpretation and application of this provision should reflect this broad policy approach because it ensures not only efficiency in collecting the tax but also fairness between one taxable person and another. It is only if all economic activities that add similar value are taxed similarly that a fair and easily administrable tax can exist.

Comment has already been made about the exclusion of land and money from the definition of supply of goods. If the above definitional structure for supply of services is used, it is necessary to repeat those exclusions in the definition of supply of services.

E. Supplies by Employees and Officeholders

The law should provide that the service undertaken by an employee for the employer of that employee does not form a supply made by that employee. Two ways of doing this are to expressly say so or to ensure that an employee can never be a taxable person, by providing that a person is a taxable person in respect only of supplies made by that person *independently.*[80] The rule also covers all those holding office, such as company directors and all government officers and employees.[81]

F. Supplies by Agents

Where a supplier supplies goods or services through an agent to another person, the supply is made not by the agent but by the supplier. Whether in a particular case an intermediary is an agent will depend on the precise legal nature of the contract between the persons involved. For example, an employee is the employer's agent. The employee's service, if supplied directly or indirectly to a third person, is a supply by the employer. This rule covers all supplies from employees, including the case where an employee works directly for some third person, if the third person contracts with, and pays, the employer. If the employee is seconded to the third person and is paid directly by that third person, then the true relationship may be that the employee is now employed by the third person. If the third person makes no payment to the employer, then the payment to the employee will probably not constitute consideration between the employer and the third person, so that there is nothing on which VAT is to be paid.

An agent is normally entitled to a fee or commission for services rendered to a supplier, and VAT is charged on those services (unless they are exempt). Where an agent is used, it is therefore for the supplier, not the agent, to charge VAT and to pay it to the budget. Special powers may be considered necessary to enforce payment of VAT by an agent where the agent, rather than the supplier, has the money to make payment and the supplier has not paid.

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[80] See the definition of taxable person in EC Sixth VAT Directive, *supra* note 3, art. 4(1), on which this text is based. The reference is to "independent workers" rather than to "dependent workers."

[81] *See also* the discussion on employment status in connection with social security, *infra* ch. 11, and income tax, vol. 2, ch. 14.

One special case is that of a sale by auction, or other forms of sale where the agent does not reveal that there is an agency or declines to reveal the identity of the person for whom the agent is acting. Here, the supplier effectively remains unidentified. Therefore, it may not even be clear whether the supplier is or is not a taxable person. In such cases, it is necessary to treat the agent as a principal for the purposes of charging VAT to customers and to include rules requiring that this be the case, whatever the underlying legal relationships. The effect of this is to require the agent (if a taxable person) to issue invoices to the customer and for the principal (if a taxable person) to issue invoices to the agent for the items sold.

G. Mixed Supplies and Multiple Supplies

In practice, it is often difficult to identify the nature of a supply. Often what is supplied is a mixture of different things and often of both goods and services. For example, *A* agrees to sell some goods to *B* and also to deliver them to *B*. *A* also agrees to install them upon delivery. An engineer agrees to repair *B*'s broken machine and supplies some small spare parts while doing so. A club allows *B* to become a member and provides *B* with both goods (such as books and a special badge) and services (such as advice or the use of club premises) when *B* joins. In each of these cases, is there a single supply or more than one supply? Are the supplies of goods or of services?

States need to adopt simple practical rules for dealing with these everyday occurrences so that those making mixed supplies and multiple supplies can determine without excess difficulty how and when VAT is to be applied to each supply. One broad practical rule is to treat any supplies incidental to a main supply as part of that main supply. If, for example, *A* makes no separate charge for delivery, then the service of delivery is ignored, and the supply is taxed only as a supply of goods. If the engineer charges separately for the spare parts, then VAT should be applied separately to them. A multiple supply, such as club membership, may require that the one payment be apportioned between the different elements of club membership.

A simple broad VAT allows many of these problems to be avoided. If none of the forms of supply is exempt and all are subject to VAT at the same rate, then it is not as critical to separate the elements of a supply. When numerous categories of exemption are allowed and more than one rate of VAT is introduced, administration becomes more complicated because much closer attention must be given to this problem.

H. When a Supply of Goods Takes Place

The time of supply is important for deciding when a tax invoice has to be issued in respect of a supply, when tax is due in respect of a supply, the rate at which the tax is payable,[82] and in which taxable period a return has to be made in respect of that supply and in which any tax credit can be claimed by the person receiving the supply.

[82] In cases where the rate of tax has been changed from one period to the other.

The rules determining when a supply of goods takes place vary from one state to another[83] but generally a supply of goods takes place when

- a VAT invoice is issued for the supply,
- the goods are delivered,
- the goods are made available,
- the goods are removed or transported to or for the customer, or
- the goods are paid for in whole or in part.

In accounting terms, these rules include both a cash basis and an accrual basis for timing a transaction. In the interests of securing the cash-flow position of the state and of ensuring efficient collection of the VAT, it is usual to provide that the time of supply occurs when the first of these events occurs, or soon thereafter.[84]

Once a VAT system is established, it may be most efficient to provide that the primary rule governing time of supply is that the supply occurs at the time when the VAT invoice is issued, provided that the invoice is issued promptly. In practice, many suppliers issue tax invoices at the time of a supply or shortly thereafter to comply with the obligation to issue a timely invoice. The law could, for example, define the time limit as seven days after what would otherwise be the time of supply under the rules set forth above.

A supply of goods is defined as a transfer of the owner's right to dispose of tangible property, but the time of supply for the purposes of this law is fixed not by reference to that transfer, but by reference to the delivery of the goods themselves. Often, the transfer of the right will occur with the delivery of the goods, but this will depend on the precise provisions of the laws of the state relating to the sale of goods and supplies of other kinds.

Sometimes goods are not "delivered" in the usual meaning of the word. For example, a supplier sells to a customer an agreed quantity of a commodity, such as grain. The grain is held

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[83] This applies for invoice-based and transaction-based approaches to VAT. If the VAT is levied on an accounts base (e.g., in Japan), the timing rules are the same or similar to those applying for corporation tax. *See* Ministry of Finance, *supra* note 4, at 172–74. This is often based on general accounting principles and therefore relates either to the cash transaction or to accrual.

[84] Special considerations may apply in some transition countries where there are serious problems of interenterprise arrears. *See generally* Summers & Sunley, *supra* note 9. Many of these countries operate VAT on a cash basis, or provide that the taxable event occurs at a specified time after the events referred to in the text. For example, in Georgia the taxable event occurs 90 days after the date that goods are shipped or services are performed. A complete discussion of the issues is beyond the scope of this chapter, but some general principles can be stated. First, it is critical that the rules for time of supply be identical for the output tax and input tax of a particular taxpayer. If a taxpayer is allowed to pay output tax on a cash basis, the taxpayer should not receive credit for input tax until the taxpayer makes payment for supplies. Second, as a general matter, to avoid claims of input tax in advance of output tax being paid, it is best to have a single rule that applies to all taxpayers, perhaps with limited exceptions, such as for small taxpayers.

in a store by the supplier, who releases the grain only when the customer sells it to a third person, to whom the supplier delivers the goods on demand from the store. In such a case, not only are the goods not delivered to the customer, but they are not appropriated to the customer either. Cases such as this could be dealt with in regulations. Those regulations might be based on the legal provisions of the state dealing with the transfer of ownership of goods in situations where the transfer does not involve delivery.

Where payment is made in advance of goods being delivered, the supply should be considered as taking place on the date of the payment to the extent of its amount. The aim is to ensure that the VAT liability arises as an advance payment is made and does not await any transfer or dealing with the goods. Otherwise, advance payments could be used as a means to avoid or delay the payment of VAT. This may happen, for example, where an advance payment is made, but no invoice is issued. If the goods are delivered, it may be said to be a loan for which no payment is claimed pending the more formal agreement. This more formal agreement never occurs, thus leaving the supplier with an advance payment that apparently does not relate to any supply and leaving the person supplied with the use of goods for perhaps a long period.

The reference in the preceding paragraph to a supply taking place to the extent of the amount of the payment implies that where only partial payment is made, portions of the amount of the supply will take place on different dates. A partial payment is treated as the first occasion of supply and the occasion for any further supplies is determined in accordance with the general rules. This rule will apply separately to the situation where two or more payments are made for a supply if separate invoices are issued in respect of each payment. If one invoice is issued for the full amount due, then this will represent the applicable date for the supply for the whole sum, although payment is made in installments.

Where the "supply" of goods is actually a series of supplies occurring on a number of separate occasions, then a taxable supply occurs on each separate occasion. This is equally true for a supply of services. For example, a customer may agree to buy from a supplier the right to set up a market stall on the supplier's land each Thursday throughout a year. A supply of the use of land in this way is a taxable supply of services. Is it one supply or a supply of the use of the land each Thursday? A technical answer to this question might refer to the precise terms of the contract under which the supplier agrees to supply the use of land in this way, including the method of payment adopted. Treating each date of supply as a separate supply achieves an efficient and practical result in that the supply is regarded as occurring each Thursday if payment is made for each week only after that week. If payment is made for the whole year at a set time before the end of the year, the rule about prior payment will apply. It is normally appropriate to apply the rules by reference to the terms of the agreement between the supplier and the customer. To avoid practical problems and to simplify administration, regulations can deal in detail with cases such as this.

J. When a Supply of Services Takes Place

The considerations set out as applying to the time when a supply of goods takes place also largely apply to a supply of services. However, services are not "delivered" or "appropriated" in the same way as goods. Instead, it is usual to determine the time of supply by reference to when the services have been rendered. This is a question of fact to be interpreted in the light of any contract or agreement under which the services are supplied.

A special case that may need a different rule is that of a supply of services over a long period or a continuing supply. If a supplier agrees to supply a customer with a continuing service (e.g., a telephone service, a supply of electricity, or continuing professional assistance), the supply might be regarded as never reaching the point at which it "is performed" until the contract between the supplier and the customer is ended, or it might be viewed as provided every minute, which would be impractical. However, payment is made from time to time, and the rule about partial payment can be applied. Alternatively, it may be that the contract between the supplier and the customer shows that the services are supplied, in effect, on a series of separate occasions. If so, it is usual to treat each supply as made when a partial payment for the supply is made or when an invoice is issued for that part. It may be that the "supply" is not one supply, but a series of supplies. If cases of difficulty arise under this general rule, special provision can be made through regulation.

K. Where a Supply of Goods Takes Place

The introduction to this chapter stressed that the VAT is usually based on the destination principle, that is, with goods being subject to VAT where they are either received or consumed. For this reason, goods crossing frontiers are subject to a regime similar to customs duties on arrival. Therefore, it is necessary to clarify where goods are received. In the case of imported goods, the adoption of customs laws will help deal with this problem. The VAT laws can adopt from the customs laws rules to determine when goods are imported and the nature of the goods imported.

In practice, most international supplies of goods are caught in this way by the customs laws of states. Location rules may also be useful within the state and to deal with exports. Often, a general rule is included in the law to locate a supply of goods where the goods are delivered or made available to the person supplied, in other words, where they are physically handed over. The fact that legal title does not pass at that time is not the important issue. For goods that are being transported, a rule is needed to determine whether they are delivered at the start or at the end of the transportation. A rule that goods are delivered where the transportation starts will accord with the common commercial arrangement that goods are at the risk of the buyer while being transported. It will also ensure that the location of the supply of goods being exported is within the state. That is necessary to provide a legal basis for providing a rebate of VAT on inputs used to produce those goods.

L. Where a Supply of Services Takes Place

Determining the location of a supply of services can be a matter of considerable difficulty, especially for international services. Customs rules cannot be used because they do not apply to services.

A second difficulty arises from the application of the destination principle. This provides that services should be taxed where they are received or consumed. However, consider, for example, the supply of legal services by a lawyer in one country to a person in another country. Where does that supply occur? The physical location of the supply may be both difficult to determine and irrelevant to the place where the supply is consumed. It might take place in the country of the lawyer, that of the client, in some third state, on an aircraft, over the telephone, or through e-mail originating in, or received in, a range of offices. If the law firm has offices in several states, the advice could be sent from any of those states. The underlying legal research, writing, and investigation could also be performed in a variety of places.

Behind those problems lies that of ensuring that a taxable person is within the jurisdiction of the state, so that the VAT can be enforced. This does not matter for imported goods, because in the last resort the goods themselves provide security for payment of the VAT. Equally, it is easy to identify a person who can be treated as importer, and duties may be imposed on that person. Another policy aspect is that fairness and neutrality require that services that originate overseas be taxed in the same way as services that originate in the state. Otherwise, overseas suppliers may be able to compete on unfair terms.

In the absence of any international agreement setting jurisdictional limits to VAT and any ready assistance in enforcing VAT in other states, there is no clear and universally accepted answer to the question of how to treat international services.[85]

Some aspects of the problem can be solved by identifying separate rules for particular kinds of supply. For example, where the services relate to land or other immovable property, it is common to treat the services as supplied where the land is situated.[86] This provides a rule consistent with usual rules on conflicts of laws, and also access to security. Similarly, a supply of transport services can be treated as occurring where the transport is supplied.[87]

[85] The EC adopted standard rules in 1977 but was unable to adopt a simple and universal rule. *See* EC Sixth VAT Directive, *supra* note 3. As will be noted further in the text, the main rule relates to the supplier's place of business, but there are four sets of exceptions to this, two of which are permissive rather than mandatory. As a result, the location rules within the EU member states are not entirely consistent.

[86] This is the rule for the European Union. EC Sixth VAT Directive, *supra* note 3, art. 9(2)(a). The New Zealand Goods and Services Tax Act taxes supplies of services to "goods" in New Zealand at the time of supply; this includes land. NZL GST § 8. The Swiss OTVA adopts the EU rules. CHE OTVA art. 12(2)(a). The South African Value-Added Tax Act achieves a similar result by zero rating supplies connected with land in another state. *See* ZAF VAT § 11(2)(f).

[87] International transport services are usually either exempted or zero rated, *see infra* sec. VII(C), but a jurisdictional rule is still needed. This rule is found in EC Sixth VAT Directive, *supra* note 3, art. 9(2)(b). The Swiss OTVA, art. 12(2)(b), makes similar provision, save that a discretion is reserved to the Swiss authorities to decide cases where only part of a journey is through Swiss territory.

Beyond this, states tend to adopt rules that locate a supply at a place of business either of the supplier or of the customer.[88] The practical problem about locating the supply where the customer is located is imposing the VAT on that supply. One answer to this is that of *reverse charging*. A reverse-charging rule treats the customer being supplied with a service originating abroad as making the supply to itself. It must then account to its tax authorities for the VAT due as output tax on that supply.[89] If the customer pays that VAT as input tax, it can claim an offsetting deduction, and will owe no VAT. However, if the customer makes exempt supplies, then no VAT credit or deduction is available.

M. Treatment of Imports

The destination principle requires a charge to VAT to be placed on all imports. This is usually done through a charging provision that parallels the one on internal supplies. The parallel provision normally adopts and adapts the laws imposing customs duties on the imported goods. The laws determining whether items are goods (inclusion in the tariff), whether they are imported (rules of origin), and when and where they are imported will serve for VAT purposes as for customs duty purposes, although it may be necessary to make clear that the act of importing occurs within the territory of the state for VAT purposes to avoid any legal problems.[90] Customs regimes, such as free ports, duty-free shops, and tax-free zones can be applied readily to VAT on this basis, the zones being regarded as outside the territory of the state.

IV. Taxable Supplies

A. Definition

[88]The primary rule in the European Union is that the service is supplied "where the supplier has established his business or has a fixed establishment . . . or . . . his permanent address or [where he] usually resides." EC Sixth VAT Directive, *supra* note 3, art. 9(1). The Swiss OTVA uses the same primary rule: OTVA art. 12(1). Does this amount to the same thing as a permanent establishment for direct tax purposes? In some cases, it will. The New Zealand approach is to base jurisdiction on the residence of the supplier. NZL GST § 8(2). However, unlike income tax, this is not subject to provisions about double residence.

[89] This is not the same thing as self-supply. Self-supply means that there is no supplier—the goods or services are consumed by the person producing them. Reverse charging applies where the person receiving the supply is deemed also to be the supplier so that a charge to VAT may be applied to it. *See* GBR VAT § 8 (from which the name "reverse charge" is taken).

[90] Normally, the customs law, or general law, of a state will provide that imported goods are within the state for procedural purposes. If any doubt arises about the extent of procedural or substantive VAT provisions in the absence of such laws or their clear application, a simple deeming provision will resolve doubts.

A "taxable supply" is a supply or transaction on which VAT is imposed.[91] When a taxable supply is made, the person making the supply, if a taxable person, must impose and collect VAT and account for it to the tax authorities. Even if the person does not do this, the tax authorities are still entitled to collect VAT from the taxable person on the assumption that the VAT had been imposed. On what supplies is VAT imposed? The law should impose it on all supplies of goods and services within the scope of VAT and made by a taxable person unless the law itself exempts the supply from VAT.

As previously noted, to be within the scope of VAT, a supply of goods and services must also be made (a) as part of the economic activities of the supplier, and (b) against payment (or for consideration) to that person from some other person. To complete the full definition of taxable supplies, the law must also therefore define both these criteria and determine the extent of exemption. Each of these issues is addressed in this section.

B. Economic Activities

VAT is a tax on supplies made in the course or furtherance of economic activity, or, put another way, as part of a business.[92] It should therefore be confined to activities of this nature and not be imposed on other activities, such as the personal hobbies of an individual,[93] gifts made for personal reasons, or charitable activities with no business or commercial content.[94] In

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[91] This term is used in the laws of New Zealand, NZL GST § 2(1); South Africa, ZAF VAT, and the United Kingdom, GBR VAT § 4(2). Title V of the EC Sixth VAT Directive, *supra* note 3, refers to "taxable transactions," as do Hussey and Lubick in their draft, *supra* note 13, § 211. The French CGI avoids the term, referring to "*opérations obligatoirement imposables*," FRA CGI art. 256, and the French version of the Swiss OTVA follows this vocabulary. CHE OTVA § 1 (*Opérations imposables*). The term depends on whether it is appropriate to use "supply."

[92] The phrase "economic activity" is based on the EC Sixth VAT Directive, art. 4, *supra* note 3. This is chosen from the range described in this note because it is felt the term is best fitted to be translated widely. The scope of the term is wider than "business," in the sense that the term tends to imply only profitable activities. Profit is irrelevant to VAT (although the profit motive is not). Note, however, there are alternative approaches. The New Zealand Goods and Services Tax Act refers to "taxable activity." NZL GST § 6. The South African VAT Act refers to a supply "in the course or furtherance of any enterprise...." ZAF VAT § 7(1)(a). The Irish VAT Act applies to supplies "in the course or furtherance of any business...." IRL VAT § 2(1)(a). The United Kingdom VAT Act uses the term "in the course or furtherance of any business...." GBR VAT § 4(1). Hussey & Lubick, § 211(b)(2), *supra* note 13, uses the phrase "in connection with a business," as does the American Bar Association draft, *supra* note 11, § 4003(a)(1). From this it will be seen that the general approach described here is widely adopted, but that there is no standard vocabulary for it.

[93] The definition of a "hobby" or leisure activity is difficult because it depends at least in part on the subjective intentions of the individual undertaking the activity and will also vary with the cultural context in which the individual is operating. The New Zealand Act excludes any activity of an individual "carried on essentially as a private recreational pursuit or hobby...." NZL GST § 6(3)(a).

[94] For a discussion of the economic and legal rationales for the tax, *see* ch. 7 *infra*. This approach can lead to the exclusion of some personal consumption from the tax base. This may be justified primarily by administrative consideration, such as difficulties in allocating input credits where supplies are not made as part of a business.

practice, the separate criterion that a supply of goods and services must be made, or treated as made, for consideration (or against payment) serves to remove many nonbusiness activities from the scope of VAT.

The rule under which only supplies by taxable persons are within the scope of VAT has a similar effect of excluding many transactions by individuals. However, whether or not a person is a taxable person is defined by reference to the total activities of that person, so an independent definition of taxable supplies is needed. Another unclear area is that of the activities of public authorities. These may be economic activities but may also be exercises of sovereign power with no economic content (as against economic effect). Examples are the activities of the armed forces or the courts.

As a result, the law imposing the VAT usually makes it clear that only economic activities are within the scope of the tax. How this is defined varies among laws.[95] Some laws require that the supply be made as part of economic activity, or the business activities of the supplier, or in the course or furtherance of a business carried on by the supplier. Others refer to supplies made by the taxable person acting as such, that is, acting in the capacity as a taxable person making taxable supplies.[96]

Some laws offer definitions of these activities,[97] but such definitions often do not add much to the overall clarification of the scope of the law. This point will need separate consideration in individual states. The key point is that here as elsewhere the law must be interpreted and applied so that it catches all economic activity that is not deliberately excluded. Government activity, charitable activity, and personal nonbusiness activity should therefore be excluded. The extent to which this point needs to be spelled out in the law will depend on the ease with which the concept of economic activity or business activity is understood within the state.

[95] *See supra* note 91 (addressing the varied vocabulary and national practices).

[96] This is the key approach of the EC Sixth VAT Directive, *supra* note 3, in applying VAT to the supplies of a "taxable person *acting as such*...." *Id.* art. 2 (emphasis added). This reflects the French approach of subjecting to the tax those who make, *in an independent manner,* habitually or occasionally, one or more supplies on which the VAT is imposed. FRA CGI art. 256A (emphasis added). The Swiss OTVA adopts the same focus, applying the tax only to those persons who exercise *in independent manner* a commercial or professional activity with a view to realizing receipts. CHE OTVA art. 17 (emphasis added).

[97] *See, e.g.,* NZL GST § 6(1). The United Kingdom defines "business" by implied reference to its income tax laws, *see* GBR VAT § 94(1)(using the same language as GBR ICTA § 18 (the income tax charge on business activities)), and this approach, adjusted to the local laws, might be useful.

C. Payment for a Supply

A supply is made for payment, consideration, or compensation[98] if the taxable person making the supply receives, or is entitled to receive, payment for the supply.[99] For this purpose, it does not matter in what form the payment is made. An exchange of goods is a supply for payment or consideration by both parties to the bargain, as is a supply of goods in exchange for the provision of services by the person receiving the goods.[100] In addition, it does not matter who makes the payment. It will usually come from the person receiving the supply, but the source is irrelevant. Therefore, some laws make it clear that all forms of payment are to be included as payment or consideration for the supply, even if this includes grants made by public authorities or other third parties.[101]

The concept that a supply is within the scope of VAT only if there is payment or consideration for it follows from the fundamental nature of the tax as one imposed on the value added by a transaction. If a supply does not result in gain for the supplier, directly or indirectly, then no value is added in making the supply. By contrast, the same reasoning argues that the consideration should include all forms of payment received by the supplier, in cash or in kind, whenever and however paid, and regardless of who pays them.

This definition is usually used as the definition of the taxable value of the supply, that is, the amount on which the VAT is imposed. Both efficiency and fairness therefore argue for a comprehensive definition.

Liability for payment of VAT on a supply does not depend on the transaction complying with provisions of the contract law or commercial law of the state. The obligation arises, in the usual case, because as a matter of fact, a taxable person has made a supply and has received

[98] Compensation" sometimes carries the meaning of pay for employees, which is not intended here. The alternatives are provided because in a common law country the term "consideration" normally conveys a sense of the consideration required as part of the necessary elements of a contract between two parties. "Consideration" has a wider meaning than this in a VAT context, because it includes payments from third parties and payments made even when, for some technical reason, no contract has been created.

[99] Note the discussion at the text accompanying notes 25–28, *supra*, on the terms used here. The wording "payment" is preferred to "consideration" for the reasons already discussed. There is no consistent usage internationally.

[100] Except where the person supplying the services is an employee of the person supplying the goods, in which case the supply of the goods is treated as a supply, while the supply of services is not treated as a supply for purposes of VAT. *See supra* sec. III(D).

[101] The inclusion of public subsidies "directly linked to the price of ... supplies" is found in the EC Sixth VAT Directive, *supra* note 3, art. 11(A)(1)(a), but is not found in all the laws of the EU member states. Subsidies not linked to prices or to any specific service or goods produced by the person being subsidized will not be consideration or payment for any specific item and are therefore not within the scope of VAT. It is possible that some direct tax provisions might amount to subsidies within this provision, although the writer is not aware of any practical example of this. It might be considered preferable to exclude such possibilities from the VAT law by providing an exemption for subsidies.

payment for it. The legal obligation to supply or pay is not relevant at this level. It becomes relevant if no payment is received, although the supplier is entitled to receive it, because the timing rules of VAT, discussed above, generally impose liability to pay VAT whether or not payment has been made at the time the VAT is due. Failure to pay should require a subsequent revision of the overall VAT liability of the taxable person. This is discussed below.[102]

Of course, if *A* pays *B* to make a supply to *C*, it must be asked who is being supplied. Is it *A* or *C*? This will depend in part on the laws of contract of the state. However, the amount paid by *A* is payment or "consideration" for VAT purposes even if there is no contract between *A* and *B*.[103]

D. Transactions Where No Payment Is Payable

In principle, if there is nothing paid or payable for a supply, then it is not a taxable supply. Safeguards are needed to prevent the operation of this principle from allowing transactions to escape a charge to VAT in inappropriate situations. For example, a taxable person who makes gifts of goods acquired for the purpose of the person's economic activities should be brought within the scope of the tax. Likewise, an individual trader who personally uses goods purchased for the business should also be made subject to VAT on the use. The reason for this is that the trader will have received a VAT credit (or deduction for input tax) for the goods on purchase. If there is no offsetting output tax, then there is a hidden subsidy of the trader's personal consumption and gifts.

It is therefore wise to extend the definition of supply for consideration to cover certain nonbusiness uses of a supply. The following transactions or occasions should be considered for this purpose:

(a) personal consumption by an individual of goods purchased for the individual's business, including consumption by the individual's family and household;

(b) gifts of goods, or the use of goods, made by a taxable person where the goods were purchased solely for the person's business, and the gifts are not themselves for business purposes (e.g., advertising or trade samples); and

(c) supplies of goods made without charge to employees of the taxable person.

[102] *See infra* secs. VI(E), VII(L).

[103] This complication does not arise where states do not require "consideration" as part of a contract. It is another example of a concept that does not readily translate between languages and law systems.

For example, a shopkeeper who purchases food as part of her or his business but later uses the food for personal consumption might be obtaining an unfair advantage. The shopkeeper will treat the purchase of the food as a supply on which any VAT paid can be reclaimed. When the shopkeeper consumes the food, if there is no charge to VAT, the shopkeeper will have been able to obtain a credit without any charge of tax to someone else. It is appropriate to provide that the supply or use of goods in this way is taxable. The shopkeeper will therefore have to account to the tax authorities for the value of the goods consumed as if they had been sold. At a minimum, the effect is to prevent excess tax credits from being given.

This rule will apply equally to the use of durable goods. For example, where the shopkeeper uses partly for private purposes a car that is regarded as purchased as a business asset, there should be an appropriate adjustment in the accounts of the shopkeeper to reflect this. It may be desirable to provide more detail of how such accounting should take place by regulation.

These rules usually apply to supplies of goods but not to supplies of services.[104] This is deliberate and is intended to stop any attempt to tax, for example, the situation where a builder repairs part of the builder's own home or a professional person applies part of her or his professional expertise to her or his own benefit. Attempts to tax such events will prove impracticable and may be potentially unfair, because the events may be part of the private activities of the individual and often do not involve any claim for tax credits. If goods are used as part of a supply of services (e.g., by a builder), then the rule should apply to the goods unless, as a practical matter, the goods are incidental to the services.

A rule that imposes VAT on a supply for which there is no consideration must also provide a taxable value to that supply. Alternative measures for determining that value are considered below.[105]

The general rule is sometimes made subject to an exception for advertising, trade samples, and trade use. A business may make gifts of goods it supplies, or make available free use of those goods, to customers as part of the business without consideration in such a way that the expense of providing the goods or the use of the goods is properly regarded as a business expense. This exception is designed to protect those practices from being subject to VAT if it is considered inappropriate to impose a charge on these gifts. It is for the tax authorities to consider whether more detailed guidance is needed to ensure that this provision is used appropriately, but not abused, by taxable persons.

E. Supplies Where Payment Is Not Full

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[104] This is another example where the theoretical tax base (consumption) does not correspond with the legal tax base as typically defined. *See* ch. 7 *infra.*

[105] *See infra* sec. VI(D).

Together with transactions for which no payment is made, but where it is deemed to be made, mention must be made of supplies where the payment made is less than the full payment or consideration that should, or might, be paid in the open market. If some payment is made, then the supply is within the scope of VAT. However, a partial payment is not itself a proper measure of the value added by the supply, and an alternative measure of that value added is needed. This was addressed previously.[106]

V. Exempt Supplies

A. General Comments

All states have found it necessary, when introducing a VAT, to create exceptions to the breadth of the potential scope of the operation of VAT. The standard way of dealing with this is to exempt certain forms of supply that are otherwise within the scope of VAT from liability to VAT.[107] By definition, exempt supplies are not taxable supplies.[108] By contrast, some states have adopted the practice of listing those supplies that are subject to VAT, rather than adopting the approach here.[109]

State practice on the exemption of supplies is inconsistent. Few common themes emerge. When VAT was first introduced, it was more common than it is now to apply VAT to supplies at

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[106] *See supra* sec. III(H).

[107] This pattern applies throughout the European Union under the EC Sixth VAT Directive, *supra* note 3, Title X. It is also the pattern explicitly adopted by New Zealand, NZL GST § 14, and the countries that followed the New Zealand approach of minimizing exemptions. *E.g.,* CAN GST § 123(1) (definitions of supply, taxable supply, exempt supply). The French CGI approach is similar, first stating the taxable transactions in broad terms, then listing the exemptions. FRA CGI arts. 256, 261; *see also* CHE OTVA arts. 4, 14 (first, setting forth the taxable transactions in a short, broad form, and then setting forth the exceptions).

[108] The terms "exempt supply" or "exempt transaction" are widely used in English-language texts. *See, e.g.,* EC Sixth VAT Directive, *supra* note 3, Title X ("exemptions"); IRL VAT, §§ 1(1), 6 ("exempt activities"); NZL GST § 14 ("exempt supplies"); South Africa, ZAF VAT § 12 ("exempt supplies"); GBR VAT § 31 ("exempt supplies"); *cf.* Hussey & Lubick, *supra* note 13, § 211(c)("exempt transactions"). The French approach is the same, the equivalent term being "*opérations exonérées*." FRA CGI art. 261. This stands in contrast with the Swiss approach in the OTVA, where the exemptions are stated as operations outside or excluded from the scope of the tax. CHE OTVA art. 14. This drafting approach therefore limits the scope of the tax, rather than carving out areas of exclusion within it. It is the main difference between the Swiss VAT and that of the EU states that surround it.

[109] For example, Argentina. ARG IVA art. 3. The VAT law in the People's Republic of China is also limited in scope, *see* CHN VAT art. 16 (items exempt from VAT), but this is because the VAT is deliberately not intended to have the universal coverage assumed in this chapter. Save where the intention is to limit the tax (not the approach adopted in this chapter or in most states), the approach adopted in the chapter is to be preferred to the alternative. This is because the approach of listing in some detail the kinds of transactions taxed inevitably means that any new kind of transaction or any transaction not specifically considered falls outside, rather than within, the scope of VAT. This renders the structure of the tax more open to the activities of those who plan to avoid tax and who will seek to identify and exploit the gaps in the list. A specific list of exemptions means that the "gaps" are deliberate.

a range of rates, including very low rates, and also to exempt a wide range of supplies. Since then, state practice has tended to reduce the range of supplies exempted and also to cut down the range of reduced rates of VAT and to increase the levels of the lowest rates.

Broad policy considerations, including ease of administration, the revenue levels produced by VAT compared with other taxes, the trade-off between the rate structure of VAT and the base on which those rates are levied (the broader the base, the lower the rates), fairness, and economic neutrality of the tax, all argue for minimal use of exemptions.[110] Political considerations in individual states and, in particular, the political perception of social considerations have been used to argue to introduce or preserve exemptions. An additional consideration to a newly introduced tax is that it is easier to introduce a broad-based VAT when the tax is first operated than to attempt to remove exemptions once established.[111]followed in Singapore. *See* SGP GST.

A few states have distorted the VAT framework even further by allowing zero rating of internal supplies.[112] As discussed below,[113] zero rating of exports and international supplies is very common. It is justified by the destination principle on which international transactions are subject to VAT. This does not apply to internal supplies. Zero rating may also be described as "exemption with credit," which is why it is mentioned here. To keep the discussion of exemption separate from the complication of zero rating, comment on zero rating is limited to the section on rates of VAT.

[110] *See generally* Tait, *supra* note 2, ch. 3.

[111] This was not true when the first VAT laws were introduced and when the EC first adopted VAT. New Zealand, in 1977, was the first state to adopt a form of VAT (deliberately named Goods and Services Tax to avoid comparison with the British VAT) with minimal exemptions. The New Zealand example has been

[112] The main state to do this is the United Kingdom. GBR VAT § 30. The extent to which zero rating was and is permissible under EU law has long been a matter of dispute. *See, e.g.,* Case 416/85, European Commission v. United Kingdom, 1988 E.C.R. 3127 (where the EC Commission successfully challenged several categories of supplies previously zero rated by the United Kingdom—in particular, many supplies of land and buildings). *See also* NZL GST § 11. Ireland also zero rates some categories of internal supplies. IRL VAT Second Schedule. In addition to exports, Italy zero rates certain supplies assimilated to exports, for example, supplies of airplanes to airlines engaged primarily in international transport. *See* ITA IVA art. 8 *bis*.

[113] *See infra* sec. VII(D).

B. Effect of Exemptions

It is often assumed that "exemption" results in the reduction of the VAT burden on a supply. This is true if the person supplied is a consumer and is not receiving the supply as part of a business. It is not true if the person supplied is a taxable person. Exemption of a supply to a business results in an *increase* in the burden of VAT on the supply. The reason for this is that the person running the business can offset the VAT against the VAT charged by the business, so claiming a full rebate for any VAT. The person making the exempt supply will probably have had to pay VAT on some part of the supplies made to it and will therefore have to pass some VAT on to the business as part of its price. It is this VAT that can be recovered if the supply is subject to tax, but that cannot be recovered if it is exempt. To avoid the distortions caused by this failure to recover, it is good policy not to exempt the types of supply that are typically made to business.

C. Specific Exemptions: Internal Supplies

Although there are strong policy arguments for minimizing exemptions, no state has succeeded in removing all exemptions from the law. Even New Zealand, which has been most successful in curbing the extent of exemptions, has maintained some.[114]

1. Land and Buildings

Transactions involving land and buildings are commonly exempted. As previously noted, many states provide that a sale of land, or other transfer of the title to land, is outside the scope of VAT. Other states achieve the same effect by exempting these supplies. Further, the law needs to deal with supplies of services related to land. The main service is the use of land, or leases or tenancies of land. For the same reason that land itself is exempted, it is common to find that leases and lettings of land are also exempted.[115]

At the same time, there is no strong reason for exempting commercial uses of immovable property, such as accommodation in a hotel. Accordingly, states restrict the extent to which leases, licenses, and tenancies are exempt. This may be done by excluding categories of land use (such as holiday use) from the exemption or by setting a minimum time period for exempt leases and tenancies (perhaps two months).[116]

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[114] The New Zealand exemptions are (in summary) financial services, certain supplies by nonprofit bodies, certain supplies of accommodation and land, and supplies of gold and fine metals. NZL GST § 14. *Cf.* SGP GST 4th Schedule (under which the only major exemptions are financial services and certain residential real estate transactions).

[115] *See infra* ch. 7.

[116] *See, e.g.,* the extent of the exemption and the exceptions from it, in the EC Sixth VAT Directive, *supra* note 3, art. 13B(b). This approach has been widely adopted.

2. Supplies by Nonprofit Organizations and Individuals

Many states provide exemptions for social goods and services, that is, supplies that are made to individuals and that do not form, or do not usually form, business supplies. An example of this is the supply of health services that are by their nature supplied to individuals. Many social supplies are outside the scope of VAT because they are not made as part of a business or are not made for payment or consideration (as with free health supplies from a state authority). The only supplies that fall within the scope of an exemption are those that would, but for exemption, be within the scope of VAT. A compromise recommended in this context is to exempt social activities of nonprofit organizations[117] and also of individuals providing supplies in similar circumstances to these organizations. If a charity provides hospital treatment or a religious organization provides education for a nominal fee, this can be exempted.

Similar activities carried out by an ordinary commercial organization will not be exempt. As a result, nonprofit bodies may be tempted to engage in commercial activities in such a way as to gain unfair advantage over ordinary suppliers. It is not enough to justify exemption that those profits are used by the organization for nonprofit purposes. For example, a religious organization that runs profit-making shops to help finance repairs to a religious building should be subject to VAT on the goods it sells. A distinction must accordingly be drawn between the social or charitable activities of nonprofit bodies and their commercial activities.[118]

3. Financial Services

Exemptions of financial services[119] are also included to avoid problems of complex administration, for example, where it is difficult to identify the value added within a transaction. In principle, any fee or charge for a financial service should be liable to tax. The difficulty is in identifying that charge separately from the other elements that are included when determining levels of payments of interest or fees. Those other elements include the real cost of the capital

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[117] This requires a definition of "nonprofit" organization or body. However, such definitions will usually be needed for income tax and for general legal purposes, so these may be used for VAT also.

[118] This is similar to the approach usually taken in an income tax. *See* vol. 2, ch. 19. The distinction is difficult to draw in many instances. For example, is a book-publishing activity carried on by a church or educational institution charitable or commercial in nature? A relevant criterion is whether treating an activity as exempt would distort competition with commercial activity.

[119] The exemption is usually focused on primary financial services, that is, services supplied direct by banks and finance houses. Definitions of services exempt under this category usually take the form of a list. *See, e.g.,* EC Sixth VAT Directive, *supra* note 3, art. 13B(d)(which has been followed by the Swiss OTVA art. 14(15) and in several other European states); NZL GST § 3 (followed in ZAF VAT § 2). The phrase "primary financial services" is not a formal phrase, but is intended to emphasize that it is the primary or core financial services, not all services connected with finance, that are exempted. One test is whether the supplier of the service is at risk. For example, the supplier of loan credits or banking services is at risk of loss because of the services. A provider of advice about where to borrow money or what banking services to use is not at risk. The exemption is normally considered relevant to the former category only.

involved, the risk to the lender of undertaking the transaction, and the inflation rate operative during the transaction. Transactions involving these elements may be termed primary financial services, and nearly every state exempts these forms of financial services for this reason.[120]included is the difference between the interest rate that, for example, a bank charges its customer and the interest it pays the people that lend to it. *See* Tait, *supra* note 2, at 92. Russia is the only state to have applied VAT to any form of primary financial service. The European Union has been considering restrictions on its broad exemptions.

D. Using Alternative Taxes

The exclusion of categories of supply from the scope of VAT, or the exemption of those categories, does not mean that those supplies need be excluded from all indirect taxation. Some examples may be given of this practice. It is noticeable that states, finding it less practicable to impose a VAT on forms of internal and international supply, are increasingly adopting other taxes to make good the revenue loss.

Examples of internal supplies taxed in this way are taxation of transactions involving land and buildings by imposing stamp duties or transaction taxes or high registration fees on the documents used for the transfers; exemption of insurance services, but the imposition instead of taxes on insurance policies or premiums; use of income taxes and other direct taxes to ensure taxation of payments for financial services (particularly interest) in place of the almost universal exemption from VAT of those services; exemption from VAT for betting and gaming, offset by specific taxes on those activities; exemption of activities where there is a state monopoly (e.g., postal services and some transport services), with fiscal adjustments to prices being used to the same effect.

Examples also occur of taxes being imposed on those international supplies that are exempted or zero rated by reason of the destination principle or pressures of competition. An increasingly common example is taxation of airports and airline tickets. Another is tourist taxes of various kinds, such as exit taxes when tourists leave the state. Further discussion of this topic is beyond the scope of this chapter.

E. Exemption of Diplomatic Activities

States generally have accepted treaty obligations to exempt certain supplies or imports as part of the recognition of diplomatic and consular immunities and of similar immunities for

[120] Several states have considered the taxation of financial services in detail, including New Zealand, Canada, and the United States, but found themselves unable to resolve satisfactorily the practical and conceptual problems raised by this charge to tax. There is an unresolved disagreement between experts about whether, and to what extent, interest should be subject to VAT. It is argued by some that the whole interest should be included in the potential charge to VAT. Others argue that the only amount that should be

international organizations.[121] These involve immunity from taxation for the embassies and consulates and for the recognized diplomats and consuls. These immunities are normally operated on a reciprocal basis and are based on the provisions of the international conventions that set out the required immunity from taxation.

In many states, no express provision is included in the VAT law on this matter, because the exemption is provided under the terms of international obligations that are part of national law. If such obligations are not self-executing in a particular country, or if the country wishes to clarify or expand on the exemptions accorded, a specific exemption needs to be provided in the VAT law.

F. Exempt Imports

International practice recognizes agreed categories of goods that are exempted from customs duty on import. Practice on this is well established and ranges from the import of a limited quantity of goods bought duty free in other states to exemption of gifts to charities or similar organizations. It is for consideration how far those exemptions should also apply for VAT purposes. Some are appropriate because of the underlying reason for the exemption from customs duty. Others would not be appropriate because they would create unfair competition with those supplying similar goods from within the state.[122] Principles of fairness and efficiency argue for minimal exemption from VAT even where customs duty exemptions apply, particularly if there is a business purpose behind the import. Whatever the policy adopted, it is convenient in most cases to frame the VAT exemptions on imports with the customs duty exemptions in mind, so as to avoid unnecessary inconsistencies.

One particular category of import has caused particular concern in developing states and the economies in transition. This is the import of foreign-produced machinery and equipment for the use of local businesses. In principle, such items should be subject to VAT when imported, if also subject to VAT when produced locally. In some states, there is no local capacity to produce such items, and importers lobby strongly for VAT exemption. The imposition of VAT would not be much of a problem for taxpayers if a credit for the tax were immediately allowed, but there are often restrictions on such credits (e.g., a delayed credit for capital goods, a requirement to carry over excess credits, or a de facto difficulty in obtaining refunds). If an exemption is granted for pragmatic reasons, it should be restricted in scope and time and conditional on the genuine business use of the equipment.

G. Problems Caused by Exempt Supplies

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[121] The main treaties are the Vienna Convention on Diplomatic Relations, Apr. 18, 1961; the Vienna Convention on Consular Relations, Apr. 24, 1963; and the agreements and conventions relating to individual international organizations. The exemption often takes the form of zero rating. *See infra* sec. VII(D).

[122] For example, an exemption on the import of manufactured goods will distort competition with any similar goods produced internally unless they are also exempt. There are, however, only limited circumstances in which it may be appropriate to exempt the domestic production of manufactured goods.

While, as discussed above, for both political and technical reasons it may be necessary to exempt a number of different types of supplies, exemptions create significant distortions beyond those that may be obvious (i.e., the fact that certain supplies to final consumers are favored over others). One of these distortions—the problem of exempt supplies made to businesses that are VAT taxpayers—has already been discussed above.[123] Another important problem is that of input credits to a business that makes both taxable and exempt supplies.[124] That problem involves the conceptual and practical difficulty of determining which inputs are attributable to exempt supplies. Inputs to exempt supplies cause an additional problem; namely, they create an incentive for a person making exempt supplies to supply itself through its own employees, instead of purchasing inputs from others. For example, a bank whose supplies are entirely or largely exempt financial services may enter into a contract with a security company to provide security guards. The security company will charge VAT to the bank if it is a taxable person, and the bank will be unable to recover the VAT as an imput credit.[125] The bank would have an incentive to hire security guards as its own employees. Because employee services are outside the VAT, this maneuver quite legally minimizes the bank's tax costs. In response, some states have imposed VAT in certain cases of self-supply by taxpayers.[126] However, antiabuse rules of this kind are of necessity limited in scope and cannot be generalized unless the VAT is fundamentally restructured (such as by treating all employee services as taxable). In addition to such legal avoidance, exemption leads to temptation for evasion: while normally businesses do not have an incentive to avoid VAT on their supplies (except as part of a scheme of tax evasion that would also involve the understatement of sales), a person making exempt supplies has an incentive to pay its suppliers under the table.[127] Widespread exemptions can therefore undermine the integrity of the VAT as a whole. This is a consequence of the invoice-credit method of VAT. The method works reasonably well if all supplies are taxable, but starts to break down when some supplies in a chain are exempt.

VI. Taxable Value of Supplies

A. Charge to VAT

[123] *See supra* sec. V(B).

[124] *See infra* sec. VII(G).

[125] *See Id.*

[126] *See* GBR VAT sec. 5; The Value Added Tax (Self-Supply of Construction Services) Order 1989, now SI 472, *reprinted in* Butterworths VAT Handbook 1995 at 381. The order treats a taxable person who constructs a building for use in the taxable person's business as making a supply to itself. This will give rise to tax liability only if the person is not able to claim a full input credit for the supply.

[127] For example, in Georgia restoration work on churches is exempt. A contractor hired to restore a church has an incentive to pay its suppliers under the table. If the contractor paid VAT on its supplies, it could not recover the VAT as an input credit.

VAT is designed as a tax levied as a proportion of the value added on any taxable supply. It is therefore necessary to attribute a value (referred to as "the value"[128]) to all taxable supplies to ensure that this objective is achieved. To be consistent with the fundamental principles of the tax, the value to be taxed must reflect the value added by the supply.

B. Value of Internal Supplies

The general rule for valuing a supply for VAT purposes is to value it at the total of all payments, or consideration, that the supplier receives or is entitled to receive as a result of the supply. In other words, the value is taken as the actual realized value. This relates to the requirement, already discussed, that there be payment for a supply in most cases for it to be within the scope of VAT. All forms of payment or consideration, whether paid by the person supplied or some other person, are relevant for that purpose. They are also relevant in determining the total value.

For the purposes of the general rule, it is irrelevant whether the total payment represents a "good" or a "bad" price for the supply, as long as it is a genuine price and not a sham. It is common to find rules that displace the price paid in certain cases, but in most commercial transactions it is a matter of indifference to the tax authorities if the price is "too" high or low. This is because any distortion of the price is neutralized if both the supplier and the person supplied are fully taxable persons. Any increase or decrease in the VAT collected will then be offset by a similar increase or decrease in the VAT credit or input tax deduction claimed. The matter is only of concern if the high or low price increases the overall amount of input tax available for deduction or decreases the overall collection of output tax. This will happen only where one party is a taxable person and the other is not.

C. Tax Inclusive vs. Exclusive Base

The value of a supply should be taken as including all other taxes paid on that supply. VAT is not an alternative form of excise tax or customs duty, but is a separate tax. Both customs duties and excise taxes reflect the state's separate decisions to increase the price of the dutiable and excisable products by the amount of the duty or tax. That represents the value of final consumption of the goods for VAT purposes and is therefore the basis of the value for VAT.

If it is felt that the combined effect of excise duty and VAT on a product is too high, the answer lies in adjusting the level of excise duty, not of the VAT. This is not only consistent with principle, but is also both simpler to administer and less distortionary. The alternatives would

[128] “Value" is the simplest English term (and is used, for example, in New Zealand, NZL GST § 4, and the United Kingdom, GBR VAT § 19), although "taxable amount" is also used in the Basic World Tax Code, Hussey & Lubick, *supra* note 13, § 221. As the tax is a "value-added" tax, it seems most appropriate to reflect the core wording here. The term "taxable value" is another option but is not used here because it merely adds to the length of the law without assisting understanding. The French CGI uses "base d'imposition," art. 266, and the Swiss (French) OTVA refers to *base de calcul*. CHE OTVA art. 26.

either be to exempt the items from VAT if subject to duty or to calculate the VAT on the price without counting the duty. Both would add significantly to the overall administrative burden on suppliers and the tax authority for no fiscal purpose.

One proviso to the general rule is needed. The law should state that the value does not include the VAT itself. Otherwise, a circular element is introduced into the calculation. The amount paid by the customer for a supply may be defined as including or excluding the VAT. For example, the price may be stated as "100." In some states, it is assumed in such a case that the VAT is to be added to that price, so that the full amount paid by the customer is 100 plus VAT.[129] In other states the assumption is the reverse of this, namely, that if the price is stated as "100," then that is the total that the customer is obliged to pay, including VAT.[130] In the first case, the value of the supply is, as defined above, 100. In the second case, the value *plus the VAT* is 100. For example, if the rate of VAT is 10 percent, then in this case the value is 90.9, and the VAT payable is 9.1 (rounded to the nearest decimal point).

The decision whether to include or exclude the VAT in determining the relationship between the value and the total consideration will need to be taken into account in framing the VAT law. However, it is a rule that belongs to the commercial law or consumer law of the state, not the VAT law. Any measure penalizing the exploitation of the rule to overcharge customers also belongs in a law other than the VAT law.

D. Fair Market Value of Supply

Where the person supplied is not a taxable person, or not a fully taxable person, but the supplier is a fully taxable person in respect of the supply, there may be a temptation for taxpayers to understate the price to avoid creating input tax that the person supplied cannot reclaim. There are also cases[131] where a supply is treated as being made for payment, even though nothing is paid or payable. In both cases, it may be considered appropriate to override the general rule.[132] Instead, value would be based on an independent measure of the value added by the transaction. This would normally be the open market price, or arm's-length price, of the supply. Again, clear rules will be needed to apply an alternative basis of valuation.

Temptation to adjust prices may also arise in the case of mixed supplies or supplies where a number of different parties are involved. For example, where a taxable person is acting on behalf of someone else, those transactions undertaken as agent for the other person may not

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[129] This is the standard approach taken with regard to sales taxes in the United States.

[130] This is the standard approach taken in Europe.

[131] *See supra* sec. IV(D).

[132] This is a common, but not universal, practice. For example, in Japan there is no power to override the value determined by the parties. Instead, the Japanese tax authorities may use the "substantial attribution" rule (in CLT art. 13) to attribute the value to the person who is in substance, rather than in form, receiving it. *See supra* note 54.

be subject to VAT because the principal is not a taxable person. Here, close attention needs to be paid to ensuring that the total payment is shared properly between the different parts of the total transaction. This does not require the *total* payment to be altered. Rather it calls for careful auditing.

The open market price—or some other objectively determined price—will need to be determined in any case where a supply is treated as made for consideration although no consideration is actually paid or payable. It will also be needed in any other case where the law allows the tax authorities to override or ignore the actual price.

Put at its broadest, the power to override may be justified in any case where the relationship between the supplier and the person supplied is such that the price fixed between them may be open to pressures other than market pressures and where one or both parties are not fully taxable persons in respect of the supply. This will, for instance, include transactions between related persons. More generally, this issue can be addressed through legislative provisions similar to those found in income tax law (and customs law).[133]

E. Adjustments and Rebates

The rules to determine value need to be simple and easy to apply at the moment of sale, without delay or difficulty. They are applied in millions of transactions by everyone actually making supplies and fixing prices. Save for specifically documented adjustments, the person making the sale or supply must be able to determine what figures to put on the VAT invoice at that time without any need to revise them.

The rules determining value must therefore deal clearly with any adjustments, such as discounts, made to prices. For example, if goods are sold as "normally 100, but 90 for today only," what is the price? The answer is that today the price is 90, that is, the value actually added by the transaction. However, tomorrow, it is 100, unless the lower price is actually agreed upon. For this reason, the value should be the price after any discounts.

The position is more difficult if the price for a sale is "100, but only 95 if you pay within seven days." In this case, the customer might pay either 95 or 100, and the supplier does not know at the time of sale. Here, the usual practice is to take the lower price, which is all that the customer needs to pay. The extra 5 might be regarded as a fee for late payment (and as such might be regarded as payment for an exempt financial service). Another complication is the use of vouchers or tokens. For example, a person buys an item at a shop and pays the full price, but also receives a voucher good for a reduction of 10 in the price on purchase of a second item. The sale of the second item will then be discounted to this person, even though others pay the full

[133] This topic, together with the problems of definition within it (such as the problem of defining a market price), is of considerable concern in the income tax. It links, in particular, to the problem of transfer pricing. This topic receives thorough discussion elsewhere (*see* vol. 2, ch. 18) and is not covered further here.

price. The value added, in the case of the sale to this person, is always the discounted price. This is both consistent with the principles of the tax and the most practical answer.

Further complications arise where the effect of a discount, or an arrangement on purchase, results in a later adjustment. In this case, no account should be taken of the change in connection with the first transaction. This should be dealt with as a separate transaction and treated in the same way for administrative reasons as a separate supply, even if the supplier pays money to the person supplied and therefore reduces the net consideration. When the adjustment occurs, the VAT should be added, or rebated, in exactly the same way as on the original supply. It is important from the point of view of the tax administration that there be no reason to alter the VAT invoice issued in connection with a transaction. Once the VAT invoice is issued, there should be no provision allowing for its alteration, except for the correction of an error. For example, if a customer pays $1,000 and an invoice is issued for $100, then a corrected invoice should be issued upon discovery of the mistake.

F. Value of Imports

In the special case of imports of goods, it is standard practice to use the customs value of goods as the value for VAT, subject to specific adjustments. The "customs value" generally represents an internationally agreed upon approach to the valuation of goods subject to customs duty and therefore minimizes the scope for difficulty or dispute in levying VAT on the import. It also simplifies the operation of VAT on imported goods and allows the VAT to be calculated at the same time as the customs duty and by the same officials. The customs approach may also be used when fixing the value for VAT of goods exempted from customs duty but liable to VAT. Attention has already been drawn to the advisability of aligning as far as appropriate the VAT exemptions on imports with the exemptions that apply under the customs code.

Two standard adjustments are needed to convert the customs value of goods to the value for VAT. First, consistent with the policy discussed previously on internal supplies, the value for VAT should include the customs duty itself. Excises levied on imports should likewise be added to the VAT base. Second, the customs duty will usually include all freight and handling charges and similar costs to bring the goods into customs control. The obligation on the person delivering the goods to the state may include further charges and the cost of inland freight to the place of delivery within the state. If the goods are not handed over at the time or place of customs clearance, then the value for VAT should include all additional freighting and other charges incurred up to the time of delivery to the customer. This is, again, consistent with the approach taken on internal supplies. If these extra charges are separate, then they may need to be dealt with as separate supplies.

VII. Payment of VAT

A. Determining the Amount to Be Paid

Two important elements remain in order to establish how much VAT the taxable person must pay to the tax authorities. The first is the rate of VAT to be paid on the value of any supply. This, together with issues already discussed, deals completely with the question of determining the output tax on any supply. The second is the offset of input tax against output tax to identify the net VAT payable. These topics, and associated issues, are discussed in this section.

B. Rates of VAT

Countries' practices in setting the rate or rates of VAT have varied widely over the forty years since the tax was first introduced. Some countries have imposed six or more effective rates at the same time. The result has been some confusion as to the purpose of the tax and considerable administrative complexity and market distortion. Recognition of these problems, and of the underlying policy issues, has led states to abandon complex rate structures. A detailed discussion of the relevant policy issues is beyond the scope of this chapter.[134] However, recent practice may be noted, and best practice commended.

It is now generally accepted that the VAT should not be used as a vehicle for imposing luxury rates of indirect tax.[135] If a state wishes to impose high rates of indirect tax on specific goods or services, then the generally easier way to do so is with a separate excise duty or tax.[136] This is the usual route now chosen. Internally, it simplifies the identification of luxury goods. Internationally, it avoids any accusation that differential rates of VAT are being used for discriminatory purposes.

It follows from this that VAT will have a main or basic rate and one or more lower rates. The main rate of VAT is an important matter of fiscal policy in any state and the level varies significantly among states.[137]

[134] *See* Tait, *supra* note 2, ch. 2.

[135] This is expressly excluded within the European Union. EC Sixth VAT Directive, *supra* note 3, art. 12. Several EU states that used to impose luxury rates of VAT have therefore withdrawn them. Some African countries still use luxury rates (in some cases first introduced following the French example, although France itself has since adopted the EU rules). An interesting example of a VAT-style tax being expressly geared at luxury items is the Wholesale and Luxury Tax in Venezuela. VEN IC. The VEN IC is levied at a standard rate and at two additional luxury rates. *Id.* arts. 56–58. The additional rates are applied to items such as cars, tobacco, jewelry, and cable TV. *Id.* arts. 57–58.

[136] In making such a decision, however, one would have to bear in mind the manufacturing process for the goods in question and, accordingly, the suitability of excise administrative procedures compared with procedures under the VAT.

[137] The European Union has agreed upon a minimum main rate of 15 percent, and rates vary from that to 25 percent in Europe. EC Sixth VAT Directive, *supra* note 3, art. 12(3)(a); OECD, Consumption Tax Trends 16 (1995). Elsewhere, countries with very broad forms of VAT can afford lower rates (such as New Zealand, NZL GST § 8(1)(rate of 12.5 percent)), while states under fiscal pressure have had rates of 30 percent or above. Tait, *supra* note 2, at 40.

Clearly, the higher the main rate, the more pressure there will be from lobby groups to apply one or more lower rates to specific items. In practice, it should be remembered that no long-term social objective is achieved by setting any rate other than the main rate on goods or services supplied to fully taxable persons. There may be a cash-flow advantage to them in not having to pay quite so much VAT before making a claim for the VAT credit for deductible input tax, but in the longer run the VAT they pay is reclaimed against their own output tax as a VAT credit for input tax and thus has no residual effect.

Arguments for lower rates therefore concentrate on socially important goods such as food, and socially important services that are not exempted or outside the scope of VAT. Of course, there is a cost in VAT forgone in allowing a lower rate, and any lower rate will usually cause either the main rate of VAT to be higher than it otherwise would be, or other taxes to be higher, given the total tax revenue. Some states have decided that it is better to collect VAT at one rate and to deal with such pressures in other ways (through subsidies or adjustments in social security entitlements), while others have opted for a lower rate. Again, practice used to involve a range of lower rates but has tended to simplify toward one lower rate (as is happening within the European Union) or none.

C. Zero Rate

In addition to the main rate of VAT and any lower rates, it is normal practice for states to have a zero rate of tax, although it may not be called this.[138] A zero rate means that, while no VAT is due on the supply, the supplier remains entitled to claim any input tax incurred in making that supply and is therefore entitled to a refund of that input tax if there is no output tax against which to offset the input tax.

The zero rate is sometimes known as exemption with credit.[139] Both terms are correct, depending on the approach taken to exemption and the structure of the tax. From one point of view, a tax rate of 0 percent is nonsense. It is not a rate of tax, and no tax is collected. A zero rate is therefore an exemption of the supply from output tax. A contrary argument is that in taxes with progressive rate schedules, a zero rate of tax is commonly found at the bottom bracket, so this is not a contradictory concept. It certainly works mathematically. The effect of a zero rate is approximately the same as that of a very low positive rate of tax. In any event, a zero rate does

[138] "Zero rate" has become the usual English-language term, except in EU documents. It is used, for example by Tait, *supra* note 2, ch. 3, and Hussey & Lubick, *supra* note 13, § 222; and in IRL VAT Second Schedule; NZL GST § 11; ZAF VAT § 11; GBR VAT § 30; KAZ TC arts. 62–66. (There is inconsistency in the use of the hyphen—both "zero rating" and "zero-rating" are found.) There is no direct French equivalent. The French CGI, art. 261, addresses "*opérations exonérées*," and this term is followed in the Swiss law. *See* CHE OTVA art. 15.

[139] Technically, in EU law, the requirement is that states exempt the supplies that are discussed here as zero rated. *See* EC Sixth VAT Directive, *supra* note 3, arts. 15–16. However, a separate provision grants a right of deduction for input tax. *Id.* art. 17. This has the same effect as zero rating. It is the form followed in most EU countries and elsewhere in Europe, for instance in Bulgaria. BGR VAT arts. 7–12.

make the supply "taxable" in a technical sense and therefore achieves the objective of bringing these transactions within the operation of the VAT credit for input tax, which an exemption does not. This is because a VAT credit is allowed only for inputs to be used in making taxable supplies. For this reason, those who do not accept the existence of the zero rate recognize the right to the credit for input tax by saying that these supplies are "exempt with credit." There are arguments in favor of both approaches, and the present writer will readily confess to regarding both as entirely proper ways of defining the process. The question is one of terminology, and the appropriate solution may depend on the language and practice of a particular state.

D. Zero Rating Exports and International Supplies

Why do states have a zero rate? Its main use is to deal with exports of goods and exported supplies of international services. The destination principle calls not only for removing a direct charge to VAT from exports and international services, but also for removing any VAT indirectly imposed on those supplies in the form of input tax paid by a supplier. Only if the input tax is rebated will the goods leave the state free of VAT. The arguments about zero rating exports are also sometimes applied to supplies to diplomats, which are typically zero rated. The justification is that embassies are to be regarded as outside the tax territory of the state.[140]

Another specific service that is often zero rated is the supply of international transport.[141] The zero rating is usually widely drawn to cover both the supply of the services themselves and also supporting supplies of goods and services (e.g., selling provisions to shipping or repairing an aircraft). This is often done to protect international transport businesses based in the state from uneven competition from other states.[142] For example, two companies, one based in state *A* and the other in state *B,* supply bus services between cities in state *A* and state *B*. If state *A* zero rates the transport supplies, and state *B* does not, there will be a strong inducement for passengers to travel with state *A*'s company. In addition, if tickets for the state *B* company are sold in state *A*, they may also be zero rated. An alternative approach of taxing the services in state *B*, but not beyond *B*'s frontier, might be theoretically attractive but will pose practical difficulties. Some states have adopted the alternative approach of imposing a separate excise tax on the tickets provided for international transportation.

Coordinating rules will be needed to deal with supplies that fall under both exemption and zero rating. For example, if medical supplies are generally exempt, what about an export of

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140 *See supra* sec. V(E) (discussing the exemption of diplomatic activities).

141 This applies throughout the European Union and elsewhere in Europe. EC Sixth VAT Directive, *supra* note 3, art. 15. It is easier for island states, such as New Zealand, to avoid this problem because the competition is less severe.

142 It also avoids problems for some states that have goods transiting across them between third states. The transport service is supplied in the state, but none of the parties involved need have any contact with it (save for the presence of the vehicle and cargo during transit).

medical supplies? Such an export should be treated the same as exports generally, for example, by excluding from the category of exempt transactions those that fall under zero rating.

E. Should Internal Supplies Be Zero Rated?

A few states zero rate some internal supplies. This is widely viewed as inappropriate, because it amounts to a subsidy of the activity or transaction treated in this way. It would usually be better to identify the policy reason for the subsidy and address it through a direct subsidy.[143]its activities is zero rated than is in fact the case. On the other hand, one aspect of zero rating is more consistent with the structure of the VAT: unlike exemptions, zero rating does not provide an incentive for suppliers to avoid input tax. *See supra* sec. V(G).

A few special cases exist where zero rating may be justified on internal supplies, notwithstanding the above point. One case is of monetary supplies made to the national bank of the state. Failure to protect the national bank from a charge to VAT on all supplies of gold to it may result in taxing the national reserves. Similarly, it is normally regarded as appropriate to protect supplies of the currency itself to the central bank from the imposition of VAT. This will have to be done in any event in some way, and the simplest way is through zero rating. Other financial supplies are of course likely to be exempt.

Another special case is that of the sale or other transfer of an ongoing business. The problem arises when a taxable person transfers a business activity to another taxable person. Strictly, the seller must treat the sale of the business as subject to VAT (usually at the main rate). The buyer must therefore pay, along with the purchase price, the VAT on that price. If the purchaser is also a taxable person in respect of that business, then the purchaser can claim back the whole of the VAT paid as a credit for input tax. However, the associated credit or refund may take some time to receive, depending on the rules in the state dealing with large rebates of input tax. There are therefore significant potential cash-flow problems for the purchaser even though, in the long run, the input tax can be recovered. For the tax authorities, the sale of an ongoing business presents no problem. The VAT is accounted for from the business before and after the sale in the same way. In the long run, therefore, the sale will involve no additional VAT or loss of VAT.

To avoid this short-term problem, and recognizing that in the long run there is no revenue significance in this kind of sale, some states provide that such sales or transfers are zero rated. This means that the transaction remains taxable and does not distort any claims for input tax by

[143] As discussed in sec. V(G) *supra*, there are similar problems with using exemptions. If it is determined to provide a VAT preference rather than a direct subsidy, the question arises whether the preference should take the form of exemption or of zero rating. The latter is more costly in terms of revenue. It can also be unwise as a political matter, because it would open the door for arguments to zero rate other internal supplies. Zero rating also leads to administrative problems, in that a supplier may claim that a greater portion of

the seller. Other states remove the transaction by taking it outside the scope of VAT, but in this case an adjustment may need to be made to deal with the problem of input tax.[144]

F. Paying VAT to the Tax Authorities

The law must establish a mechanism for each taxable person to account for the VAT collected by that person on sales, and to pay this tax over to the tax authorities at regular intervals, after deduction of any allowable input tax. The procedures for doing this are noted briefly in the next section. The element of substantive law involved is the right to claim a deduction for input tax.

[144] If a sale or other transfer of an ongoing business is taken outside the scope of VAT, then it must be provided that the business is treated as continuing regardless of the change of owner to prevent a break in the flow of output tax and claims for input tax and also to prevent any claims by the new owner for input tax already credited to the former owner.

G. Entitlement to Credit for Input Tax[145]

It follows from the definition of "value added" on which VAT is based that any VAT incurred by a taxable person as input tax should be repaid to that person in some way. The usual method of repayment is to allow the input tax to be set off as a deduction or credit[146] against output tax collected during the same period. A duty is imposed on the taxable person to pay only the net amount to the tax authorities. In principle, therefore, all relevant input tax incurred by a taxable person should be available for credit in this way.

While the mechanism for crediting input tax presents few difficulties for taxable persons who make only taxable supplies (or exempt supplies that carry a right of credit), two sets of problems arise in particular cases. The first is that of the person who makes both taxable supplies and other supplies (either exempt supplies or supplies outside the scope of VAT). The second is the need to safeguard the award of input tax credit against fraud and transactions that may cause revenue loss to the state by avoidance or evasion. In addition, many states have, partly to deal with the second problem, made provision in the law disallowing credit for some kinds of input tax. Further, credit of input tax on capital goods is sometimes limited and spread over a period of years. Both sets of problems are discussed below.

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[145] Here again, there is inconsistent terminology in different VAT laws. The use of "output tax" (meaning the VAT imposed by the supplier on taxable supplies made by the supplier) and "input tax" (meaning VAT paid by the supplier) is now widespread in English-speaking countries, but it is by no means universal. The terms are used by Tait, *supra* note 2, but not in Hussey & Lubick, *supra* note 13, which uses the term "input credit." *Id.* § 231. "Input tax" is a defined term in the laws of New Zealand, NZL GST § 2(1); South Africa, ZAF VAT § 1(xxix); and the United Kingdom, GBR VAT § 24, but is not found in the EC Sixth VAT Directive, *supra* note 3, which focuses on tax for which the right of deduction has arisen. *Id.* arts. 17–18. The Swiss law refers to a right of deduction for the "previous tax" (*impôt préalable*). *See* CHE OTVA art. 29. The French law is not as consistent, referring to a deduction for the VAT "imposed on the elements of the price of a taxable operation", *see* FRA CGI art. 271, and in another place to a "deduction for the tax imposed on the goods or services which are not used exclusively for the realization of taxable operations." *See* FRA CGI art. 273. The lack of a precise term in the statute is perhaps due to the fact that the operative rules for input tax are left to regulations. *See id.* The term in the German law is *Vorsteuer*, which could be translated as advance tax. *See* DEU UStG § 15.

[146] Again, there is inconsistent use of terminology about whether the input tax is available for deduction or credit. We have noted that the EU laws refer to a right of deduction. EC Sixth VAT Directive, *supra* note 3, arts. 17–18. The alternative form is to refer to a "tax credit" or "VAT credit." The latter term is, in the view of this writer, slightly preferable because it emphasizes that the input tax may exceed the output tax (and, at the extreme, that there may be input tax when there is no output tax), so that the "deduction" exceeds the sum from which it is deducted. This gives rise to an excess deduction or, better, an excess credit. It also helps to emphasize that there should be a credit (or deduction) for all VAT incurred by the supplier for business purposes. Direct tax laws impose strict controls on deductions, and such thinking sometimes erroneously strays into VAT laws.

H. Partial Exemption

The main category of taxable person with problems in identifying the amounts of input tax available for credit is businesses that make some taxable supplies and some exempt supplies. These are often termed cases of partial exemption. The problem is the same for those that make supplies outside the scope of the tax. If a state has many exemptions from VAT, or has a limited base for the tax, these problems will be common. If a state exempts goods of a kind available for retail purchase, then a shop or business that sells these goods and other goods will be partially exempt. Most states exempt financial services; consequently, banks and other suppliers of financial services routinely confront the problems of partial exemption. For example, a finance house makes supplies of financial services, which are exempt, and also supplies business advice that is subject to VAT at the main rate. The finance house is a heavy user of telephones and incurs a substantial amount of VAT on its telephone bills. If the finance house were allowed to claim all the input tax on its telephone bills, it would be receiving excessive input tax. The law therefore allows the finance house to claim the VAT on the telephone bills that relate to its business advice services but not to its financial services. How is this to be handled?

The law must limit the right to claim a credit so that it covers only input tax incurred for the purposes of making taxable supplies. This requires a careful review of the total input tax paid by a partially exempt taxable person to separate out that input tax that is to be allowed and that which is not. There is no quick but entirely accurate way of doing this. The principles are that input tax incurred only for the purpose of making taxable supplies is allowed, but input tax incurred only for some other purpose or purposes should not be allowed. Input tax incurred partly for the purpose of making taxable supplies and partly for other purposes should be apportioned so that only the part of the supply devoted to making taxable supplies is available for credit.

There are significant practical problems in attempting to divide each item of input tax in this way, and a variety of solutions have been adopted in practice, such as averaging or estimating or generalizing from a partial audit of input tax. For example, the rules may be applied strictly for a trial period. During this period, the taxable person is required to identify any input tax paid on supplies acquired solely for the purpose of making taxable supplies, any input tax paid in connection with making supplies that are exempt, and the input tax to be apportioned. The input tax is apportioned in proportion to the total of taxable supplies and the total of exempt supplies (and, depending on how the law is structured, supplies outside the scope of the tax). This produces an overall ratio of taxable supplies to total supplies that might be, say, 40 percent. In the following year, unless either the tax administration or the taxpayer dissents, the same ratio of 40 percent can be used for allowing input tax without asking the taxable person to keep the same detailed records.

I. Disallowed Input Tax

It is increasingly common practice for states to deny input tax credits for certain kinds of supply. The main group may be described as supplies of or for luxuries, amusement, or entertainment. The precise application of a rule such as this will involve careful definitions. For example, supplies of "luxuries" to a luxury business cannot be disallowed fairly if the business is thereby prevented from recovering input tax on goods it buys in order to sell. By contrast, expenditure on business entertainment, such as a lavish meal for members of the staff of the taxable person, may more readily be disallowed. The justification is that these forms of input are always personal consumption. In effect, there is considered to be a deemed supply to the person benefiting from the expenditure. Denial of the input credit is an administratively simple mechanism for dealing with this deemed supply. There will also always be marginal cases, such as the claim that a racehorse or a yacht bearing the name of the taxable person's products is not a luxury or that a particularly expensive item is bought for the business and not for the benefit of those who own the business.

In some states, all credit for input tax on cars is disallowed, sometimes with exceptions, such as for taxis and rental cars.[147] Input tax on vans or trucks is allowed. Many states already have rules for income tax and other purposes distinguishing between cars and vans, and they can also be used for this purpose.

J. Capital Goods

For revenue protection reasons, some states have rules that require input tax on capital goods, or certain kinds of capital goods,[148] to be set off over a period of years in much the same way as the deduction of capital expenditure is controlled by capital allowances or depreciation for income tax purposes.[149] These rules are exceptions to the principle that, in general, no distinction is made for VAT purposes between revenue transactions and supplies and capital transactions and supplies. As such, rules identifying capital goods and applying limitations on credit of input tax are a breach of the fundamental principles underlying VAT because they

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[147] The EC Sixth VAT Directive, *supra* note 3, art. 17(6), provides that "VAT shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainments" and provides a procedure for agreeing on these disallowances. However, member states have failed to agree on a common set of rules for such deductions, and the article allows existing national disallowances to continue in force. The disallowance on cars applies in Denmark, France, Portugal, and the United Kingdom, and with exceptions in Greece, Ireland, Italy, and Spain. *See* Tolley's VAT in Europe, ch. 7 (1995). If a credit is denied for cars, it will generally be appropriate to exclude from the denial cars that are used for rental or that are held for resale.

[148] This approach was carried into the VAT in Russia and some other states of the former Soviet Union from the previous turnover tax under which expenditure on equipment did not qualify as a deduction against the sales tax payable. The EC Sixth VAT Directive, *supra* note 3, provides for adjustments for input tax credits to spread the credits on equipment over five years and on immovable property over ten years, although member states have the right to disapply the rules. *Id.* arts. 19–20.

[149] If such rules are adopted, the law must address the same issues, including the distinction between capital and revenue items, as under the income tax. *See* vol. 2, ch. 17.

prevent—or, rather, delay—the credit of all relevant input tax. As delay imposes cost, these rules create a distortion.

K. Safeguarding the Revenue

Claims for input tax credits are an inherent part of VAT, which is a tax on differences. Any attempt to curb input tax credit is therefore wrong in principle because it changes the way VAT operates from a tax on value added to a tax on gross sales prices. States are entitled to protect the revenue base of the VAT against abuse of the credit procedure in order to ensure that improper claims for input tax are not made. A major threat to the integrity of the revenue base exists where input tax exceeds output tax and a claim is made for a refund to the taxable person of the amount of the excess. In a perfect VAT system, all such claims should be allowed within the normal time scale for paying the tax. However, some states have encountered widespread fraud in the operation of this practice, making safeguards necessary. Some can be linked specifically with the payment of a refund. The state should ensure that the rules dealing with input tax credits are clear and effective so as to prevent any doubt as to the extent of entitlement. This should also make it easier to check claims and audit taxable persons making claims.

L. Bad Debts

The rules suggested in this chapter are designed to ensure timely payment of the VAT related to a supply. Under these rules, occasions would frequently arise when the VAT has been paid on a supply to the tax authorities, but payment for the supply is not received until a later time. In the extreme cases, more common in economies in transition, some or all of the payment will not be received at all, because the customer becomes insolvent or in some other way the debt becomes bad.

Payment of VAT to the tax authorities ahead of receipt of the VAT from the customer is a normal aspect of a VAT. This may provide a cash-flow disadvantage to the taxable person. In many states, this disadvantage is not particularly significant because the taxable person benefits from a much greater cash-flow advantage that arises from holding VAT collected from some customers for several weeks before having to pay it to the tax authorities. In addition, the supplier may recover some of the economic cost of the delay in payment through an interest charge on the sums outstanding. Where this happens, the interest charge is not subject to VAT. In addition, where the customer is a taxable person and receives an input credit for the VAT on the transaction, the customer could use the cash saved by the input credit to pay the supplier at least the amount of VAT. The parties are always free to make such an arrangement as part of the terms of their sales agreement. If they do not make such an arrangement, then the seller is in effect extending a credit to the purchaser above and beyond the cost of the goods.

Bad debts may be seen as presenting a different problem. It is no longer one of cash flow, but of ensuring that the tax remains a tax on value added. If payment is not received by a supplier, then the supply may result in a loss to the supplier, with no value added. A distinction may be drawn between the case of the very slow payer and the person who cannot pay. A solution to the problem of nonpayments, as opposed to late payments, may entail a specific allowance for bad debts.[150] This allowance will amount, in effect, to the equivalent of input tax to offset any output tax paid to the tax authorities but not collected from the customer.

If this approach is followed, a definition of "bad debt" is needed to ensure that any allowance for a bad debt does not encourage slow payment. For this reason, it is important that the mere fact of nonpayment should not make the debt bad. It should be shown that the debt is not collectable with reasonable effort on the part of the supplier, and that a minimum set time has elapsed. The length of that period will depend in part on the business practice of a state and on its economy. Inflationary factors are clearly relevant, as is the usual practice for payment of bills. Where all bills are long delayed before being settled, the period for this provision will need to be longer.

While it is typical to provide an allowance for bad debts, there is a counterargument. On the assumption that finance charges are set at a level adequate to compensate for bad debts, the total group of borrowers bears the burden of bad debts through the interest payments they make. The cost of the consumption by defaulting customers is therefore borne by other borrowers. But because interest is not subject to VAT, there would be an understatement of the overall tax base if the amount of bad debts were subtracted from the base, in addition to excluding interest. The difficulty in deciding on an appropriate policy for bad debts is that not all bad debts are covered by finance charges. Instead, suppliers may take the risk of bad debts into account in setting prices for all. On this assumption, it would be appropriate to provide an allowance for bad debts. In the case of bad debts owed by customers who are themselves taxable persons, however, a bad debt allowance would not be necessary. If an allowance for bad debts is made, there should also be a reversal of the customer's input credit, leading to a wash. The conclusion is that the case for a bad debt allowance is not as obvious under the VAT as it is under the income tax, and that under certain assumptions such an allowance would not be needed.

VIII. Procedure and Administration

A. Need for Specific VAT Rules

Legislative approaches to dealing with administrative and procedural provisions of tax laws vary markedly from state to state. It is therefore difficult to provide any general form of provision for the procedure that must be associated with the collection of VAT by taxable persons or for the administration of VAT by the tax authorities.

In general, there are distinct advantages to combining, as far as possible, the procedure and administration of VAT with that of other taxes. If this is done, then the matter can be dealt with in common laws dealing with taxes generally and with compatible procedures. This is more efficient for the administration and easier for taxpayers to understand.

[150] *E.g.,* GBR VAT § 36.

B. Combining VAT and Customs Administration on Imports

The case for combining the collection of VAT on imports of goods with the collection of customs duties is particularly strong. Questions of procedure for handling VAT on imports should as far as possible follow the procedures followed for customs duty purposes, just as this chapter has assumed that the substantive law follows customs duty law. Similarly, there is a clear case for giving the duty of collecting VAT on imports to customs officials. For that reason, the relevant administrative provisions should be aligned to customs laws. The simplest form of provision is one that treats VAT on the import of goods as a customs duty for all purposes of administration of VAT. This would mean that customs officials can use the same powers to enforce VAT on imports as they have to deal with customs duty. This approach will ensure that powerful provisions exist to handle VAT on imports with a minimum of legal difficulty, administrative provision, and taxpayer confusion.

C. Handling VAT on Internal Supplies

There is also a strong argument for combining the administration of VAT on internal supplies with the administration of the direct taxes. In particular, many income tax payers with business income will also be taxable persons for VAT purposes. Many transactions will require review for both income tax and VAT purposes, although the ways in which income tax and VAT liabilities are calculated from that common base are radically different.

Despite the differences in result, many of the problems of administration of direct taxes and VAT invite similar solutions. For example, the powers of auditors carrying out field audits, or those of desk officers demanding information from taxpayers or from third parties may be aligned. There is an additional advantage in aligning these powers in that officers will be able to gather information for the two kinds of tax liability at the same time, thereby minimizing the demands on taxpayers. This approach also enables a cross-check on compliance with the requirements of one tax from information gathered in checking compliance with the other. One of the strengths of the invoice-based form of VAT is the resulting audit trail, which can be used to check other taxes.

In the light of these general remarks, this chapter discusses only those areas of administration and procedure that are peculiar to VAT. It is assumed that for other matters the state will have separate legislation dealing with tax administration or that the rules in the VAT law will parallel those in other tax laws.

D. Regulations, Instructions, and Guidance

The VAT is an invasive tax and potentially applies to every aspect of the economy. It is impossible to set out in one law all the rules, regulations, procedures, and working practices necessary to ensure the smooth operation of a tax that can apply to several millions of transactions a day in a state. Not only does the VAT have this invasive, and pervasive, effect, but it must also take a clear enough form so that all those charged with settling transactions and issuing VAT invoices can do so with confidence and without delay. The laws, rules, and guidance must be effective, and the legislation is no more than the highest level of a multilayered system of providing rules and procedures.[151]

E. VAT Invoices

A VAT invoice is an invoice, chit, till roll print, or other document[152] that is issued by a taxable person who makes a taxable supply and that records the supply and the amount of VAT payable on it. In an invoice-based VAT system, as described in this chapter, the issue of invoices in the proper form is an essential part of the procedure for imposing and enforcing the VAT. The requirement that a special invoice be issued is a feature unique to VAT.

An invoice is a "VAT invoice" if it complies with the requirement of the VAT law. Invoices issued for other purposes or that do not comply with these requirements do not count as VAT invoices.

VAT laws typically condition the allowance of a credit for input tax on the existence of a VAT invoice issued during the period for which the credit is claimed. An invoice is also required by the tax authorities to audit the collection of VAT. To allow these requirements to be met, the law should require a supplier making a taxable supply to another taxable person to provide a VAT invoice with that supply or the payment for it. The requirement should be enforceable by some penalty or procedure. The law could further specify that the purchaser's copy of the invoice, once created, is the property of the tax authorities, and not of the supplier or the purchaser.[153]

The timing rules noted previously[154] are linked to the time of issue of a VAT invoice. For that reason, together with the reasons noted in this paragraph, the supplier is usually required to issue the VAT invoice at the same time as, or soon after, the supply. For example, the law might require the supplier to issue a VAT invoice no more than seven days after the delivery of goods or payment for those goods. This type of short time delay ensures that an invoice in respect of a transaction, say, at the end of the last working day of a week can be legally issued at the beginning of the following week.

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151 *See supra* ch. 2, sec. IV; ch. 3, sec. IV(D).

152 There is a strong case for providing in regulations for paper records to be substituted by electronic records in some cases, provided that the requirements of evidence for effective auditing are also met.

153 This would impose a duty on the person holding the invoice to preserve it and produce it on demand.

154 *See supra* sec. III(H).

A VAT invoice is normally required to be identified as such (perhaps by having the words "VAT invoice" on it) and to contain a minimum of information about the supply being invoiced. That information would normally include[155]

- the name, address, and VAT number of the taxable person making the supply,
- the nature of the supply made (type of supply, type of goods or services, and quantity of goods or extent of services),
- the time the supply was made,
- the amount of payment for the supply,
- the amount of VAT,
- the name, address, and VAT number of the taxable person supplied,
- the date on which the invoice is issued, and
- the serial number of the invoice (together with identification of the printer if the invoice was purchased privately).

A state may not need to include all this information. For example, if there is only one rate of VAT, then it is redundant to state both the amount of VAT and the amount of payment for the supply. The redundancy may, however, be considered appropriate in light of the fact that taxpayers can make computational mistakes, particularly if both exempt and taxable sales are shown on the same invoice.

The requirement to include all this information will make a VAT invoice a formal document. This will not be appropriate for small transactions, for example, those made by a retail store, particularly where the customer is not a taxable person. States frequently allow special simplified invoices for small transactions or for transactions recorded in a retail store in a till or cash register. For example, in these cases, it will not be required that the details of the customer be recorded unless, perhaps, the customer wishes it. For the sake of clarity, the law should distinguish between the formal VAT invoice[156] and simplified invoices. Only the VAT invoice will entitle the purchaser to a credit for the VAT shown on the invoice, and special procedures will apply to the VAT invoice that do not apply to simplified invoices. While the basic distinction should be drawn in the law, matters such as acceptable forms for simplified invoices are best dealt with by regulation and guidance.

It will make for efficient administration if the tax authorities produce examples of the forms of VAT invoices acceptable to them that comply with the law. However, it is better that this level of detail be omitted from the main legislation. Flexibility should be provided, for example, to allow computer-issued invoices.

F. VAT Returns

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[155] *See, e.g.,* The Value Added Tax (General) Regulations 1985, art. 13, *reprinted in* Butterworths VAT Handbook 1995, at 465.

[156] This is typically known as a "tax invoice."

The other essential document in administering a VAT is the required provision of information at regular intervals by all taxable persons. This provision of information and the document on which the information is provided is commonly known in English as a "return." There should be a standard form of return, so that taxable persons know precisely what is required of them and can comply more easily with the formalities of making a return, and so that the tax administration can process returns efficiently.

All taxable persons should be required to make a return of their taxable transactions and other relevant information at predetermined and regular intervals. These intervals are called "VAT periods."[157]

The return should cover all taxable transactions made by the taxable person during the VAT period and should show how much VAT is payable to the tax authorities for that period.

The essential information on a return is therefore the following:

- the total VAT collected on all taxable supplies made by the taxable person (output tax) in the VAT period,

- the total VAT paid by the taxable person on supplies made to the taxable person in the VAT period and for which a credit is allowed (the allowable VAT credit or input tax deduction),

- the amount of any bad debts to be set off against output tax in that VAT period, and

- the amount of any excess of allowable input tax over output tax in the previous VAT period that can be carried forward (allowable excess VAT credit or input tax deduction).

The requirement that a return be made for each VAT period needs to be enforceable, with a reasonably strict time limit for submission, such as within 15 days of the last day of the VAT period to which the return relates. A return should be required even if the taxable person has no taxable supplies for a VAT period. This rule allows efficient operation of systems to detect and chase after persons who are delinquent in filing.

G. Payment of VAT

The law should also specify that all taxable persons must pay to the tax authorities at a specified time the net amount of VAT due for the VAT period (i.e., all VAT collected (output tax) less allowable VAT credit (deduction for input tax) and any allowable excess VAT credit carryover and VAT with respect to bad debts).

[157] *See infra* sec. VIII(J).

The duty to pay is usually on a self-assessment basis (i.e., the taxpayer itself determines the amount due by filling out the return). Each taxable person is responsible for paying the VAT due to the tax authorities in respect of any VAT period at the same time as (or, if convenient, separately but before) the return for that period is due.

Some states require advance payments of VAT, for example, three times a month, based on VAT liability for previous periods.[158] The advance payments are then credited against the VAT due with the return.

H. Assessing VAT

Where a return has not been made by a taxable person (including persons not registered for VAT that should be registered or importers not covered by the import procedures) for a period for which a return should have been made, the tax authorities should be given reserve powers to impose an obligation on the taxable person to pay VAT to the tax authorities. For example, the tax authorities can be empowered to make a formal assessment[159] of the estimated amount of VAT that a taxable person or other person is believed to owe to the tax authorities in accordance with the law.

The tax authorities should also have the power to collect any other VAT, estimated amounts of VAT, or sums equivalent to VAT. This can deal, for example, with an unauthorized person issuing what purports to be a VAT invoice. The "VAT" collected by that person is due to the tax authorities, and the power to assess could provide the most convenient way of doing this.

The power to assess should also be available to deal with cases where the tax authorities have reason to believe that the returns made by a taxable person are not accurate and do not show the full amount of VAT due from that person. The tax administration law should deal with the formalities of making assessments and procedures for challenging them.

I. VAT Periods

The payment of VAT to the tax authorities is linked to a "VAT period" as explained previously. The length of a VAT period is a policy matter for the state. The standard period is the calendar month; often, taxable persons with small levels of taxable turnover are allowed to use longer periods of three months or a year.[160] The VAT period should be distinguished from payment periods.[161] Thus, for example, a state may require enterprises of a certain size to make

[158] *E.g.*, KAZ TC art. 72(1).

[159] The process is an inherent part of the income tax in most states, and it will be efficient to apply the same procedures used for the income tax, except for those that are not relevant to VAT.

[160] In economies with high levels of inflation, shorter periods may be appropriate. *See infra* ch. 13, sec. II.

[161] *See supra* sec. VIII(H).

advance payments of VAT three times a month, while the VAT period remains a calendar month.

J. Repayment of Excess VAT Credit

Where the input tax credit for any VAT period exceeds the output tax collected, there is an excess of VAT credit or of deductible input tax. As a direct result, the taxable person will pay no VAT to the tax authorities for that period. However, should the tax authorities pay the difference to the taxable person?

VAT is fundamentally different from direct taxes in that it involves regular situations where a taxable person is owed money from the tax authorities. This is an essential feature of VAT if it is truly a proportional tax based on regular VAT periods. The situation will arise, for example, where the taxable person buys expensive equipment or machinery costing more than the total of taxable supplies made by the taxable person during that VAT period. It also arises if the law makes provision for rebating tax to exporters.

Policymakers may be tempted to reduce or abolish the right for taxable persons to demand payments from the tax authorities, especially where state budgets are under pressure. There is an opposite temptation on political representatives to make the operation of VAT "fair" by imposing the same tight timetables on the tax authorities rebating VAT as on taxable persons paying it.

Both temptations can present major problems for the state and the tax authorities if the rules concerning VAT refunds are not carefully formulated and applied. A failure to allow any repayment of excess input tax undermines the fairness and economic neutrality of VAT collection. If applied to exporters and other similar taxable persons, it can harm the economic competitiveness of those persons and therefore of the state.

By contrast, a regime demanding early rebates of excess VAT credit or excess deductible input tax places a tax authority at a disadvantage in dealing with evasion and fraud. In particular, there is a danger that rebates will be given in situations where an input tax credit has been claimed for a supply but the supplier (or alleged supplier) of the supply (or alleged supply) has not paid an output tax to the tax authorities. There is also a danger of persons representing themselves as taxable persons when they are not, in order to claim input tax repayments when they have no intention of paying more than a nominal amount of output tax to the tax authorities. In the worst case, the so-called taxable person will simply disappear after receiving the credit, having made money from the tax authorities. There will also be cases where an expenditure that is not made for business purposes is said to be made for business purposes (e.g., on the purchase of a car or boat), so that an input tax repayment is made for input tax not paid out for business purposes.

Balancing these two pressures on a tax authority has proved problematic in a number of states. Repayments of excess VAT credit should be allowed, but with safeguards. One possible safeguard is to require the excess VAT credit to be carried forward for a specified period (e.g., six months) before a repayment can be claimed. Another safeguard for the revenue is a phasing of VAT credit on large expenditures through capital goods rules.

Further safeguards should empower the tax authorities to audit any claim for repayment before being required to make the repayment if there is reason for suspicion. For example, if the tax authorities are bound to make the repayment within a certain time, they should have the right to stop the time running if an audit is carried out. It is also important that the tax authorities have all the powers necessary to carry out these audits, and that they be seen to exercise those powers. The tax authorities should also have the power to assess taxable persons (or others) to recover excess repayments of excess input tax.

Another safeguard is to allow the tax authorities to require securities or guarantees (e.g., from a bank) to ensure that the taxable person continues making taxable supplies after the repayment is made or to make repayments only when subject to other conditions for the protection of the integrity of the revenue. Where the financial system allows, this may be a particularly convenient way of balancing the needs of the tax authority with the entitlements of larger taxpayers.

IX. Special Cases

The potential complexity of VAT when applied to every form of taxable supply has been mentioned. There will, in practice, be whole classes of supplies and of taxable persons where one or more of the general rules of VAT pose difficulties or uncertainties. Small businesses may find that some aspects of VAT procedure impose heavy burdens. Specific sectors of economic activity such as farmers may have difficulty conforming with the way the tax works. Auctioneers or other agents may have difficulty determining how VAT applies to their supplies. Problems may arise for them and for other kinds of agent in the supply of items between taxable persons and nontaxable persons. Taxable persons such as retailers may find it difficult to account to the tax authorities for the VAT on a large number of low-value supplies, particularly where only some of the customers are other taxable persons.

A detailed study of any fully developed VAT law will reveal a range of special rules derogating from the general framework in particular cases. These derogations are usually designed to make VAT workable. The law should make provision for these special rules to be created. This is probably best done in most states through regulation although, in some areas, it may most effectively be done through agreement with trade organizations or after discussion with other government agencies. While these schemes should be the exception rather than the rule, some special provision is usually unavoidable.[162]

[162] The EC Sixth VAT Directive, *supra* note 3, makes provision for a number of special schemes, including for small undertakings, *id.* art 24.; a common flat-rate scheme for farmers, *id.* art. 25; for travel agents, *id.* art. 26; and for secondhand goods and works of art, *id.* art. 26a. The member states of the EU do not have common schemes for these special cases (except for secondhand goods, where a common approach was agreed upon in 1994, Directive

94/5 of February 14, 1994, 1994 O.J. (L 60) 16, nor have they all adopted the special schemes. Other special schemes are allowed by derogations, for example, fisheries (Belgium and Netherlands), oil and gas (France), and gold (United Kingdom). *See* the summary of national laws *in* Tolley's VAT in Europe, *supra* note 162. However, the approach of countries with a broad-based tax, such as New Zealand, is to avoid these schemes wherever possible.

7

VAT Treatment of Immovable Property

Sijbren Cnossen

Housing is one of the most difficult items to handle under a value-added tax.

—Charles E. McLure, Jr.

I. Introduction

The appropriate treatment of housing and housing services, as part of the wider area of immovable property, is probably one of the more complicated and, it seems, intractable issues in the theory and practice of the value-added tax (VAT). In most industrial countries, housing services, comprising rents and rental values of owner-occupied dwellings, constitute 15 percent or more of total annual consumption expenditures as computed for national accounts purposes. Surely, this is too large a portion to ignore under a broad-based VAT. Yet, conceptual difficulties and, above all, administrative and political problems seem to preclude the taxation of housing services in a satisfactory and evenhanded manner.

To understand the principles and approaches that are found in various countries, a brief review of some of the pertinent characteristics of the VAT provides some clues as to how immovable property should be taxed. Next, the actual VAT treatment of immovable property in the member states of the European Union (EU) and selected other countries that are members of the Organization for Economic Cooperation and Development (OECD) is surveyed. Finally, a concluding section evaluates this chapter's major findings.

II. Nature of the VAT

The VAT is an *in rem* tax on domestic consumption. The tax is of the *in rem* type because personal circumstances are left out of consideration, unlike, for instance, under the income tax (or, for that matter, an expenditure tax). Although the tax is intended to be borne by the consumer, the consumer is not taxed directly. Instead, "taxable persons" are all producers and distributors who manufacture and trade in taxable goods and services. Each taxable person has to remit that part of the total tax, collected by the

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retailer from the final consumer, that equals the tax rate times the value added by that taxable person. To achieve this, the VAT is imposed upon "taxable events," that is, the delivery of taxable goods and services. Each time a commodity changes hands, tax is due and tax on inputs can be credited against tax on outputs. As a result, all commodities can in effect be traded tax free within the "ring" of registered businesses, but the full tax is payable once goods and services leave the ring, because they are sold to unregistered persons, usually consumers.[1]

There is wide agreement on the nature of the VAT collection mechanism. VAT is simply a retail sales tax that is collected piecemeal throughout the entire production-distribution process. The consensus may be smaller, however, on some of the theoretical underpinnings of the tax. Is the VAT a tax on consumption *activities* or, more narrowly, on consumption *expenditures*? Is the VAT a tax on *current* consumption or, more broadly, a tax on all commodities that leave the ring of registered businesses, regardless of whether they are consumed forthwith or embody a stock of services that are consumed over the useful life of the asset? Cars, household appliances, furniture, and, of course, houses are examples of the latter type of asset.

The answers to these questions seem pertinent to obtaining the right focus on the appropriate treatment of immovable property. To a large extent, the answers depend on whether one adopts a theoretical, economic point of view or whether one takes a more practical, legal approach to the VAT.

A. Activities or Expenditures?

From an economic point of view, ideally the VAT should tax all consumption activities because this approach would most closely satisfy commonly accepted equity and neutrality criteria. As a tax on consumption activities, the VAT should in principle include self-produced items of consumption, such as garden vegetables and household meals, in the base at market value. This would ensure equal treatment with other products bought in the marketplace. Proponents of this view draw a parallel with the accretion concept of income that, in theory, also includes in the base the value of self-produced items.[2] Purists stretch the point even further by insisting that the consumption of leisure should be taxed as well.

To be sure, it is readily admitted that it would be impracticable to tax home-produced consumption (not to mention leisure), but, the argument goes, this should not detract from the principle. It is also pointed out that all VAT laws stipulate that goods withdrawn from the stock of a business for personal use are taxable. If a butcher takes meat from the larder for consumption at home, he or she has to pay tax on its market

[1]For a discussion of the nature of the VAT, *see* Sijbren Cnossen, *The VAT and RST: A Comparison*, 35 Canadian Tax Journal 559 (1987). Sales in the ring are in effect tax free because, even though such sales are taxable, the tax paid is offset by a tax credit available to the purchaser. *See, e.g.,* CAN GST § 169. By contrast, under a sales tax with a ring system, such sales are exempt.

[2]*See, e.g.,* Victor Thuronyi, *The Concept of Income*, 46 Tax L. Rev. 45, 79-83 (1990).

value, although the supplier's price is often taken as a close enough proxy (this means that, as an alternative, the tax credit attached to the purchase of the meat can simply be denied). Generally, the meat would also be taxable if it were "produced" by slaughtering a calf that had been fattened on the butcher's premises.

Under the legal approach to VAT, however, it is emphasized that even in principle the VAT is not intended to tax nonmarket consumption activities. If, in the example above, the butcher is taxed, it is because as a taxable person he or she supplies him- or herself with the meat, either directly from the larder or indirectly by raising the calf. In other words, the meat is not produced in a personal capacity, but in a business context. This triggers the taxable event. In contrast, the homegrown vegetables of the butcher would not be subject to the VAT. The definition of "taxable event" in VAT statutes emphasizes that only goods and services bought in the marketplace are taxable. Moreover, the VAT generally becomes due only if the taxable transactions are undertaken for a "consideration." Self-produced items of consumption and, for instance, gifts are not taxable. In short, the tax is on consumption *expenditures* rather than on consumption activities.

B. Flows or Stocks?

Is the VAT a tax on current consumption or simply a tax on consumption items that leave the ring of taxable persons? Most economists would insist that the VAT is a tax on flows, not on stocks.[3] Ideally, under the VAT, durable consumption goods, such as cars, that provide a flow of services over a long period of time (extending, say, beyond the normal tax reporting period) should not be taxed on their value at the time of purchase, but rather on the value of the services that the goods subsequently provide.

Again, it is admitted that it would be impracticable to implement this rule literally. Hence, as a second-best measure, it is assumed that the purchase price of a durable consumption good represents the discounted present value of its future services. By extension, the tax on the purchase price may be considered a close proxy of the discounted present value of the tax that should have been levied on the flow of services. This "prepayment method" is also found in the literature on the personal expenditure tax.[4]

Lawyers and tax administrators point out that the foregoing view is a misrepresentation of the nature of the VAT. The VAT is not a personal tax, but an *in rem* tax on consumption expenditures. For all goods and services, a cutoff point must be established at which the tax becomes final. That point is the retail stage, regardless of the kind of commodity that is sold. The *in rem* nature of the VAT does not support the position that durable consumption goods should be treated differently from nondurable consumption goods. Neither in theory nor in design does the VAT permit imputing a

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[3]This is the view found in Alan Schenk, *Value Added Tax: A Model Statute and Commentary: A Report of the Committee on Value Added Tax of the American Bar Association Section of Taxation* 72-79 (1989). For a strong defense of the VAT as a tax on consumption flows, *see also* Robert F. Conrad, *The VAT and Real Estate*, *in* Value Added Taxation in Developing Countries 95 (Malcolm Gillis et al. eds., 1990).

[4]*See, e.g.,* Michael Graetz, *Implementing a Progressive Consumption Tax,* 92 Harv. L. Rev. 1575, 1597-1623 (1979).

current consumption value to durable goods. Ultimately, the VAT is a tax on consumption expenditures as they are incurred. Although the taxation of transactions may not be a goal in itself (as it would be under, say, a stamp duty), it is sufficiently central to the nature of the VAT that it cannot be ignored.

III. How Immovable Property Should be Taxed

The previous discussion has an important bearing on the way in which immovable property should be treated under the VAT. Land and buildings embody stocks of services that can be used for consumption or production. If immovable property is used for production purposes, like plant and machinery, the services that it generates should not be taxed. Any tax paid at the time of purchase of the property should be creditable immediately against the tax on the sale of other property or the tax on the products made by, say, the factory situated on the property. If there is no tax on sales, simply because there are no sales, a refund would be due forthwith. On balance, no tax should attach to the factory, regardless of whether it was used or not.

A. An Economic Point of View

From an economic point of view, the same treatment should be accorded immovable property that generates housing services. The most attractive solution from a theoretical perspective would be to register for VAT purposes all persons, natural as well as juridical, who own or buy residential real estate. By purchasing a dwelling, these persons would become producers, not consumers, of housing services. In their role as producers, they would subsequently sell the housing services to consumers. These consumers might be either third parties who buy the services against a consideration, that is, a rental charge, or each producer might sell the housing services to him- or herself as the owner-occupier of the dwelling.

The VAT consequences of these events are obvious. The registered taxpayer who buys a bundle of housing services in the form of a dwelling would pay tax on the purchase price, but at the same time the taxpayer would be entitled to a tax credit (and refund, if due) for the same amount. If the taxpayer sells the housing services to a third party, that is, a lessee, he or she would have to charge VAT on the amount of the rental. The lessee, being an unregistered consumer, would not be able to pass the tax on but would be stuck with it just like consumers of other commodities. Similarly, as owner-occupier, the producer of housing services would charge VAT on these services, represented by the rental value of the dwelling, rendered to him- or herself as consumer. And like the lessor, the producer would have to remit that tax (net of any tax on inputs, such as repair and maintenance services) to the tax office.

So far the discussion has been about buildings, but the treatment of land would not be any different. If land generates production services, it should follow the same treatment as the factory above. If it is a producer good that generates consumption services (because it is used for hunting hares or simply to sit on), then the same reasoning holds as given above in respect of housing services. Feasibility considerations may dictate other solutions, but it is simply nonsense to say that land should be left out of the base because it is not a consumption good. The issue is whether land generates consumption services.

B A Legal Point of View

Those who take a legal point of view, as outlined in Section II above, do not subscribe to the characteristics of the VAT as a tax on flows. For them, the VAT is a tax on transactions designed in such a way that, ultimately, only consumption expenditures are taxed. In their opinion, immovable property should be taxed if and when it is transferred from the production or business circuit to the consumption or consumer circuit. Thus, newly constructed buildings, residential as well as other real estate, should be taxed at the time they are completed. If the buildings are subsequently rented out for business use or residential use, the rents should be taxed and the tax on the purchase should be creditable against the tax on rents. If residential property were sold to an owner-occupier, however, the tax on the sale would be considered final. The notion that this tax represents the capitalized value of the tax on the value of all future housing services is a useful, but not essential, rationale for this approach.

Furthermore, it is pointed out that, in practice, the registration of all owner-occupiers, as well as the computation of all rental values, would present formidable administrative problems that a VAT should not take on. Most countries do not tax the rental value of owner-occupied property under their income tax or do so at reduced values. Politically, taxing rental values under the VAT would be even harder to accomplish. It would be difficult to explain to owner-occupiers that taxing the rental value of their dwelling under the income tax as well as under the VAT would not constitute double taxation. Under the income tax, owner-occupiers enjoy the rental value in their role as investors, whereas under the VAT they would enjoy the rental value in their role as consumers. Finally, most nonresidential property is located in the agricultural and industrial sectors or is owned by the government. Taxing such property would not yield any net revenue.

Admittedly, taxing rents but not rental values appears to favor owner-occupiers over lessees who would pay the VAT on rental charges. To achieve approximately equal treatment, moreover, it would be necessary to levy the VAT on the sale of owner-occupied dwellings, because the sale of a dwelling from a (taxable) lessor to an owner-occupier would also be taxable. The tax on the original purchase would then have to be taken into account as well as the tax paid in respect of repair, maintenance, and other costs. Complications would arise if dwellings that were initially occupied by the owner were subsequently rented out or if rental property subsequently became owner-occupied.

In the legal view, therefore, the best alternative is to tax new residential construction and then to forget about it. In other words, lessors would also be treated as exempt persons. They would pay tax on purchases of new housing, but would not be able to charge the VAT on rental charges, take credit for tax on purchases of new fixtures, appliances, maintenance costs, and so on. Levying a final tax on new residential construction might leave some distortions in the consumer market for housing services, but few in the market of producers of housing services. The treatment would not discriminate against other services or against services involving the maintenance or renovation of the existing housing stock, assuming that these services are taxed in full along with building materials, fixtures, and whatever else goes into a house to make it habitable. The tax on new residential construction would favor the owners of the housing stock in existence at the time the VAT is introduced, but this advantage would diminish over time.[5]

If current housing services are to be left out of the base, what about current commercial building services, assuming that new commercial buildings are to be taxed? For the most appropriate VAT solution, the use that may be made of these buildings must be taken into account. Commercial buildings, that is, buildings that are used for production purposes, may comprise factory buildings that are difficult to convert to other uses, but also office buildings that may be used either by a registered manufacturer or trader or by an exempt entity such as a bank or nonprofit organization. Moreover, some office buildings can be converted into apartment complexes without much ado and vice versa.

C. Practical Solutions

Two approaches, largely identical in result, are used to resolve the issue. Under the tax method, found in Canada and New Zealand, the sale and rental of immovable property are taxable in principle, but residential rents (and rental values) are exempt,[6] as is the sale of previously occupied residential property.[7] This implies that the construction, alteration, and maintenance of all buildings are taxable. So is the rental of business accommodations. Also, sales of existing buildings are taxable, unless such buildings constitute residential property. The definition of "previously occupied" should be tailored to the mechanics of the tax in the particular country. For example, in Canada, the exemption applies to the sale of a residential complex by the individual who built the complex and who occupied it as a place of residence, unless the individual claimed an input tax credit in respect of the acquisition of the real property included in the complex. Also exempt is a sale of a residential complex by a person who is not a builder of the complex, unless the person claimed an input tax credit in respect of the acquisition of the complex.

Under the exemption method, prescribed in the Sixth Directive of the EU, in principle the sale and rental of immovable property are exempt,[8] but newly constructed buildings as well as alterations and maintenance of the existing building stock are

[5]The extent of this advantage depends on what tax the VAT replaces. If it replaces a turnover tax that covered construction goods and services, then the existing housing stock may be largely tax paid.

[6]CAN GST sched. V, pt. I § 6; NZL GST § 14(c), (ca).

[7]CAN GST sched. V, pt. I §§ 2, 3; NZL GST § 14(d).

[8]*See* Sixth Council Directive 77/388, art. 13B(b), (g), (h), 1977 O.J. No. L 145/1.

taxable.[9] Unlike the tax method, which requires a definition of residential use, the exemption method needs a definition of specified nonresidential use, such as hotel accommodation, camping facilities, and parking space, which are taxable. Furthermore, because the commercial use and sale of existing immovable property are also exempt, the opportunity of optional registration must be provided to avoid potential discrimination and cumulation of tax.

Both approaches must address the VAT implications of the supply of land. Unimproved land is traded less often than buildings are and is used more often for productive purposes in exempt sectors, such as agriculture. New Zealand exempts all land, improved as well as unimproved. Under the Sixth Directive, however, unimproved land is exempt, but improved land, including land on which buildings are sited, is taxable. Probably, the difference in treatment reflects the difference in the relative scarcity of unimproved land. In New Zealand, the "land element" of the purchase price of a building must be separated out from the total consideration. Under the Sixth Directive, the land element must be separated out from the value of other (unimproved) land that is part of the same parcel.

Under both approaches, sales of existing housing stock are exempt. Thus, the introduction of a VAT that raises housing prices provides a windfall gain for the owners of the existing housing stock. This effect can be mitigated by taxing the initial sale of all dwellings following the introduction of the VAT.[10] Although feasible, no doubt such a novel extension of the VAT base would be strongly resisted. The existing housing stock would have to be valued at that time. Moreover, owners of the existing housing stock would have to retain all invoices of alterations and maintenance expenditures showing VAT that would be creditable against the VAT on first sale at some future date. These invoices would become more difficult to verify with the passage of time. No country has adopted this approach upon the introduction of the VAT.

IV. How Immovable Property Is Taxed

Table 1 shows the treatment of immovable property in the member states of the EU and some other OECD countries with VATs. For expository purposes, it seems useful to distinguish construction activities from the lease and sale of immovable property. In several countries, property transfer taxes, such as registration duties, imposed on gross selling prices interact with the VAT; when the VAT is levied, the transfer tax is not imposed, and vice versa. Hence, these taxes are also shown.[11]

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[9] *See id.* art. 4(3).

[10] *See* Alan A. Tait, Value-Added Tax: International Practice and Problems 83 (1988).

[11] For a summary review, *see also* OECD, Taxing Consumption 183–86 (1988).

A. Construction

The consistent VAT treatment of various construction activities, such as the sale of building materials, the rendering of repair and maintenance services, and the creation of new buildings, is essential if distortions and administrative difficulties are to be avoided. As indicated in Table 1, nearly all countries tax building materials at the standard rate. Exceptionally, Ireland applies the lower rate of 12.5 percent to concrete, and Italy taxes "raw materials and semifinished products for the building industry" at 9 percent. In most countries, the treatment of repair and maintenance services follows that of building materials. Exceptions are found in Belgium, which taxes construction services (and, by extension, building materials) in connection with dwellings that have been occupied for at least 20 years at the lower rate; in Ireland, which taxes repair and maintenance services at 12.5 percent;[12] and in Italy, which favors work on old buildings (of which it has many) by taxing it at 4 percent. These end-use types of exemptions must be difficult to monitor properly.

Logically, building materials and repair and maintenance services (broadly interpreted as construction services) add up to a new building. Most countries realize this; under their VATs, the treatment of newly constructed buildings is the same as that of materials and labor. If the rate on new buildings were different, the effective rate on materials and services embodied in these buildings would, of course, be different from the rate applied to materials and services used for maintaining, repairing, and renovating the existing housing stock. This would create distortions, raise administrative difficulties, and be a breeding ground for tax evasion and avoidance.

However, not all countries see it this way. Thus, the United Kingdom applies the standard rate to all construction other than the sale (or long-term lease) of new residential buildings, which is zero-rated.[13] As a result, complications arise when "mixed work" is supplied, for example, the alteration and renovation of an existing house in combination with the construction of an adjoining new dwelling. Another baffling distinction is made regarding builders' hardware: fitted cupboards in kitchens are zero-rated, but built-in units in bedrooms are taxed at the standard rate.[14]

Presumably, similar problems arise in Spain, which taxes new buildings at a lower-than-standard rate.[15] Spain attempts to limit the damage by stipulating that the standard rate continues to apply to construction work carried out by someone other than the

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[12]How complicated such exceptions to the rule may become is evident from the Irish VAT Act, which prescribes that the lower rate applies to, among others, "services consisting of the development of immovable goods, and the maintenance and repair of immovable goods including the installation of fixtures, where the value of movable goods (if any) provided in pursuance of an agreement in relation to such services does not exceed two-thirds of the total amount on which tax is chargeable in respect of the agreement...." IRL VAT 6th sched. (iii).

[13]GBR VAT sched. 5, Group 8.

[14]*See* Tait *supra* note 8, at 83.

[15]*See* ESP IVA art. 91(3).

building contractor,[16] but, in fact, the legal and practical mess may be largely the same as in the United Kingdom. Sweden used to tax new buildings by applying the standard rate to one-half of the taxable value, but since 1992 it has applied the standard rate on the full value.

Preferential treatment based on the end use of new buildings causes the same problems as it does for materials and services. Italy taxes the repair of historical buildings and the construction of low-cost housing at 4 percent. (In terms of VAT statistics, the country's housing stock probably consists largely of historical buildings and low-income housing.) Social housing programs are also favored in Belgium, Canada, France, and Portugal. Furthermore, Portugal levies the lower rate on public works contracts.[17] This is a needless complication, because raising the rate and increasing the subsidy would be a simple bookkeeping exercise that would deter evasion. Turkey exempts housing units of up to 150 square meters.[18] Presumably, some families are then tempted to buy two units and subsequently connect them.

Germany and Portugal exempt newly constructed buildings from the VAT, but apply instead the property transfer tax (registration duty).[19] The rate of the transfer tax is lower than the standard VAT rate; on the other hand, no credit is available for the tax on inputs. Except by coincidence, the sum of the transfer tax and the VAT on inputs will not be the same amount as the VAT that would have been levied on the total consideration for the new building. This could be a source of distortions and complications. Optional registration and payment of tax for business property, available in most EU countries, mitigate these effects.

B. Lease

No country in the OECD taxes or has ever contemplated taxing the imputed rental value of owner-occupied property under the VAT. Hence, information on this point is not shown in Table 1. If rental values of owner-occupied properties are not taxed, the equal treatment rule requires residential rents to be excluded from the VAT base. With the exception of Austria, all countries surveyed do indeed exempt the lease of residential real estate.[20] This does not necessarily mean that lessees pay less rent, because the VAT will have been paid at the time the dwelling was created. The exemption does, however, mean that lessors, like owner-occupiers, are stuck with an element of the VAT on repairs and alterations. This should not occur in Austria, which taxes residential rents at the lower rate of 10 percent.[21]

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[16] The law states that the reduced rate applies to works resulting from contracts made directly between the developer and the contractor. ESP IVA art. 91(3).

[17] PRT CIVA app. II, no. 3.7.

[18] Such residences were exempt from tax until December 31, 1995. Provisional arts. 8, 9, Law No. 3099, Official Gazette of Dec. 15, 1984, No. 18606.

[19] *See* DEU UStG § 4(9)(a); PRT CIVA art. 9(30), (31).

[20] *E.g.,* CAN GST sched. V, pt. 1(6); IRL VAT 1st sched. (iv).

[21] AUT UStG § 10(2)(5). A tax on residential rents (not rental values) may be preferable if a country's real estate sector is dominated by large apartment complexes and hotels.

In all countries surveyed except Canada, Iceland, Japan, New Zealand, Spain, and Turkey, the lease of other real estate (commercial, agricultural, and government land and buildings) receives the same treatment as the lease of residential real estate. In principle, therefore, the leasing of real estate is exempt from the VAT. However, most countries mitigate or eliminate the potential cumulative effect of this approach by allowing lessors to opt for registration and payment of the VAT (treating them at par with other taxpayers: full credit for input tax and payment of tax on lease payments), provided that lessees are also registered taxpayers (meaning that they can take credit for the tax on their lease payments) or agree to become registered taxpayers. This provision takes the "cascade sting" out of the exemption. In practice, the exemption-cum-optional-taxation approach may closely approximate the effect of the taxation approach in the six countries mentioned above. Given a choice, lessors will opt for the least-tax-expensive option, but they must take into account that the choice is irreversible. In Belgium, France, and Italy, lessors of furnished commercial real estate are always taxable with respect to the lease or sale of such real estate.

Countries that exempt leases of immovable property and hence housing services, however, do tax hotel accommodation and the rental of parking space and camping grounds.[22] An exemption applies if hotel and similar accommodations, such as boarding houses, are used for residential purposes. Usually, a simple period test, say, an uninterrupted stay of 30 days or more, is used to establish eligibility for the exemption. Under the Sixth Directive, permanently installed equipment and machinery are also taxed.[23] Without an explicit charging provision, such equipment and machinery would be exempt, because they are immovable by law. Finally, the directive also taxes the rental of safe-deposit boxes.[24]

C. Sale

As Table 1 indicates, all countries exempt the sale of previously occupied residential real estate, and most countries the sale of other real estate, too. Six countries (Canada, Iceland, Japan, New Zealand, Spain, and Turkey), however, tax the sale of other (nonresidential) real estate under their VATs. The same countries that allow lessors of real estate the choice of being taxed extend that right to sellers of real estate. Exemption means that increases in the value of the stock of housing services are not taxed (nor is a tax credit provided for decreases in the value). Interestingly, in France, the VAT is levied, albeit at the lower rate, on the realized capital gains of traders in real estate; a credit is allowed for the tax on repairs but not for the tax paid at the time of purchase. Not surprisingly, this approach resembles the treatment of secondhand goods bought and sold by registered businesses.

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[22] Sixth Council Directive 77/388 art. 13B(b)(1), (2), 1977 O.J. No. L 145/1.

[23] *Id.* art. 13B(b)(3).

[24] *Id.* art. 13B(b)(4).

The VAT treatment of the sale or lease of immovable property, as described above, should cause little discrimination unless the purpose to which the building or the land is applied changes from exempt to business use or vice versa. In the event, the member countries of the EU provide for an adjustment period of up to ten years from the date of purchase.[25] If, say, after four years, a building changes from exempt to taxable use, a tax credit is permitted of six-tenths of the tax originally denied. Conversely, if the building has been used for taxable purposes for, say, seven years, a change to exempt use implies that a VAT payment of three-tenths of the original tax must be paid. Annual apportionment of the tax, depending on the relationship between exempt and taxable use, is also possible. In Italy, the adjustment period is five years. In New Zealand, there is no time bar to the adjustment period.

V. Conclusion

This chapter has shown that there are two opposing points of view on the nature of the VAT. The economic point of view is that the VAT is a tax on current consumption activities, although feasibility considerations often dictate that the reach of the tax must be confined to market transactions and that stocks instead of flows must sometimes be taxed. The legal point of view, on the other hand, holds that what economists present as the exception to the rule actually is the rule. In other words, the VAT should be confined to transactions in the marketplace, and it is perfectly legitimate to tax stocks of consumption services as they leave the ring of registered businesses. The collection mechanism of the VAT is a quintessential feature of the tax rather than a means of reaching the consumption base.

The economic point of view holds considerable attraction for the theoretically inclined mind. However, no legislator has ever thought of, let alone proposed, taxing nonmarket consumption activities or durable consumption goods on the flow of services they provide. As the legislative history of every VAT indicates, the reach of the tax ends at the retail stage. Concessions to this view are not made on grounds of principle, but only as a means of blocking possible avoidance routes or to mitigate undue distortions. The *in rem* nature of the VAT considerably weakens the view that durable consumption goods should be taxed on the flow of services they generate to the owner.

The second-best solution, applied to housing services (exemptions of rents and rental values, taxation of newly created houses) by nearly all countries with a VAT, broadly satisfies generally accepted criteria of horizontal equity, neutrality, and feasibility. The tax method (tax all immovable property, unless exempted; exempt housing services and the sale of previously occupied dwellings) is, however, superior to the exemption method (exempt all immovable property, except new dwellings). Under the tax method, commercial exploitation of immovable property, other than houses, is fully taxed. Under the exemption method, increases in the value of commercial housing services are not taxed. Moreover, optional taxation causes differential effects. More

[25] *Id.* art. 20(2).

generally, under the philosophy of the VAT, it is better and easier to define selective exemptions than to define selective charges to tax.

As the examples in this chapter show, the consistent and neutral application of the VAT to immovable property requires that all building activities, forms of leasing, and sales be taxed at the standard rate. Preferential rates cause distortions and raise administrative complications. Their effect may be undone if low-taxed activities, for example, repair and maintenance services, are supplied in combination with normally taxed goods, such as building materials or new buildings. Similarly, building materials, subject to the standard rate, may effectively attract a lower rate if supplied in combination with preferentially treated low-cost housing. Furthermore, it is essential that leases and sales be taxed at the same rate. In the immovable sector also, goods (buildings) and services (renting) have become nearly perfect substitutes. Equal treatment should be more fully achieved under the tax method.

In some countries, such as the Netherlands, the limited adjustment period[26] of ten years led to tax avoidance. Local governments, for instance, established legal entities from which they rented their buildings. The legal entity opted for registration; it charged VAT on the rent but was also entitled to a credit for the tax on the purchase of new buildings. After the expiration of the ten-year period, the buildings were sold tax free to the local governments. In the case of a building with a useful life of 40 years, this yields a VAT saving of three-fourths of the tax that should have been paid. To repair this loophole, the Dutch VAT law was changed. Currently, the option of registration and payment is available only if the immovable property is sold or leased to an entity 90 percent or more of the turnover of which consists of taxable transactions. Here, as in many other VAT matters, New Zealand has chosen the best approach: in addition to the tax method, it has an unlimited adjustment period. Moreover, New Zealand taxes local governments.

By any standard, transfer taxes (registration and stamp duties) are an anachronism. These taxes exhibit the same cumulative effects as a cascade turnover tax. In most countries, they yield little revenue. At best, they can be viewed as a proxy for the VAT that should have been levied on the increase in the value of immovable property realized at the time of sale. This increase represents the capitalized value of the increase in the value of the (housing) services of the immovable property that belongs in the VAT base. It would be better to abolish the transfer taxes and subject gains realized upon the sale of immovable property (including dwellings) to the VAT. This would justifiably resemble the treatment of other secondhand goods.

[26] *See supra* sec. IV(C).

Table 1. VAT Treatment of Immovable Property in Selected OECD Countries

Country	Construction			Lease		Sale		Alternative tax	
	Building materials	Repair and maintenance	Newly constructed	Existing residential real estate	Other real estate[a]	Residential real estate	Other real estate[a]	Kind	Rate[b] (percent)
EU Countries									
Austria	S	S	S	L	S	E	E	Property acquisition tax	3.5
Belgium	S[c]	S[c,d]	S[c]	E	E[*,e]	E	E[*,e]	Registration duty	12.5
Denmark	S	S	S	E	E[*]	E	E[*]	No, stamp duty	
Finland	S	E[f]	E	E	E	E	E	No, stamp duty	
France	S	S	S	E	E[e]	E	E[e,g]	Registration duty	6.9- 18.6
Germany	S	S	E[h]	E	E[*]	E	E[*]	Property acquisition tax	2
Greece	S	S	S	E	E	E	E	Registration duty	9
Ireland	S[i]	L[j]	L	E	E[*]	E	E[*]	No, stamp duty	0-6
Italy	L	S[k]	S[k]	E	E[e]	E	E[e]	Registration duty	8
Luxembourg	S	S	S	E	E[*]	E	E[*]	Registration duty	10
Netherlands	S	S	S	E	E[*]	E	E[*]	Transfer tax	6
Portugal	S	S	E[h,l]	E	E[*]	E	E[*]	Registration duty[m]	8-10
Spain	S	S	L[n]	E	S	E	S	Registration duty	6
Sweden	S	S	S	E	E[*]	E	E[*]	No, stamp duty	
United Kingdom	S	S	Z[o]	E[n]	E[*,p]	E	E[*]	No, stamp duty	

Selected Other OECD Countries									
Canada	S	S	L	E	L	E	L	None	
Iceland	S	S	S	E	S	E	S	None	
Japan	S	S	S	E	S	E	S	Transfer tax	4
New Zealand	S	S	S	E	S	E	S	No, stamp duty	
Norway	S	S	S	E	E	E	E	None	
Turkey	S	S	S	E	S	E	S	Transfer tax	4

Key: S = normally liable to the standard rate
L = normally liable to the lower rate
E = normally exempt from tax
Z = normally subject to the zero rate
* = optional registration and taxation are possible if the property is for use in a taxable activity.

Notes:
a In the member states of the EU and some other OECD countries, hotel accommodation, camping sites, and parking space are taxed.
b Special rates that may apply are not shown.
c Belgium applies an intermediate rate of 12 percent to public housing, such as dwellings supplied to regional housing corporations and apartment buildings for the elderly, the handicapped, the homeless, minors, and students. Work on such buildings is also taxed at 12 percent.
d In Belgium, renovation, repair, and maintenance services to dwellings that have been used as such for at least 20 years are taxed at the lower rate of 6 percent.
e Taxed if leased or sold by a commercial lessor.
f Finland taxes installation work relating to water pipes, sewers, heating, gas pipes, and electric wires.
g In France, the supply of building sites for social housing programs is taxed at the lower rate of 5.5 percent; other building sites are taxed at 13 percent. Traders in commercial property are subject to the VAT on gains; no credit is allowed for the tax on purchases, but the tax on repairs is creditable.
h In Germany and Portugal, newly constructed property is subject to the alternative tax.
i In Ireland, concrete is taxed at the lower rate of 12.5 percent.
j In Ireland, repair and maintenance services are taxed at the standard rate if their value is less than one-third of the work contract.
k In Italy, the lower-lower rate of 4 percent applies to work on specified (historical) buildings and the construction of low-cost housing.
l In Portugal, the lower rate of 5 percent applies to public work contracts and to construction work of housing development cooperatives.
m In addition, stamp duty at 0.75 percent is payable on property transfers, while construction work attracts a 0.6 percent stamp duty.
n In Spain, the standard rate applies to construction work carried out by someone other than the building contractor.
o In the United Kingdom, the standard rate applies to the supply of new commercial buildings.
p Leases in excess of 21 years granted by the original builder-developer are zero-rated.

8

Excises

Ben J.M. Terra

> Excise—A hateful tax levied upon commodities, and adjudged not by the common judges of property, but wretches hired by those to whom excise is paid.
>
> —Samuel Johnson

I. Introduction

A. Nature of Excise Taxes

According to the late H.C. Simons, an American professor of public finance, the only cogent defense of excises rests on Calvinist premises. Calvinism, according to Simons, divides mankind into the elect and those who are obviously damned for their next life. The elect noticed that the damned consumed large quantities of certain goods and liquors, providing an obvious reason for the elect to tax these goods and liquors. This taxation would properly prepare the damned for their fate while at the same time carrying what would otherwise be tax burdens for the elect. This explanation of excises, definitely not meant as a joke, can easily be refuted. The more southward one travels in Europe the less the Calvinist influence, but the larger the number of different specific taxes.[1]

Value-added tax, as discussed in chapter 6, refers to a technique (the so-called credit of input tax based on the invoice method) of levying a turnover tax. The VAT is a general indirect tax on consumption. The general character of this tax requires that locally produced goods and

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[1]It is precisely this distinction among the EU member states in relying on various excises that made a unanimous decision on harmonization so difficult. The instruction of art. 99 of the EEC Treaty to the Commission to examine, among other issues, how excise duties can be harmonized only resulted in a few directives on tobacco and many proposals for directives that have not been adopted. It took until the completion of the internal market (1992) to harmonize the excises within the EU, although it is admitted that it is based on a new concept of "general and flexible harmonization" or on the "least common denominator." *See* E. Stubbe, *Die Harmonisierung der besonderen Verbrauchssteuern in der Europäischen Gemeinschaft,* Zeitschrift für Zölle und Verbrauchssteuern 170 (1993).
The harmonization of the excises in the EU is based on three sets of rules: (1) one directive (92/12 of March 23, 1992, O.J. (L 76) 1, as amended) on the general arrangements for products subject to excise duty and the holding, movement, and monitoring of such products, known as the "horizontal directive," (2) three directives on the harmonization of the structures of the excises which are the subject of the general arrangements procedure, namely, mineral oils, alcohol and alcoholic beverages, and manufactured tobacco, and (3) four directives on the approximation of rates of duties applicable to the above-mentioned excises, referred to as the "Directives on rates." *See* Ben Terra & Peter Wattel, European Tax Law 145–46 (1993).

imported goods be treated equally; thus, imports are equally subject to VAT.[2] The levy of VAT on importation of goods is not discriminatory (like import duties) but compensatory. VAT on importation is characterized by its *equivalent nature*. The indirect character of VAT is exemplified by the fact that VAT is remitted on exportation in accordance with the rules of the General Agreement on Tariffs and Trade (GATT). VAT is a general, as opposed to specific, tax on consumption. Excises are examples of specific taxes. The levy of excises on importation is equally characterized by its equivalent nature. Excises on importation are meant to compensate for the internal levy on identical or similar goods. The indirect character of excises is exemplified by the fact that excises are remitted on exportation in accordance with the GATT rules.[3]

Although sometimes applied to services, excise taxes are generally imposed on the sale of specifically listed goods. Import duties and VAT are based on the value of the goods concerned (ad valorem duties). Although a strong argument can be made in favor of charging excises on an ad valorem basis,[4] many excises are levied as specific duties, that is, they are imposed at a specific monetary charge per unit sold, for example, based on weight, quantity, or alcohol content, or in combination with ad valorem duties.

Because of their generally simple nature, excise tax statutes normally lack the technical complexity and need for great detail associated with, for example, income tax laws. Although excise taxes are administered by fiscal authorities, both their administration and their special problems are similar to those encountered in customs duties. The computation of the amount of tax owed is relatively simple. Typical problems involve classification and definition of goods subject to excise, questions about who is responsible for collecting the tax and when it is to be collected, how to treat leasing, and technical issues such as withdrawal from warehouse, how to deal with exempt purchasers or uses, how to handle returns, lost or damaged merchandise, exporter's refunds and issues related to effective dates, such as how to treat floor stocks at the time of the imposition, termination, or change in rate of a tax. An excise tax statute should provide as much guidance as possible with respect to these issues.

B. Terminology

The term "excise" has a historic connotation. As early as the Han dynasty (207 B.C.–A.D. 220) excises were levied on tea, liquor, fish, and reeds used for fuel and thatching.[5] Cnossen refers to a study according to which the word excise derives from the Middle Dutch *exijs*, which might be a modification of the old French *assise* meaning session, settlement, or assessment.[6] We submit that the word excise could also be derived from the Latin *excisere*: to carve, to cut out, referring to the carvings on a stick intended for measuring quantities of beer or liquor.

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[2]Since January 1, 1993, the taxable event of importation between member states of the EU no longer occurs.

[3]*See* discussion *infra* sec. I(C).

[4]*See infra* sec. I(D).

[5]–*See* Sijbren Cnossen, Excise Systems 1 (1977).

[6]*See id.* at 160, ch. 1, n.1.

More important is the definition of excises. According to Cnossen, "broadly speaking, the distinguishing features of excise taxation are selectivity in coverage, discrimination in intent, and some form of quantitative measurement in determining the tax liability."[7] Cnossen's classification of excise systems is still useful:

1. *Limited excise systems* comprise at least the traditional excise goods: tobacco products, alcoholic beverages, and petroleum products as well as motor vehicles and various forms of entertainment.... However, all in all, the coverage of limited systems would not exceed 10–15 commodity groups, with closely related products (various petroleum products, or sugar and saccharine, for instance) being treated as one excisable item. 2. *Intermediate excise systems* consist of between 15 and 30 commodity groups.... 3. *Extended excise systems* comprise more than 30 commodity groups spanning almost the whole range of production activities in a particular country.[8]

This chapter is restricted to limited excise systems in the belief that it is preferable to limit excises to a few principal groups of products and to remove vexatious minor excises and regressive excises in favor of a general tax on consumption. A further restriction is that we will focus on the traditional excise goods, such as tobacco products, alcoholic beverages, and petroleum products. Under the subject "others," we discuss some design issues of other excises in general terms.

C. Territoriality

As with the VAT,[9] the two conflicting principles on which the territorial scope of excises can be based are the origin principle and the destination principle. Most countries have adopted the latter for both VAT and excises, resulting in so-called border tax adjustments. The issue of border tax adjustments reemerges with a certain regularity in discussions on world trade. Border tax adjustment refers to the treatment of taxes under the rules of the General Agreement on Tariffs and Trade (GATT), now embedded in the World Trade Organization (WTO). The provisions on the international treatment of internal taxes in the GATT are interpreted to mean that border tax adjustments are permitted for indirect taxes, but not for direct taxes.

Border tax adjustments are a surcharge on imports, which must not exceed the internal taxes or other internal charges levied on similar domestic products, and a refund of duties and taxes upon exportation in amounts not exceeding those that have accrued. Taxation on importation and remission of taxes or duties on exportation are also called "tax frontiers," "tax boundaries," or "tax barriers."

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[7] *Id.* at 7. Certain narrowly-based taxes are sometimes called excise taces, even though they do not fall within traditional categories of excises. *See, e.g.,* USA IRC §§ 4940–48 (excise taxes imposed on tax-exempt organizations). These are beyond the scope of this chapter.

[8] *Id.* at 13.

[9] *See supra* ch. 6.

The application of border tax adjustments is voluntary, rather than mandatory. The Contracting Parties to the GATT may impose compensatory taxes on imports and may exempt, or remit, taxes on exports, but they are not required to do so.

In the 1960s, a proposal was made to modify the GATT rules by eliminating border tax adjustments altogether, under the assumption that adjustments result in unfavorable trade patterns. During the Tokyo Round (one of the major multilateral negotiations held under auspices of the GATT), the proposal to eliminate border tax adjustments was, however, rejected and the existing practices confirmed.

The concepts regarding subsidies and border tax adjustments are embodied in the GATT. However, there is no unified GATT provision dealing exclusively with border taxes. Besides Article VI, dealing with antidumping and countervailing duties, the only GATT articles concerning border tax adjustments are Article II on tariff concessions, Article III on internal taxation on imports, and Article XVI, adopted in 1955, on the border tax adjustments on exports.

Articles II and III govern border tax adjustments on imports. Article II prohibits import charges other than those provided in the GATT, but excludes from this prohibition the levy on imported products of "a charge equivalent to an internal tax imposed, consistently with Article III in respect of like domestic products." Article III provides that internal taxes shall not be applied to protect domestic production. Discrimination is also forbidden: imported products shall "not be subject, directly or indirectly, to internal taxes or internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products."[10]

D. Method of Charging

The two main methods of charging are specific rates, based on quantity, and ad valorem rates, based on value. Which is better is controversial, and may differ depending on the product and the details of implementation of the charging method. Conventional policy generally advocates that all excises be levied on an ad valorem basis rather than on a specific basis, because this protects the base of the tax from inflation. This is particularly important in countries with high rates of inflation. "Nevertheless, the real value of revenues may be maintained under a specific-rate excise tax if there are regular adjustments of the rate to reflect inflation."[11] It may be argued that with periodic adjustments for inflation, revenues under a specific-rate system will still lag during the periods between adjustments[12] but that the lag can be mitigated by introducing "automatic" adjustments of the specific rates when inflation reaches a certain threshold. Without such automatic adjustment, there could be political pressures to cancel or postpone increases, based on the argument that the tax increases will just make inflation worse.[13]

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[10]General Agreement on Tariffs and Trade, art. III(2).

[11]William J. McCarten & Janet Stotsky, *Excise Taxes, in* Tax Policy Handbook 100, 102 (Parthasarathi Shome ed., 1995).

[12]*See* Ward M. Hussey & Donald C. Lubick, Basic World Tax Code and Commentary: 1996 Edition 306 (1995).

[13]*See id.*

"An additional reason for [advocating] *ad valorem* rates is that they are fairer for the less prosperous, whose economy brands under a specific rate would bear the same tax as the luxury brands of the affluent."[14] This argument is most relevant for excises that are imposed on luxury goods for the purpose of introducing progressivity to the system. For goods such as alcoholic beverages, specific rates, for example, based on the unit of alcoholic content (or a combination of specific and ad valorem rates) make more sense given the purpose of the tax.[15] The most compelling reason for recommending specific rates is based on the difficulties of determining the taxable value related to the stage of production or distribution where excise should be levied. The problem can be dealt with under a system of ad valorem rates by providing a presumptive minimum valuation for certain products.

There are two distinct types of excise taxes. Manufacturer's excise taxes are imposed on the producer or importer of a taxable good and included in the price paid for that good by the ultimate purchaser. Retail excise taxes, in contrast, are imposed at the point of sale to the ultimate purchaser. Although recent work in the applied theory of optimal taxation suggests that indirect taxes, including excises, should be imposed as close to the final sale as possible because of the potential for excises to have unexpected distributional and efficiency effects when imposed on intermediate goods,[16] the small number of taxpayers affected by a tax imposed at the manufacturer's level may involve an administrative advantage that outweighs the suggested advantages of levying as close to the final sale as possible. Because of problems of control, most excises in developing and transition countries take the form of manufacturer's taxes. However, under an ad valorem tax, the taxable value is presumably the price actually paid or payable. At the manufacturer's level, certain costs such as transportation, storage, or even part of the profit can be transferred to the next stage. This type of circumvention requires complex legislation dealing with such matters as what should be included in the value, and special rules for transactions with related parties. Thus, specific taxes may be better than ad valorem rates if tax administrative capacities are limited so that undervaluation of domestic goods or imports is a common problem. Under a specific-rate excise tax, disputes over valuation do not arise. The choice of manufacturer's taxes requires a more frequent use of specific taxes. Furthermore, ad valorem taxes at the manufacturer's level would be either excessive or related to a final consumption price that is not always known, unless it is fixed, as may be the case with tobacco.[17] This chapter will therefore assume the manufacturer's tax and a frequent use of specific taxes in the general discussion without, however, recommending what approach should be taken in specific cases.

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[14] *Id.*

[15] *See* Leif Mutén, *Some Comments on the Basic World Tax Code,* 7 Tax Notes 179, 184 (1993). A study conducted for the European Commission, reported in the Commission Report on the rates of duty laid down in the various rates directives on the approximation of excises (July 1995), shows that "excise duty affects consumption of the different alcoholic beverages through their sensitivity of their specific price" and that "excise duty can also affect the market share of different categories of alcoholic beverage because of competition through prices."

[16] *See* McCarten & Stotsky, *supra* note 11.

[17] *See* discussion *infra* sec. III(C).

E. Principle of Nondiscrimination

The GATT practices as discussed in section C are based on the principle of nondiscrimination between domestically produced and imported products. If an excise does not apply equally to both domestic production and imports, then, to maintain a given degree of protection, a given excise tax rate change will require a corresponding change in the tax rate on imports. In India, for example, changes are made simultaneously in excises and in levies on imports. In Latin America and the EU, excises typically apply to both imports and domestically produced commodities. Within the EU, the principle of nondiscrimination requires an identical excise on locally produced products and products produced in other member states. The identical treatment applies not only to identical goods but also to similar goods; as applied to the latter, this principle has resulted in an extensive body of case law of the European Court of Justice.

II. General Design Issues

It is advisable to limit excises to a few principal groups of products and to remove vexatious minor excises and regressive excises in favor of a general tax on consumption. In contrast to a general tax on consumption, for which a single set of rules suffices, each distinct principal group of excised products requires specific legislation with specific design issues.[18] It is nonetheless advisable to lay down in a single statute the arrangements common to all products subject to excise duties and to set out in specific subdivisions or separate laws the particular provisions relating to the structures and rates of duty on the distinguished products subject to excise duty. The statute should contain at least the following items: general provisions, taxable event, movement of goods, payment of the duty, reimbursement, and exemptions. The most important design issues are discussed below.

In this discussion, we draw heavily on the EU directive in this area, known as the horizontal directive.[19] This directive sets forth principles that member states must follow in drafting their excise tax laws. The discussion is not, however, a commentary on the horizontal directive, nor do we analyze the many provisions that relate to the treatment of transactions within the EU. Rather, we view the directive as setting forth useful guidelines and definitions that countries designing excise tax laws should take into account, even though not all the aspects of the directive will be relevant outside the EU.

A. General Provisions

A statute laying down provisions common to all products subject to excise duties usually starts with the *scope* of the statute itself. Particular provisions relating to the structures and rates of duty on the distinguished products can be set out separately.

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[18]*See infra* sec. III.

[19]*See supra* note 1. We also draw on Terra & Wattel, *supra* note 1, at ch. 7.

The general provisions should define the *territorial application* of excises, in general, the territory of the country. For constitutional or other reasons (remoteness, autonomy, degree of development, etc.), certain parts of the territory may have to be excluded. It is highly recommended that the territorial scope of the tax be defined in the same manner as for VAT, so that there is a uniformity of application of the two taxes.

The *products subject to excise duties* should be mentioned. For example, "this statute applies to mineral oils, alcohol and alcoholic beverages, manufactured tobacco, and others as defined in articles [-], hereinafter referred to as excise products."[20] Here, or in the provisions containing rules for specific products, the items subject to tax will have to be defined.

It is recommended that the *definition* of the items subject to tax refer to the customs tariff, based on the harmonized system (HS)[21], a single harmonized method of classifying goods for customs, statistical, and trade purposes, that has been adopted by all the major trading nations, including the United States, the EU, and Japan. The advantage of using this approach is, in addition to the comparability of trade statistics, the use of a uniform "language" in international trade based on a systematic classification that avoids linguistic differences. In light of the destination principle,[22] the classification based on the HS may prevent disputes.

Finally, the general rules should provide which *definitions*, such as those for tax warehouse, suspension arrangement, and authorized warehousekeeper, apply for the purposes of the statute.[23]

The definitions that may be required are discussed in the sections below, under the subject to which they pertain.

B. Taxable Event and Chargeability

[20]Although it is advisable to limit excises to a few principal groups of products, the division of fiscal powers within a state, [con]federation, or economic union may allow for separate local excises. It is recommended that, in addition to VAT, the above-mentioned products be made subject to other (specific) indirect taxes only if determination of the tax base, the calculation, chargeability, and other aspects comply with the tax rules applicable to excise duties, based on the horizontal statute. If levels other than the central government retain the right to maintain or even introduce taxes on other products and services (provided that these taxes cannot be characterized as turnover taxes, i.e., a VAT), obviously it should be provided that these taxes may not give rise to border-crossing formalities in the trade within the state, [con]federation, or economic union.

[21]*See* Customs Cooperation Council, The Harmonized Commodity Description and Coding System (1984).

[22]*See supra* sec. I(C).

[23]The following definitions may apply:

(a) authorized warehousekeeper: a natural or legal person authorized by the competent authorities ... to produce, process, hold, receive, and dispatch products subject to excise duty in the course of his business, excise duty being suspended under tax-warehousing arrangement;

(b) tax warehouse: a place where goods subject to excise duty are produced, processed, held, received, or dispatched under duty-suspension arrangements by an authorized warehousekeeper in the course of his business, subject to certain conditions laid down by the competent authorities ...; [and]

(c) suspension arrangement: a tax arrangement applied to the production, processing, holding, and movement of products, excise duty being suspended.

Council Directive 92/12, *supra* note 1, art. 4.

The statute should provide for the taxable event, namely, that excise products are subject to excise duty at the time of their *production* within, or *importation* into, the territory of the country (as defined under the general provisions). A distinction should be made between the taxable event and the chargeability of the tax. "Taxable event" means the occurrence by virtue of which the legal conditions necessary for the tax to become chargeable are fulfilled, that is, production or importation. The tax becomes chargeable when the tax authority becomes entitled under the law at a given moment to claim the tax from a person liable to pay.[24]

Although production techniques may be different depending on the product subject to excise duty, the definition of the chargeability (see below) does not in principle require a definition of production. If for certain products a definition is deemed to be necessary, it is better covered in the specific provisions dealing with the structure and rates of duty on the product in question.

Importation is to be defined as the entry of a product subject to excise duty into the territory of the country. The entry from territories excluded from the territory of the country for excise purposes under the general provisions also gives rise to the taxable event of importation.[25] This all-encompassing definition needs some refinement based on the customs legislation in force. Generally, customs legislation provides for a variety of approved treatments or uses of goods, such as placing goods in a free zone or free warehouse, re-exporting the goods from the territory to a third territory, or even the destruction of goods or their abandonment to the state. If the goods do not undergo such treatment or use, they must be declared to customs, in which declaration, depending on the national customs legislation, a variety of procedures are again possible, such as transit, customs warehousing, inward processing, processing under customs control, or release for free circulation.[26] The definition of the taxable event should make clear when the excise duty is deemed to be suspended and when the importation is deemed to take place.

Notwithstanding a clear-cut definition of the taxable event (i.e., production or importation), the occurrence of the event should not necessarily result in chargeability of the tax. The excise duty becomes chargeable at the time of *release for consumption* or when shortages are recorded (the meaning of these terms is discussed below).[27] The conditions of chargeability and the rate of excise duty to be adopted should be those in force on the date on which duty becomes chargeable at the place where release for consumption takes place or shortages are recorded. This requires some further explanation.

From both the state's and a producer's point of view, an immediate collection of duties in all circumstances would have a perverse effect. Produced goods may be exported, thus not

[24]Notwithstanding that the time of payment may be deferred, for example, upon importation based on monthly payments.

[25]*See supra* sec. II(A). An additional complication could be that the excluded territories form part of the customs territory of the country. Special mechanisms have to be created in order to monitor the entry from the excluded territory into the excise (and VAT) territory without interference by customs officials.

[26]*See* B.J.M. Terra, Community Customs Law (1995).

[27]*See* Council Directive 92/12, *supra* note 1, art. 6.

requiring collection of tax or, if collected, resulting in refunds. For a product like wine, which may require time (to ripen) between production and consumption, taxation at the moment of production would result in an excessive burden. Therefore, produced or imported excise products may be held in a so-called tax warehouse without excise duty becoming chargeable (or may be placed under a customs-approved treatment or use).[28] This is called the "suspension arrangement." Any departure from this arrangement, that is, a release for consumption, results in chargeability of the duty.[29]

Release for consumption may be defined as

any departure, including irregular departure (i.e., without fulfilling the required formalities), from a suspension arrangement;

any manufacture, including irregular manufacture,[30] of excise products outside a suspension arrangement; or

any importation, including irregular importation, where excise products have not been placed under a suspension arrangement.[31]

It should be borne in mind that the taxation of excise products is based on the destination principle[32]; hence, the suspension arrangement makes it possible to postpone taxation until the products reach the country of destination.[33]

As mentioned above, the excise duty becomes chargeable at the time of release for consumption or when shortages are recorded. With regard to *shortages*, the statute should provide that authorized warehousekeepers shall be exempt from duty for losses occurring under suspension arrangements that are attributable to fortuitous events or force majeure (but not theft)

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[28]*See supra* note 25. Therefore, the statute should stipulate that the production, processing, and holding of products subject to excise duty, where the duty has not been paid, are required to take place in a tax warehouse.

[29]Excise products coming from or going to third countries or territories where the excises are not levied can be placed under a customs procedure, for example, exportation. In these circumstances, with the exception of the procedure of release for free circulation or consumption, the excise duties on the goods are deemed to be suspended. When goods leave the customs procedure, they are deemed to have been released for consumption.

[30]As mentioned in note 28, it should be required that production, processing and holding of products subject to excise duty, where the latter has not been paid, take place in a tax warehouse. The provision that manufacturing outside a suspension regime is treated as release for consumption triggers the taxable event and makes the tax become chargeable at the moment of manufacturing.

[31]Council Directive 92/12, *supra* note 1, art. 6.

[32]*See supra* sec. I(C).

[33]Only with regard to products acquired by private individuals for their own use and transported by them does the principle apply that excise duty is charged in the state in which the products are acquired. Sometimes, the acquisition is exempt and an exemption may be granted up to a threshold upon importation. Between the member states of the EU with regard to products acquired by private individuals for their own use and transported by them excise duty is charged in the state in which the products are acquired. Of course "own use" has its limitations. The horizontal directive specifies that excise duty becomes chargeable when products released for consumption in a member state are held for commercial purposes in another member state. Council Directive 92/12, *supra* note 1, art. 9(1). The directive provides for so-called minimum guide levels, below which quantities are not treated as held for commercial purposes, for example 800 cigarettes, 90 liters of wine, including 60 liters of sparkling wines. *Id.* art. 9(2). For mineral oil, the guide level is based on the form of transportation. Atypical transport, that is, other than in tanks of vehicles or in appropriate reserve fuel canisters, results in taxation in the member state of consumption. *Id.* art. 9(3).

and established by the competent authorities. They shall also be exempt, under suspension arrangements, from losses inherent to the nature of the products during production and processing, storage, and transport. The statute should lay down the conditions under which these exemptions are granted.

The statute should specify that the duty on shortages other than the losses referred to above must be levied on the basis of the rates applicable at the time the losses, duly established by the competent authorities, occurred or, if necessary, at the time the shortage was recorded. Furthermore, the statute should provide that the production, processing, and holding of products subject to excise duty must take place in a tax warehouse.

With regard to the *authorization* to operate a tax warehouse and the obligations of an authorized warehousekeeper, the statute should provide that the opening and operation of tax warehouses is subject to authorization from the competent authorities and that an authorized warehousekeeper shall be required to

provide a guarantee to cover movement and, if necessary, to cover production, processing, and holding;

keep, for each warehouse, accounts of stock and product movements;

produce the products whenever so required; and

consent to all monitoring and stock checks.[34]

C. Movement of Goods

Any departure (including irregular departure, i.e., without fulfilling the required formalities) from a suspension arrangement results in the chargeability of the excise duty. This is not always a desired result, because goods may have to move between places of production (or in general tax warehouses) or to a place or destination that will not result in the chargeability of the duty (e.g., exportation). The statute should prescribe that the movement of excise products under suspension arrangements must take place between tax warehouses or a tax warehouse and the customs office from where the products leave the territory. All such movements must be covered by the "accompanying document" (administrative or commercial). Under certain circumstances, even the movement of excise products already released for consumption (i.e., goods not, or no longer, covered by the suspension arrangements) may be covered by an accompanying document. The consignee of the movement of excise products under suspension arrangements may only be an authorized warehousekeeper. The authorized warehousekeeper[35] must return a copy of the accompanying administrative document, duly annotated, to the consignor of discharge, that is, to the authorized warehousekeeper who dispatched the goods. In this case, the authorized warehousekeeper is discharged from the duty-suspension arrangement. The products are subject to excise duty upon arrival at the consignee unless they have been placed under a suspension arrangement or have been exported.

With regard to the provision *from whom the duty is due* when goods are moved between authorized warehousekeepers, a broad provision is suggested; for example, depending on all the

[34]Council Directive 92/12, *supra* note 1, art. 13.

[35]Or the customs office where the products leave the territory.

circumstances, the duty shall be due from the person making the delivery or holding the products intended for delivery or from the person receiving the products for use.[36]

Notwithstanding the possible use of computerized procedures, all products subject to excise duty moving under duty-suspension arrangements must be accompanied by a document drawn up by the consignor. This document may be either an administrative document or a commercial document. To identify the goods and conduct checks, the packages should be numbered and the products described using the document referred to above. The consignor should seal each container when the authorities recognize the means of transport as suitable for sealing; otherwise the consignor should seal the packages. Where an irregularity or offense has been committed in the course of a movement involving the chargeability of excise duty, the excise duty should be collected from the natural or legal person who guaranteed payment of the excise duties, without prejudice to the bringing of criminal proceedings.

D. Payment of the Duty

As mentioned above in cases of movement of goods, the duty is due from the person making the delivery, the person holding the products intended for delivery, or the person receiving the products. The law should also specify who must pay the excise duty when it becomes chargeable at the time of release for consumption or when shortages are recorded. However, authorized warehousekeepers are exempt from losses occurring under suspension arrangements that are attributable to fortuitous events, force majeure, and losses inherent to the nature of the products during production, processing, storage, and transport.[37]

As mentioned earlier, the movement of excise products under suspension arrangements must be covered by an accompanying document drawn up by the authorized warehousekeeper, who must provide a guarantee. A guarantee that is jointly and severally binding on the warehousekeeper and the transporter may also be required. If the copy of the accompanying document to be returned to the consignor does not reach him or her, the consignor is not discharged from liability for the duty. The excise duty becomes due from the person(s) who guaranteed payment.[38]

E. Reimbursement

In appropriate cases, products subject to excise duty that have been released for consumption may, at the request of a trader in the course of his or her business, be eligible for

[36]*See, e.g.,* Council Directive 92/12, *supra* note 1, art. 7(3). Or from a body governed by public law. *Id.*

[37]*Id.* art. 14.

[38]"States may require that products released for consumption in their territory carry tax markings or national identification marks used for fiscal purposes." *Id.* art. 21(1). Any state that requires the use of tax marking or national identification marks as set out above is required to make them available to authorized warehousekeepers of other states. *Id.* art. 21(2). However, each state may require that fiscal marks be made available to a tax representative authorized by the tax authority of that state. *Id.* Without prejudice to any provisions, they may, to ensure that this provision is implemented properly and to prevent fraud, evasion, or abuse, specify that states should ensure that these marks or markings do not hinder the movement of products subject to excise duty. *See id.*

reimbursement of excise duty by the tax authorities when the products are not intended for consumption in the state.[39]

In applying this provision, before the goods are dispatched, the consignor must request reimbursement from the competent authorities of the state and provide proof that the excise duty has been paid.

F. Exemptions

Products subject to excise duty should be exempted from payment of excise duty where they are intended

- for delivery in the context of diplomatic or consular relations;
- for international organizations recognized as such by the public authorities, . . . and by members of such organizations, within the limits and under the conditions laid down by the international conventions establishing such organizations or by headquarters agreements; . . .
- for consumption under an agreement concluded with other countries or international organizations provided that such an agreement is allowed or authorized with regard to exemption from VAT.[40]

"Eligibility for exemption may be granted in accordance with a procedure for reimbursing excise duties."[41]

States may exempt products supplied by tax-free shops that are carried away in the personal luggage of travelers leaving the country by air or by sea.[42]

Products supplied on board an aircraft or ship during the international passenger service are to be treated in the same way as products supplied by tax-free shops.

III. Issues in Designing Specific Taxes

A. Mineral Oils

As mentioned in the introduction, one of the typical problems in drafting an excise statute is the classification and definition of goods subject to excise. In order to cover both national descriptions and the descriptions used internationally, the special provisions on the structure of

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[39]*See id.* art. 22(1).

[40]*Id.* art. 23(1). Presumably the reference to "members" of international organizations is to officials of such organizations, members usually being countries.

[41]*Id.*

[42]*See id.* art. 28(1).

excise duties on mineral oils should provide for a definition of (types of) mineral oil, referring to the codes of the customs tariff, based on the HS.[43] To avoid any form of substitution for those mineral oils for which no level of duty is specified, the statute should stipulate that mineral oil will be subject to excise duty if intended for use, offered for sale, or used as heating fuel or motor fuel. Also, any product not listed as a "mineral oil" must be taxed at the rate for the equivalent mineral oil when offered for sale or used as motor fuel or for heating purposes.

Notwithstanding the general preference for ad valorem duties, mineral oils are often subjected to specific duties. If consumer prices are not fixed, ad valorem prices at the production level could easily result in a shift of profit to later stages. Ad valorem duties levied at the retail level would result in too large a number of taxpayers. The special provisions could, therefore, provide that mineral oils be made subject to a specific duty calculated per 1,000 liters of product, for example, at a temperature of 15 Celsius; heavy fuels should be calculated per 1,000 kilograms.

In addition to the chargeable event, as defined in the horizontal statute, the specific provisions on mineral oils should specify that excise duty becomes due when (certain) products are used for such purposes as heating oil or motor fuel, which products are made subject to excise duty as mentioned above. Furthermore, it should be provided that excise duty becomes due when the conditions for exempt use or use at a reduced rate are no longer fulfilled. With regard to these exemptions or reduced rates, the law should provide for a list of activities, for example, mineral oils supplied for use as fuel for the purpose of air travel other than private pleasure flying, mineral oils used for the process of producing electricity, and so on. Care should be taken to minimize exemptions and to minimize the situations where an exempt product could be converted to a nonexempt use.

The statute must prescribe the rates that apply. As an example, Directive 92/82/EEC provides for the following rates[44] (calculated in European currency units (ECUs) per 1,000 liters of product at a temperature of 15 Celsius; heavy fuels are calculated per 1,000 kilograms): ECU 337 on leaded petrol, ECU 287 on unleaded petrol, ECU 18 on heating gas oil, ECU 13 on heavy fuel, and ECU 100 on liquid petroleum gas and methane.[45]

B. Alcohol and Alcoholic Beverages

It seems self-evident that a modern excise on alcohol and alcoholic products should be based on the pure alcohol content of a product. History and tradition, however, make it virtually impossible to come to such a straight-forward approach. Therefore, the special provisions on alcohol and alcoholic beverages may as well be built on the historic distinctions made between beer, wine, fermented beverages other than wine and beer, intermediate products, and ethyl

[43]*See supra* note 21.

[44]In contrast to the system as envisaged by the Commission with regard to the approximation of excise duties, the directive does not provide for a final rate that all member states must eventually reach. The directive merely prescribes minimum rates, which are applicable only to 7 of the 13 types of mineral oil mentioned in the structures directive.

[45]Council Directive 92/82, arts. 3–7, O.J. (L 316) 19, 19-20.

alcohol. The special provisions on alcohol and alcoholic beverages are discussed below, based on this distinction.

To solve the problem of classification and definition, with regard to *beer*, the special provisions should provide that the object of taxation is beer covered by HS code 2203 or a mixture of beer with nonalcoholic drinks falling within HS code 2206, both with an alcohol strength more than 0.5 percent vol. The duty is based on the hectoliter/degrees Plato or hectoliter/degrees of actual alcoholic strength by volume. The rates should be fixed. As an example, Directive 92/84/EEC fixes the rate at ECU 0.748 per hectoliter/degree Plato or ECU 1.87 per hectoliter/degree alcohol of finished product.[46]

The statute may exempt from excise duty beer produced by a private individual, provided that the beer is consumed by the producer or by members of his or her family or guests and provided that no sale is involved. If sales are involved, consideration could be given to applying a threshold, set in the same manner as for the VAT, below which no excise duty is due.

With regard to *wine*,[47] a distinction could be made between "still wine" and "sparkling wine."[48] Still wine (falling within HS codes 2204 and 2205) has an alcoholic strength of between 1.2 and 15 percent vol or between 15 and 18 percent vol. In both cases, the alcohol must be entirely of fermented origin.[49] This distinction could be made to allow for a higher duty on wine that has a strength of between 15 percent and 18 percent vol. Sparkling wine has an alcoholic strength of between 1.2 percent and 15 percent vol and is mainly distinguished by the use of "mushroom stoppers."[50]

The excise duty should be fixed by reference to the number of hectoliters of finished product; in principle, the same duty should be applied to all still and sparkling wines, although it is not necessary that the duty on still and sparkling wines be the same.

An exemption for private production may be granted under the same conditions as for the production of beer.

Furthermore, the specific statute could make a distinction between "other still fermented beverages" and "other sparkling fermented beverages," referring to the relevant HS codes and

[46]Council Directive 92/84 art. 6, 1992 O.J. (L 316) 29, 30.

[47]It may be considered to exempt small wine producers from the requirements of operating a tax warehouse and from the other requirements relating to movement and monitoring. *See supra* secs. II(B), (C). Where these small producers themselves move their products within the territory, they should be required to inform the relevant authorities and comply with the requirements for an accompanying document. "Small wine producers" could be understood to mean persons producing on average less than 1000 hectoliters of wine a year. If such an exemption is introduced, the tax authorities should be informed by the consignee of wine deliveries received by means of the accompanying document referred to above.

[48]Council Directive 92/83 art. 8, 1992 O.J. (L 316) 21, 23.

[49]*Id.* art. 8(1).

[50]*Id.* art. 8(2).

actual alcohol strengths, the details of which are not discussed here.[51] The provisions for the establishment of the duty on these fermented beverages other than wine and beer are identical to those on wine. If this choice is made, the statute should provide that, for the application of the horizontal statute, references to wine are deemed to apply to the products referred to above.

Intermediate products are to be defined on a residual basis, that is, falling within HS codes 2204, 2205, and 2206 and having an actual alcoholic strength of between 1.2 percent and 22 percent vol, but not covered by the definition of beer, wine, or other fermented beverages.[52] The duty on intermediate products is also to be based on the number of hectoliters of finished products. Consideration could be given to applying a single reduced rate to intermediate products with a strength not exceeding 15 percent vol under certain conditions.[53]

Ethyl alcohol covers all products of HS codes 2204, 2205, and 2206 (see the products mentioned directly above) whose alcohol strength exceeds 22 percent vol, products whose alcohol strength exceeds 1.2 percent vol that fall within HS codes 2207 and 2208 (even when they form part of a product mentioned in other chapters of the HS), and potable spirits containing the above-mentioned products, whether in solution or not.[54] The excise duty may be fixed per hectoliter of pure alcohol at 20 Celsius.[55]

C. Tobacco

It is sufficient to provide an all-embracing definition of tobacco products, (as distinct from the other products, no reference need be made to the HS code), namely, cigarettes, cigars, cigarillos, smoking tobacco, snuff, and chewing tobacco. Because rolls of tobacco for making one's own cigarettes must be taxed as cigarettes, smoking tobacco may be distinguished between "fine-cut tobacco for the rolling of cigarettes" and "other smoking tobacco." Cigarettes are defined as "(a) rolls of tobacco capable of being smoked as they are and which are not cigars or cigarillos...; (b) rolls of tobacco which by simple non-industrial handling are inserted in cigarette-paper tubes; or (c) rolls of tobacco which by simple non-industrial handling are wrapped in cigarette paper."[56]

Furthermore, the statute should provide for exemptions or refunds, for example, for manufactured tobacco that is destroyed or reworked by the producer.[57] The following definition of a manufacturer could be given: a natural or legal person who converts tobacco into

[51] *See id.* art. 12.

[52] *Id.* art. 17(1).

[53] *See id.* art. 18(3).

[54] *Id.* art. 20.

[55] *Id.* art. 21.

[56] Council Directive 79/32, art. 3(1), 1979 O.J. (L 10) 8, 9 as amended by Council Directive 92/78, art. 2, 1992 O.J. (L 316) 5, 6.

[57] Council Directive 72/464, art. 6a, 1972 O.J. (L 301) 1 as amended by Council Directive 92/78, art. 1, 1992 O.J. (L 316) 5, 6.

manufactured products prepared for retail sale. With regard to the rates, we present the EU example. A manufacturer is free to determine the maximum retail selling price for each of the products for each of the member states in which the products in question are to be released for consumption. Consumption taxes on cigarettes comprise

a specific excise duty per unit of the product,
a proportional excise duty calculated on the basis of the maximum retail selling price, and
a VAT proportional to the selling price.[58]

The member states must apply an overall minimum excise duty (specific duty plus ad valorem duty excluding VAT) the incidence of which must be 57 percent of the retail selling price (inclusive of all taxes) for cigarettes of the price category most in demand.[59] With regard to the taxes on manufactured tobacco other than cigarettes, the member states are free to apply either an ad valorem duty calculated on the basis of the maximum retail selling price, or a specific duty by quantity, or a combination of both provided that the overall excise duty is at least equivalent to

5 percent of the retail selling price inclusive of all taxes, or ECU 7 per 1,000 items or per kilogram for cigars or cigarillos;
30 percent of the retail selling price inclusive of all taxes, or ECU 20 per kilogram for fine-cut smoking tobacco; or
20 percent of the retail selling price inclusive of all taxes, or ECU 15 per kilogram for other smoking tobaccos.[60]

D. Others

As discussed earlier, it is advisable to limit excises to a few principal groups of products and to refrain from minor excises in favor of a general tax on consumption. Specific taxes, for example, on matches, lighters, playing cards, sugar, chocolate, nonalcoholic drinks, and carbonated drinks, should be relegated to the realm of curiosities. If any consideration is given to taxing other products, as mentioned in the sections above, or services, it is recommended that the advantages (revenue) be weighed against the disadvantages, such as discrimination, substitution, and administrative costs.

In various countries a tax on motor vehicles is applied, which for revenue and arguably[61] environmental purposes is treated differently from VAT, although legislation for the two is similar. Some specific design issues of a motor vehicle tax are the definition, for example, motorcars and other vehicles (HS code 8703), buses (code 8702), and trucks (code 8704); the taxable event, meaning the importation or, for domestically-produced items, the sale by the

[58]Council Directive 92/79 art. 1(2), 1992 O.J. (L 316) 8, 8.

[59]*Id.* art. 2.

[60]Council Directive 92/80 art. 3(1), 1992 O.J. (L 316) 10, 10.

[61]The Danish example shows that too high a tax on motor vehicles results in a polluting old national fleet of cars, requiring tax facilities to replace old cars for less-polluting new vehicles.

producer (i.e., the person who manufactures, produces, assembles, or rebuilds a motor vehicle) or use of the vehicle by the producer before any sale, which is treated as a sale.

No excise is to be imposed on the transfer between authorized warehousekeepers and upon exportation.

Special attention should be given to exemptions that are advocated for social reasons or to avoid intermediate costs on export goods. (For this reason, HS code 8701—applying to tractors—is not included in the definition, nor is code 8705, which covers vehicles, such as mobile cranes, road sweepers, etc.) It is worth considering granting an exemption (based on a refund, or a deduction in the framework of the VAT legislation) for commercial and public vehicles (such as cabs, police cars, buses, and trucks). The fact that these motor vehicles are subject to the motor vehicle excise prevents purchases of such vehicles to be used, without or after adjustments, as passenger cars; the latter results under the definition of production in a taxable event.

Considering the extensive range of prices—not necessarily related to specific aspects, such as weight or engine capacity of the vehicles—and the resulting regressivity of specific taxes, an ad valorem tax is preferred. The tax for imported and locally produced vehicles should be based on the current average retail price in the principal markets of the country.[62] Special attention should be paid to the exemptions on importation, for example, for used household effects. Exempt importation of used motor vehicles, for both VAT and excise purposes, should be allowed only under restricted conditions.

[62]The so-called accessories create a problem; if imported separately or sold separately, they escape taxation. HS code 8708 provides a good starting point for the articles to be subjected to the excise on motor vehicles.

9

Tax on Land and Buildings

Joan M. Youngman

The thing generally raised on city land is taxes.
—Charles Dudley Warner

I. Introduction

Taxes on immovable property, or land and buildings, as considered in this chapter generally take the form of an annual percentage of asset value. The simplicity of this concept can conceal a number of important drafting issues, some of which require a prior clarification as to the goals of the tax.[1] The primary reasons for imposing a property tax include incentives for efficient land use, a tax base that cannot be withdrawn from production, and establishment of an autonomous revenue source for local government.

Drafting a tax on land and buildings poses a number of challenges that may be surprising and frustrating in light of the simplicity of a typical property tax statute. These arise in part because many crucial issues regarding the tax resist uniform solutions. Instead, appropriate choices rely upon political, social, and economic judgments that must precede drafting but that are often not addressed until the drafting process brings them to policymakers' attention. Examples include whether to tax land and buildings together, to tax them separately at different rates, or to exempt structures; and whether the measure of the resulting tax base is to be market value, value in current use, acquisition cost, area, or some other quantity. A second set of critical issues concerning the operation of the tax may be too detailed to be addressed in the law itself, although it should be drafted with an understanding of, and an attempt to minimize, their potential difficulties. Numerous cases have addressed the meaning of "market value" when applied to property that has not been the subject of a recent sale; similar complexities arise with the definition of ownership and of property itself. In the case of a tax on land and buildings, the somewhat deceptive simplicity of the legislative language requires greater stress upon consideration of underlying policy issues. This chapter reflects that balance.

[1]*See* Janet Stotsky & Zühtü Yücelik, *Taxation of Land and Property, in* Tax Policy Handbook 185 (Parthasarathi Shome ed., 1995).

A. Why a Property Tax?

A tax on ownership and other legal interests in land and buildings can serve important fiscal, political, and legal objectives. It is critical to identify these functions, for modest initial collections may not appear to justify the administrative costs of the tax on revenue grounds alone.

1. Local Government Finance

A property tax is often designed to provide an independent source of local government finance, whether or not collected and administered locally. A tax on land and buildings offers a revenue base that, unlike sales, payroll, or income, cannot readily shift to a neighboring jurisdiction. This is one reason that immovable property[2] is appropriate for a special form of taxation that does not extend to movable property, such as inventory, equipment, and household goods.

Land and building values are also frequently associated with services provided by local governments, such as fire and police protection and road maintenance. However, this benefit justification has important limitations. Often, the properties that place the highest burdens on local services and pose the greatest fire and safety risks are poorly maintained structures of low value. More expensive buildings may be better maintained, built more recently and to more exacting safety standards, and even protected by private security arrangements.

An equally limited but politically significant justification rests on ability to pay, demonstrated in part by ownership of valuable property. The weaknesses of this rationale are readily apparent, because the tax reaches only one form of property and even that generally in a gross rather than in a net form, with no offset for mortgage indebtedness. These objections argue against excessive reliance on a property tax but not against the tax itself. Particularly in light of the ascendancy of consumption-based taxes, there is an important place for a tax upon a significant segment of wealth, especially when that segment is often subject to favorable income and inheritance tax treatment.

2. Defining the Public Claim on Property Value

The role of a property tax in defining property rights may be among its most significant contributions to economies in transition, one often overlooked when the levy is considered solely as a fiscal instrument. A period of privatization and restitution presents critical choices as to the division of public and private rights in property. The economic advantages of a system of private ownership, together with intense political reaction against the abuses of state control, frequently conflict with deeply held beliefs in the need for a continuing public interest in the permanent and irreplaceable heritage of immovable property. This conflict can arise most strongly in the case of land, whose supply cannot be expanded and whose existence is not the result of individual effort, but

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[2]*See infra* sec. II(A); *supra* ch. 3, sec. V(D)(3).

similar issues arise with regard to the privatization of buildings. Clarification of a continuing public claim upon a portion of land value in the form of an annual tax can help reconcile these competing positions.

3. Inelastic Tax Base

The inelasticity of a land tax base offers a means of raising revenue without distorting the economic signals that guide the production process. The tax will not affect the supply of land (leaving aside for the moment specialized cases such as land reclamation) and thereby imposes a lower total economic burden than would an alternate means of raising the same amount that did affect the supply of the taxed good.

4. Equity Arguments

An important political debate sometimes centers on the nature of land value as an "unearned increment," an asset attributable to social growth and public investment rather than to individual effort, and therefore appropriate for special forms of taxation. This view of land value does not properly apply to value attributable to trade and investment that have relied upon long-established systems of property rights. In that case, land wealth can represent a purchase made possible by other forms of productive effort. Of course, any tax can upset settled expectations and investor reliance, and, with sufficient notice and a gradual introduction, these detrimental effects may be greatly diminished. But the difficulty presented by this particular rationale for land-value taxation extends beyond issues of transition and implementation. The justification for a tax on "unearned" wealth is undermined when that wealth represents an investment of accumulated earnings. The alternative of a split tax base that falls more heavily on post-acquisition gains than on initial investment presents a complex administrative challenge. Individual value increments are more easily captured by a tax on realized gains than by an annual tax on property value.

Conversely, the argument for land-value taxation can be most powerful when a system of property rights is in the process of development. At this point, establishment of a continuing public claim to some portion of that value can be taken into consideration by investors formulating their bids for the property. Problems of notice and reliance arise only when a new tax is introduced after these purchases are completed. They grow more acute if the tax is capitalized into property value and so falls entirely on the owner at the time of its introduction.

Equity considerations also arise with regard to the effect of a property tax on the distribution of ownership rights. As Bahl and Linn have written,

> [a]n equity argument may be at the heart of the matter: urban land prices are frequently so high that low-income groups cannot afford to purchase land, given their disposable incomes and the prevailing capital market conditions, which prevent access to mortgage credits at affordable interest rates. To the extent that the revenue from property taxes is capitalized into lower current

land values (since the tax reduces the expected future private yield on the land), it partially expropriates landownership rights from the present owner and constitutes a loan to future owners, who can now acquire the land at the lower price but will have to pay property taxes in the future. If low-income groups cannot buy land because they lack liquidity and access to capital markets, property taxation may be one of the policy instruments to improve their access to landownership.[3]

Each of these rationales for property taxation applies equally to all types of land—agricultural, commercial, industrial, residential, and open space—as well as to land held by all types of private owners, whether individuals or enterprises. Similarly, the justification for a tax on buildings does not distinguish among them on the basis of type, use, or ownership. The multitude of special provisions that in fact differentiate among classes of land and buildings in nearly all systems of property taxation generally respond to political conditions and historical developments rather than to economic or legal considerations. For example, preferential taxation of owner-occupied housing reduces the tax burden on an important and affluent political constituency. Provisions of this type may be unavoidable to some degree, but simplicity and neutrality are best served when such preferences are minimized.

B. Drafting Issues

The elements to be specified in drafting a property tax are similar to those required for other levies: (1) definition of the tax base, (2) identification of the parties responsible for payment, (3) determination of the tax rate, and (4) assignment of administrative functions and tax revenues among levels of government. None of these has a single optimal resolution. The preferred method for addressing each issue will depend upon prior political and economic judgments, particularly with regard to the feasibility and desirability of autonomous local government. A practical evaluation of any proposed legislation must examine such questions as these:

- How is the system of identifying properties and taxpayers coordinated with current land and property records? What agencies will be responsible for maintaining this information?

- Will the proposed division of revenue between local and central governments serve the goals set for the tax? For example, will it permit local governments to undertake new responsibilities, and will it offer the government agency responsible for administration of the tax an incentive for efficient collection?

- Will the interest and penalty provisions encourage a reasonable level of compliance, particularly if this is a new tax?

[3]Roy W. Bahl & Johannes Linn, Urban Public Finance in Developing Countries 168 (1992).

- Are land-policy goals for the tax, such as control of price inflation and discouragement of speculation, realistic?

This chapter will examine alternative approaches to these issues, and examine their benefits, drawbacks, and consequences.

C. Terminology

References to taxes on immovable property as "property taxes" require some clarification. In a technical sense, "property" consists of a set of legal rights pertaining to a specific object;[4] a property tax is not imposed on the physical land and buildings, but rather on intangible rights to them. Although differentiating between a tax on a building and a tax on the rights of ownership of a building may seem a semantic exercise, this distinction takes on practical importance when partial interests that do not rise to the level of ownership are subject to tax. For example, countries that do not recognize private ownership of land but recognize private rights of use of land still have a system of private property appropriate for taxation.[5]

With these caveats, this chapter will use the terms "property taxation," "taxation of immovable property," and "taxation of land and buildings" interchangeably to mean the taxation of legal interests in land and improvements to land, including buildings, with appropriate distinctions when a choice among technical terms would affect the substance of the legislation.

The term "assessment" often gives rise to confusion, because in the property tax context it is commonly used to mean "valuation." This chapter will refer to valuation as a part of the assessment function, which includes the entire process of establishing tax liability.

A "cadastre," or official property register, can take a number of forms. A legal cadastre lists title or ownership to land and buildings; a fiscal cadastre[6] contains tax information, such as valuations and assessments; and a physical cadastre deals with parcel boundaries and building information. Because these functions are closely related, cadastre is often used to refer generally to the combined set of records, an integrated or master cadastre.

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[4]Restatement of Property §§ 8, 14–18 (1936)("real property" defined as a set of estates).

[5]*See* CHN LT.

[6]"The basis of a good property tax practice is a full fiscal cadastre. This would involve describing and defining boundaries for every property (cadastral maps), establishing ownership or taxpayer liability, valuing the land, and if necessary describing and valuing all improvements on the land." Bahl & Linn, *supra* note 3, at 109 (footnotes omitted).

II. Legal Issues in Defining the Tax Base

A. Types of Property Subject to Tax

A wide variety of definitions of property have been used in determining the base of a property tax. Where this levy was expected to function as a wealth tax, as in the United States during colonial times, an expansive definition encompassed all types of property, whether movable, immovable, tangible, or intangible. Often termed a general property tax (as opposed to an immovable property tax), this type of gross wealth tax became untenable as financial assets and other intangibles that are inherently difficult to identify and assess grew in importance. Replacement of the general property tax with a tax on immovable property, complemented by an income tax, was an important goal of nineteenth-century tax reform. The Russian model of a balance sheet tax on enterprise assets is a specialized example of a general property tax, limited to one particular sector of the economy. It functions more as a specific business tax than as a property tax.[7]

A property tax limited to tangible assets may still reach movable property, such as inventory, machinery, and household goods. Their inclusion in modern property tax systems is generally justified only on grounds of revenue. Like financial assets, they are difficult to identify and assess and are readily concealed and easily removed from the taxing jurisdiction. Particularly when such property is held by individuals rather than by businesses, attempts to tax it can result in an administrative burden out of proportion to revenue yield. One exception is the taxes sometimes imposed on registered assets, such as automobiles, whose ownership and approximate value are a matter of record. Again, these function more as specialized fees than as property taxes. They are not a natural component of a tax system intended to reach land and buildings. A number of countries impose a broad tax on net wealth; this is discussed in chapter 10.

Within the category of immovable property itself, an important choice exists between a tax on land and a tax on land and buildings alike. Buildings do not share many of the unique characteristics that recommend land as the base of a special tax—its true immovability, its inelastic supply, and its value drawn from nature and social development rather than from individual effort. However, unless a tax on land is to function as a "single tax" and the sole source of government revenue, it will operate in conjunction with other levies of a different nature. A tax on buildings, considered on its own merits as a component of a mixed revenue system, may logically be enacted together with a tax on land. In this case, however, specifying distinct rates for land and for buildings permits the option of taxing land more heavily, as may be appropriate for a commodity in inelastic supply.

The definitions of immovable property or of land for purposes of the property tax may differ from the definitions of those concepts that are given in the civil code or in other legislation. The definition of buildings or of immovable property is the subject of many disputes in marginal cases, such as those dealing with otherwise movable property

[7] *See* RUS TAE.

incorporated into immovable structures ("fixtures," such as elevators and heavy machinery) or small buildings such as kiosks, or large equipment such as transmission towers and pipelines that may or may not be considered movable. The definition of land can give rise to similar complexities when land and improvements are distinguished for tax purposes. Improvements other than buildings, such as grading, irrigation, and paving, could properly be considered outside the base of a land tax designed to encourage investment by reaching only site value.

A typical definition of "land" that does not try to address these issues states "`[l]and' means the solid material of the earth whatever may be the ingredients of which it is composed...."[8] *Black's Law Dictionary* includes such definitions as "any ground, soil or earth whatsoever; including fields, meadows, pastures, woods, moors, waters, marshes, and rock," and "the material of the earth, whatever may be the ingredients of which it is composed, whether soil, rock or other substance, and includes free or occupied space for an indefinite distance upwards as well as downwards, subject to limitations upon the use of airspace...."[9] This last reference makes the important point that not only surface rights but also air rights and mineral rights must be considered in defining the property subject to tax and determining how it is to be assessed when these rights are held by different taxpayers.

B. Measure of the Tax Base

Definition of the tax base requires a number of crucial choices with regard to determination of the property attributes that will be valued for taxation and the form that valuation will take.

1. Market Value as a Tax Base

Legislation implementing a value-based system, the most prevalent in international practice, must take into account the measure of that value and the degree of precision with which it is to be estimated. Statutory definitions of market value vary from the terse to the expansive, from the standard of a willing buyer and willing seller to the following suggested language from the 1976 Layfield Commission report in Great Britain:

> The value of the hereditament shall be the amount which the hereditament might reasonably have been expected to realize if sold by a willing vendor in the open market freehold with vacant possession at the relevant date with the benefit of any easement or other right inuring for the benefit of the hereditament and subject to any easement or other right subsisting for the benefit of other land and to any other restriction statutorily imposed upon the hereditament and on the assumptions that the use of the hereditament would be permanently restricted to that existing at the time of the valuation, including any change of use for which no planning permission would be required, that no alteration to the hereditament

[8] Cal. Water Code § 34014 (West 1984).

[9] Black's Law Dictionary 789 (5th ed. 1979).

> would be made other than any alteration for which no application for planning permission would be required, and that the hereditament was in the state of repair at the time of valuation which might reasonably be expected by an occupier of the particular property having regard to its character, its environment, and to the neighborhood in which the hereditament is situated.[10]

This extremely unwieldy formulation was offered by the Department of the Environment as "A Possible Definition of Capital Value for Rating Purposes," and its intent may have been to make the change to a capital value base appear as awkward as possible. In fact, most states in the United States implement a capital value base with no more than the willing buyer-willing seller statutory language.[11]

This lengthy definition is useful, however, in attempting to respond to numerous potential questions as to the interpretation of "market value." It points to issues that will need to be addressed, whether by legislation, regulation, litigation, or custom. For example, legal interests in property are frequently divided among multiple parties, whether through public regulation such as zoning, rent control, and environmental restrictions or through private arrangements such as leases or trusts.

The need to recognize a diminished market value by reason of such restrictions in some but not all such cases produces the most complex legal challenges to property assessment. It may seem unfair to ignore an involuntary, government-imposed restriction such as zoning, but zoning restrictions may be changed and market prices may reflect that expectation. Most private, voluntary, profit-motivated restrictions may be considered similar to joint ownership arrangements,[12] which need not affect property assessment. Just as the assessor is not required to examine all legal agreements in order to attribute the appropriate amount to each partner in a shared tenancy, so can the effect of leases and other divisions of rights in property be subsumed under a unitary valuation of the undivided estate. While this approach is logically impeccable, it encounters severe resistance when it produces a high assessment upon property whose owner is laboring under the burden of an unfavorable lease or other legal arrangement.

A similar definitional problem arises when the value of property to its owner diverges drastically from its sale value. Specialized manufacturing and assembly plants may constitute a major portion of a jurisdiction's property value on the basis of their depreciated cost but command a market price that reflects only salvage value. Problems such as these have led to criticism that the willing buyer-willing seller standard identifies "not what a real buyer and a real seller, under the conditions actually surrounding them, do, but what a purely imaginary buyer will pay a make-believe seller, under conditions which do not exist."[13] The imaginary nature of the buyer and seller is not necessarily

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[10]Layfield Commission, Local Government Finance Report, 1976 Cmnd 6453, at 441.

[11]*See, e.g.,* Cal. Rev. & Tax. Code § 110 (West Supp. 1995); 98 NY Jur. 2d, Taxation & Assessment § 303 (Law. Co-op. 1992).

[12]*Cf.* vol. 2, ch. 19 (discussion of ownership interests in legal persons).

[13]McGill v. Commercial Credit Co., 243 F. 637, 647 (D. Md. 1917).

objectionable if the computation leads to an otherwise acceptable tax base. The greater problem is the lack of certainty introduced by speculation upon the bargain that would be reached by imaginary parties.

Complex valuation issues of this type arise under any nonformulary approach to measuring the tax base, but this does not establish the superiority of a formula in any specific situation. Formulary elements are also subject to dispute and necessarily provide less information on the wealth or ability to pay represented by the asset being taxed. In a functioning market system, property owners are often extremely well informed as to the value of their holdings and are thus able to supply an immediate check on the accuracy of their assessments.

2. Capital Value and Annual Value

Property taxation in the United Kingdom was traditionally based on the annual rent a parcel would command if vacant and available for let, while in the United States the tax was based on sale price or capital value. Where the current use of property is also the most economically profitable one, these two measures will stand in a predictable relationship to one another. A tax on annual value can be expressed as a tax on capital value, and vice versa, by reference to the rate of return expected from income-producing property.

The two standards diverge when a prospective purchaser would bid an amount unrelated to current yield in the expectation of a different and more profitable use in the future. The capital-value base has the advantage of more closely approximating a tax on immovable property wealth and more effectively discouraging speculative withholding of land ready for development. These economic advantages are political drawbacks, however. The annual-value base follows more closely the realized cash income with which owners may expect to pay the tax and exerts less development pressure on open space and agricultural land bordering urban regions. There is no need to elaborate the political reaction to taxation at levels requiring sale or mortgage of family farms, open space, and elderly taxpayers' residences.

The problems of "cash-poor" taxpayers deserve special attention because they illustrate the potential conflicts between economic and political considerations with respect to tax structure. One economist has commented that "welfare cases should be treated by the welfare system on an impartial basis, without special favor to property owners. To use property tax relief as a substitute for welfare is to distribute welfare in proportion to wealth, surely an odd notion."[14] From an economic perspective, this problem might be resolved by the availability of financial intermediaries willing to extend loans secured by the property subject to tax. However, few taxpayers have participated in programs in the United States and Canada in which taxing jurisdictions offer extremely low-interest tax deferral to senior citizens willing to accept this debt as a lien upon their property. Intense concern for preserving family property as an

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[14]Mason Gaffney, *quoted in* Henry J. Aaron, Who Pays the Property Tax? 76 & n.9 (1975).

unencumbered asset rendered these programs unacceptable to most of their intended beneficiaries.

Similar issues of highest and best use arise in the valuation of structures. If a building no longer represents the most profitable use of its site, may the land value assume that a purchaser would plan to replace it? In the United Kingdom, the answer is generally negative, under the principle of *rebus sic stantibus*, which requires that property be valued in its present condition. In the United States, considerations of highest and best use would permit this approach—valuing the property not as if the replacement had already been built, but in light of alternate potential uses. These divergent approaches to valuation may reflect the United Kingdom's more restrictive interpretation of private development rights, illustrating the close relationship between property law and the structure of an appropriate property tax system.

3. Income-Based Valuation

The problem of cash-poor property owners has sometimes given rise to another form of preferential assessment, one based upon an estimate of the income earned from the current use of the parcel. This "current use" taxation is designed to reduce development pressure on farmers and owners of open space ready for development in the urban fringe. When drafted simply as a tax reduction, this provides no guarantee that the land will not be developed in the future, and so perversely subsidizes speculation by reducing the cost of withholding land from the market. The net result may simply be an exacerbation of sprawling development as new construction leapfrogs past the urban fringe. However, any attempt to impose a legal restriction on future development could prove unworkable and certainly inappropriate for an introductory property tax draft. Because owners of land ready for development in the urban fringe hold a valuable resource, it would be desirable to avoid extending tax preferences to this group. A compromise alternative requires repayment of the tax reduction enjoyed for a specified number of years before development occurs. There is no similar distinction between "current use" and "highest and best use" in the case of farmland located in agricultural areas that are not ready for urban development. Subsidies for these taxpayers are more likely to concern tax rates and exemptions for growing crops. Like other inventories, crops fluctuate in value throughout the year, and taxing them as of a specific date penalizes those farmers whose yield is at a maximum value at that time. Where profit from farm operations is subject to income taxation there is no need to include an arbitrary and unpopular assessment of crops in the property tax as well. A more difficult issue is presented by trees and other long-lived plants. A tax that includes improvements to land will have to specify whether such plants are included in the tax base.

4. Area-Based Taxation

A true area-based tax taking no account of differences in land value has the obvious drawback that "residents who own undesirable land must pay at the same effective rate as residents who own highly desirable land in a prime location with access to all services and amenities."[15] For this reason, property taxes based on area have generally been replaced by ad valorem measures, as in the Netherlands, or by a proliferation of special provisions designed indirectly to recognize gradations in value.[16] This latter situation negates the simplicity of application that is the prime recommendation for an area-based measure. Much simplicity can be retained without sacrificing the equitable benefits of a value-based tax through the use of zone and benchmark approximations of market value, discussed below.

5. Acquisition Value

In 1978 California voters amended the state's constitution to shift its property tax from one based on fair market value to one based roughly on acquisition cost. The actual California system uses a 1975–76 base-year value for property that has not changed hands since that time,[17] a 2 percent maximum annual inflation adjustment,[18] and many provisions defining the type of change in ownership that leads to reassessment at market value.[19]

This unusual system has engendered strong political support and strong criticism. Its great benefit is its predictability, allowing a taxpayer purchasing property to calculate the level of future tax obligations with great accuracy. This is a direct response to California's rapid housing price inflation of the 1970s, when property tax bills increased sharply as local governments failed to reduce tax rates in proportion to the rising tax base. This predictability carries with it a concomitant simplicity of administration: values need only be assigned upon a change in ownership, which usually yields sales data as well.

These benefits are obtained at a heavy price. Particularly in a time of rapid price increases, acquisition costs can diverge sharply from market values and therefore from property wealth as an index of ability to pay. This tax base can confer a perverse reward on owners experiencing an increase in their net wealth while burdening newer purchasers who have paid a higher price for similar property. Alternatively, to the extent the increase in tax is capitalized, the burden may fall in part on the seller, but this is also capricious and creates a lock-in effect. An acquisition value base can provide a strong disincentive for changes in residences, penalizing those whose jobs or family situations require mobility.

It has been argued that, under this system, property will be revalued at least once every generation. In fact, California permits the acquisition value tax base for a home to

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[15]Sandra Bettger et al., The Economic Impact of and Strategy for Implementing an Ad Valorem Property Tax: A __se Study of Krakow 7 (International City/County Management Association Report to the U.S. Agency for International Development 1994).

[16]Joan Youngman & Jane Malme, An International Survey of Taxes on Land and Buildings 157–73 (1994).

[17]Cal. Rev. & Tax. Code §§ 50, 110.1 (West 1987).

[18]*See id.* § 619(f).

[19]Cal. Rev. & Tax. Code §§ 60–69.3 (West 1987 & Supp. 1995).

be transferred between parents and children.[20] This greatly extends the potential duration of disparities in taxes faced by owners of similar properties and exacerbates the antimobility effects of an acquisition value base. Like many of the extensions of the California tax limitation measure, this was not part of the original legislation but was approved in a later popular election as an expression of antitax sentiment.

6. Other Tax Bases

Some form of enterprise value, going-concern value, or measure of business income is often found in the base of a tax on business property, even when the tax is nominally intended to reach only tangible property. Strictly speaking, a tax on land and building values should not include going-concern or enterprise values. The value of the immovable assets should be set at the amount a prospective purchaser would bid for those assets alone, not for the assets as part of an ongoing business. However, in practice it is not unusual to encounter hybrid taxes that combine these elements of a property tax and an enterprise income tax, sometimes producing a result inferior to both.

After property taxes in California were severely curtailed in the 1970s, some of them were replaced by per-parcel taxes or flat fees for each property unit. Equivalent to a poll tax on property rather than on individuals, these flat fees serve as an equally crude basis for distributing the cost of community services, justified only when specific limitations or historical developments leave other alternatives even less desirable. They represent an alternative to property taxation as discussed in this chapter rather than a means of implementing it.

C. Special Assessments and Betterment Levies

Special assessments finance capital improvements through additional taxes on properties within the area that benefits from such investment. These present some questions not raised by recurrent taxes used for general revenue purposes, such as whether voter approval is to be required for this imposition and whether collections will be limited to the cost of the improvements. However, for most purposes they may be analyzed as a variety of property taxation, and many of the issues discussed in this chapter, particularly with regard to valuation, will arise in the drafting of legislation to implement special assessments as well.

D. Market Value Taxation in Developing Economies

A certain degree of circularity accompanies the process of establishing public claims on land and building values through annual taxation in the early stages of a transition to a new regime of property rights. The market data needed to estimate the sale value of properties that have not themselves recently changed hands in an arm's-length transaction will become available only after investors have made purchases in reliance on the existing system of property rights. Therefore, some alternate method of estimating the

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[20]*See* Cal. Rev. & Tax. Code § 63.1 (West Supp. 1995).

value base will be required in the initial stages of the tax, even if a more sophisticated approach is adopted after market data are more widely available. Estonia, for example, "has taken the bold step to base the new land tax on values, even though the lack of market information will make it necessary to decide models for market values until proper estimation can take place based on sales prices."[21]

Even when such data are available, a statutory formula based on objective criteria designed to approximate market value may be preferable, on grounds of certainty and ease of administration, to an explicit market value standard. For example, Chile bases property taxes upon a formulary "fiscal value" of land and buildings, rather than on their market value.[22] Land within a given zone is assigned a fiscal value reflecting sale transactions, soil quality, and development in the zone. Buildings are valued according to specific characteristics and size, reflecting construction costs in the Santiago area, with adjustments for other regions.[23] Buildings are depreciated at a constant yearly rate determined by the type of construction, but total depreciation is limited to 25 percent of the initial fiscal value.[24]

This approach avoids many complications inherent in determining the meaning of "market value" for properties that have not been the subject of recent sales. Computer-assisted mass appraisal can provide strong grounds for estimating the sale price of properties that share characteristics of many similar properties, such as apartment houses and single-family residences. Often, however, valuable property will be of a type not frequently bought and sold, for example, specialized manufacturing sites. In these cases, market value can be defined either literally to mean the actual amount for which the property could be sold to an unrelated party (a figure that may be well below both the value to the current owner and the depreciated reproduction cost) or as a cost-based figure reflecting the special value to the current owner (which contravenes the general rule of market-based assessment that governs the taxation of other property). Some problems of this type will arise under any approach to value-based taxation, but the special difficulties of determining market value may recommend use of a formulary alternative even after sufficient data are available for market prices to be utilized in valuing property directly.

Within the formulary approach, three variations merit special consideration. The first and least accurate index of market value considers only a very limited number of

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[21]Danish National Survey and Cadastre, Land Taxation and Valuation in Estonia 29 (1993). "The factors that are used in valuation models are pollution, water supply, land quality, valuation factors, location, roads, etc." Jussi Palmu & Jaisa Vuorio, Defining of Suitable Value for Estonian Settlement Where As No Land Market Exists (Seminar on Taxes on Land and Buildings, sponsored by the Danish National Survey and Cadastre and the Estonian National Land Board, 1993). Similarly, factors such as utility service, transportation access, zoning, soil quality, and infrastructure entered a recent model valuation of land in Poland. The Price of Land in Poland (U.S. Agency for International Development, Office of Housing and Urban Programs Working Paper 1990).

[22]Youngman & Malme, *supra* note 16, at 105, 110–11.

[23]*Id.* at 110–11.

[24]*Id.* at 110.

factors. In the case of agricultural land, the existence of detailed data on soil analysis and productivity may permit classification on this basis. For example, in Moldova the Ministry of Agriculture has developed tax valuation charts for all forty regions (rayons) and for four cities, based on fertility measure and type of land: crop fields, forests, vineyards, hay fields, and pasture.[25] This classification does not reflect locational advantage, even though distance from markets could affect the value of land, and development potential may be more important to the value of land in the urban fringe than its agricultural productivity. A second type of index takes into account an expanded but still limited and legislatively prescribed number of factors. Finally, the specification of these factors may be delegated to the administrative body responsible for valuation. Such delegation provides the greatest flexibility but also risks the greatest sacrifice of legislative oversight. Where appropriate, it can provide the readiest transition to full market value taxation as more price data become available.

E. Taxation *In Rem* or *In Personam*

Debate sometimes arises as to whether a tax on land and buildings is to be designed as one *in rem* or *in personam*, and what consequences follow from that distinction. Terming the tax as *in rem* generally denotes consideration only of property characteristics, and not personal attributes of the owner, in the assessment process. Three particular consequences may be intended. First, assessments may name the property but not rely upon identification of the owner to establish tax liability; instead, publication may be deemed to notify all interested parties of this claim. A second consequence may be a corresponding absence of personal liability, remedy for nonpayment being limited to seizure and sale of the property itself. Finally, this approach may be intended to avoid considerations of the personal status of the owner in determining the amount of the tax.

There is no need to avoid combining the characteristics associated with *in personam* and *in rem* taxation. As an American jurist wrote, "[a]ll proceedings, like all rights, are really against persons."[26] The tax may be levied in the first instance upon the owner, while at the same time publication may put all other interested parties on notice that a default may jeopardize their property rights. In fact, such mixed enforcement measures may be highly desirable. Useful as it is to maintain the option of collection through seizure of the property and foreclosure of a tax lien, this is a cumbersome and draconian means of securing payment of what in many instances may be a relatively small sum. The availability of personal enforcement against the owner may actually increase compliance when seizure of a home is deemed undesirable or infeasible.

For these reasons, it is preferable to avoid any references to *in personam* or *in rem* taxation in legislation and regulations, addressing instead the specific liability and enforcement issues raised by this distinction. The taxing authority may be directed to

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[25]Acte Normative privind impozitul funciar i modul de impozitare, 1994 (MDA). This approach provides no basis for estimating the market value of urban land.

[26]Oliver Wendell Holmes writing for the Court *in* Tyler v. Judges of the Court of Registration, 55 N.E. 812, 814 (Mass. 1900).

draw up a tax roll, listing as liable for payment any person "owning, claiming, possessing or controlling"[27] an interest in the property on the lien date. Under such a rule, more than one person—for example, the owner of a property and the lessee of the property— may be jointly and severally liable for the tax. Parties aware of this legal regime can be expected to allocate the tax liability among themselves by contract, as through a lease contract specifying that taxes are the responsibility of the owner. This provision in the contract would not, however, prevent the tax administration from collecting from the lessee; it merely specifies the lessee's contractual right against the owner for reimbursement of the tax if the lessee must pay it.

This flexible approach to a definition of the taxpayer differs from the more familiar method of specifying only one person as primarily liable for a tax, but its broad terms offer important administrative advantages. Initially, the tax administration will, according to its usual procedures, send only one tax bill for a particular property, normally to the owner. Only if the owner fails to pay will the tax administration seek to collect the tax from others who are made liable under the law. If both the owner and the lessee are made liable under the statute, then the tax administration will not be required to show that it had made the requisite effort to collect from the owner before being able to go after the lessee. If the statute specified that the lessee would be liable only if the owner failed to pay, then the lessee might be able to avoid the tax by arguing that the tax authority had not made a sufficient attempt to collect from the owner.

This hybrid of personal and *in rem* liability raises administrative issues that may require special attention if they are not adequately addressed by general taxation provisions. The first concerns notification procedures, particularly in two special cases: where multiple parties claim an interest in taxable property (as in a joint tenancy) and where no party does. Both illustrate the benefit of the *in rem* aspects of a mixed enforcement system. Where legal interests have been divided among a number of individuals or entities, it is not feasible to require the assessor to determine the proportionate shares for which each is responsible. Because the tax is a lien against the property, all interested persons are on notice that their interests may be eliminated by foreclosure if the tax is not paid in full. Of course, this approach must be carefully coordinated with the *in personam* aspects of the enforcement provisions if the owner of a small partial interest is not to be liable for seizure of other property or funds to pay the entire amount of the tax. In the case of property with no identified owner, some statutes provide that "such land may be assessed to `unknown owner' or `unknown owners.'"[28] Although this may be useful in establishing a lien, it is always preferable to identify a named party claiming an interest in the property. The situation of unknown owners must be distinguished from systems of communal land tenure with no private ownership.[29] Property

[27]This language is taken from Cal. Rev. & Tax. Code § 405 (West 1987), but similar counterparts are found in many other statutes. For example, the Canadian Indian Act, § 83(1)(a), refers to persons "occupying, possessing or using" the property.

[28]Or. Rev. Stat. § 308.240(2) (1992).

[29]The property tax implications of communal ownership are discussed with regard to African personal taxes in R. Bird, Taxing Agricultural Land in Developing Countries 57–63 (1974).

taxation is appropriate under such a regime only if nonownership rights, such as long-term or renewable rights of use, are to be considered property for purposes of the tax.[30]

The converse issue concerns identification of those parties who may contest an assessment—both in cases where multiple interests exist[31] and in those where no claimants are identified. In the former instance, it is important to avoid potential repetitive claims; in the latter, steps must be specified for clearing title or foreclosing the tax lien within a given period, to encourage return of the property to the tax rolls and to the market.

A very interesting procedural issue sometimes arises with regard to a taxpayer's ability to protest the underassessment or improper grant of an exemption to a neighboring property.[32] This issue rarely needs to be addressed in the initial legislation introducing the tax, but considering the issue may help focus discussion on the practical questions that will arise with implementation of the tax.

F. Defining the Unit

Per-unit exemptions and progressive rate structures require a determination as to which contiguous or related parcels will be considered as one for purposes of the tax. The complexity inherent in progressive rate structures limits their applicability, and only an explicit political decision can justify their administrative costs, particularly in the case of a new tax or an economy in transition.[33]

The *in rem* aspects of the tax are in conflict with progressive rates, particularly when assessment must proceed in the absence of conclusive ownership information. Progressive rate structures assume an individual's ability to pay to be proportionate to the value of all property owned, however divided into parcels or among different tax jurisdictions. Even under a flat-rate tax, some parcel definition may be required if exemptions are designed to remove low-value parcels or structures from the tax base. Otherwise, these exemptions may be expanded by artificial subdivision of single parcels

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[30]*See infra* sec. III.

[31]Sometimes tenants obligated by the terms of their lease to pay taxes have been found eligible to protest an assessment issued against the landlord as owner. *E.g.,* Ewing Township v. Mercer Paper Tube Corp., 8 New Jersey Tax 84 (1985); Riso v. Pottawattamie Board of Review, 362 N.W.2d 513 (Iowa 1985).

[32]*See generally* Annotation, Standing of One Taxpayer to Complain of Underassessment or Nonassessment of Property of Another for State or Local Taxation, 9 Am. L. Rep. 428 (4th ser. 1981). Massachusetts permits any ten taxpayers in a single district to bring a court action to determine the legality of public actions to raise funds, expend money, or incur obligations. Mass. General laws, ch. 40, sec. 53. In Cabot v. Assessors of Boston, 138 N.E.2d 618 (Mass. 1956), *appeal dismissed*, 354 U.S. 907 (1957), a group of owners of parking garages located near Boston Common invoked this provision to protest the exemption of a portion of the property below the common leased to a private party for use as a commercial garage.

[33]Taiwan Province of China and Korea provide examples of highly developed progressive property tax systems. "When the various aspects of this question are seriously considered, it seems that the case for progression far outweighs the advantage of administrative simplicity of a flat rate." John Riew, *Property Taxation in Taiwan: Merits, Issues and Options*, 68 Industry of Free China 13 (1987).

into multiple units. Simplification is always best served by minimizing exemptions and avoiding progressive rate structures.

Another aspect of parcel identification concerns structures under construction or destruction. It is desirable that buildings under construction be assessed according to their state of completion at the time of valuation. The alternative of exempting such property until completion risks long-term tax evasion through deliberate noncompletion. Sometimes plans are deliberately drawn for large multistory buildings when only small structures are actually contemplated, solely to avoid taxation. Although property may produce no income until completion, it is not without value, and the property tax is not limited to income-generating assets. Similarly, buildings destroyed by fire or other cause during the tax year should be taxed as of their status on the valuation date, with such hardship relief as is contained in general administrative (or even nontax) provisions. A prorated property tax refund will rarely be the most effective means of disaster assistance.

G. Exemptions

Exemptions present a particularly dramatic example of the interplay among economic, legal, and political factors in the development of property tax systems. Typically, an array of complex provisions reflects the perceived social benefits of subsidizing particular property uses and owners. At the same time, considerations of economic neutrality and administrative efficiency recommend that exemptions be as few as possible.

Among the most common exemptions are those granted to property owned by charitable organizations. It is important to consider the commercial use of property that will negate the exemption and the effect of division of interests in property between charitable and noncharitable uses and owners. Many practical issues also arise with regard to the status of uses that are not charitable in themselves but are ancillary to an exempt purpose, such as parking lots and administrative offices. Often, such determinations will be too detailed and factual for consideration in the statute itself, but it is important that they be addressed explicitly, whether by decree or by regulation.

Where feasible, a charge in lieu of a tax on exempt property can serve both land use and revenue functions by reflecting the cost of property-related services, particularly if this amount is set as some proportion of the tax that would be due absent the exemption.

The taxpayer claiming the exemption should be required to file appropriate documents establishing the exempt status of the property. In practice, such filings are sometimes required annually and sometimes only on a change in status.[34]

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[34]*See, e.g.,* Cal. Rev. & Tax. Code § 254 (West 1987) (colleges, libraries, and museums required to file annually); *id.* §257(c) (religious institutions required to file only when exemption is first established).

III. Property Rights and Valuation

A. What Is "Ownership"?

A legal view of property as a set of intangible rights raises a question as to which rights are being valued for tax purposes.[35] While the physical dimensions of a parcel of land or of a building may be objectively established, this does not determine which rights constitute a property interest in those physical elements. Two particularly important issues concern the extent to which restrictions on the owner's use or enjoyment are to be considered in assessment and the manner in which partial interests are to be taxed.

All property rights are subject to some restrictions that may affect market value, whether in the form of building codes, zoning, health and safety regulations, environmental protection or remediation measures, rent control, or other publicly imposed limitations on use. In addition, a wide array of privately negotiated provisions, such as leaseholds, easements, and restrictive covenants, may diminish or redistribute the value of the original undivided interest.

Public legislation that has reduced the value of an owner's interest may be considered part of the overall legal structure of property rights within which the valuation is to take place. Private agreements stand on a different footing. Permitting these to reduce taxable value runs a clear risk of encouraging non-arm's-length agreements, such as disadvantageous leases designed solely to lower property assessments. Even legitimate, profit-motivated agreements need not be allowed to reduce the tax base if owners are on notice before concluding them that tax liabilities will remain unchanged if the contract reduces the market value of their holdings. Actions that reduce property value (such as failure to modernize or maintain a building) must, however, be clearly distinguished from those that redistribute that value (such as a disadvantageous lease, which increases the value of the tenant's interest even as it reduces the value of the landlord's position). Disregarding the former actions violates the goal of taxing property values and risks unverifiable and subjective valuations. Disregarding the latter, however, simply effectuates the aim of taxing all private interests in property. It is equivalent to requiring only a single assessment of property held by joint tenants.

An owner who conveys property rights to another party has clearly diminished the sale value of his or her remaining interest. For example, property encumbered by rights of access or limitations on building will not command as high a market price as it would in the absence of these provisions. Many legal disputes have arisen with regard to the property tax treatment of such encumbered property. On the one hand, assessors generally disregard most private and voluntary divisions of interests to avoid the administrative difficulties of dividing property value among lessors, lessees, mortgagors, mortgagees, life tenants, holders of a remainder interest, and other holders of property

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[35]It is important to consider this point within the context of existing property law. Civil law systems, for example, are more likely to consider "ownership" indivisible than are common law countries. *See* John Merryman, *Ownership and Estate,* 48 Tulane L. Rev. 916 (1974).

interests. This result is fair as long as parties to these agreements are on notice that it is their own responsibility to allocate an undivided tax bill among themselves. On the other hand, certain interests in property, primarily easements, will affect the value of other taxable parcels, and it is important that the tax treatment of the two properties be consistent. For these purposes, an easement may be considered any partial, nonpossessory interest in property, such as a right of way over it or a right to prevent construction upon it. If the easement is ignored in the assessment of the property whose value it diminishes, it should not be allowed to raise the assessment of the property whose value it enhances.

An early case addressing this issue[36] dealt with the assessment of Gramercy Park in New York City, a private park laid out in 1831 by Samuel Ruggles, a real estate developer who then sold 66 building lots on the perimeter of the park. The purchasers of those lots received rights to the park and keys to its gates, an arrangement that continues to the present day. The trustees holding title to the park argued successfully in court that the park itself had no market value in its encumbered state and that its value had been transferred to the adjoining lots. Although this result avoids inconsistency, it may encourage tax-motivated encumbrances. Land-use agreements may raise, lower, or leave unchanged the value of all affected parcels; there is no necessary conservation of taxable value when private arrangements of this type are permitted to determine property assessments.

One area of current interest with regard to taxation of restricted property concerns conservation easements, which prohibit or restrict development on environmentally sensitive land through an agreement between the landowner and a conservation organization or governmental institution. Although the land remains in private ownership, its market value may be greatly reduced by such an arrangement. Unlike the appurtenant easement, a conservation easement does not transfer rights to neighboring landowners, leaving the *Gramercy Park* rationale inapplicable. However, the development rights might be viewed as property interests held for charitable purposes by a tax-exempt organization. If charitable interests held for charitable purposes are generally exempt from property tax, then there would be an argument by analogy for taking the easement into account in valuation. In the United States, some states have addressed this problem directly by statute; in others, it has been left to the courts to determine according to general principles of property tax law. Both approaches have produced a range of results.[37]

Where ownership rights are uncertain or in the process of being established, the *in rem* attributes of a property tax may permit assessment against the property itself. All persons with interests in the property are then on notice to arrange for payment in order to

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[36]People *ex rel.* Poor v. O'Donnel, 124 N.Y.S. 36, *aff'd mem. sub nom.* People *ex rel.* Poor v. Wells, 93 N.E. 1129 (N.Y. 1910).

[37]*E.g.,* Idaho Code § 55-2109 (1994): "The granting of a conservation easement across a piece of property shall not have an effect on the market value of property for ad valorem tax purposes, and when the property is assessed for ad valorem purposes, the market value shall be computed as if the conservation easement did not exist." Village of Ridgewood v. The Bolger Foundation, 517 A.2d 135 (N.J. 1986) (finding conservation easement to reduce property value).

protect their rights. This could permit a tax system to begin operation and to become an element in purchasers' bids and in contract negotiations, even before property owners are registered or identified. The absence of a designated owner may also give rise to multiple claims to property, but it is unlikely that these would be avoided by delaying imposition of the tax. In fact, it may encourage payment of the tax by those who hope to use this to buttress their claims to ownership in the event of a later challenge.

B. Property Rights and Tax Liability

The problem of divided legal interests in property raises a question as to whether interests that do not rise to the level of ownership may be subject to taxation. In some property tax systems, they may. In the United States, claim of a right to use charitable or public property for profit may potentially leave the holder liable for property tax on that interest or even on the value of the full, undivided property.[38] However, the perceived unfairness of this result has prevented states and localities from exercising this power broadly.[39] It is more important that a new tax specify precisely when partial interests in otherwise exempt land or buildings will themselves be taxable. Examples may include grazing rights on public land, concessions and restaurants in public parks, and commercial activities of religious, educational, or charitable institutions. If no tax is due on property owned by an exempt organization but leased for a commercial use, the exempt lessor will simply be able to command higher net rents than are available to its private competitors.

[38]United States v. City of Detroit, 355 U.S. 466 (1958).

[39]The harshness of this result may be debated in specific cases. For example, it could be argued that a lessee with the right to occupy the property for the full taxable year should be responsible for the full property tax that year. A dissenting opinion in one U.S. case wrote, "[t]he single, the most important incident of ownership of industrial goods is possession *and the right to use them in a business conducted for profit*. That right is coextensive with other forms of ownership if it is borne in mind that the tax covers but a one-year period." Continental Motors Corp. v. Township of Muskegon, 135 N.W.2d 908, 915 (Mich. 1965) (Adams, J., dissenting). The alternate perspective would allocate the market value of the entire property between the value of the tenancy and the value of the remainder and base the respective tax liabilities of the tenant and the (possibly exempt) landlord on that division.

C. Valuation of Land and Buildings

Different tax rates for land and buildings can raise many complex issues as to the allocation of value between the two, because sales data will generally reflect transactions in which the land and the structures upon it were sold as a unit. In some legal systems, it is possible to convey ownership or rights of use in a building without rights in the underlying land. In reality, any use of the building, including moving it to a different location, requires some use of the underlying land. The right to keep the building in a particular location implies surrender of all alternate uses of the land. The converse, a transfer of rights to land without any rights to the structures located on it, suffers from similar artificiality. From this perspective, the land and building constitute two integral components of a larger entity whose value cannot be divided in a meaningful way. In his 1937 treatise on property valuation, Professor James Bonbright wrote

> [a]lthough a separate valuation of land and of improvements is called for by many of the statutes as well as by the practice of assessors, the fictitious nature of this separation is apparent.... The attempt to do so would result in the same error that would be committed were we to seek the value of Raphael's Sistine Madonna by adding the separate value of the lower half of the canvas to the separate value of the upper half.[40]

Conundrums of this type can be avoided by specifying that land values are to be based upon sale prices of comparable unimproved land. Building values may then be specified either as the residual of the combined land and building value or as the product of a formulary approach such as construction cost of a new building less depreciation.

IV. Legal Issues in Setting the Tax Rate

A. Use of Assessment Ratios

Some tax rates are set by a two-step process in which a fractional assessment ratio is first applied to property value and a tax rate is then imposed on the resulting figure. This results in a distinction between the nominal tax rate (the specified rate applied against the diminished value) and the effective tax rate (the proportion of full value represented by the tax; the product of the assessment ratio and the nominal tax rate). In some cases, this may be a necessary response to special legislative or political constraints. Where a nominal rate must be set by law and can be changed only rarely or with difficulty, there may be reasons for administrative discretion to vary the effective rate in this way. Absent an unusual situation of this type, it is far preferable to determine the tax by applying a specified rate to full market value. Because assessment ratios diminish taxpayers' ability to understand and challenge their assessments, "extralegal" fractional systems often develop as a means of reducing taxpayer protests by concealing

[40] James Bonbright, 1 The Valuation of Property 485 (1937).

the relationship between assessed values and tax bills. There are no grounds for establishing such a situation if extraneous factors do not require it.

B. Responsibility for Setting Tax Rates

The status of the property tax as a central or a local levy will affect the assignment of responsibility for setting tax rates. Where the tax will function as an autonomous local revenue source, it is possible to allow local governments to set rates, or to set them within bounds established by the central government. Over thirty years ago, Ursula Hicks wrote the following:

> If local bodies are to play any significant part in economic or social development, they must clearly have access to adequate finance. If they are both to act responsibly and to show initiative, some, not negligible, part of this control over resources must be independent, in the sense that the local councils are free to choose the rates (and to some extent the conditions) of their taxes or service charges.[41]

Some local governments will be limited by their administrative capacity and competence as to the autonomy they can responsibly exercise with regard to revenue. Debate on this point is by no means restricted to newly formed local governments or to economies in transition. The past two decades have seen many initiatives in the United States and the United Kingdom to curtail local control over tax rates. In particular, the nationalization of business rates in the United Kingdom reflected suspicion that local governments sought to place an undue tax burden on nonvoting property owners. A 1986 Green Paper stated: "There is no voting right attached to the payment of non-domestic rates [i.e., business property taxes]. However much a business might contribute to the income of a local authority, it cannot exercise any direct electoral influence over local taxation decisions that can affect its competitiveness and its scope for investment."[42]

Actual rates of tax vary widely in international practice, and a lack of reliable data on assessment practices prevents ready translation of reported nominal rates to effective levels. For example, in Boston, Massachusetts, the nominal rate was 25 percent before the property tax was reformed in the late 1970s; however, this represented a far lower effective rate based on current market values because assessed values--with some exceptions--generally tended to be a very low percentage of full market value.

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[41]Ursula Hicks, Development from Below: Local Government and Finance in Developing Countries of the Commonwealth 277 (1961).

[42]Parliamentary Green Paper, Paying for Local Government, 1986, Cmnd 9714, at 14.

V. Administrative Issues

A. Assignment of Responsibility

The tension between the goals of local autonomy and central control, particularly where local administrative capacity may be lacking and central government resources overstretched, will require special attention in dividing responsibility for tax administration. One alternative allows local responsibility subject to oversight by the central government. In a typical example of legislative language addressing this point, the Massachusetts statutes provide that the state Commissioner of Revenue shall set forth "rules, regulations and guidelines" for assessment, develop forms, and conduct mandatory training programs for local tax officials.[43] Another possibility is to divide property into categories assigned to local tax administration, such as residential and commercial property, while the central government values and assesses complex properties and those spanning multiple jurisdictions, such as public utility property, railroads, and pipelines.

If administrative responsibilities with regard to the tax are shared between two or more levels of government, it is important to provide each with a share of collections at least sufficient to cover its costs and to specify how any refunds later found owing are to be financed.

Although not necessarily addressed in property tax legislation itself, the treatment of the property tax for purposes of income taxes or other central government levies is an extremely important aspect of intergovernmental fiscal relations.[44] In effect, a deduction or credit serves as a central government subvention to local authorities. Such transfers have been praised as supporting autonomous local government and appropriately recognizing the diminished ability to pay resulting from local tax liabilities. They have also been criticized as hidden subsidies for free-spending localities and deductions for payments that are equivalent to personal consumption, funding as they do local amenities and services rather than large-scale transfer payments and national programs.[45] These are political issues that cannot be resolved by tax legislation, but that must be taken into account in its drafting.

B. Enforcement and Liens

One frequently mentioned advantage of property taxation is the immovable nature of the asset securing its payment. A lien upon land and buildings serves to assure the taxing authority of eventual payment; at some point, a purchaser will require unencumbered title and the outstanding tax liability will be met.

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[43]Mass. Ann. Laws ch. 58, §§ 1–3 (Law. Co-op. 1990).

[44]*See supra* ch. 2, sec. V(B)(6).

[45]*See, e.g.,* U.S. Treas. Dept., The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity: General Explanation 62–64 (1985).

In the absence of the drastic step of foreclosure and sale of the property, a lien itself may or may not be a powerful enforcement tool. Owners who are preparing to sell may be motivated to lift this cloud on their title and may also have the cash with which to do so, but the lien may have little effect on others. Foreclosing the lien and selling the property, particularly when it constitutes the residence of poor or middle-class taxpayers, may have unacceptable political consequences, which will be exacerbated if the tax represents a small percentage of the value of the property seized. This weakness of liens recommends a combined approach: the option of foreclosure and auction, which can be exercised in a few well-publicized instances of flagrant tax evasion, together with the alternative of personal remedies, such as fines and attachment of assets other than the property itself. It is particularly important to apply a market interest rate to outstanding liabilities if interest on unpaid tax is not addressed in the general tax law.[46]

C. Revaluation Cycles

Ideally, all information affecting the property tax base would be taken into account in an annual assessment process. However, a complete revision of the valuation or formulary basis of the tax may be feasible only on a periodic cycle. It is far preferable to establish a multiyear cycle, possibly with interim provisions for indexing values for inflation, than to allow an unrealistic goal of annual valuation to be ignored. Taxpayer reliance upon inaccurate assessments that, over time, are capitalized into land and building prices can prove an almost insurmountable political obstacle to revaluation. This was a major reason for the failure of domestic rates in the United Kingdom, where the law required a reassessment every five years but where none had been undertaken in England and Wales since 1973.[47]

If a cyclical system is instituted, it is desirable to address directly the issue known as "spot assessment," that is, revision of one assessment to reflect increases in market value, as upon a recent sale, when other parcels in the jurisdiction are not similarly revalued. If it is practical to keep valuations reasonably up to date, it would not be unfair to utilize new information of this type. More commonly, whatever cycle is permitted as the maximum interim between revaluations becomes the norm; if more frequent individual changes are allowed, partiality and inequity may result.

[46]*See supra* ch. 4, sec. II(J).

[47]*See* Peter G. Richards, *The Recent History of Local Fiscal Reform, in* The Reform of Local Government Finance in Britain 28 (Stephen J. Bailey & Ronan Paddison eds., 1988). In 1986, legislation was passed to implement the Community Charge or "poll tax" in Scotland in 1989. Similar legislation passed in 1988 implemented the Community Charge in England and Wales in 1990. *See* David Butler et al., Failure in British Government: The Politics of the Poll Tax (1994), App. 1. "A revaluation of all rated property might have caused an eruption, given the relative increase in the value of property in the south-east since the previous valuation in 1973." *Id.* at 61.

VI. Checklist of Issues for Legislative Drafting

The preceding discussion has identified a number of items to be clarified in establishing a new legislative approach to property taxation. These may be summarized as follows:

A. Scope of the Tax

- What kinds of property are to be subject to this tax? Alternatives discussed here have included all property, all tangible property, land and buildings, land alone, and unimproved site value alone.

- How does the definition of property in the taxing statute coordinate with the property law of the jurisdiction? For example, are mineral rights to be taxed to the owner of the surface land?

- How is property to be identified? Is this identification coordinated with the work of other government agencies, such as title or deed registries, cadastres, and mapping offices?

- How is an individual parcel to be identified if progressive rates or per-parcel exemptions require such identification?

B. Identification of the Taxpayer

- Is the taxpayer a person standing in a particular relation to the property, such as the owner or occupier? The alternative, *in rem* approach gives public notice of the outstanding amount and requires all parties interested in the property to arrange among themselves for its payment.

- How is tax liability allocated among multiple parties holding partial interests in a single property?

C. Exemptions

- What specific types of property are to be exempt? Examples include charitable, religious, and educational property.

- Does the exemption stem from ownership of the property by a specific type of organization or from its active use in furtherance of an exempt purpose?

- Are governmental properties exempt? If so, is this exemption limited to property held by the level of government imposing the tax? Do treaty obligations or other agreements require that properties held by foreign governments or international organizations be exempt?

- Is the burden of establishing the exemption on the property holder?

- Must the exemption be reviewed or renewed periodically?

- How are commercial uses of exempt property treated for tax purposes?

- What is the tax liability of private persons holding partial interests in otherwise exempt property?

D. Concessions and Preferential Assessments

- Are there specific concessions for special groups, such as low-income, handicapped, or elderly taxpayers?

- Do these concessions take the form of a reduction in the tax or an extension of the time within which to pay it?

- Do specific types of property, such as farmland, forestland, or residential buildings, qualify for special assessment procedures? Are growing crops and forests subject to taxation?

E. Measurement of the Tax Base

- Is the tax based on a market-value measure? Alternatives discussed here have included formulary computations, an area base, acquisition cost, and per-parcel fees.

- If the tax is based on market value, is this capital value or annual value?

- If the tax is based on a formula designed to approximate market value, what provisions have been made for periodic review and revision of the formula as more market data become available?

- What is to be the assessment of property under construction as of the valuation date? Of property destroyed after the valuation date but before the close of the tax year?

F. Setting the Tax Rate

- What level of government is responsible for setting the tax rate?
- May the rate vary annually? If so, within what limits?

- Do other elements in addition to the tax base and rate (e.g., assessment ratios) enter the tax calculation?

G. Intergovernmental Issues

- How is responsibility assigned for assessment, collection, oversight, and regulation?

- How are tax collections to be divided among levels of government?

- Is any portion of tax collections earmarked for specific purposes?

- Will payment of the tax give rise to a deduction or credit for purposes of other taxes?

- What level of government bears the burden of reduced collections as a result of exemptions and concessions?

- Are values assigned to property for purposes of this tax coordinated with values used for other tax purposes, such as eminent domain (compulsory purchase) awards and calculation of capital gains?

H. Procedural Issues

- Are specific collection procedures or collection points called for by this tax?

- What is the required or permitted frequency of revaluations?

- May individual parcels be revalued in the absence of a general revaluation?

- What procedure governs tax appeals?

I. Collection and Enforcement

- Do unpaid taxes give rise to a lien upon the property? If so, what steps are required for foreclosure and sale?

- What is the priority of such a lien? Does a foreclosure sale convey a new and clear title?

- Does the lien arise as of the date of assessment or at another time?

- May recourse for unpaid taxes be had against the taxpayer personally, with seizure of other property, to satisfy this obligation?

- How is liability for tax payment allocated when multiple parties hold partial interests in the same property?

10

Taxation of Wealth

Rebecca S. Rudnick and Richard K. Gordon

> It is not righteousness that you turn your faces toward the East and West, but righteousness is that one should believe in God and the last day and the angels and the Book and the prophets, and give away wealth out of love for Him to the near of kin, and the orphans, and the needy, and the wayfarer, and the beggars, and the captives, and keep up prayer and pay the poor-rate....
>
> The Qur'an, Surah II 177

I. Introduction

Two major types of taxes are levied on wealth: those applied sporadically or periodically on a person's wealth (net wealth taxes), and those applied on a transfer of wealth (transfer taxes).[1] Net wealth taxes are typically assessed on the net value of the taxpayer's taxable assets (i.e., value of assets minus any related liability), either sporadically (often known as "capital levies") or on an annual or other periodic basis.[2] Transfer taxes, which are typically assessed on the net value of the taxable assets transferred, fall into two basic categories: those levied on the transferor or her or his estate (more typical in common law countries), and those levied on the recipient.[3]

Table 1. Wealth Taxes

Form	Examples
Net Wealth Tax	Periodic
	Sporadic (capital levy)
Transfer Tax	
Transferor-based	Estate tax, gift tax, unified tax
Recipient-based	Inheritance tax, gift tax, accessions tax

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[1]On the distinction between the two, *see* Dennis Kessler & Pierre Pestieau, *The Taxation of Wealth in the EEC: Facts and Trends*, 17 Canadian Public Policy 309, 309-10 (1991).

[2]*See* Alan A. Tait, The Taxation of Personal Wealth 70 (1967).

[3]*See* Jack M. Mintz, *The Taxation of Personal Wealth in International Perspective*, 17 Canadian Public Policy 248, 250-51 (1991).

Transferor-based taxes can be levied separately on inter vivos transfers (gift tax) and on transfers at death (estate tax), or together in a single integrated tax.[4] Recipient-based taxes can also be levied on inter vivos transfers (gift tax), on transfers at death (inheritance tax), and on an integrated basis (accessions tax). Other taxes relating to property and wealth that are not levied on a net basis are not discussed in this chapter.[5]

Generally, the tax base for taxes on wealth can include either the worldwide net assets owned by, transferred to, received (depending on the type of tax) or given away by a taxpayer who has a sufficient connection with the jurisdiction, or those assets situated in a jurisdiction regardless of the taxpayer's connection with it.

Taxes on wealth are typically applied at graduated rates.[6] The applicable rates for net wealth taxes may be determined by the wealth of the taxpayer alone or may involve aggregation of the wealth of members of a family. The rate of those transfer taxes levied on the transferor is typically based on the cumulative amount transferred by gift, bequest, or both, although some exemptions are based on relationship to the transferee.[7] The rate of taxes levied on the recipient is typically based both on the amount received by each separate recipient and on the relationship of the recipient to the transferor.[8]

The distinction between transferor-based and recipient-based taxes is not black and white. In the case of transferor-based taxes, the existence of various exemptions, exclusions, and deductions based on the status of the recipient can make the tax liability

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[4]*See* Tait, *supra* note 2, at 137-40. The former U.K. Capital Transfer Tax, which was in effect from 1975 to 1986, was levied on a cumulative basis on all transfers during lifetime and at death. *See* M.R. Moore, *United Kingdom Inheritance Tax*, 34 European Taxation 421 (1994). An integrated tax was established in the United States in 1976. *See generally* Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 525-32 (1976). The U.S. tax is still in effect.

[5]Taxes on immovable property are sometimes described as a type of wealth tax; these taxes are discussed in ch. 9. Assets taxes serving as a minimum income tax are discussed in ch. 12. A number of miscellaneous taxes are also sometimes described as forms of wealth taxes, such as taxes on some types of personal property (such as automobile excise taxes), or stamp duties on registration of deeds to immovable property. However, each of these taxes is typically applied to the gross value of assets, without accounting for any liabilities. Hence, they are not taxes whose base is measured on a *net* basis, and are not covered here. Capital transfers may also give rise to income tax or value-added tax liability; these issues are discussed in chs. 6 and 7 and, in vol. 2, chs. 14 and 16.

[6]Wealth taxes often have an exempt amount, or an amount that is taxed at the rate of 0 percent. Such wealth taxes, even if they have only a single positive rate, actually have two rates, thereby resulting in a progressive rate schedule. *Cf.* vol. 2, ch. 14 (discussion of progressive rate schedule for income tax). For example, in Germany physical persons are subject to only a single rate of tax, at 0.5 percent. DEU VStG art. 10(1)1. However, various tax-free amounts result in a 0 percent rate for those tax-free amounts. DEU VStG art. 6.

[7]*See, e.g.*, USA IRC § 2001(c)(1). However, unlike most transferor-based tax systems, the United Kingdom has only a few rates, 0 percent on an exempt amount, 20 percent for *inter vivos* transfers, and 40 percent on testamentary transfers, with a sliding scale if death takes place in the fourth, fifth, or sixth year following an *inter vivos* transfer. *See* Moore, *United Kingdom Inheritance Tax*, *supra* note 4, at 424.

[8]*See, e.g.,* FRA CGI art. 777 (rates ranging from 5 to 60 percent depending on amounts and degree of relationship between transferor (deceased) and transferee (heir or assignee)).

similar to that under a recipient-based tax. In the case of a recipient-based tax, administrative techniques of collecting the tax at the level of the transferor can make it procedurally similar to a transferor-based tax. Therefore, the listing of forms of wealth tax in Table 1 should not be seen as necessarily presenting sharp dichotomies in the operation of these taxes.

Taxes on wealth are in effect in most developed countries, although wealth transfer taxes are more common than net wealth taxes.[9]Netherlands, Spain, and Sweden have net wealth taxes, while all have wealth transfer taxes. Organization for Economic Cooperation and Development [OECD], Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals tbl. 0.1, and ¶ 1.1 (1988). Canada, however, has a net wealth tax but no wealth transfer tax. *Id.* A number of developing and transition countries also have either a net wealth tax, a transfer tax, or both.[10] Over the past 25 years, a few countries, both developed and developing, have repealed their wealth transfer taxes.[11]

A. Tax Capacity

1. Wealth Taxes in General

"Taxes on wealth," writes the public finance economist Richard Bird, "...are among the oldest fiscal instruments in most countries.... [But] [d]espite their antiquity, wealth taxation has been relatively neglected in recent years."[12] Development economists were once very interested in the possible benefits of taxes on wealth. Lord Kaldor recommended the enactment of wealth taxes in developing countries, reflecting his belief that the holders of substantial economic resources in developing countries had the capacity to pay higher taxes than those with similar incomes but with less wealth.[13] Wealth tax advocates have argued that a tax on income does not by itself take into account the claim on overall resources that wealth confers. There is, for example, a difference in ability to

[9]For example, among the EU, the United States, and Japan, only Austria, Denmark, Finland, France, Germany, Luxembourg, the

[10]For example, India, Pakistan, and Vietnam have net wealth taxes but not wealth transfer taxes, while Bulgaria, the Czech Republic, Hungary, Montenegro, the Philippines, Russia, Romania, and Serbia have wealth transfer taxes but not net wealth taxes; Slovenia has both, while South Africa and Turkey have wealth transfer taxes and have recently had one time net wealth taxes. *See, e.g.,* CZE IHT, PHL NIRC, RUS IHT, SVN TC.

[11]Including Argentina, Australia, Canada, India, Israel, Mexico, New Zealand, Pakistan, and Sri Lanka. *See* International Bureau of Fiscal Documentation, Taxes and Investment in Asia and the Pacific (1994). For a review of wealth transfer taxation in developing countries, *see* Bernadette T. Davey, *Gift and Inheritance Taxes in the African Continent,* 39 Bull. for Int'l Fiscal Documentation 123 (1985); M.A. Ga. Caballero, *Latin America: Taxation of Gifts and Inheritances, a Practical Approach*, 39 Bull. for Int'l Fiscal Documentation 55 (1985).

[12]Richard M. Bird, Tax Policy and Economic Development 130 (1992).

[13]Nicholas Kaldor, Indian Tax Reform 19-28 (1956); Nicholas Kaldor, Suggestions for a Comprehensive Reform of Direct Taxation 13-14 (1960).

pay between a person who has $20,000 in annual income from a $200,000 investment, and a person who earns $20,000 a year from her or his labor.[14]

Other tax theorists have suggested that addressing the additional tax capacity afforded by wealth could allow top marginal income tax rates to be reduced without sacrificing overall tax progressivity. In the alternative, a wealth tax may add to the overall progressivity of an income tax without having to increase marginal rates.[15]*Praise It*, 52 Tax Notes 1413 (1991), who argues that changes to the income tax can make up for any loss of revenue (or progressivity) from the repeal of a wealth tax. However, others have argued that, simply because a wealth tax does not make a major contribution to progressivity, it can make some contribution. *See, e.g.*, Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 Yale L. J. 259, 271 (1983). Commentators from other countries have also pointed out difficulties with wealth taxation. *See, e.g.,* Klaus Tipke, Die Steuerrechtsordnung 768-808 (1993); Gunnarsson, Skatter Ettvisa 299 (University of Uppsala doctoral thesis, 1995) ("Today, however, circumstances are such that, in principle, all those forms of ability to pay tax which are founded on the net wealth, yield, funded earned income, ability to consume, and different kinds of wealth transfers, are being taxed in other forms than by a net wealth tax. Hence, there is no room for justifying the net wealth tax with the support of the theory of ability to pay tax."). For a general discussion of the use of wealth taxation to provide for equality, *see* Edward N. Wolff, Top Heavy: A Study of the Increasing Inequality of Wealth in America (Twentieth Century Fund Report, 1995). A wealth tax could also assist the administration of other taxes, providing information to collect income taxes and property taxes. A wealth tax base separate from an income tax base can help ensure that taxes not collected on the latter, because of avoidance or evasion, might be collected on the former.[16] This may be

[14]This example is taken from Richard Goode, Government Finance in Developing Countries 133 (1984).

[15]The progressivity effects of wealth taxes have been the subject of much scholarly debate, most particularly in the United States. In that country, before the considerable increase in reliance on the income tax as a revenue source during the Second World War, the estate tax provided up to half the amount of revenue, as did the income tax, contributing substantially to the progressivity of federal taxation. *See* John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring, and Refinement, or Replacement*, 50 Wash. & Lee L. Rev. 539, 544 (1993). By the 1980s, the relative amount of contribution to total revenues by the estate tax had declined dramatically. *Id*. In 1994, estate and gift tax revenue represented 1.2 percent of federal revenue ($ 15.2 billion) in the United States. In France, the wealth tax (*l'impôt de solidarité sur la fortune*) yields F 9 billion out of total revenue of F 1,400 billion. *See* Le Monde, April 21-22, 1996, at 6. According to one scholar, this drop has ensured that the estate tax no longer materially contributes to the progressivity of the federal tax system. *Id*. *See also* Joel C. Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 Syracuse L. Rev. 1215 (1984). According to one study, no country currently derives significant revenues from taxation of wealth. Henry J. Aaron & Alicia H. Munnell, *Reassessing the Role for __alth Transfer Taxes*, 45 Nat'l Tax J. 121, 133 (1992). *See also* OECD, *supra* note 9, ¶¶ 0.21–0.22 (1988). In the words of another American scholar, "a strong wealth transfer tax system runs counter to deep-seated human motivations," making it unlikely that any jurisdiction would ever enact a wealth tax with sufficient revenue implications to add significantly to progressivity. Edward J. McCaffery, *The Uneasy Case for Wealth Taxation*, 104 Yale L. J. 283, 294 (1994). *See also* Charles O. Galvin, *To Bury the Estate Tax, Not to*

[16]*See, e.g.,* Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes after ERTA*, 69 Va. L. Rev. 1183, 1185–86, 1189–97 (1983); Henry J. Aaron & Harvey Galper, *A Tax on Consumption, Gifts, and Bequests and Other Strategies for Reform*, in Options for Tax Reform 106, 111–12 (Joseph A. Pechman ed., 1984).

particularly true with regard to income from asset appreciation that has accrued but that is not taxed owing to the "realization event" nature of most income tax systems.[17] While a net wealth tax would by no means be an equal substitute for an accrual-based system of income taxation, it might at least help capture some additional revenues from appreciated assets.

2. Wealth Transfer Taxes

Wealth transfer taxes can also be viewed as complements to an income tax.[18] An income tax by itself does not tax wealth, only accretions to wealth. In virtually all income tax systems, gifts and bequests are not taxed as income to the recipient.[19] There are a number of reasons for this exclusion, including problems of income averaging. Assuming that gifts and bequests are not included in the income tax base, a separate wealth transfer tax can serve as a surrogate to such inclusion.[20]

B. Social, Moral, and Political Justifications

1. Wealth Taxes in General

The measure of tax capacity is not the only justification for levying taxes on net property ownership. Major concentrations of wealth held by a relatively small number of people can have many unfortunate political and social side effects; to the extent that these concentrations can be reduced through wealth taxation, the side effects can be ameliorated. First, the very wealthy may be able to influence government, either through legal or illegal means, in a manner far disproportionate to their numbers; such influence may result in government actions designed to protect the interests of the propertied elite.[21] In addition, it may be seen as an affront to democracy that a group of people can

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[17]*See* Paul B. Stephan III, *Commentary: A Comment on Transfer Tax Reform*, 72 Va. L. Rev. 1471, 1479 (1986).

[18]*See* Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 Yale L. J. 1081, 1112–14 (1980).

[19]Some scholars have argued that gratuitous transfers should be excluded from the income tax base of the recipient. Michael McIntyre & Oliver Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 Harv. L. Rev. 1573, 1577 (1977). Henry Simons, however, argued that, as changes occur in the recipient's net worth, gifts and bequests should be included. Henry Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy 50, 56–8, 125–47 (1938). *See also* Victor Thuronyi, *The Concept of Income*, 46 Tax L. Rev. 45, 68-69 (1990). *See generally* Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 Harv. L. Rev. 1177 (1978).

[20]However, most accessions tax proposals do not aggregate accessions with other income, only with other accessions. *See* William D. Andrews, *The Accessions Tax Proposal,* 22 Tax L. Rev. 589, 591–93 (1967). Japan following the Shoup Commission Report in the 1940s, *see* Shoup Mission, Report on Japanese Taxation (1949), adopted an accessions tax but later replaced it with an inheritance tax.

[21]For example, former President of the United States Franklin Roosevelt, no pauper himself, remarked in his 1935 Address to Congress that "[g]reat accumulations of wealth . . . amount to the perpetuation of great and undesirable concentration of control in a relatively few individuals over the employment and welfare of many, many others." Franklin D. Roosevelt, Message to Congress (June 19, 1935), in H.R. Rep. No. 1681,

exercise disproportionate power. Second, some may consider it a moral affront that large divergences in wealth exist in a particular country. This latter justification for wealth taxation admittedly imposes a moral belief on a country that may or may not actually be present. Moreover, moral justifications for wealth taxation may also run counter to dominant social cultures, such as capitalism and wealth creation, that may prevail in the country.

In particular, the wide disparity of wealth found in many developing countries may exacerbate political or social problems. Legacies of colonialism and authoritarianism may include popular beliefs, whether justified or unjustified, that economic elites gained their position through illegitimate means. Such economic elites may tend to be grouped in definable religious, ethnic, or racial groups, exacerbating tensions among such groups. A special wealth tax on these groups may work to reduce such tensions.[22]the comfortable may benefit the poor psychologically. Revenues raised from a wealth tax can also be spent directly on programs to aid the poor. *See* Richard Bird, *Public Finance and Inequality*, 11 Finance and Development 2-4, 34 (1974). These may be among the reasons for South Africa's recent adoption of a temporary net wealth tax. *See* Patti Waldeman & Michael Holman, *South Africa Imposes Wealth Tax and Curbs Spending*, Financial Times, June 23, 1994, at 1.

More conservative commentators have argued that the government should not seek to violate the rights of property in too ambitious a fashion in order to advance equality.[23] Also, economists have argued that both experience and analysis strongly suggest that wealth taxes, at least as they now exist, are unlikely to have much effect on actual wealth distribution. If so, why bother?[24] However, even if a tax on wealth did not have a substantial effect on wealth distribution, even a marginal effect may be preferable to none at all.

A perhaps more compelling argument is that the nonmonetary benefits of wealth create another type of tax capacity. For example, Professor Bird argues that wealth carries with it "a degree of security, independence, influence, and social power that is not adequately measured by the flow of realized money income to which it gives rise.... Wealth constitutes, at least to some extent, *an independent tax base* that is appropriately tapped by an annual tax on net wealth."[25]

74th Cong., 1st Sess. (1935), *reprinted in* 1939-1 C.B. (pt. 2) 642, 642–43, *cited in* Mark L. Ascher, *Curtailing Inherited Wealth,* 89 Mich. L. Rev. 69, 95–96 (1990). John Rawls, one of the most influential contemporary liberal English-speaking legal philosophers, writing in favor of intergenerational wealth transfer taxes, argues that "concentrations of power [are] detrimental to the fair value of political liberty." John Rawls, A Theory of Justice 279 (1971).

[22]While the taxation of the wealthy will not provide sufficient revenue to significantly benefit the poor directly, afflicting

[23]*See generally* Friedrich A. Hayek, The Constitution of Liberty (1960).

[24]*See* OECD, *supra* note 9, ¶¶ 0.21-0.22; McCaffery, *supra* note 15, at 294.

[25]Bird, Tax Policy and Economic Development, *supra* note 12, at 133 (emphasis added).

2. Wealth Transfer Taxes

Commentators have advanced a number of additional arguments against the desirability of allowing unfettered intergenerational transfers of substantial wealth. Some have argued that, because heirs have done nothing to earn their wealth, there is greater moral justification for taxing gifts and estates or inheritances.[26][is] that its acquisition is generally unrelated to the *merits* and efforts of those who benefit from it (emphasis added)." Cedric Sanford, Taxing Inheritance and Capital Gains: Towards a Comprehensive System of Capital Taxation 11 (1967). Taxing such wealth acquired through "family lottery" may therefore be perceived to be fairer that other types of taxation.[27] Other commentators have argued that taxing transferred wealth may help bring about greater equality of opportunity for the next generation. The argument favoring the advancement of equality of opportunity by creating a more "level playing field" for each new generation has both moral and economic aspects to it.[28] The economic aspect is discussed below.

Again, more conservative commentators have taken issue with the argument that the government should actively seek to level the playing field for new generations,[29] while economists have argued that wealth taxes do not raise enough revenue to level the playing field anyway. However, the economist Michael Boskin, who served as Chairman of U.S. President Ronald Reagan's Council of Economic Advisors, has responded that taxes on the transfer of wealth can at least help prevent "*extreme* concentrations of wealth from being passed from generation to generation."[30]

C. Economic Efficiency

1. Wealth Taxes in General

Taxes on wealth are sometimes described as being more economically efficient than taxes on income. Some have argued that wealth taxes have a smaller effect than the income tax on the choice between work and leisure because they are not levied on productive activities, only on accumulated capital.[31] Others have argued, however, that because wealth taxes are not levied on consumption, they are likely to reduce rates of

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[26]For example, the economist Cedric Sanford writes "[T]he particular ethical justification for taxing inherited property

[27]*See*, *e.g.*, Lawrence McQuaig, Behind Closed Doors 347 (1987).

[28]*See generally* Kurt Klappholz, *Equality of Opportunity, Fairness, and Efficiency*, *in* Essays in Honor of Lord Robbins (Maurice H. Peston & Bernard Corry eds., 1972).

[29]*See* Friedrich A. Hayek, *supra* note 23, at 87–91.

[30]Michael J. Boskin, *An Economist's Perspective on Estate Taxation, in* Death, Taxes, and Family Property 56, 65 (Edward C. Halbach, Jr., ed. 1977), *quoted in* McCaffery, *supra* note 15, at 289 (emphasis added).

[31]*See, e.g.,* Goode, Government Finance in Developing Countries, *supra* note 14, at 134. *See also* Sanford, *supra* note 26, at 25 (1967); Joseph Pechman, Federal Tax Policy 234-35 (5th ed. 1987).

savings.[32] A counterargument is that, in order to maintain a desired rate of after-tax savings, wealth tax payers may increase their savings rate.[33] Wealth taxes may also encourage capital flight; theoretically, any tax on capital will induce mobile capital to migrate (and influence capital to stay out) until the overall rate of return on capital rises to offset the tax.[34]

Another aspect of economic efficiency concerns the overall revenue yield from a wealth tax relative to the economic costs of collecting it.[35] One argument is that, for wealth taxes to collect a substantial amount of revenue, they would have to be so onerous as to either create insurmountable political opposition or result in substantial negative economic effects. Therefore, some have suggested that wealth taxes probably need to be justified largely for social and political reasons, rather than simply for revenue reasons. However, if the cost of administering a wealth tax can be minimized, even relatively small amounts of revenue can be important to countries suffering from deficits.

2. Wealth Transfer Taxes

Wealth transfer taxes may have additional economic benefits. An individual who inherits property or receives it as a gift may have less incentive to work to accumulate assets on his or her own. Taxing inherited wealth may increase the incentive for the heir to work or, at least, will not act as a disincentive against work.[36] In addition, one does not choose one's offspring on the basis of their ability to invest capital; persons who have accumulated capital through skill may as likely as not pass that capital on to fools. However, others have suggested that a principal reason for accumulating wealth is to pass it to one's heirs. As noted earlier, a tax on such wealth may result in either a decrease in work to accumulate wealth or an increase to maintain the same after-tax bequest.

Overall, both the theoretical and empirical research on such economic effects is far from conclusive. Professor Bird concludes that "[i]t is safe to say that there is as good (or bad) an economic case for, as there is against, wealth taxes."[37]

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[32]*See* McCaffery, *supra* note 15, at 294-95; M. Zühtü Yücelik, *Taxation of Bequests, Inheritances, and Gifts, in* Tax Policy Handbook 188, 190-91 (Parthasarathi Shome ed. 1995).

[33]Yücelik, *supra* note 32.

[34]*See* OECD, *supra* note 9, ¶ 1.11.

[35]Gerald Jantscher, for example, argued that it may be far less costly administratively to raise the same amount of revenue by increasing other taxes, including the income tax. Gerald Jantscher, *The Aims of Death Taxation, in* Death, Taxes, and Family Property, *supra* note 30, at 142.

[36]*See* John Wedgwood, The Economics of Inheritance 194-95 (1929).

[37]Bird, Tax Policy and Economic Development, *supra* note 12, at 136. Gerald Jantscher reached a similar conclusion. *See* Jantscher, *supra* note 35, at 46.

D. Problems of Administration

1. Net Wealth Taxes

Lord Kaldor recommended that developing countries impose periodic taxes based on the actual total cash and net property owned by an individual.[38] However, in the years since Kaldor made his proposals, taxes on net wealth have frequently been deemed too impractical, particularly in developing countries. Problems of uncovering the ownership of wealth and assigning it to particular taxpayers, and of accurately determining net values, can combine to make the tax especially difficult to enforce. On the basis of substantial experience, Richard Goode concludes that "[a] net wealth tax, although attractive in principle, must be judged impractical in most developing countries."[39]

Nevertheless, modern net wealth taxes, if designed with ease of administration in mind, can be effective, even in developing and transition countries. The features necessary to simplify administration include employing large exempt amounts and taxing legal persons and other entities in lieu of interests in those entities.

2. Wealth Transfer Taxes

Fiscal experts have often argued that wealth transfer taxes may be easier to administer than net wealth taxes and have therefore tended to be less skeptical about their adoption in developing and transition countries.[40] While the problem of making accurate net valuations is probably no easier under a transfer tax than under a net wealth tax, the problems of uncovering wealth and of assigning ownership to it are often smaller. The principal reason for this is that transfer taxes are generally assessed when the legal rights of ownership change, either through the giving of a gift or through death.[41] Such changes in ownership happen relatively infrequently and are likely to be easier for tax administrations to keep track of. Also, to protect her or his new ownership interest, the recipient has a clear interest in ensuring that the necessary legal requirements to reflect the appropriate ownership change are completed. The act of registering such ownership changes may be easier to uncover than ferreting out unchanging ownership interests. Also, property rules can be adopted that prevent the legal accession to wealth if wealth transfer tax is not paid.[42]

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[38]*See* Kaldor, Suggestions for a Comprehensive Reform of Direct Taxation, *supra* note 13, at 14.

[39]Goode, *supra* note 14, at 135. One commentator notes that Finland's tax (at a rate of 0.9 percent on net wealth exceeding Fmk 1 million ($186,440)) "is a good tax in theory, but an unsatisfactory tax in practice." Kari Tikka, Tax Reform in the Nordic Countries 105 (1973-1993 Jubilee Publication of the Nordic Council for Tax Research, 1993).

[40]*See* Yücelik, *supra* note 32, at 188.

[41]In the case of property held by trusts and trustlike entities, the transfer of property ownership may not be complete. The issues raised by this problem are discussed *infra* sec. III(I).

[42]A number of issues relating to the specific jurisdiction's laws of inter vivos and testamentary transfer affect the design of a wealth transfer tax. These issues are discussed *infra* sec. III(A), (I).

Administrative costs as a percentage of revenue are likely to be lower for a transfer tax than for a net wealth tax, since the former is by and large collected only at death, while the latter must be collected every year.

However, in some ways, wealth transfer taxes are more difficult to administer than net wealth taxes.[43] Unlike yearly net wealth taxes, transfers through gift and at death are not predictable, and taxing them requires a number of adjustments (described later in this chapter), whether for political or technical reasons. Second, because legal persons do not die, it is more problematic than under the net wealth tax to tax them as a surrogate for taxing their owners.

The administration of both net wealth taxes and transfer taxes could be concentrated on a relatively few large holdings of wealth. If a principal goal of a wealth tax is to deal with very large concentrations of wealth, a large exemption amount could easily be justified. This may be particularly true in the context of many developing countries, where the very wealthy may be relatively easy to identify. A net wealth tax or wealth transfer tax with a large exempt amount may be administratively feasible in many jurisdictions.

E. Conclusion

Ultimately, the decision whether to enact a tax or taxes on net wealth or wealth transfer must take into account the country's political, social, and administrative circumstances. The principal policy goals behind a wealth tax might include (1) a modest reduction in current concentrations of substantially great wealth, (2) a modest reduction of the concentration of similar wealth in the future, (3) the social and political benefits to be achieved from realizing these goals, and (4) the general raising of tax revenues. In addition, several factors are important in choosing among the different systems of taxing wealth transfer. These include (1) overall fairness, (2) administrative convenience, and (3) political and popular support for enactment and enforcement.

Unlike taxes such as the value-added tax, excises, and income tax, which very few countries can do without, developing and transition countries can generally get along without taxes on wealth, without serious consequences for either revenue or progressivity. Reforms of the income tax can often bring more revenue from the wealthy than is brought by wealth taxes. However, if, on the basis of the above factors, a decision is made to adopt a wealth tax—or to revitalize a moribund wealth tax that has been on the books without adequate enforcement—the timing should be decided upon so as not to distract from the collection of revenues from other taxes. The costs of administration should be seriously considered and the tax designed accordingly. Care should be taken to design the tax so that it will apply in an evenhanded manner, and adequate time should be allowed for drafting the law so that the tax can be effective.

II. Issues in the Design of Periodic Net Wealth Taxes

[43] *See infra* sec. III(A), (H).

Periodic net wealth taxes and wealth transfer taxes share many design issues. However, the two forms of taxation are different enough to be considered sequentially below, starting with periodic net wealth taxes. Because of shared issues, the discussion of transfer taxes will frequently refer back to the previous discussion of net wealth taxes.

A. Taxpayers

1. Physical Persons and Residence

Typically, physical persons are taxed either as individuals or, if they are married, minors, or themselves have minor children, as part of a family group.[44] When net wealth taxes are applied on a flat-rate basis, aggregation of family wealth benefits the taxpayer, assuming that it involves applying exemptions on a per person basis, although no more than the taxpayer could have obtained through self-help by splitting wealth among the members of the family.[45] However, if the tax is applied at graduated rates, there will be a more significant difference between taxes applied at an individual level and those applied at the family level. Under graduated tax rates, the tax unit is often the family. This makes sense in that family wealth is often shared, either legally, as in community property regimes, or practically.[46] In a developing or transition country that adopts a net wealth tax with a large exempt amount, one would expect to have a family unit of taxation, but probably without a full exempt amount for each of the children.

The taxation of resident and nonresident physical persons is considered further in connection with the taxation of entities. Under a net wealth tax, in general, residents are typically taxed on their worldwide net assets, while nonresidents are frequently taxed only on their assets that are physically located within the jurisdiction.

2. Entities and Resident and Nonresident Owners

There are a number of other important connections between the taxpayer and the composition of the tax base. In most jurisdictions, only physical persons (individuals and

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[44]For example, in France under the net wealth tax, the taxpayer is either an individual or a family. A family is defined to include spouses and minor children, as well as any "concubine" and her minor children. FRA CGI art. 885E.

[45]For example, in Germany, families are taxed as groups, a single rate is applied, and an exemption of DM 70,000 is allowed for each spouse and minor child. Additional exemptions are provided for elderly disabled persons. *See* DEU VStG § 6. Nonresidents are not entitled to the exemption. *See id*.

[46]The rules concerning community property between spouses are diverse and depend on the legal tradition of the particular jurisdiction. The general rule, that all property acquired during marriage other than by gift, devise, or descent, is owned in half shares, is found in most civil law jurisdictions, as well as in some common law ones, although the traditional common law rule does not provide for community property. *See, e.g.*, Civil Code arts. 1401–1408 (FRA); William de Funiak & Mark Vaughn, Principles of Community Property (2d ed. 1971). In Islamic law there is no standard community property rule, although, as part of a marriage contract, a man must present his wife with a dower. David Pearl, A Textbook on Muslim Personal Law 60-76 (2d ed. 1987). The rights of spouses and heirs to property following death are also often regulated by law and may be of particular importance to the operation of wealth transfer taxes.

families) are taxed.[47] This means that, if all wealth is to be included in the base, that which is held indirectly through legal persons or other entities must be attributed to the physical person taxpayer.[48] Moreover, attribution is necessary to prevent the double taxation of capital owned by entities. This involves determining who is the holder of the ownership interest and valuing the interest. In certain circumstances, both of these tasks can be relatively easy. For example, the ownership of the shares of a company can be revealed by examining the company's share register. And, if the company is listed, valuing the shares will also be relatively easy.

However, ownership interests in entities other than companies, partnerships, or other typical methods for organizing a joint business enterprise might be much more difficult to ascertain, and valuation of those interests, particularly if not publicly quoted, may also be difficult.[49] Moreover, debt interests in all types of legal persons, which are often held as bonds in bearer form, may be relatively easy to conceal from the taxation authorities.

In addition to typical for-profit business entities, where ownership interests are often relatively clear (if sometimes easy for the taxpayer to hide), persons may hold wealth more indirectly through equity-type interests in entities for which identification of the owner, as well as the nature of the interest, can be quite difficult. Perhaps the most important of these is pension funds. While pension funds may (depending on the jurisdiction) hold title to considerable amounts of wealth, the vesting rules for pension benefits may make determination of the value of a beneficiary's interest particularly difficult.[50]

The same type of problem is presented by family trusts, family foundations, and similar entities. These entities are often set up by individuals to hold and manage wealth.[51] The trust is a creation of the common law and is not found in either the French or the German civil code.[52] However, trust laws, although occasionally more limited in

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[47]*E.g.,* FRA CGI art. 885. This is also the general rule followed in the Nordic countries. In fact, Germany's law is the exception. *See infra* note 66.

[48]For example, in France, wealth held by physical persons through companies, associations, and foundations is included in the physical person's tax base by valuing the ownership interest. FRA CGI arts. 885A, 885N, 885O.

[49]The general matter of valuation is considered *infra* at secs. II(B)(3) & III(F). *See also infra* text accompanying notes 51-67 concerning legal forms of organizing business enterprises.

[50]*See* Joseph Pechman, Comprehensive Income Taxation 77-84 (1977). The issues with regard to identification of beneficiary are similar for both income and wealth taxation. Pension funds are often created in the legal form of a trust, foundation, or similar entity. A discussion of these forms of legal organization follows immediately *infra*.

[51]These entities can also be used for regular, for-profit business purposes. However, in these cases it is typically not difficult to ascertain who the investors are and to attribute wealth directly to those investors. *See* Richard K. Gordon & Victoria P. Summers, *Trusts and Taxes in Civil Law Emerging Economies: Issues, Problems, and Proposed Solutions*, 5 Tax Notes Int'l 137, 142-43 (1992).

[52]*See generally* the historical discussion in George G. Bogert, Law of Trusts and Trustees, Section 3 (2d rev. ed. 1984).

scope than under common law, have been adopted in a number of Latin American countries[53] as well as in a few other jurisdictions.[54] The basic legal concept of the trust is the separation of the ownership interests in property into a legal title, held by one or more trustees, and an equitable title, held by one or more beneficiaries. The legal title gives the trustees control over the property, while the equitable title gives the beneficiaries rights to the benefit of the property.[55] Benefits may favor some beneficiaries over others and may change over time. It is often true that no particular beneficiaries or beneficiary has the full right to enjoy all the benefits of the property, nor are the shares of the respective beneficiaries fixed. This can make determining the attributes of ownership of the underlying wealth exceptionally difficult.[56]

Civil code countries that do not have trust provisions frequently have other rules that permit the creation of entities involving trustlike relationships. These include the family or private foundation. Such entities, known as *fondation* in French and *Stiftung* in German, are similar to trusts in that legal title to property is held by one person, while the benefits of the property accrue to others. In France and other jurisdictions that follow the French model, *fondations* may be set up with approval from the appropriate governmental agency.[57] The German civil code provides for foundations both with and without independent legal existence.[58] Foundations are managed under the terms of a notarial deed of mandate or a "constitution." Neither specific beneficiaries, nor beneficiary rights, need be noted in the constitution.[59] Therefore, the foundation can duplicate many of the problems found with family trusts in attributing ownership rights.

Other forms of ownership of property under different legal regimes can create similar wealth attribution problems. Islamic law recognizes the *waqf dhurri*, which can be translated as "family foundation."[60] There is disagreement among the different schools of

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[53]Bolivia, Costa Rica, El Salvador, Guatemala, Mexico, Panama, Puerto Rico, and Venezuela have each adopted some kind of civil code provision for trusts, although they vary greatly in extent. *See* William F. Fratcher, *Trust, in* VI International Encyclopedia of Comparative Law 11-104 (1973). Moreover, there is a convention on the recognition of trusts, *see infra* note 65.

[54]Quebec has long had trust provisions. *See* Civil Code, arts. 1300-1337 (Quebec). In 1989 Mauritius adopted complete trust provisions. Mauritius Public Trustee Act of 1989 (Act 27 of 1989); Mauritius Trusts Companies Act of 1989 (Act 28 of 1989). In 1992 the French government introduced comprehensive trust legislation. *See* Jean Delattre, *France Introduces Comprehensive Regime for Trusts*, 4 Tax Notes Int'l 643–44 (1992). However, the bill was withdrawn before enactment.

[55]*See, e.g.*, Restatement (Second) of Trusts § 2 (1959); 1 Austin W. Scott & William F. Fratcher, The Law of Trusts §§ 2.3-2.6, at 40-48 (4th ed. 1987-89).

[56]*See generally* Gordon & Summers, *supra* note 51, at 137.

[57]There are no provisions in the French Civil Code concerning the creation of foundations; instead, they are a construct of French common law. *See generally* Maurice Pomey, Traité des fondations d'utilité publique (1980).

[58]Civil Code arts. 80–88 (DEU).

[59]*Id.*

[60]All *waqfs* must have a purpose that pleases God. This admonition has occasionally led to mistranslation of *waqf* as a *charitable* foundation. However, support of family and friends, if not otherwise in violation of law, is considered pleasing to God. Akshoy Rekhi, The Law of the *Waqf Dhuree* (1993). *See also* The Qur'an, Surah II 177 (M.H. Shakir trans., 7th ed. 1994) (quoted at the beginning of this chapter). *See*

Islamic law as to who actually owns the property held in the *waqf*; in Shi'i law the ownership of the underlying property itself is also vested in the beneficiaries, while in Hanafi law it is the property of God, raising interesting issues of ownership attribution.[61] Regardless, as with the trust and family foundation, it can be difficult to attribute ownership to particular taxpayers. In addition to civil code and Islamic law foundations, customary law entities may exist that could frustrate the operation of a net wealth tax levied on physical persons only, for example, the *yayasan* in Indonesia,[62] or real property rights vested in an entire community found in many developing countries.[63]

Foreign laws can be relevant to the structure of the ownership interests of residents. For example, a resident of a French civil code country (or indeed a resident of many counties with other laws) can set up a Cayman Islands trust or a Liechtenstein *Stiftung*.[64]central Americans wishing to avoid wealth (among other) taxes have set up such *Stiftungen* there. In addition to the considerable administrative problems that could arise, the legal question of ownership of the corpus of a trust or family foundation would still be important to the country of residence.[65]

Some jurisdictions tax not only physical persons on their property, but also certain entities.[66] The entity can be taxed as a surrogate for the person or persons who receive the benefits of ownership. Such an approach can help obviate the need for identifying and attributing the many different forms of ownership interests that can be created in entities; however, as noted below, if the entity is taxed, provision must be made to prevent double taxation if the owner of the entity is also subject to tax. Moreover, similar to the case of taxing a family as a unit, a problem with taxing entities as a surrogate for taxing their owners or beneficiaries arises if the wealth tax is levied at graduated rates (or involves

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generally Monica M. Gaudiosi, *The Influence of the Islamic Law of Waqf on the Development of the Trust in England: The Case of Merton College*, 136 U. Pa. L. Rev. 1231 (1988).

[61]*See* Pearl, *supra* note 46, at 197.

[62]The *yayasan* is a creature of both customary law and of the civil code, and is similar in most respects to the foundation and the *Stiftung*. *See* Civil Code arts. 365, 899 (IDN); Soetjipto Wirosardjono, From Foundation to Foundation (Aug. 12, 1991) (unpublished manuscript on file with the authors) (discussing how the civil code provisions concerning the *yayasan* make only reference to them, while the operation of the *yayasan* is governed by customary law).

[63]For example, among at least some of the Bataks of north Sumatra, real property is not only held by living members of the ethnic group, but by generations yet unborn. Complete agreement by all members of the group must be secured before alienation of real property may take place, and the rights of future generations must also be considered. Norman Pakpahan, Notes on Group Ownership under Batak Customary Law (Sept. 16, 1992) (unpublished manuscript on file with the authors).

[64]Commercial Code arts. 552, 558 (LIE). We are informed that this jurisdiction has become a center for *Familienstiftungen* created by foreigners. We are further informed that, in particular, many wealthy

[65]*See generally* Convention on the Law Applicable to Trusts and on Their Recognition (1984).

[66]In Germany, the taxpayers are basically the same as those who are subject to corporate income tax. *See* Klaus Tipke & Joachim Lang, Steuerrecht 469 (1991). Taxpayers include "associations, foundations, and other funds of private law that do not have legal personality." *See* DEU VStG §§ 1, 2. This means that partnerships are generally not subject to net wealth tax. (For discussion of application of corporate tax in Germany to partnerships, *see* vol. 2, chs. 19, 21).

exempt amounts).[67] Incentives would exist to split assets into a larger number of entities so as to take advantage of lower marginal rates. The alternative of taxing entities at the top marginal rate would result in some persons being overtaxed.

Another consideration is that if both physical persons and entities are taxed, double taxation can occur unless ownership interests in taxable legal persons are themselves exempt. This is the case in Germany, where the value of an ownership interest in an entity is generally included in the tax base of residents, but where the net wealth of entities is also, with limited exceptions, separately taxed and at a higher rate.[68]

A related problem exists with regard to nonresidents who have ownership interests in resident entities that themselves own property not located in the jurisdiction. As noted above and discussed below at greater length,[69] residents are typically taxed on their worldwide net assets, while nonresidents are frequently taxed only on their assets that are physically located within the jurisdiction. However, if legal persons and other entities are taxed on all their net wealth, including wealth located abroad, then nonresidents with interests in a resident legal person will also be taxed on those assets located abroad. The result is that they will be overtaxed, compared with a situation in which they owned their share of the legal person's assets directly. The statute can be drafted to correct this distortion in the manner suggested below.

The technique of taxing entities as a surrogate for taxing their owners will not work for nonresident entities because they may be beyond the effective administrative reach of the jurisdiction. Therefore, interests in nonresident entities would have to be included in the net wealth tax base of the resident physical persons who own them. In such cases, many of the daunting issues discussed above with regard to trusts and similar entities resurface.

Finally, the question arises as to whether debt interests, such as bonds, should be separately attributed and valued or should be included in the surrogate tax levied on legal persons. As noted at the beginning of this chapter, the tax base of the net wealth tax is the sum of assets minus liabilities. However, it would be possible to levy a surrogate tax on the value of a bondholder's investment in a legal person by not allowing liabilities as a deduction from a legal person's tax base. In such cases, all wealth in the form of bonds and other debt interests in resident legal persons should be excluded from the tax base to avoid double taxation. The authors are not aware of any net wealth tax that adopts this

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[67]*See supra* note 8. The German net wealth tax has a flat rate for entities, but includes an exemption for the first DM 500,000 of business assets; taxpayers with net wealth below DM 20,000 are also excluded from the tax. The latter of course also involves a "cliff" problem, with a high marginal rate (although not necessarily a large amount of tax) on taxpayers whose wealth increases to just above the threshold. For German wealth tax rates on individuals, *see supra* note 45.

[68]*See* DEU VStG §§ 1, 10(1)(2); Tipke & Lang, *supra* note 66, at 469. However, if a taxpayer owns shares that constitute more than 10 percent of the registered capital of a resident company, those shares are exempt from the tax base under the so-called affiliation privilege. *See* International Bureau of Fiscal Documentation, The Taxation of Companies in Europe: Germany ¶ 392 (1991).

[69]*See infra* sec. II(B)(1).

approach, but some countries with an assets tax that acts as a minimum income tax do take such an approach to debt instruments.[70]

3. Exemptions

The agencies and instrumentalities of government are normally exempt from net wealth taxation; such entities are already publicly held, and levying a wealth tax on them would not advance any of the stated goals of wealth taxation.[71] Also, not-for-profit entities may, depending on the particular jurisdiction, enjoy an exemption from net wealth tax. For example, in Germany the exemption applies to not-for-profit entities that provide education, health services, or social assistance or that support religious activities.[72] A number of arguments favor such exemptions. One is that if the beneficiaries of not-for-profit legal persons constitute either the public at large or a reasonably broad segment of that public, they should receive an exemption for the same reason that agencies and instrumentalities of the state do. In other words, it makes little sense to redistribute wealth from an entity that benefits the general public.

Another argument is that charitable activities should be encouraged, and an exemption from wealth taxation may serve as a reasonable tax subsidy.[73] However, exemptions may spread far beyond such limited parameters. For example, Germany exempts such diverse entities as pension funds, small mutual insurance companies, public utilities, and certain capital participation companies.[74] The pension fund issue is, of course, quite controversial. On the one hand, exempting pension funds seems counter to nearly all the arguments advanced for taxing wealth in the first place. Such funds can hold considerable wealth, and beneficiaries are typically physical persons.[75] On the other hand, the bulk of the pension funds rights may be allocated to savers whose taxable net wealth does not exceed the threshold for wealth tax. With respect to charities, a blanket exemption for charitable institutions could be taken advantage of by family foundations that, even if restricted to charitable purposes, can involve family control over wealth,

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[70]*See infra* ch. 12, sec. III(C). *See also* vol. 2, ch. 19, which discusses the analogous issue under the income tax.

[71]*See, e.g.* DEU VStG §§ 3(1)(1), 3(1)(1a), 3(1)(2), 3(1)(2a). These do not include legal persons owned by the state but that do not act in a governmental or sovereign function.

[72]*See, e.g.* DEU VStG §§ 3(1)(4), 3(1)(12).

[73]This argument can be made to advance exemption for all forms of taxation of socially beneficial not-for-profit enterprises. *See* Yishai Beer, *Taxation of Non-Profit Organizations: Towards Efficient Tax Rules*, 2 British Tax Rev. 156 (1995). Other arguments also exist, including that an exemption from taxation for all not-for-profit enterprises (meaning those that cannot distribute earnings to owners) can help compensate for difficulties not-for-profit entities experience in raising capital. *See* Henry Hansmann, *The Rationale for Exempting Non-profit Organizations from Corporate Income Taxation*, 91 Yale L. J. 54 (1981) (although the arguments advanced are addressed to income taxation, they largely also apply to wealth taxation).

[74]Some of the exemptions are linked to exemption from corporate income tax. *See* DEU VStG § 3.

[75]Some may argue in favor of exempting pension funds from wealth tax as an incentive for individuals to save. However, as with any government investment subsidy, this can create misallocations of investment and tax administration problems as individuals structure their investments for rent-seeking purposes. *See* Richard K. Gordon, *Privatization and Legal Development*, 13 B.U. Int'l L. J. 367, 374-75 (1995).

presumably a target of a wealth tax. Excluding private foundations from an exemption for charities would involve some drafting and administrative complexity, in that it would require defining private foundations, not an easy task. Alternatively, all charities could be taxed, but only on their business or investment assets, that is, not on assets used in charitable activity.

4. Implications for Drafting

If a developing or transition country wishes to adopt a net wealth tax, relative ease of administration suggests that, in addition to physical persons, at least those legal persons and other entities whose ownership interests cannot be readily attributed to identifiable persons should also be subject to tax. To avoid double taxation of wealth held by entities (and to obviate the need to attribute and value ownership interests), interests in those taxable entities should themselves be exempt from tax. Under a progressive rate schedule, the rate for such persons should probably be the top rate for physical persons. Although this will result in overtaxation of interests held by physical persons who are taxed at lower rates or who do not pay wealth tax, the consequences of this effect are likely to be minor. In this case, the trade-off between fairness and administration probably militates in favor of administration.

A developing or transition country would probably be advised to adopt a large exemption amount and a single, low rate of tax (something like the German rate of 0.5–0.6 percent; in any event, probably not more than 1 percent). The flat rate would simplify the operation of the tax, as it would provide equal treatment for wealth held inside or outside an entity.

To avoid an incentive to set up numerous legal persons, legal persons could be denied an exempt amount. However, a *de minimis* exemption may have considerable administrative advantages. If the *de minimis* amount is small enough, and if attribution rules are adopted that allow the taxation authority to group together legal persons whose beneficiaries are the same, there may not be too much incentive for taxpayers to take advantage of the exemption by setting up numerous legal persons. The *de minimis* amount should probably be in the form of an exemption rather than a threshold that determines taxability of the legal person; this will avoid the peculiar result in Germany where marginal tax rates over a small range can be astronomical.[76]

Overtaxing nonresidents who have ownership interests in legal persons that themselves hold wealth not located in the jurisdiction might create a disincentive for nonresident investment. It might make sense in such cases to exclude as taxpayers those legal persons most likely to have both reasonably significant numbers of nonresident investors and substantial amounts of foreign assets. Another, more accurate solution would be to give such legal persons the option of paying either a full wealth tax or two separately calculated surrogate taxes, one for residents and one for nonresidents.[77]

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[76]*See supra* note 67.

[77]The first tax could be the sum of the company's net assets, multiplied by a fraction equal to the ratio of the total value of shares held by resident shareholders to total value of all shares. The second could be the sum of the company's net assets located in the jurisdiction, multiplied by a fraction equal to the ratio of the total

It might be preferable if legal persons and other entities that are taxed as a surrogate for taxing their investors were taxed on their gross, rather than on their net, assets. This would mean that those who had both equity and debt ownership interests in the entity would be covered by the tax. Therefore, both equity and debt interests in legal persons and other entities subject to wealth tax would be exempt from the tax base.[78]

B. Tax Base

1. Base for Residents and Nonresidents

As mentioned previously, it is common for wealth taxes to distinguish between residents and nonresidents, with the former being taxed on their worldwide net assets, and the latter only on those assets located within the jurisdiction.[79] Presumably, the reason for taxing a resident's entire net wealth is that it is the sum of such wealth, wherever it is located, that determines the person's tax capacity. The justification for taxing nonresidents on their assets located within the jurisdiction is less clear. There is the obvious practical consideration that these are the only assets that the jurisdiction is likely to be able to tax. Also, if one of the justifications for the wealth tax is to reduce the inequality of asset ownership within a jurisdiction, to leave out all assets within it that are owned by nonresidents would make another policy justification of wealth taxation—a modest reduction in inequality of wealth harder to implement.

Taxing assets within the jurisdiction can also form part of international coordination of the net wealth tax. If most jurisdictions taxed domestic assets (together with worldwide assets of residents) and allowed relief for foreign wealth tax paid on assets located abroad, there would be no double taxation, and each jurisdiction would tax the assets over which it is likely to have the greatest control. Given the relatively narrow degree of adoption of wealth taxes, this possibility is more of theoretical interest, although it could be relevant to a region in which all or most countries implemented a net wealth tax.[80]

To limit a nonresident's tax base to those assets located within the jurisdiction, it is necessary to define both residency and asset location. The criteria for determining residence are normally identical, or nearly identical, to those for the income tax.[81] Given

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value of shares held by nonresident shareholders to total value of all shares. Which of these solutions chosen will depend on the size and nature of the transnational investments and on the capabilities of the tax administration.

[78]If the approaches discussed in the paragraphs above concerning the taxation of nonresidents on nonresident assets in the case of certain companies were adopted, these could be appropriately drafted to take account of debt.

[79]*See, e.g.* FRA CGI arts. 885 1°, 885 2°; DEU VStG §§ 1, 2.

[80]At the moment, the greatest regional concentration of net wealth taxes seems to be in the EU, but even there it is far from universal.

[81]*See, e.g.*, FRA CGI art. 4B; 2 *Précis de fiscalité* ¶ 4825 (1994); DEU VStG §§ 1, 2. For a general discussion of principles of residence under the income tax, *see* vol. 2, ch. 18.

that the net wealth tax is an annual tax like the income tax (or is levied for a few years at most), it makes sense to use the same rules as under the income tax for administrative simplicity. These rules focus on the taxpayer's status in the current year. As discussed below, longer-term rules may be appropriate for transfer taxes. However, given the tax advantage of ceasing to be a resident of a jurisdiction with a wealth tax, some taxpayers with considerable wealth located outside the jurisdiction may seek to expatriate to avoid tax. Such an attempt to avoid wealth tax could be countered through a rule that continues to impose a tax on all assets for a certain period after the residency status changes.[82] Another possibility would be to continue to impose tax on all assets if tax avoidance was a primary motivation for the person's change in residency.[83] Both measures suffer from the limitation that it is generally difficult for a country to enforce its tax laws in the territory of another sovereign country. An alternative would be to impose a tax at a much higher rate in the year of expatriation.

It is generally easy to determine whether tangible property is located within the country. Intangible property, however, raises more difficult issues with respect to its location. The location of many assets for purposes of determining the nonresident's tax base can be determined by analogy to general income tax principles.[84]

2. Exemptions

Certain assets are often exempted from the tax base for particular taxpayers. Statutes frequently provide a zero-bracket amount to exclude taxpayers who do not have sufficient wealth to warrant taxation.[85] Different jurisdictions have enacted various exceptions for different reasons. For example, in France, goods necessary for the practice of a profession are exempt, presumably so as not to burden the means necessary to an individual for the production of her or his livelihood.[86] However, given the relatively low rate of tax (between 0.5 and 1.5 percent of net worth)[87] and the large zero-bracket amount of nearly F 4.5 million,[88] such an exemption hardly seems necessary. France also seems to exempt other assets, such as woods and forests, for either ecological or political reasons.[89] At first blush, the French exemption for antiques, art objects, and collector's

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[82]The United States has considered recent analogous legislation. *See* Expatriation Tax Act of 1995, H.R. 1812, 105th Cong. 1st Sess. (1995); Joint Comm. Tax'n, Explanation of H.R. 1812, JCX-26-95 (1995).

[83]*See* USA IRC § 2107 (renouncing of citizenship to avoid tax). The United States does not impose a wealth tax; in addition, the United States bases its tax jurisdiction on citizenship as well as on residency.

[84]*See* vol. 2, ch. 18. With regard to the debt of a legal person, see *infra* note 105.

[85]For example, in France the zero bracket amount for 1994 was F 4,470,000, or $ 881,656 (French franc-U.S. dollar rate of Feb. 12, 1996). 2 *Precis de fiscalité* ¶ 4825 (1994).

[86]FRA CGI arts. 885N–R.

[87]FRA CGI art. 885U.

[88]*See supra* note 85.

[89]FRA CGI 885H.

items[90] seems quite perverse in light of the earlier-enumerated goals of wealth taxation. The exemption may be related to the difficulty of administering such a tax on objects that are typically kept in the home of the taxpayer as well as to concerns for preserving national culture and patrimony.

The French exemption for the value of rights to literary or artistic property, and the right of inventors to their inventions,[91] appears to be based on some other principle, perhaps to encourage innovation. The exemption for the capitalized value of certain life annuities payable as a pension or received as compensation for personal injury[92] appears designed to support other goals. France also exempts financial investments the income from which is sourced within the country, unless the investment is in a company or legal entity whose assets are principally immovable property or rights to such property.[93]lump-sum assessment if it is justified for national economic reasons or if it is particularly difficult to evaluate the net wealth tax for nonresidents. *Id.* § 13. This exemption seems designed to encourage foreign investment without acting as an incentive to foreign ownership of French real estate.

Perhaps one of the most important lessons to be drawn from these few examples is that exemptions should be as limited as possible, with carefully articulated criteria. Among those criteria might be that the exemption should either demonstrably advance the ease of administration of the tax or promote as efficiently as possible an articulated national policy, without undermining the objectives or purpose of the tax.

3. Valuation

Valuing net wealth often poses serious practical difficulties. Some jurisdictions, such as Germany, have a general valuation law that is used for all taxes.[94] Other jurisdictions, such as France, have different rules for income taxes and for wealth taxes.[95] The value of immovable property, for example, can be estimated using the same rules as for real property taxes or stamp taxes. This can of course lead to large inequities if the value for purposes of the other tax is distorted, but developing and transition countries in particular may have no realistic choice given administrative constraints. Because of the difficulty of performing a valuation, it is often provided that for certain kinds of assets a

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[90]FRA CGI art. 885I. The practice of exempting these assets is also followed in many other countries. *E.g.*, in Sweden, antiques, art objects, and collector's items are exempt from net wealth tax (*see* SWE SF, § 3(2)(e)), and jewelry in practice is hardly ever taxed.

[91]*Id.*

[92]FRA CGI arts. 885J, 885K.

[93]FRA CGI art. 885L. *C.f.* Germany, where nonresident individuals and entities are taxed on the net wealth located in the national territory. *See* DEU VStG § 4. However, the tax authorities in accordance with the Federal Finance Minister may decide on a full or partial exemption or establish a

[94]*See* DEU VStG § 4 (referencing DEU BewG).

[95]*See* FRA CGI art. 885S.

valuation remains in effect for a specific number of years, or there may be a formulary adjustment of the valuation for a specified period.[96]

For both net wealth taxes and wealth transfer taxes, certain types of interests can pose valuation problems and require special rules. Specific classes of property[97] and particular assets, for example, jewelry and collectibles, fall into this category.[98] Ongoing businesses that are not taxable as entities also pose difficulties.[99] One extreme approach to the problem of valuation could be to require the estate or owner to sell the property to the government for the amount claimed on the return (plus a specified premium) should the government wish to buy it.[100]

Ownership rights included in the tax base should be defined broadly. This broad definition should include direct undivided ownership interests, joint tenancy with rights of survivorship, ownership of property subject to dower, curtesy, or usufruct interests, and property transferred to the taxpayer where the transferor retains power over the property such as through a general power of appointment, a reversionary interest, or a retained life estate. While valuation of such split interests in property may be difficult, a general market value approach should usually be followed.

Perhaps the most difficult valuation problems are likely to arise from the varying forms of interests found in companies, partnerships, trusts, and other entities. As discussed above, the problem of valuing these interests may largely be taken care of through the taxation of entities as surrogates. However, in the case of nonresident entities, such indirect taxation is not usually possible. In these cases, it will be necessary to value the interest. With regard to companies and partnerships, estimates will have to be made of share and partnership values. Attribution rules found in income tax laws can help determine ownership interests.[101]

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[96]*See* OECD, *supra* note 9, at 62.

[97]For example, in Spain, time-share ownership is valued according to the percentage of ownership in property valued under the regular valuation rules or, if the taxpayer does not share in the ownership of the property, the value is the acquisition price for the time-sharing certificate or other instruments representing them. *See* ESP IP art. 10.

[98]*See, e.g.,* FRA CGI art. 764(II) (under the wealth transfer tax, art objects, precious stones, jewelry or other collector's items may not be valued at less than their insured value at the date of death unless there is evidence to the contrary).

[99]For example, there are a number of difficulties with valuing small businesses. While a general method is to capitalize the earnings, that valuation method produces great difficulties when valuing personal service businesses. Merely taking the book value of assets as the value of the business substantially understates the value of assets not shown on the balance sheet, such as goodwill. For other issues in business valuation under the wealth transfer tax, *see infra* sec. III(F).

[100]This approach was used in a property tax statute in Zimbabwe. *See also* Luis F. Ramirez Acuña, *Privatization of Tax Administration, in* Improving Tax Administration in Developing Countries 377, 386 (Richard M. Bird & Milka Casanegra de Jantscher eds., 1992).

[101]*See infra* vol. 2, ch. 21.

In the case of publicly traded interests, market value can be defined as the mean between high and low market quotes on the valuation date.[102] With regard to valuing untraded interests, the law could provide a percentage increase for all controlling interests, a percentage decrease for all minority interests in other than publicly traded companies, and a percentage decrease for large blocks of shares in publicly traded companies. This would eliminate much of the administrative difficulty and valuation problems in determining the appropriate premium for a controlling interest, minority discount, or blockage discount.[103] Alternatively, because valuation issues are difficult to deal with in a tax administration structure that lacks great sophistication, the statute could flatly disallow blockage or minority discounts.

The taxation authority may have difficulty determining the ownership of interests in family trusts, foundations, and similar entities. A number of countries have elaborate rules for determining who owns the beneficial interest in such entities.[104] Although such rules can be used to assign ownership interests in the wealth held by the entity, they can be difficult to implement. Developing and transition countries in particular may not wish to complicate their wealth tax administration by implementing such elaborate rules. Instead, they may prefer to adopt rules of thumb that assign ownership interests to the creator of the entity, or to the heirs and assigns, absent a showing by the beneficiaries as to what their respective beneficial interests are worth.

Of course, wealth taxes are due on net wealth, meaning values accounting for liabilities. As noted earlier, it may be considerably easier to tax debt interests in legal persons by using the legal person as a surrogate.[105] However, when valuing debt interests in physical persons, it may be preferable to account for them directly, with the physical person deducting the value of the debt and the creditor including the debt. This is because most creditors of physical persons are likely to be banks or credit finance agencies who can easily produce the necessary records concerning their lending activities.

C. Double Taxation

Net wealth taxpayers whose worldwide net wealth is subject to tax may be subject to double taxation. Double taxation can be eliminated either by unilateral relief[106] or by tax treaties. For example, under treaties, immovable property is normally taxable in the country in which the property is situated. An important difficulty in relying on treaties is that there are relatively few that cover net wealth taxes. It is probably not a top priority

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[102]Another approach is to value listed securities in accordance with the last day's quotation or with the average of the last 30 days, as is done under the French wealth tax. *See* FRA CGI 885T *bis* (1988).

[103]A blockage discount reflects the lower value for company shares if they were liquidated in the market in one transaction rather than in a series of transactions because of the effect that the liquidation would have on the market price.

[104]*See, e.g.* USA IRC §§ 641–679. *See also* vol. 2, ch. 21.

[105]*See supra* secs. II(A)(4), (B)(1).

[106]*See* J.F. Avery Jones, *A Comparative Study of Inheritance and Gift Taxes: Introduction,* 34 European Taxation 335-36 (1994).

for developing and transition countries to devote resources to negotiating treaties in this area. It therefore makes more practical sense for them to structure their net wealth taxes so as to impose the net wealth tax on nonresidents in a manner that is creditable in a nonresident's home country if that country levies a net wealth tax on worldwide assets.

Relief from double taxation for residents who are taxed on net wealth outside the country can be provided through a credit or an exemption. The issues are similar to those under the income tax.[107] Exemption is effective in eliminating double taxation and is relatively easy to administer because the only issue is the location of the property. Its disadvantage is that it may result in no taxation at all on assets located in jurisdictions without a net wealth tax. A tax credit approach ensures that a tax will be payable either to the foreign country or to the country of residence.

To implement a credit for foreign taxes, it is necessary to define a qualifying foreign tax. For example, what if the foreign country has a tax on the ownership of immovable property? Is this a net wealth tax that qualifies for the credit, or is it a property tax that does not? What if the income tax in the foreign country is creditable against the net wealth tax? Should a credit be allowed in that case only for the whole tax, only for the excess, or not at all? Should a credit be allowed at all for a tax that is in the nature of a minimum income tax? In addition to determining whether a foreign tax qualifies as a creditable net wealth tax, it is necessary to provide a mechanism for calculating the limitation on the credit.[108] This can be done on a per-country or an overall basis, as with the foreign tax credit under the income tax.

D. Administration

A time for filing returns and making installment payments must be provided. In most countries, net wealth is revalued annually, but in Germany and countries that follow the German model, it is generally done every three years.[109] It may be convenient to provide for net wealth tax returns to be filed at the same time as income tax returns. The returns should be cross-checked with income tax returns, so as to obtain information that may be relevant in auditing both taxes. Indirect controls for determining wealth tax compliance can be provided by requiring proof that the wealth tax has been paid for such transactions as the issuance of passports, sales and transfers of immovable property, and transfers of vehicles.

A distinction should be drawn in the law between the time that net wealth is measured (usually at a specific date every year) and the due dates for paying the tax.

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[107] *See* vol. 2, ch. 18.

[108] *See* ESP IP art. 32; DEU VStG § 11. In Germany the credit limitation is calculated on a per-country basis. As an alternative to the foreign tax credit, Germany provides for a 50 percent reduction in tax for certain business assets located abroad. DEU VStG § 12.

[109] *See* OECD, *supra* note 9, at 62-63; DEU VStG §§ 15-18.

These may be set more frequently than once a year, particularly for taxpayers with larger amounts due.[110]

III. Design of Wealth Transfer Taxes

As noted earlier, an argument favoring wealth transfer taxes is that it may be easier to keep track of relatively infrequent changes in wealth ownership than it is to keep track each year of all the taxpayer's assets. However, this administrative advantage over net wealth taxes also carries with it an important difficulty. The principal policy goal of transfer taxes is to collect a certain percentage of intergenerational transfers of wealth. Unfortunately, people do not transfer wealth, whether by gift or at death, in a predictable manner. Transfers to members of the same generation or untimely deaths in successive generations may lead to excessive taxation under a transfer tax. More likely, insufficient tax may be collected as taxpayers plan to avoid the transfer tax by transferring wealth directly across more than one generation (a so-called generation-skipping transfer). Special provisions must therefore be made to account for these potential problems.

A. Taxable Transfer and Taxpayer

It is the transfer of wealth that attracts tax, but the tax rate is based on the total amount of wealth transferred. For this reason, the issues of who the taxpayer is and when a taxable transfer occurs are unavoidably and inextricably linked. Perhaps the most common transfer of wealth is from one spouse to the other, both by gift and at death. However, such a transfer would not typically be "intergenerational." In addition, as noted earlier, some legal traditions consider the property of spouses acquired during their marriage as being common property.[111] This tradition may also be reflected in a spouse being guaranteed a certain share of the other spouse's property after death.[112] For these reasons, although most particularly the intergenerational one, many jurisdictions exempt transfers from one spouse to the other.[113] Other reasons include providing a uniform

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[110]*E.g.,* DEU VStG §§ 20, 21.

[111]*See supra* note 46 and accompanying text.

[112]Such shares are quite common in civil law countries. *See, e.g.*, Civil Code art. 540 (ITA). In other civil law jurisdictions, the right to a spousal bequest depends on the needs of the surviving spouse. *See, e.g.,* Civil Code art. 1368 (MEX) (the testator must provide support for the surviving spouse if he or she is unable to engage in gainful employment and has insufficient means with the right, except as otherwise expressly provided by the will, continuing as long as the surviving spouse does not remarry and lives an honorable life).

[113]*Compare* USA IRC § 2056(a)(unlimited marital deduction); GBR IHT § 18 (same); PNG WPA § 145 (same); *with* JPN IHT art. 19-2 (reduction of inheritance tax amount for spouse). In many countries, the allowance is not as generous. *See, e.g.,* DEN INH § 2(A) (no inheritance tax if the amount received by the surviving spouse does not exceed Dkr 100,000); FRA CGI art. 779 (F 330,000 personal allowance for transfers between spouses); Inheritance and Gift Tax Law § 12 (FIN) (the surviving spouse is allowed a deduction of Fmk 37,500 from the taxable inheritance); DEU ErbStG §§ 16, 17 (spouses are allowed a personal allowance of DM 250,000 for transfers of property by reason of death or gift and surviving spouses (an additional DM 250,000) and children up to age 26 (up to DM 50,000 depending on age) are granted a special maintenance allowance on transfers by reason of death).

treatment of ownership between spouses, extending support to the spouse posthumously, and perhaps pure sentimentality. Some jurisdictions limit the rollover amount to only one transfer between spouses, so as to avoid the skipping of generations that results from having widows and widowers marrying younger spouses.[114]

The exemption of property transferred to a spouse will often depend on the citizenship or domicile of the transferee spouse. As with net wealth taxation, wealth transfer taxes typically restrict the tax base of nonresidents to assets located within the jurisdiction.[115] As noted earlier, a tax can be levied either on the transferor or on the transferee; the choice of which type of tax to adopt will depend, at least in part, on the type of legal rules affecting the transfers of property.[116] Under a transferee type of tax, a nonresident spouse would not, unless special rules exist, have to pay tax on assets located abroad. Under a transferor type of tax, the foreign assets would still be taxed, but all future transfers of those assets would be exempt. In the United States, which taxes the transferor, the spousal exemption does not generally apply to noncitizen transferees, but the transfer of property into a qualified trust for the benefit of the spouse is exempt under certain circumstances, a tax being due on amounts remaining in the trust at the death of the surviving spouse.[117]

In designing an exclusion for transfers to the spouse, the drafter must consider whether the transfer of a terminable interest (i.e., an interest that terminates with the death of the spouse) is eligible for the exclusion. Normally, it would not be, because the property with respect to which the terminable interest applies would not be included in the spouse's estate. In the United States, an exclusion has been extended to qualified terminable interest property, but the price of this exclusion is that the property must be included in the transferee spouse's estate upon the death of that spouse.[118] Such a rule mirrors the treatment for decedents with retained reversionary or income interests in property transferred during life.

Recognizing the hardship that occurs on the death of a parent, in the case of transfers at death, some jurisdictions provide a limited exemption for property transferred

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[114]Other tax laws deal with this problem differently. *See, e.g.,* Luxembourg loi concernant l'impôt sur la fortune [Law Concerning the Imposition of Wealth Tax], 3 Code fiscal art. 10 (exemption from inheritance tax between spouses where there are children from their marriage or these children have children, and, if an inheritance tax is levied between spouses, the amount subject to inheritance tax is reduced by Lux F 1,5000,000).

[115]*See infra* sec. III(B), (C).

[116]*See supra* text accompanying notes 3 and 8, and *infra* text accompanying notes 132–42.

[117]*See* USA IRC §§ 2056(d), 2056A. However, double taxation is prevented if property is included in the estate of the decedent who transfers the property to a noncitizen transferee because upon the death of the transferee, the transferee's estate is given credit for the estate taxes paid by the transferor's estate. *See* USA IRC § 2056(d)(3). Parity with transfers to citizen spouses is not accomplished because in the United States there is an unlimited exemption for transfers to spouses, and if the transferee spouse consumed the assets received from the transferor, no wealth transfer tax would ever be paid.

[118]*Id.* at §§ 2044, 2056.

to minor children.[119] In some statutes, exemptions are provided for children regardless of age, although the amount of the exemption is limited.[120]

The problem of taxing too many transfers over a period of years because of other transfers to the same generation or untimely deaths in consecutive generations can be dealt with in a number of ways. The most common problem occurs when tax is paid on a wealth transfer resulting from a death, and this occurrence is followed within a relatively short time by the death of the transferee. Some statutes provide full or partial relief from taxation on the second transfer. Such relief is normally restricted to property included in the initial decedent's taxable estate.[121] One issue in designing such a scheme is whether the relief should be based on the tax payable on the first estate, the second estate, or on the lower of the two. The last would seem most logical in light of the purpose of avoiding double taxation, but the practices of countries differ.

In the United States, a credit is allowed for estate tax imposed on other estates with respect to all property that passed from such other estates to the decedent and that is included in the decedent's gross estate.[122] The statute provides for a 100 percent credit for tax due on the property acquired from the transferor when the transferee dies within two years of the transferor and thereafter provides for a declining percentage of the tax owing on the property to be credited against the transferee's taxable estate when the transferee dies within ten years of the transferor. Other countries provide for a reduction of estate duty payable on interests in immovable property or a business when the transferee dies within five years of the transferor.[123] If the value of the property has appreciated since the death of the first decedent, the reduction of estate duty is based on the value of the property at the time of the first decedent's death.[124]

At the other end of the spectrum, a comprehensive tax base will deal with generation-skipping transfers. This can be done through a separate tax on generation-

[119]*See, e.g.,* JPN IHT art. 29-3 (exempt amount reduced with age up to age 20); DEU ErbStG § 17(2) (exempt amount reduced with age up to age 26).

[120]*See, e.g.,* NOR Aal. (children are granted a personal allowance of Nkr 100,000 for each child, with the next Nkr 300,000 subject to an 8 percent rate and the excess amount, 20 percent, others are similarly allowed a Nkr 100,000 exemption, but the next 300,000 is taxed at 10 percent and any excess at 30 percent); ESP ISD art. 20 (exemption of Ptas 2,386,000 for descendants; increased exemption for descendants under age 21); PRT ISD art. 12(2) (limit applied to cumulative amounts received from the transferor); FRA CGI art. 779 (F 300,000 exemption for child); SVK INH (exemption for inheritance of immovable property up to maximum value of K 500,000 if the heirs are minors or are under 26 years old and are preparing themselves for their future profession).

[121]*See, e.g.,* USA IRC § 2013; JPN IHT art. 20; PNG WPA § 145; HKG EDO § 31 (relief limited to leasehold interest or business).

[122]*See* USA IRC § 2013(a). *See also* PNG WPA § 145 (providing for a reduction of net estate duty payable on property acquired from a deceased predecessor where deceased successor was a spouse, parent, child, grandchild, brother, sister, or spouse of a child of the deceased predecessor).

[123]*See, e.g.,* HKG EDO § 31. The definition of business excludes a business carried on by a company.

[124]*See id.* § 31.

skipping transfers or through a periodic tax on property held by entities.[125] Generation-skipping transfers of property are either direct skips of generations in the outright transfer of property or generation-skipping transfers that occur through the termination of a trust, foundation, or similar entity or a distribution of property held by such an entity.[126] A large exclusion is normally combined with generation-skipping provisions.[127] Thus, a generation-skipping tax would normally apply only to the largest estates. The mechanism for providing for the exclusion—an inclusion ratio—should not be determined when property is placed in trust at a time in which the generation-skipping tax does not apply, but should be determined at the time the generation-skipping transfer occurs.[128] Whether a transfer constitutes generation skipping should be determined at the time of the transfer, and the transfer should be valued at that time in applying the relevant exemption. Generation-skipping tax statutes require a definition of a skipped generation, which generally focuses on lineal descendants with a common grandparent; skips between unrelated persons can be defined with respect to age differences.[129]

Wealth transfer taxes often exclude from the tax base transfers disclaimed by the transferee.[130] The recognition of disclaimers is important to limit the amount of transfers subject to the transfer tax. Without recognition of the disclaimer, a second transfer tax would be imposed on the transfer to the ultimate beneficiary. Some statutes provide detailed rules on the time and manner in which the disclaimer must be made in order for

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[125]While the United States uses the separate tax approach, it is an exception, and the more usual approach is to have no provision, or as in the case of Germany, a periodic tax on property held in foundations or trusts. DEU ErbStG §§ 1(1), 9(1) No. 4. An indirect way of taxing generation-skipping would be to tax transfers to more remote generations at higher rates than to closer generations.

[126]*See* USA IRC §§ 2611(a), 2612.

[127]*See, e.g., id.* § 2631(a) ($1 million exemption per transferor).

[128]In the United States, the inclusion ratio is determined by allocating the exemption amount over the value of the property transferred. *Id.* § 2642(a). The fraction is set at the time of the transfer of property rather than when the generation-skipping transfer tax applies and thus a significant appreciation in property can be sheltered when the generation-skipping transfer tax is triggered either by the termination of a trust or the distribution of property rather than by a direct transfer of the property to a "skip" person. However, direct skips of more than one generation triggers only one generation-skipping transfer tax, for example, a direct transfer from a grandparent to a great-grandchild.

[129]*See id.* § 2651.

[130]Many civil code jurisdictions allow transferees to disclaim transfers. For example, under Italian law, the transfer of the decedent's estate to the heir does not take place automatically. Instead, it occurs only upon the acceptance of the inheritance by the heir. *See* Vittorio Tadei & Ugo Tribulato, *Italian Law and Practice, in* International Personal Planning 9/77 (Robert C. Lawrence, III, ed. 1994). The acceptance may be express or tacit. *See* Civil Code, art. 474 (ITA). Similarly, French law provides that heirs may refuse the inheritance if they expressly mention the refusal in a register kept specifically for this purpose by the Tribunal de Grande Instance at the last domicile of the decedent. Paul Chamont, *French Law and Practice, in* International Personal Planning 7/69 (Robert C. Lawrence, III, ed. 1994). Sweden has the same rule on disclaimers but rules that a disclaimer must be unconditional, not allowing the person to redirect the inheritance. Göran Englund & Christer Silfverberg, Beskattning av arv och gäva, 65-70, 112-13 (10th ed., 1994). To be effective the disclaimer must, in other words, have the same effect on the distribution of the inheritance as if the disclaiming heir had been dead. (Disclaiming a legacy, of course, may have other consequences, depending on the conditions made in the will.)

the disclaimer to have the intended tax consequence.[131] The reason for such rules is to limit the use of disclaimers as a tax planning tool, whereby property can be transferred to the next generation free of transfer tax.

Drafters of any transfer tax statute must be cognizant of the property ownership regimes, forms of ownership, and rights upon death that apply in the particular jurisdiction and must tailor the statute accordingly. In countries in which property can be held jointly by spouses or family members with a right of survivorship and the joint tenancy of that property ceases upon death, the statute must be carefully drafted in line with the survivorship provision. Jointly held property could be included in full in the decedent's gross estate and then any exemption or other rate reduction relief could be applied to tax the transfer to the person who receives the property under the survivorship provision. Alternatively, jointly held property, such as under a tontine, in which the successive survivors among the joint owners obtain ownership of the property, could be presumed to be owned ratably by the joint owners during the time the property is owned jointly.

In civil law countries, it is common for the decedent's estate to vest directly in the heir, unless the heir makes a disclaimer.[132] As the debts and assets of the decedent in such cases automatically become the debts and assets of his or her heirs and legatees, the actual transfer of the estate of the decedent can be accomplished without an executor or administrator. As a result, an administrator is not typically appointed except in extraordinary circumstances.[133] In countries that follow the common law tradition, transfer of property is not automatic, and an executor or administrator is required to administer the estate and effect the transfer; typically, such persons are appointed under the terms of the will.[134] The practice of administering the estate as an entity and having

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[131]*See* USA IRC § 2518 (defining qualified disclaimer as an irrevocable and unqualified refusal by a person to accept an interest in property if the refusal is in writing and is received not later than nine months after the later of the date on which the transfer creating the interest is made or the day on which the person attains age 21 and where the person has not accepted the interest or any of its benefits).

[132]*See, e.g.,* Civil Code (ITA) (the estate is not treated as a separate legal entity under Italian law); Introductory Law to the Civil Code, arts. 25-26 (DEU) (under the doctrine of universal succession, all assets owned by the decedent are deemed to have transferred automatically and by operation of the law to the heir upon the decedent's death).

[133]*See, e.g.,* Civil Code, art. 528 (ITA) (the court may appoint an administrator while the estate is "vacant"); *id.* arts. 484, 491 (if the heir has accepted the estate "with benefit of inventory," the administration falls upon the heir).

[134]*See, e.g.,* Probate and Administration Act, ch. 251 (SGP). The executor will then petition the court for "probate," a term literally meaning "proving a will," and is in essence a grant authorizing the administration of the estate. In the absence of a will, upon the application for a letter of administration, the court will appoint an administrator. *See, e.g.,* Administration of Estates Act, § 18 (SGP). Responsibilities of an executor include ascertaining the decedent's assets and liabilities, paying the estate duty, collecting the assets, realizing sufficient assets to pay debts and transferring the residue to the beneficiaries. Under many systems, executors may become personally liable for the tax due on the decedent's estate to the extent of the assets they receive or might have received but for their neglect. *See, e.g.,* GBR IHT § 204.

the estate pay the inheritance taxes on behalf of the heirs and legatees also occurs in other countries.[135]

The choice between levying a wealth transfer tax on the transferor or the transferee will often turn on the manner in which property is transferred. Typically, transferor-based taxes have been adopted where, upon death, an executor takes charge of the estate. Transferee taxes are more congruent with a model in which there is no executor and property passes through a legal form of succession.

One aspect of a transferor tax that makes it somewhat simpler to implement than a transferee regime is that tax is levied on the entire amount of wealth transferred. This means that only a single calculation of the total tax base is required, to which the applicable tax rates are applied. Typically, this means that only a single tax return is necessary. In contrast, a transferee tax is based on the special attributes of each recipient, requiring the calculation of separate tax bases and the application of rates for each base. The actual implementation of a transferee-based tax can rely, however, on using the transferor essentially as a withholding agent, requiring the transferor to calculate tax due for each recipient and to remit tax. If the substantive civil law concerning transfer of assets at death allows, such a withholding system can greatly aid administration; this is particularly true when the recipient is a nonresident.[136] If the transferor fails to remit the correct amount of tax, a secondary liability will rest with the recipients. Also, executors can be held personally liable in certain cases.[137]

Legal persons and other entities can be either transferees or transferors of wealth. In a manner analogous to net wealth taxes, the holdings of legal persons can be attributed to physical persons, or the legal persons themselves can be treated as taxpayers. However, legal persons and other entities do not die. This makes it difficult to tax entities as a surrogate for taxing their owners. Some jurisdictions deal with this problem by taxing certain entities at regular intervals designed to approximate the life span of a generation.[138] To the extent that not all entities are taxed, a method of avoidance exists. However, in part because transfer taxes are levied relatively infrequently, they tend to have higher and more steeply graduated rates than yearly net wealth taxes. This may

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[135]*See, e.g.*, DEN INH. In most Nordic countries, especially Sweden, an executor administers the estate as an entity until it has been divided. *See* Englund & Silfverberg, *supra* note 130, at 13-14 & ch. 4. The inheritance tax is paid on the basis of the values at the time of the death. The listing of the estate and its valuation constitutes the basis for computation of the tax, and the estate pays the tax, either as an estate or on behalf of the heirs and legatees. The total tax on all the property is computed on the basis of a presumed division, and whether the heirs in fact deviate from the presumed division when actually splitting up the estate has no relevance in the tax computation. *Id.*

[136]*See supra* text accompanying notes 132–35 & *infra* text accompanying notes 139–42.

[137]*See* SGP ED § 30(1)(an executor is not liable for any duty in excess of the assets that the executor has received or but for the executor's own neglect or default, might have received).

[138]*See, e.g.*, the United Kingdom, which taxes trustees every ten years. GBR IHT § 64(the tax applies only to "settlements without interests in possession," for example, a discretionary trust in which no person has a present right of present enjoyment). The German term for such a tax is *Tote-Hand-Abgabe* and the French term is *main-morte.*

make it problematic to identify an appropriate tax rate to apply to entities that are taxed as a surrogate for taxing owners. Surrogate taxation tends to work much better under a net wealth tax with flat rates than under a transfer tax.

To prevent persons from avoiding tax by transferring their wealth to a nonresident entity in a jurisdiction where no wealth transfer tax exists, some countries with territorial systems have enacted statutory provisions that assess a tax on assets held by controlled entities if these assets were received from a resident decedent.[139] For example, in Hong Kong, if the decedent transfers property to a closely held corporation, a portion of the assets of the company is included in the decedent's estate, determined according to a formula based on the benefits accruing to the decedent from the company in the three years before death. The Hong Kong rules are highly complex and involve attribution rules to provide for deemed ownership for purposes of determining whether an entity is closely held.[140] Presumably, the complexity of the rules allows sophisticated tax planners to design transactions so as to avoid the rules, which thus largely serve as a trap for the unwary.

In the case of a nonresident transferor, property held by a nonresident legal person is often untaxed under most rules.[141] If a valuation mechanism is in place to tax the value of the foreign shares attributable to assets within the country,[142] however, taxing shares in a foreign corporation with assets within the country may be a disincentive for nonresidents to invest in the country. A hybrid regime might be applied to tax a nonresident on wealth within the country or, if wealth is held through a foreign corporation, on an inheritance basis for inheritors who are residents of the country and who inherit the foreign shares. If an attempt is made to look through the assets of a nonresident legal person, then, as a drafting matter, provision should be made so that the rule cannot be avoided by using multiple tiers of entities.

Under an accessions regime, the use of entities and trusts becomes particularly problematic. For example, an accessions regime would require taxing transfers to trusts at creation rather than at distribution. Also, under estate and gift and inheritance regimes, another question arises: what is the appropriate value when the inheritor is a holder of a remainder interest rather than a life beneficiary? If the value used is that of the remainder at the time of the receipt of the remainder interest, significant wealth transfers escape

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[139]*See, e.g.,* HKG EDO §§ 34-45; SGP ED §§ 18-19, 21. Under GBR IHT § 94(1), when a "close company" makes a transfer of value, a portion of such transfer of value will be treated as if it were made by each of the company's "participators." The company, however, will be primarily liable for the tax liability.

[140]*See* HKG EDO § 34.

[141]*See* USA IRC § 2104(a).

[142]This mechanism would differ from an approach that directly taxes foreign investment in national property. For example, in the United States, a nonresident is taxed on the capital gain from the sale of U.S. real property or rights in U.S. real property as well as on the sale of shares in domestic corporations that are not publicly held, but that hold significant U.S. real property assets. The Foreign Investment in Real Property Tax Act does not directly apply to transfers of foreign shares in companies that hold U.S. real property assets, but the foreign corporation will be taxed on the gain if and when it sells the property. *See* USA IRC § 897.

taxation over the passage of time if the value of the underlying assets increases. One solution would be to revalue the assets of the trust at the time of transfer to reflect the changing relative values of the interests, either annually or periodically. If revaluation occurs only periodically, it should be performed at a minimum upon the death of the life beneficiary, and the difference in value relative to the value upon creation of the entity should be taxed. Difficulties arise in collecting the tax on the transfer to a nonresident trust.

B. Tax Base

Like that of the net wealth tax, the base of wealth transfer taxes usually includes all transferred assets of or to residents (depending on whether the tax is transferee or transferor based),[143] while the base of transferred assets of (or to) nonresidents is limited to those located within the jurisdiction.[144] Unlike net wealth taxes, the residency rules found in income taxes may be inappropriate for wealth transfer taxes[145] because the income tax residency rule is typically based on factors limited to a particular taxable year(such as presence for 183 days).[146] By contrast, wealth transfer taxes often take a long-run view of jurisdiction because they are imposed less frequently. Residence is often based on domicile. Individuals who have a domicile of origin in the country (because they were born there or their parents were domiciled there) or a domicile of choice (because they have established close connections with the country and have not shifted their domicile elsewhere) could be considered residents for transfer tax purposes even if they have a fiscal residence for income tax purposes in another country at the time the transfer tax is applied. The concept of domicile is generally more difficult to administer than the concept of residence used for income tax purposes, because it is based on an evaluation of a complex of factors and does not lend itself to objective, clear-cut determination.

C. Double Taxation

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[143]This course is followed in many countries, but many exempt foreign situs immovable property, and others also exempt foreign situs movable property.

[144]*See, e.g.,* USA IRC § 2103 (nonresident decedent's estate liable for tax on property located in the United States); GBR IHT §§ 5, 6 (nondomiciliary is liable for tax on assets located in the United Kingdom); Ireland Capital Acquisitions Tax Act 1976 (assets situated in Ireland are within the capital acquisitions tax, *see* Lynda A.M. Carroll, *Ireland: Inheritance and Gift Tax*, 34 European Taxation 374 (1994)); FRA CGI art. 750 *ter* (nonresidents pay tax only on property located in France); ESP ISD art. 7 (nonresidents liable for tax on property located in Spain and rights that may be exercised in Spain); Law Decree 118/1973, arts. 3, 35 (GRC)(inheritance tax imposed on property of any kind located in Greece); Capital Transfer Act, § 1 (NOR) (transfer of assets of immovable property in Norway or property connected with a Norwegian permanent establishment is subject to tax). In developed countries, attempts have been made to tax nonresidents on property located in the country as well as residents on property worldwide. For example, in Ireland a person who receives property from an Irish resident or who receives property in Ireland from an Irish resident or nonresident is required to report the tax. In Germany, beneficiaries are taxed on receipts of property from German decedents and on receipts of property from nonresidents.

[145]*See, generally,* J.F. Avery Jones, *supra* note 106, at 335-36.

[146]*See* vol. 2, ch. 18.

Because different jurisdictions apply different jurisdictional rules, both with respect to definitions of residence, situs of assets, and scope of the tax, the problem of double taxation of wealth may arise. To some extent, this matter can be addressed through treaty. Although less common than bilateral income tax conventions, some bilateral estate tax conventions do exist.[147] This avenue is not likely to be relevant to most developing and transition countries, for which negotiating this type of treaty cannot be a top priority. Therefore, such countries would do better to provide unilateral relief to avoid double taxation.

To avoid problems with crediting transfer taxes paid outside the country, a developing or transition country could remove from the tax base for residents property that is subject to a transfer tax by another country,[148] and should ideally do so if the domestic tax rate is equal to or lower than the foreign tax rate. A number of countries exclude from the tax base immovable property located abroad, presumably on the theory that the property will be taxed abroad.[149] Of course, it may not be. Portugal and Hong Kong have a territorial system for both movable and immovable assets.[150]

Taxes on nonresidents should be imposed in a manner that ensures crediting of such taxes in the country of residence. For example, when a tax statute deviates from an accepted definition, it may be difficult to credit a tax paid on the tax base so defined.[151]

For taxes imposed on residents' property located abroad, the statute should provide a credit for foreign transfer taxes that are imposed on property abroad.[152] For example, if a wealth transfer tax resident dies holding property in a foreign country and that country levies a tax on the property, then the country of residence should allow a tax credit or, at a minimum, a deduction for foreign taxes. In addition, if lower governmental

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[147]*See* Jones, *supra* note 106, at 337-38. The OECD has published a Model Estate Tax Convention, which is the basis for many such agreements. *See, generally* Wolfe D. Goodman, *The OECD Model Estate Tax Convention*, 34 European Taxation 338-43 (1994). For the OECD model treaty, *see* Convention Between (State A) and (State B) for the Avoidance of Double Taxation with respect to Taxes on Estates and Inheritances and Gifts, August 31, 1989, Warren, Gorham, and Lamont, No. 1366-71. The OECD model, and the treaty networks of selected countries are discussed in International Bureau of Fiscal Documentation, *supra* note 1. The United States, which has numerous income tax treaties, as of 1995 has wealth transfer tax treaties with only 17 countries. As of 1995, approximately 13 treaties with France, including the treaties with the United States, Canada, Germany, Spain, the Netherlands, and Switzerland, deal with the French net wealth tax or contain provisions to determine the allocation of the tax.

[148]*See, e.g.,* Hungary (Hungarian residents and legal persons having headquarters in Hungary are taxed on movable property and rights that can be sold and money or value inherited abroad if no estate or inheritance duties are payable in the country in which the property is located).

[149]*See, e.g.,* SGP ED § 2 (definition of "property").

[150]*See* PRT ISD art. 6; HKG ED § 19(b).

[151]*See infra* text accompanying notes 155-58, discussing the definition of the value of property by including debt on the property.

[152]*See* JPN IHT art. 21 (inheritance tax); *id.* art. 21-8 (gift tax); SGP ED § 28 (credit for estate duty paid to other countries in the Commonwealth but where duty is paid to countries not within the Commonwealth, an allowance in the amount of the duty is made from the property value); PNG WPA § 156(1).

subdivisions of a national government impose transfer taxes, recognition of those taxes in the form of a full or partial credit against the national tax may be granted as a form of revenue sharing.

A foreign tax credit system for this tax will have to deal with the same issues as foreign tax credits for other taxes, namely, definition of the qualifying tax, definition of what property is located abroad, and an appropriate limitation rule.

D. Deductions

Several types of deductions are typically allowed in determining the net estate or net inheritance. In an inheritance regime or an accessions tax regime, these deductions are implicitly allowed because the tax is based on the net amount received, although limitations on some deductions may be imposed.[153]

Expenses of administering the estate are typically deductible. Administrative expenses include executor's commissions, legal fees, investment banker fees, valuation expenses, and in general any other expenses incurred to manage or conserve the estate, rather than being incurred for the benefit of a beneficiary.[154] The criteria for deductibility of administrative expenses should be carefully defined so as to avoid disputes. Often, the definition refers to standards used by courts for purposes of supervising administration of the estate, but these may not in all cases be appropriate for tax purposes. Administrative expenses should be limited to those that are reasonable in amount to prevent an executor from siphoning off funds to relatives for performing services. Thus, executor's commissions should be limited by statute or regulation. Furthermore, the statute should explicitly provide for the denial of deductions related to exempt property transfers.

The cost of a decedent's funeral is normally deductible. Debt is often[155] but not always[156] deductible in determining the tax base. If debt is deductible, nonresidents who

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[153]*See* DEU ErbStG § 10(5).

[154]For example, in some countries, a commission incurred on a sale of property may not be considered an administration expense unless the will directs the executors to sell the property.

[155]In France, Greece, and Portugal, debt is deductible in full if due by the decedent on the date of death and evidenced in writing, and in Italy if the property to which the debt relates is included in the taxable estate and the debt is proved by an officially dated document. *See* FRA CGI arts. 768-74; Law-Decree 118/1973 arts. 21-23 (GRC); PRT ISD arts. 27-29. In Norway, Spain, Sweden, the United Kingdom, the United States, and Switzerland, debt is also deductible, but some Swiss cantons limit debt to property that is taxed in the canton. *See* International Bureau of Fiscal Documentation, 34 European Taxation 397, 407, 412, 414, 416, 424, 428 (1994); USA IRC § 2053(a)(4).

[156]While debt is normally deductible, in Belgium, debts in the form of mortgages and liens on immovable property located in Belgium are not deductible. *See* International Bureau of Fiscal Documentation, *supra* note 155, at 348. In Denmark, debts of the decedent to the decedent's spouse, children, and other descendants are deductible only if real value has been received. *See id.* at 351. In Finland, debts secured by immovable property outside Finland, and debts related to nontaxable property are not deductible. *See id.* at 356. In Venezuela, debts are not included if declared and recognized in the will or shown in documents privately signed by the principal when no other evidence exists to verify them nor are debts originating or executed outside of the country unless originated for investment purposes within the country

own property within the country can mortgage the property so as to reduce its net value.[157] The problem of debt finance is endemic to any wealth transfer tax system that seeks to reach the property of a nonresident within the country. An antiabuse rule ought to apply. One alternative is a presumption that debt is used to limit the tax base, with the decedent or the estate bearing the burden of showing that the property had to be financed out of borrowed funds. A less onerous approach would be to allocate the debt ratably over the value of all of the decedent's property. This would be less arbitrary than having the statute disallow the deduction for debt for nonresidents. Or, the statute could stipulate that no deduction is allowed for debt that is either incurred or unilaterally recognized within a certain period before death.[158] The important concern is to show that the decedent would receive cash or assets for the debt.

Income taxes on the decedent's income should be deductible from the tax base as a debt of the estate. If a credit for estate taxes paid in foreign jurisdictions is not allowed, then a deduction for these taxes should also be allowed as a debt of the estate.

A deduction for transfers to charitable beneficiaries, including religious organizations, is often allowed. The theory is that the property will be devoted to public purposes. Also, under an inheritance tax regime, no individual receives an inheritance when property is transferred to charity. Nonetheless, charitable transfer exemptions raise several policy issues. These include the location of the charity, the definition of eligible charitable recipients, and the taxation of partial transfers to charities. With respect to partial transfers to charities, tax benefits that arise from both charitable lead trusts and charitable remainder trusts should be properly valued in determining whether and to what extent partial transfers to charities should be allowed.[159] For example, if a transfer is made to a charity for a term of years with remainder to the transferor's family, under certain actuarial and investment assumptions, the entire amount of the property would be deemed to be transferred to the charity even though after the passage of time significant assets would be available for distribution to the family members and the transfer would avoid all wealth transfer taxes. This result can be avoided by specifying appropriate valuation rules.

While some countries allow a deduction for transfers to both local and foreign charities,[160] others limit the deduction to local charities.[161] A developing or transition

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unless the external debt is guaranteed with pledges or mortgages on property located abroad. *See* Inheritance and Gift Taxes Law, art. 26 (VEN).

[157]For example, widespread fraud in the transfer tax regime with respect to false claims of debt against the decedent's property prompted repeal of the largely flawed and unadministrable transfer tax in Mexico.

[158]Belgium and several other countries have such a rule. *See supra* note 156. The unilateral recognition of debt could also be treated as a gift. Nonetheless, a possible mechanism of avoidance still occurs if the decedent incorporates activities and has the company incur the debt, thereby reducing the value of the corporate shares. Therefore, a look through rule would be necessary to police any form of abuse in valuation through the use of debt.

[159]These also raise issues under the income tax deduction for charitable contributions.

[160]*See, e.g.,* USA IRC § 2055(a)(2).

country can generally limit eligibility for the deduction to charities in the country so that the benefits of the charity will accrue locally. There may be some exceptions, however, particularly for immovable property located abroad. In such a case, the property will typically be used by a charity for its charitable purposes, and it might be impossible to find a domestic charity interested in using the property.

E. Exclusions

The decision whether to include life insurance in the tax base involves several considerations. First, if the decedent had not died, then he or she would have had the opportunity to transfer value to the heirs in a form that would not be subject to transfer taxes (e.g., by allowing them to share in favorable business opportunities). To the extent that insurance compensates for this lost opportunity, the proceeds should arguably be excluded. Second, when the insurance proceeds represent the value of a person's human capital that would have been consumed during life, it is arguably unfair to include the life insurance in a transfer tax base. This argument does not apply to the portion of the life insurance proceeds that represents more than that.[162] On the other hand, the argument for including life insurance proceeds is that they represent a transfer of wealth. The fact that the transfer may have been smaller under other circumstances does not mean that the tax should not apply. Moreover, excluding life insurance can lead to problems of defining rules to prevent abuse.[163] In countries where life insurance is excluded from the gross estate, there is generally a requirement that the estate not be a beneficiary of the policy and that the decedent have not possessed within three years of death any incidents of ownership over the policy, such as the right to change beneficiaries or borrow on the cash surrender value of the policy. Such provisions complicate administration, but may be needed to prevent abuse of a rule that excludes insurance.

If life insurance receives special treatment, then the issue arises as to how to define life insurance. In the United States, complex definitions apply to both the income tax and the estate tax.[164] That complexity would apply in any tax system that differentiates between life insurance and other assets, such as annuities, that are generally included in the decedent's estate. Moreover, if the statute exempts from estate taxation a certain amount of life insurance, then it can be argued that the same amount should be

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[161]*See, e.g.,* CZE IHT (exempts legacies left to religious, cultural, educational, scientific, health, social, ecological, or sports institutions).

[162]This would include the capital cost of the insurance policy (together with an investment return on this capital), as well as the amount that represents compensation for human capital that could have been expected to have been converted to property and passed on to the heirs.

[163]*See* USA IRC § 2042 (proceeds of life insurance passing to estate or in which the decedent possessed an incident of ownership at the time of death are included in the estate, but proceeds passing directly to other beneficiaries are excluded); SGP ED § 8(f)(property passing on the death of the deceased includes insurance proceeds where the policy is kept up by the decedent); NZL EGD § 14 (abolished 1992) (gross benefits payable on a life insurance policy are includable in dutiable estate if beneficial interest in policy is disposed of within three years of death); JPN IHT §§ 3, 12(5) (insurance proceeds includable in taxable estate with reference to portion of premiums paid by decedent, but limited exemption available).

[164]*See* USA IRC § 7702.

allowed as an exemption for annuities arising from death benefits payable on the basis of the decedent's pension and retirement rights when the decedent does not have life insurance. As set forth above, there is little rational basis for exclusing life insurance, annuities, or death benefits. Moreover, annuities and death benefits represent pre-existing wealth (e.g., deferred compensation), and the rationales for excluding life insurance do not apply to these other items.

Many countries have special provisions for agricultural properties.[165] To the extent that agriculture is treated as a special asset based on public policy grounds of encouraging small agricultural holdings, a good definition of property used for agricultural purposes is required, as is an antiabuse rule aggregating holdings of agricultural property to prevent splitting such ownership among numerous persons to avoid the tax. One approach is to subject all agricultural property to tax, but to impose a lower rate on such property. Another is to assign to agricultural property the value it has in agricultural use, as opposed to the higher value it may have for development. To qualify for the lower valuation, the property would be valued for its agricultural use with the requirement that it remain in agricultural use for a specified period of time.[166] All such rules conplicate tax law. The preferable solution is not to adopt any special rules and to rely on the general exemption to protect small holdings.

Some countries exclude from the wealth transfer tax base subsistence assets, such as small (and often large) businesses,[167] a home, and the decedent's personal effects.[168]succession to the deceased or donor provided the person lived in the same household with the deceased or donor for at least one year); Russia Law of 12 December 1991, *noted in Taxation and Investment in Russia,* 5 Taxation and Investment, *supra* note 165 § 9.4.3 (July 1993 Supp.) (home or apartment exempt); *Taxation and Investment in Romania*, 5 Taxation & Investment, *supra* note 165 § 9.2.3 (Apr. 1994 Supp.) (50 percent of value of home not taxed if property was used exclusively by decedent and the decedent's family, the heir was living with the decedent at time of death, and the inherited

[165]*See* JPN IHT § 26-2 (standing timber valued at 85 percent of market value); SVN TC (full exemption for farmers on land); Serbia and Montenegro Taxes on Property Act of 1992, *noted in Taxation and Investment in Serbia and Montenegro,* 5 Taxation and Investment in Central and Eastern European Countries § 9.2.3 (Apr. 1995 Supp.) [hereinafter Taxation & Investment] (exemption for inheritance of property used for agriculture by a farmer in the second order of succession to the deceased or donor, provided the person lived in the same household with the deceased or donor for at least five years); USA IRC § 2032A (special valuation for real property used in farming or business; continuing use requirement); GBR IHT §§ 115–116, 124A (value of agricultural property is generally reduced by 50 percent; continuing use requirement).

[166]*See* USA IRC § 2032A.

[167]Several countries exempt businesses from transfer taxation. *See, e.g.,* CZE IHT (business property exempted); Perint jalahjaverolaki (Inheritance and Gift Tax Law) No. 378/1940 of 12 July 1940, as amended, § 63a-c (FIN) (partial relief from inheritance or gift tax where a farm or business enterprise is passed to the next generation); GBR IHT § 104 (50 percent reduction in taxable value for a business).

[168]*See* SGP ED § 14 (value of dwelling house excluded, up to a specified amount); PNG WPA § 134(1)(e) (exclusion for joint ownership interest in the matrimonial home); HKG EDO § 10A; Serbia and Montenegro Taxes on Property Act of 1992, *noted in Taxation and Investment in Serbia and Montenegro,* 5 Taxation and Investment *supra* note 165, § 9.2.3 (Apr. 1995 Supp.) (exemption for inheritance of apartment by person in the second order of

property does not include borrowed personal property). Because of difficulties in defining such subsistence assets, a better approach is to provide a broad exemption from tax for a certain value of property. However, if specified property, such as a residence, is excluded, the amount of the exclusion should be limited.

Certain countries treat cultural property favorably.[169] This raises questions of horizontal equity as well as definitional questions as to what property should be subject to such protection. To the extent that a country allows a charitable contribution deduction for transfers of property to either the government or a charitable organization, the protection of cultural property in this manner for the public benefit is encouraged. Exemptions for cultural property that permit the property to remain in family ownership can be difficult to administer.

F. Valuation

Valuation is a key issue for wealth transfer taxes and one that involves considerable difficulties. The basic problems are that property transferred is often unique, and there is no arm's-length transaction to establish a price. These problems are shared with the net wealth tax, discussed above.

For estate and inheritance regimes, the statute should provide that the valuation of the property is determined as of the date of death. Some statutes provide for an alternate valuation date based on a set time after the decedent's death.[170]after the decedent's death). Often property is valued based on the date it is sold if within one year of death. In contrast, some countries take the approach of providing the tax authority discretionary power to determine the appropriate value of the property transferred if there has been depreciation of value due to the death of the decedent, which might occur for example in the case of a closely held business. *See* SGP ED § 24(3). As with all discretionary provisions, the latitude given in tax administration should be circumscribed. Some statutes take other approaches to valuation problems caused by the fortuitousness of death in a changing market.[171] At the price of some complexity, the availability of an alternate valuation date helps to minimize such problems. An alternate valuation date must be elected generally for all assets.

One way of limiting the amount subject to an estate or an inheritance duty is to dilute techniques that freeze the value of property. Freezing techniques include converting common shares into preferred shares, thereby limiting their future

[169]*See, e.g.,* SGP ED § 15 (the Tax Commissioner may choose to remit the estate duty payable in respect of books, works of art, and so on if the commissioner finds them to be of national or artistic interest and if they are given for national purposes or to a university).

[170]*See, e.g.,* USA IRC § 2032 (allowing the executor to elect to value the gross estate based on a valuation date six months

[171]*See* SWE AGL 23 A7 B, 4th para. (provides for an adjustment if a sale under normal circumstances cannot be expected to return a price corresponding to the market quotation on the date of death) (rule enacted as a response to a particular case).

appreciation. In some countries, freezing techniques have been dealt with by statute.[172] A developing or transition country can instead provide a bright line rule that a preferred interest that is created from a common interest shall be deemed to have a particular rate of return attributed to it for the purpose of estate tax or inheritance tax valuation. Moreover, retained controls over property should be dealt with consistently over different types of entities; that is, a retained control that would be impermissible with a trust should not be allowed with a partnership or corporation.

Inflation, even high inflation, does not pose major problems for wealth transfer taxes, provided that a few relatively simple adjustments are made. Whether these are required will depend primarily on how high inflation is expected to be. One adjustment that may be appropriate is to the rate brackets and any other items expressed in national currency. The most appropriate mechanism would be to use any inflation adjustment mechanism under the income tax or, if one is not available, to provide for one in the inheritance or estate tax schedule.[173] The extent of the collection lag problem[174] will depend on the inflation rate and the length of time between the occurrence of death and the time the tax is due. Often, substantial time is allowed. In such a case, consideration should be given to shortening the time period or indexing for inflation the amount of tax due. Finally, an inflation adjustment may be required if there is an integrated gift tax. For example, when there is a lifetime unified credit for estate and gift tax purposes, the amount of unused credit should be adjusted for inflation each year. Such inflation adjustments should also apply to any annual gift tax exclusion. Similarly, for an accessions tax, cumulative lifetime accessions will have to be adjusted for inflation in order to apply the rate schedules.

G. Rate Schedule and Exempt Amount

The rate schedule to be established for an estate or an inheritance tax as well as for an accessions tax should take into account both an exempt amount and graduation in the rates.

Estate taxes invariably provide a general exemption, deduction, or nonrefundable credit against tax. Usually, the amount of the estate that can pass free of tax is substantial, the policy of the tax being to reach only the largest concentrations of wealth. Thereafter, the estate is commonly subject to graduated rates, although sometimes there is a flat rate of tax after the application of a broad exemption.[175] A similar regime exists with respect to inheritance taxes, where there is an exemption and a graduation of rates, often depending upon the consanguinity of the decedent from whom the individual has

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[172]USA IRC §§ 2701-2704. In addition, split-interest transfers pose valuation problems that can also reduce the tax base.

[173]*See supra* ch. 13. The same type of adjustment should be made for the net wealth tax.

[174]*See id.*

[175]*See, e.g.,* GBR IHT sched. 1.

received a bequest.[176] Graduated rates for an inheritance or an accessions tax reflect the policy that bequests from persons who are more distantly related should bear a higher tax.[177] Under many regimes, bequests from spouses bear either no tax or a reduced tax.[178]

H. Administration

Under an estate tax regime, only one tax return is filed. More reporting may be required under an inheritance or accessions tax, although provision is generally made for an estate to file a single return that reflects the separately computed taxes on the shares of the various beneficiaries.[179] The tax identification numbers of recipients of property from the estate and of the estate itself should be included on the return. A filing deadline should be fixed within a particular time after death, such as six months. Small estates and inheritances should be exempt from filing because it would not be feasible for taxpayers or the tax administration to require reporting for all transfers. [180] Family law in many countries provides for a listing and valuation of all estates, even for the absolute poor. These listings can be used for inheritance tax purposes.

Payment of tax would appropriately be required on the due date of the return. Special provisions can be made for extending the time of payment with an appropriate interest charge in the case of hardship, such as when the estate is primarily composed of illiquid assets (e.g., agriculture or small businesses). Eligibility for extended payment can be stated in terms of a mechanical rule based on the composition of the estate.[181] The statute should not be drafted to delay the tax until the asset is sold because such a provision would cause a severe lock-in problem.

Some countries allow payment in kind of estate duties through the transfer of cultural property.[182] An estate tax payment could also conceivably be made through the transfer of other property that the country would deem appropriate, such as a scenic easement over property to preserve the natural environment.

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[176]In a typical regime, the inheritance and gift tax regime of the former Yugoslav Republic of Macedonia exempts transfers received by children from their parents or by spouses ("first-order heirs"), but taxes transfers to second-order heirs, *e.g.,* siblings and grandparents, at a 5 percent rate (although under certain circumstances exemptions also apply), and taxes transfers to third-order heirs, for example, cousins, aunts, and uncles, at a 10 percent rate. *See* MKD PPT § 14.

[177]*See supra* note 125.

[178]*See supra* notes 111-18 and accompanying text.

[179]*See supra* text accompanying notes 132–35.

[180]For procedures on assessment and collection of the tax, *see* Inheritance and Gift Taxes arts. 36-45 (VEN).

[181]*See, e.g.,* USA IRC § 6166.

[182]*See, e.g.,* GBR IHT § 230 (works of art are accepted in satisfaction of tax); FRA CGI § 1716 *bis;* Ann. II § 384A (works of art, books, collectibles, or documents with a high historic or artistic value may be used to pay the inheritance tax if the government agrees).

The statute should address the manner in which probate assets are transferred and require a certification that the estate tax has been paid before the transfer of assets, such as immovable property listed on a registry, can be recorded.

I. Gift Tax

The most straightforward estate planning technique for the minimization of estate tax is to make lifetime transfers of property. However, taxpayer clients often do not take full advantage of this opportunity because it requires them to part with property, something that the type of taxpayer who has estate tax problems generally does not like to do. For those willing to plan, lifetime gifts can substantially erode the base of a transfer tax imposed at death. An integrated gift tax is therefore necessary to prevent avoidance of the estate, inheritance, or accessions tax. With an integrated gift tax, the property will either be taxed under the estate or inheritance regime or under the gift regime.

Property transferred by gift is valued as of the date of the transfer. For purposes of determining the amount of the taxable gift, the amount of the gift should be grossed up by the amount of the tax to provide parity with an accessions and estate tax, but this is not always done.[183]

The failure to gross up is significant. If a person's estate is subject to an estate tax of 50 percent, then the beneficiaries and the government will each receive one-half of the available estate. If a gift is taxed at a rate of 50 percent without gross up, then of the total amount transferred by the donor (gift plus gift tax), the beneficiaries get two-thirds and the government gets one-third. Thus, there is an incentive for lifetime giving.

Other countries have adopted rules for requiring full gross up of lifetime gifts. For example, in the United Kingdom, the value transferred is the difference between the value of the transferor's estate before and after the transfer. When the transferee pays the tax on the gift, the value transferred is the full amount of the gift with no reduction for tax payable by the transferee. When the transferor pays the tax, her liability for tax on the value transferred is taken into account in determining the value of her estate immediately after the transfer so that the amount subject to tax includes both the amount of the transfer to the beneficiary and the gift tax due on the gift. *See* Gift Tax Act, ch. 7 §§ 19(1), 20(2), 38, sched. 10, para. 1(1)-(2) (GBR). In Germany the inheritance tax is generally applied on a tax-inclusive basis, the transferee being liable for the tax. If the donor or testator pays the inheritance tax, then this amount is added to the taxable amount of the inheritance. *See* DEU ErbStG § 10(2). However, there is an incomplete gross up in that

[183]In some gift tax systems such as in the United States, the tax is computed only on the net amount that actually passes to the beneficiary. This is true regardless of whether the donor or the donee pays the gift tax. If the donor pays the tax, the tax is simply calculated on the value of the property that actually passes to the donee. A donee who agrees to pay the tax is considered as relieving the donor of liability and as giving partial consideration for the gift, which reduces the amount of the gift that is subject to tax. Thus, the tax is calculated on the net gift amount received by the donee rather than the grossed-up amount, regardless of who pays the tax. The only exception in the United States on the failure to gross up is in the case of lifetime transfers made within three years of the transferor's death. Both the gift and the gift tax paid are brought back into the donor's estate. *See* USA IRC § 2035(c), (d).

the tax on this amount is not taken into account, thereby leaving some advantage to the assumption of tax by the donor. *See* Jens Peter Meincke, Erbschaftsteuer- und Schenkungsteuergesetz Kommentar 340 (10th ed. 1994). Moreover, because the timing of a tax is important, there must be definitions with respect to when taxable property transfers occur. Several countries address this issue directly in the statute,[184] while others deal with it through judicial interpretations of the law. As noted below, some statutes include gifts in the taxable estate if they are made shortly before death. Two approaches compatible with a gift tax system are to cumulate inheritances with gifts that have been previously received from the deceased,[185] or to tax gifts under an inheritance or accessions regime.[186]

1. Inclusion of Certain Gifts in Taxable Estate

Often, statutes provide that transfers shortly before death will be subject to death tax if a decedent surrenders, whether or not for value, her or his right to receive any benefits from property in which the decedent has retained an interest or transfers property within a certain period before death. Generally, such transfers will be treated as not having been made for death tax purposes if made within three years of the decedent's death.[187] Thus, estate and inheritance tax statutes include transfers in which the decedent has a retained interest, transfers made within three years of death, or property where a decedent transfers a retained interest within three years of death. In some countries, the time period for gifts made in contemplation of death is less than three years.[188] This is because of the valuation difference that can occur for gift and estate tax purposes. When property is included in the estate and has also been subject to gift tax, the amount of the gift is not added back, but the full value of the property at the time of death is, with credit given for any previous gift tax paid. Moreover, the amount of the gift tax paid is also added back to the gross estate.

2. Definition of Gift

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[184]*See, e.g.,* USA IRC § 2501(a)(7); DEU ErbStG § 9.1 No. 2; Gift Duty Assessment Act, 1941-73, § 12 (AUS)(abolished 1979) (specifying when a gift is deemed to be made).

[185]For example, Chile's inheritance tax operates in part as an accessions regime with respect to gifts or inheritances from the same donor. *See* CHL IHAD art. 23 (consolidations of gifts and bequests made by the same donor to the same transferee for purposes of applying the progressive gift or inheritance tax rates).

[186]This is somewhat the approach that has been adopted in Ireland. *See* Capital Acquisitions Tax, 1976 (IRL); Inheritance and Settled Property Tax, 1993 (IRL). The Irish inheritance tax regime has been recently supplemented with a 2 percent probate tax on estates.

[187]*See* HKG ED § 37(3); SGP ED § 8(c)(five-year period); JPN IHT art. 19; PNG WPA § 134(1)(d)(i).

[188]For example, in Venezuela immovable property that at the time of the beginning of the estate has been sold by the principal by documents not registered in the public register is included in the estate, except for sales shown by authentic documents authorized at least two years prior to death. Assets sold for a consideration in the year prior to death to any person who is a legal successor are also included in the decedent's gross estate. *See* Inheritance and Gift Taxes Law, art. 18 (VEN).

Most statutes define a gift as occurring when, without consideration or for inadequate consideration, one person transfers property to another,[189] discharges the other person from a debt or other contractual obligation, or releases an actionable claim.[190] Furthermore, a person will be deemed to have made a gift by causing title to property to be vested in him- or herself and another person jointly without adequate consideration.[191] Some statutes expressly exclude from the definition of "gift" any property passing by will[192] and gifts *causa mortis*,[193] both of which would be taxed under the estate or inheritance tax.

At least one country taxes gifts made by a controlled company[194] where the transfer is (1) to or for the benefit of any person related to the controlling person, or (2) to any company that is under the control of a person related to the controlling person.[195] In some countries, corporations have been held directly liable for gift tax.[196] In the United States,[197] the regulations make clear that gifts to corporations are gifts to the individual shareholders and that gifts from corporations are gifts from the individual shareholders. A better drafting approach would be to deal with such transactions in the statute rather than in regulations.

3. When Gift Is Complete

The issue of when a gift is complete assumes increasing importance to the extent that the transfer tax system falls short of integration, that is, when it fails to provide equivalent treatment for lifetime gifts and transfers at death. As a policy matter, a perfectly integrated system, which would eliminate questions of completion of gifts, would be preferable. Furthermore, uniform valuation rules would also solve problems with valuation distortions through split-interest gifts and gifts by which the grantor retains an income or other interest.

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[189]*See, e.g.,* USA IRC § 2512(b); DEU ErbStG § 7.1 No. 1.

[190]*See, e.g.,* USA IRC § 2511; DEU ErbStG § 7.1 No. 2; Gift Tax Act, 1958, § 4(c) (IND); Inland Revenue Act, 1980, § 53(d) (LKA) (abolished 1993).

[191]*See, e.g.,* Gift Tax Act, 1958, § 4(d) (IND); Inland Revenue Act, 1980, § 53(c) (LKA) (abolished 1993).

[192]*See, e.g.,* NZL EGD § 2(2).

[193]*See, e.g.,* Gift Tax Act, 1958, § 5(xi) (IND); Inland Revenue Act, 1980, § 54(h) (AUS) (abolished 1979).

[194]In New Zealand a controlled company is defined as "any company that, at the time when the disposition of property is made, is controlled by or on behalf of any one person (in this section referred to as the controlling person), whether directly or indirectly, and whether through holding a majority of the shares in the company or in any other company, or in any other manner whatever." NZL EGD § 65(1).

[195]*Id.* § 65(2)(a)-(b). Payment of the gift duty assessed by the donor-controlled company, however, does not constitute an additional gift. *Id.* § 65(2), at 273.

[196]In Sweden closely held corporations have been held liable to gift tax when they have received undervalued property and the court has found that those directing these operations have intended to benefit the owners of the recipient corporation. Christer Silfverberg, *Gäva till aktiebolag ur inkomst-och voskattesynvinkel*, 1993 Skattenytt 693-701.

[197]Treas. Reg. § 25.2511-1(h)(1) (USA).

The following transactions give rise to issues of whether gifts are complete. First, gifts made within a certain period prior to death often appear to be substitutes for testamentary transfers and may be made in an attempt to benefit from the less comprehensive or reduced tax on lifetime giving.

Second, in some countries, a gift is treated as presently effective when made even though the gift has strings attached to it.[198] For example, a transferor may reserve to him- or herself the right to possess or enjoy the property or receive the income from it for the transferor's life or some other period that has not yet expired when the transferor dies. In the United States, this type of transfer would result in an immediate gift tax on the remainder interest. Moreover, the entire value of the property including the remainder interest would be included in the transferor's estate when he or she dies.[199] Thus, the United States makes it hard to complete a gift when the transferor maintains a beneficial interest in the property transferred. The United Kingdom also has a hard-to-complete rule for transfers when the transferor retains an income or enjoyment interest. In addition, a U.S. rule stipulates that transfers under which the transferor can no longer enjoy the property but where he or she can exercise some control over who will enjoy the property does not constitute a completed gift.[200]*But see* Commissioner v. Warner, 127 F.2d 913 (9th Cir. 1942) (gift occurs if the beneficial interests have become fixed with respect to who is entitled to the property, so that the transferor has retained control only over the timing of the enjoyment). Where the retained interest is in the nature of a remainder, the statute adds back only the value of the remainder interest that is held by the decedent. The alternative is to have a rule such as in the United Kingdom whereby, if a transferor retains control over the enjoyment of transferred property (excluding enjoyment of the property by the transferor), the transfer would normally be the creation of a "settlement" of property with no interest in possession, and a tax would be collected at the time of the creation of the settlement. A statute treating such a settlement as a gift must take into account the valuation of property and the consequences of the grantor's changing the disposition of the property.

Third, revocable transfers do not result in a completed gift. Thus, revocable transfers of property result in the inclusion in full of the value of the property in the

[198]Inland Revenue Act, 1980, § 53(e) (LKA) (abolished 1993) ("the gift of any property subject to a reservation in favor of the donor or any other person shall be deemed to take effect when it is made and not when the interest created by the reservation is extinguished"). The statute does not define "reservation." Presumably, it refers to a life estate retained by the donor or a life estate created by the donor in favor of another. However, absent a precise definition, it could also be construed to mean a reservation in the donor of a power to revoke the gift or to change the persons entitled to possession or enjoyment of the gift (if, for example, the gift was in trust). Hence, the gifted property could potentially be subjected to double taxation since the gift duty would be assessed on a gift that was incomplete when it was made, and the estate duty would be assessed at the donor's death since the donor effected a transfer with retained powers.

[199]*See* USA IRC § 2036(a)(1).

[200]Thus, if the transferor retains the right to designate who can enjoy the property she has transferred, or if the transferor can change the enjoyment of the property through a power to alter or amend the terms of the prior transfer, no taxable gift occurs. *See* USA IRC §§ 2036(a)(2), 2038(a)(1).

decedent's estate because revocability indicates continuing dominion and control over property.[201] Issues arise as to whether powers that may be exercised under a standard such as the health, maintenance, and support of a beneficiary constitute a retained interest. A simple rule would stipulate that the donor will be treated as retaining an interest when discretion exists as to the payment of proceeds. This would encourage the use of third-party fiduciaries but would perhaps increase costs for smaller estates. Life insurance is a common example of property in which the transferor commonly retains an interest, because the owner of the policy can normally change the beneficiary unless he or she expressly gives up this power.

Fourth, retained powers to withdraw property from a trust should be treated the same as a retained power to alter the beneficial enjoyment of the property. Failure to do so creates a method for avoidance.[202] Fifth, transfers taking effect at death may mean that if a beneficiary can obtain possession or enjoyment of property only by surviving the donor, then the property will be included in the donor's estate. Notwithstanding this inclusion, the property transferred subject to the survivorship requirement is a taxable gift of the contingent interest. A *de minimis* rule may also apply, to allow minimal interests to be disregarded.[203]

4. Jurisdictional Issues

Jurisdictional issues are the same as for taxes on transfers at death, except that the administrative problems of identifying taxable gifts are greater because there are many more potential donors in any given year than there are decedents. A comprehensive gift tax regime should apply to all gifts of property, wherever located, to and from residents. This principle is difficult to apply, especially when the recipient is a nonresident. Gifts of property within the country to nonresidents should also be included within the base. There are obvious difficulties with collection of the tax in such cases.

5. Integration with Estate, Inheritance, or Accessions Regimes

A gift tax should be integrated with the estate or accessions regimes. An integrated regime involves a cumulation of lifetime gifts and transfers at death for purposes of applying the graduated rate schedule. Under an integrated regime, it is not necessary to provide that gifts made within a specific period before death are included in the estate or inheritance tax regime as is done in some countries.[204] Such inclusion is

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[201] *See* USA IRC § 2038.

[202] In the United States cases make a distinction between a retained power and a right to invade the corpus and make withdrawals, with the latter power not treated as a retained power. *See* Estate of Kisling v. Commissioner, 32 F.3d 1222 (8th Cir. 1994) (holding that the terms of a trust permitted the decedent to invade the corpus and make withdrawals without terminating the trust where the exercise of the powers to make transfers of the withdrawn assets was treated as distinct from powers over the remaining trust corpus).

[203] For example, in the United States if the donor's retained reversionary interest has a value of 5 percent or less of the value of the property immediately before death, the property will not be included in the donor's estate. *See* USA IRC § 2037(a)(2).

[204] *E.g.,* USA IRC § 2001.

redundant and complicates administration unnecessarily. However, under certain circumstances, the failure to add back gifts made within a certain period before death limits the total amount of the tax collected.[205]

6. Exemptions

Many gift tax regimes deal with small gifts by granting the donor an annual gift exemption.[206] This exemption can erode the tax base.[207] At a minimum, one should consider making the amount very small or putting a cumulative cap on the total amount of exempted gifts. The small gift rationale is based on the administrative concern that it is difficult to monitor certain transfers of property that are usually of a small value. Under that view, there should be no exclusion for any gift of registered property, including life insurance, because in these cases there are public records of transfer.

The annual exemption is generally expressed in terms of the gift of a present rather than a future interest in property. Complications arise in distinguishing between present and future interests. If a legal but somewhat illusory right is given to the beneficiary of a future interest to claim a present interest in property, the amount that could have been claimed may be treated as a transfer of a present interest for purposes of the exclusion.[208] Therefore, a well-drafted statute should limit the right to the annual exclusion to actual transfers of a present interest. A simplified form of drafting the statute would eliminate from the annual exclusion any transfers in trust.

Gifts made for the maintenance or education of the donor's relatives are generally also exempt.[209] A definition of support needs to be provided in the statute so that the gift tax base is not eroded by support payments. For example, support could be defined as transfers of in-kind consumption in addition to minimal amounts of currency.

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[205]Sales of property by the estate of a celebrity are a perfect example. The property gifted before death would presumably have a transfer tax value based on the fair market value of such property, which may or may not have an increased value due to the celebrity status of the owner. However, after death the same property may have an increased value because of the celebrity status of the owner, as is illustrated by the auction experience in the United States with the estates of Rudolf Nureyev and Jacqueline Kennedy Onassis.

[206]*See, e.g.,* NZL EGD § 71 ($200 annual exemption per donee); USA IRC § 2503(b) (referred to as annual exclusion).

[207]For example, in the United States, a husband and wife may give $20,000 a year each free of gift tax. *See* USA IRC § 2503(b).

[208]The existence of a legal power to claim the amount transferred is considered sufficient to support the annual exclusion under the U.S. statute. *See* Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). In addition, each contingent beneficiary is also able to be counted for the annual exclusion if such beneficiary has such a right. *See* Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991).

[209]NZL EGD § 72 (exemption applies to all relatives as long as the amount of the gift is not excessive).

Concomitant with the treatment under an estate or inheritance tax, gifts to spouses are generally exempt.[210] The same issues occur with respect to whether to allow exempt gifts to noncitizen spouses.[211]

Most nations exempt from gift duty transfers of property to the government[212] and to charities.[213] Also typically exempt are funds paid by an employer for employee retirement, pension, and benefit plans; bonuses paid to an employee if the bonus is in recognition of "special or faithful services rendered";[214] and death benefits payable to an employee's surviving spouse and/or dependents.[215] Premiums paid for life insurance on the life of the donor are commonly exempt from gift duty, subject to certain monetary limitations if the policy is for the benefit of a spouse and/or dependent children.[216]

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[210]*See supra* sec. III(A).

[211]In the United States, there is no unlimited exemption for gifts to noncitizen spouses; *see* USA IRC § 2523(i) (gifts limited to $100,000 a year).

[212]*See, e.g.,* Inland Revenue Act, 1980, § 54(e) (LKA) (abolished 1993); Gift Tax Act, 1958, § 5(iv) (IND); Gift Duty Assessment Act, 1941-1973, § 14(d) (AUS) (abolished 1979).

[213]*See, e.g.,* NZL EGD § 73.

[214]Gift Duty Assessment Act, 1941-1973, § 14(b) (AUS) (abolished 1979).

[215]*See, e.g.,* NZL EGD § 75.

[216]Gift Duty Assessment Act, 1941-1973, § 14(g) (AUS) (abolished 1979) (premiums may not exceed $A 200 a year); Gift Tax Act, 1958, § 5(ix) (IND) (premiums may not exceed RS 10,000 in aggregate for each donee).

11

Social Security Taxation

David Williams

> Will you still need me, will you still feed me, when I'm 64?
> —John Lennon and Paul McCartney.

I. Introduction

Social security taxes are a major revenue source and a critical element in fiscal policy.[1] Much useful literature is published by the International Social Security Association. *See infra* note 7. Other current summaries of national social security systems are available in the following publications: Coopers & Lybrand, 1995 International Tax Summaries (summarizing the position in most states) [hereinafter C&L 1995]; Organization for Economic Cooperation and Development, The Tax/Benefit Position of Production Workers, Annual Report Information Covering 1990-93 (1994)(containing details for each of the OECD member countries) [hereinafter OECD Tax/Benefit Report]; OECD, Revenue Statistics of OECD Member Countries 1965-93 (1994)(published annually) [hereinafter OECD Revenue Statistics]; K.C. Messere, Tax Policy in OECD Countries 167-84 (1993). For more detailed summaries of the position of most European countries, *see* 6 International Bureau for Fiscal Documentation, Guides to European Taxation, Taxation of Individuals in Europe (looseleaf) [hereinafter 6 IBFD European Taxation]. The European Commission has also published summaries of the systems operating in the European Union. Comparative Tables of Social Security Schemes (5th ed. 1990). Most, but not all,[2] states have social security taxes. Some states with mandatory contributions to the funding of social security schemes do not call those contributions "taxes." Nor do states always pay close attention to the interaction between their social security taxes or contributions and other taxes. Yet, most states incur social

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[1] For further information on this subject, *see* Janet Stotsky, *Payroll Taxes and the Funding of Social Security Systems, in* Tax Policy Handbook 177 (Parthasarathi Shome ed., 1995).

[2] Larger countries without any social security taxes include China, Australia (at federal level), Indonesia, and Thailand. *See* OECD Tax/Benefit Report, *supra* note 1, at 110 (regarding Australia). For a full comparison of coverage in 1990, *see* World Bank, Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth, tbls. A.1 to A.6 (1994).

security expenditure. In some, such as those with economies in transition, social security expenditure and related social welfare costs can be the largest part of the fiscal obligations of the state. It is also accepted that the burden of social security expenditure is growing and will continue to grow during the foreseeable future.[3] In Europe in particular, the law of social security has evolved together with labor relations law. Although the same enthusiasm for this approach is not present in the Americas and Asia, international agreements have been formulated to set minimum standards of entitlement to social security and to coordinate social security systems among states. These have been devised under the auspices of the International Labor Organization (ILO), an intergovernmental body, and the International Social Security Association (ISSA).[4] As a result, the terminology and concepts used in social security law have tended to be drawn by analogy with labor relations law rather than with tax law in Europe. Some effects of this Eurocentric approach are noted in this chapter.

The comparative history of social security taxes and contributions in different countries shows widely varying approaches. The developed countries that do not have a compulsory social security contribution or tax are in a small minority.[5] In contrast, in other countries, social security taxation is the most important single source of public revenues.[6] Countries with economies in transition generally have social security taxes. In some they are a major burden and, in those countries, social security is one of the most

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[3]Detailed treatment of the problem of levels and trends in social security expenditure is beyond the scope of this chapter. The main problem is that of the growing world population of older people. The World Bank recently provided an updated analysis of the problem in Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth (1994). *See* World Bank, *supra* note 1. The key conclusion is that the number of people over 60, measured as a percentage of the total world population, will double between 1990 and 2030, and that this growth would be reflected in all parts of the world. For a critique of the report by authors from the International Labor Organization and the International Social Security Association, *see* Roger Beat & Warren McGillivray, *A Risky Strategy: Reflections on the World Bank Report "Averting the Old Age Crisis,"* 48 Int'l Social Security Rev. 5 (1995).

[4]The ILO, based in Geneva, is a specialized agency of the UN. ISSA is a nongovernmental body unofficially linked with the ILO, and also based in Geneva. The members of ISSA are representatives of individual social security schemes (national, industry-based, or specific). ISSA has a regular conference and publication program on contribution and benefit issues.

[5]Of the OECD member states, only Australia and New Zealand have no, or minimal, social security taxes. OECD Tax/Benefit Report, *supra* note 1, at 110, 186; *see* Messere, *supra* note 1, tbl. 8.1, at 183. Denmark also used to have minimal contributions, but in a reform taking effect between 1994 and 1997, it is introducing a "labor market contribution" payable by employees, employers, and the self-employed. 6 IBFD European Taxation, *supra* note 1, at 63; OECD Tax/Benefit Report, *supra* note 1, at 131. Korea also has no social security contributions, although it has a less common education tax. KOR BNTA, Part XIV.

[6]OECD Revenue Statistics, *supra* note 1, shows that 45 percent of total French tax revenues come from social security contributions, 39 percent of total Dutch revenues, and 38 percent of total German revenues. *Id.* at 21-22. The definition of "public revenues" is that used in OECD Revenue Statistics. *See id.* at 28 *et seq*. This publication monitors both taxes and other contributions to schemes operated within the government sector. *Id.* at 10. For example, Finland (like most Nordic countries) has high compulsory contributions to a general scheme, but does not regard this as taxation, even though the contributions use tax laws for assessment purposes. 6 IBFD European Taxation, *supra* note 1, at 55.

important fiscal problems of the state.[7] Many developing countries are also faced with problems of social security funding as their economies change and develop.[8]

Social security taxes should therefore, it is suggested, be part of the agenda for a review of the tax law of any state. The adoption and operation of any form of social security taxation should be undertaken as part of or parallel with the total tax structure of the state. It is for these reasons that this chapter analyzes the legal issues inherent in imposing social security taxes within a state's general tax system.

Whether a state has social security taxes or not, all but the least developed or least interventionist of states have social protection expenditure. The choice between direct and indirect funding of this expenditure must affect the fiscal pattern. This is a policy issue, but one with significant practical implications at both internal and international levels. A state that funds all or most of its social expenditure by levying taxes on employees, their employers, and the self-employed is committed to significant levels of income taxation. If the state intends also to collect a general income tax, it must consider both the interaction between the two taxes and their combined effect.[9] It must also consider that, while it can reach international agreements to offset double income taxation, agreements rarely do this for social security taxes. A result may be that a state that chooses to collect social security costs through high social security taxes rather than through income taxes may tax some export transactions more heavily than states that use higher income taxes offset by reliefs.

Conversely, a state that chooses to bear all or most of its social security costs from general revenue must also determine whether direct or indirect taxes will bear that burden. If the cost is transferred primarily to income tax,[10] the levels of tax become significantly higher than what would otherwise be required. Otherwise, general levels of state expenditure are forced down. If a state chooses indirect taxes, then it is likely to face problems in levying them. For example, a high level of value-added tax (VAT)[11] will impose a burden on all those whom the social expenditure seeks to benefit. The level of

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[7]The subject was extensively reviewed recently in ISSA, Restructuring Social Security in Central and Eastern Europe (1994). *See also* George Kopits, *Social Security*, *in* Fiscal Policies in Economies in Transition 291 (Vito Tanzi ed., 1992).

[8]For an account of recent reforms in Argentina, Colombia, and Peru, *see* Monika Queisser, *Chile and Beyond: The Second-Generation Pension Reforms in Latin America*, 48 Int'l Social Security Rev. 23 (1995).

[9]The contrast in approaches in OECD states is sharp. In France and the Netherlands, lower-paid workers pay far more in social security contributions than in income tax. In Australia and New Zealand, there are no separate social security taxes, although a tax on fringe benefits is imposed on employers in addition to the income tax. For an annual survey of the position in each OECD member state, *see* the annual volumes of OECD, The Tax Benefit Position of Production Workers; *see also* note 1 *supra*.

[10]As in Australia, which adopted a fringe benefits tax that imposes an additional charge on employers who grant fringe benefits to their employees. New Zealand, which also has no direct contributions to social funding, adopted a similar tax. C&L 1995, *supra* note 1, at A-39 to A-40.

[11]This is one factor in the high VAT rate in Denmark, and the reason why Denmark attempted to adopt its employment levy and has since adopted its labor market contribution scheme. *See supra* note 4.

benefits, and consequently of contributions, may have to be raised to offset the burden of the indirect tax if the base of that tax is not to be affected.[12] If, instead, the form of the indirect tax is affected, then other problems about the efficacy of that tax arise.[13] Again, there may be international aspects to this if the resulting tax affects internal costs and export costs without affecting import costs.

Much of the above is a matter of general state and fiscal policy and concerns macroeconomics and public finance rather than law, and so is beyond the scope of this book. However, unless all tax, benefit, and contribution patterns are looked at together, many points made elsewhere in this book about forms of taxes may be modified in unintended ways. Specific examples of this issue are raised at the end of this chapter.

A. What Is Social Security?

To clarify the scope of this topic and chapter, the terms to be used in the discussion must be defined.[14] In addition, the limits imposed on the analysis in this chapter must also be set forth.

"Social security" is the commonly accepted global term[15] for public schemes (provided or regulated by the state)[16] for the social and economic protection of individuals and families. Social security is normally classified under five headings:

old-age, invalidity and survivors' benefits;
benefits for sickness and maternity;
occupational or work-related risks;
unemployment protection; and
family assistance.[17]

[12]This happened in New Zealand upon the introduction of the broad Goods and Services Tax. *See supra* ch. 6. New Zealand, however, does not impose social security contributions.

[13]The issue of socially sensitive exemptions from value-added tax is discussed in chapter 6, *supra*, where it is argued that such exemptions should be minimal.

[14]*See also* sec. II(A).

[15]This is true in the English language. Terminology in other European languages is similar and poses few terminological problems.

[16]Analysts have categorized the approaches that states may take in providing or encouraging provision of benefits for individuals with a social effect. The six accepted, basic kinds of approach are (i) social insurance; (ii) employer mandates, or compulsory provision of employee welfare benefits by employers; (iii) individual mandates, or compulsion on individuals to provide for their own welfare benefits; (iv) tax-supported voluntary arrangements; (v) social assistance, or means-tested welfare payments financed from general funds; and (vi) universal schemes, with entitlement for all citizens or residents funded from general funds. This chapter focuses on schemes that fall in category (i), with less attention to categories (ii) and (iii). Category (iv) is relevant in the context of the interaction between tax and social security. For a recent critique of these approaches, *see* Lawrence H. Thompson, *The Advantages and Disadvantages of Different Social Welfare Strategies*, Int'l Social Security Rev. 59 (1995).

[17]This framework has long been the basis for discussion and action by the ILO, the international body with prime responsibility for this area of activity. *See also* Messere, *supra* note 1, at 170 (commenting that contributions for other benefits in the OECD states "are of negligible revenue importance").

States with social security schemes may not provide all these benefits. For example, there may be no unemployment benefit scheme because the state provides no support for the unemployed.[18]opposed to welfare payments for those without income. The state may instead provide a means-tested benefit funded from general taxes for those without income or savings. There may also be separate organizations and separate contributions to different benefits. For instance, the state may provide family assistance for all children, financed from general taxes, while having separate contributory pension and work-related benefits.

If funding is provided on a form modeled on commercial insurance, it is often termed "social insurance."[19] It is distinguished from "social assistance," whose chief activity is the provision of minimum incomes or material help to the poor, often on a means-tested basis.[20] In some countries, health care and support for families or children is provided through "universal benefits" given to all regardless of contributions or ability to pay.[21] Some are financed by contributions, and others by general tax revenues. If such schemes do not involve contributions, they are omitted from further discussion in this chapter. This chapter is concerned only with forms of social security met by specific funding from any source, but not those funded through general tax revenues. Most states with social security schemes have separate social security funds to meet this form of expenditure.[22] Specific social security taxes or contributions are widely used to finance such funds.

This chapter is not about social security systems as such. There is no discussion of general policy issues, such as the desirability of public provision of social support, nor of the kinds of social security benefits that might be funded through specific social security

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[18]That is, there is no special compensation for unemployed individuals, as

[19]*See supra* note 16, in which this is category (i). Social insurance has been defined as consisting of schemes with the following attributes: compulsory membership extending beyond government employees; compulsory contributions payable by members (or their employers); government regulation or support; prescribed benefit entitlements; benefit entitlement deriving from contributions, but not directly related to them; and separate scheme accounting and financial planning. *See* Robert J. Myers, Social Security 877 (4th ed. 1993)(setting forth the definition developed by the Committee of Social Insurance Terminology of the American Risk and Insurance Association).

[20]*See supra* note 16, categories (v) and (vi).

[21]An example is the U.K. national health service, which is available to all residents without contribution or charge. It is funded largely from general taxes, but also from a (largely hidden) levy on social security contributions. The hidden levy is authorized by the Social Security Administration Act, 1992, ch. 5, § 162. Known officially as the national health service allocation, the levy is between 10 percent and 15 percent of total contributions, but is not separately identified in any way to contributors. Free national health services were established by the National Health Service Act, 1946, ch. 81, § 1.

[22]For example, Denmark has significant social security benefits financed from general taxes, although it has only recently started introducing specific contributions. The specific contributions are imposed by the Labor Market Fund Law. Lovbekendtgorelse nr. 837 af 28.9.1994 am arbejdsmarkedsfonds. The rate was 6 percent in 1995 and will be raised to 8 percent by 1998. *See also* Danish Labor Market Supplementary Pension (ATP), Annual Report (1995).

taxes. There is no discussion of the detail of social security benefits.[23] Other topics excluded from this account are personally funded benefits, such as retirement benefits, the general issue of pensions, the peculiar legal problems involved with compulsory but largely privatized schemes that are found in countries such as Chile or Peru, and the voluntary provision of pensions.

The focus, therefore, is only on compulsory or state-mandated systems, which, in some countries, are also state run.[24] In other countries, the administration of the system is in the hands of separate organizations or agencies.[25] The administrative structure of social security is not addressed in this chapter, except insofar as it relates to the use of the state tax authorities for the collection of contributions.

B. Are Social Security Payments Taxes?

When is a payment to a social security fund a tax? The answer to this question in any particular state depends on its constitution and laws. As a general conceptual matter, it also depends on how government and others view the payments. The assumption in this chapter is that a contribution to a social security fund is a tax if there is a requirement to make payments either to state funds or to state regulated funds from which there is an obligation to pay social security benefits.[26] In short, the payment must be mandatory and must be state regulated. If the potential payer can choose whether to make the payment, then it is not a tax.[27] In some countries, the system of social security payments is mixed, with some payments being compulsory and others voluntary. A complete account of social security must deal with all forms of payment. However, the system is, for present purposes, a tax system only if a substantial part of those payments are compulsory.[28]

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[23]ISSA produces a significant amount of literature on these issues and also publishes a regular international bibliography. *See* World Bibliography of Social Security (semiannual); Catalogue of ISSA Publications (semiannual).

[24]This is the method throughout Central and Eastern Europe. *See* Restructuring Social Security in Central and Eastern Europe, *supra* note 7; Kopits, *supra* note 7.

[25]This approach is used in many West European countries. In the United States, the Social Security Administration was recently made an independent agency in the executive branch of the Government. Social Security Independence and Program Improvements Act, Pub. L. No. 103-296, 103d Cong., 2d Sess., 108 Stat. 1464 (1994). This is one of many institutional reforms that have taken place to the structure of social security schemes in recent years. Institutional changes are summarized in the ISSA newsletter, Trends in Social Security (published quarterly).

[26]This is offered as a working definition. It reflects the OECD working definition of a tax in its *Revenue Statistics*, published annually. This defines taxes as compulsory general payments for public purposes and includes social security contributions. For further discussion, *see* the introduction to each year's volume. This is not offered as a formal definition because the wide variety of arrangements that have been adopted make it almost impossible to generalize. For example, in Peru, employees are required to insure either through the state scheme or a private scheme. Insurance is mandatory, but public insurance is not. Therefore, the individual can choose between the social insurance scheme and private schemes.

[27]For example, social security coverage of the self-employed is sometimes voluntary (e.g., Germany). 6 IBFD European Taxation, *supra* note 1, at 41.

[28]For example, a state may impose contributions on most citizens, but may allow those not required to pay to be voluntary contributors. This happens in the United Kingdom, where "Class 3" contributions are

The working definition does not resolve a question of characterization: are contributions, although mandatory, *really* taxes or are they actually insurance premiums? Some argue that the payments constitute, in essence, an insurance premium or a contribution. The payments will, or may, be returned to the payer as benefits. They are therefore, viewed from that standpoint, not taxes.[29] Unless the payments have the individualized market character of premiums related to the risk presented by each person insuring (adjusted, for example, to take account of the illnesses an individual suffers or whether the individual smokes or of the risks of a particular employer's activities), this argument is not conclusive.[30] It may affect the presentation of the system to those required to pay, but it does not affect the underlying requirements of the law in imposing the contributions. If contributions are risk related and are determined by actuaries rather than by law, then at least some features of the scheme are not truly tax features.[31] It must be recognized that contributions in some states imposing national standard social contributions are nonetheless regarded by all concerned as not part of taxation. It must also be recognized that the characterization is a political and cultural matter to which, in the abstract, there is no "correct" answer.

For some purposes, a compulsory payment may not be considered a tax if the payment creates an entitlement to a benefit.[32] It may be relevant in this regard that social security systems generally do not involve an entitlement to benefits, because the legislature has the power to change the formulas under which benefits are determined, even with respect to benefits that relate to contributions that have already been made. Some argue that the feature that benefits can be set independently of contributions distinguishes tax-style systems.

A second argument against categorizing compulsory contributions as taxes is the identity of the fund-holding or administering body. In some states, the fund is held by the state itself as part of the general tax and budget exercise.[33] In others, it is held by the state, but in separate funds.[34] In yet others, it is held by extrabudgetary bodies that are state

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authorized by the Social Security (Contributions and Benefits) Act, 1992, ch. 4, § 13. The Irish scheme contains a similar provision. Social Welfare Act, 1993, § 21.

[29]This approach is often adopted in France, where the institutions running social security schemes are much nearer the market model than in neighboring countries, such as the United Kingdom and Ireland, which have uniform state-run systems.

[30]Generalization again is difficult because some states have hybrid schemes. Compulsory insurance (e.g., that required of employers who are liable to employees for accidents at work) is widespread. It may occur through a state scheme or by obliging companies to take out private insurance, which may or may not be regulated. Premiums may be individual to companies, generalized across industries, or spread throughout all similar workers or across the entire working community.

[31]This is true of some features of the French system where contributions are often closely related to risk because of the many different funds within the French compulsory system.

[32]*See* Treas. Reg. § 1.901-1 (as amended in 1987)(USA).

[33]For example, the limited provisions in Australia and New Zealand.

[34]As in the United Kingdom, where the National Insurance Fund was created under the authority of the Social Security Administration Act, 1992, ch. 5, § 161.

entities.[35] Finally, in other states, the funds are run by separate individual funds under general state control.[36] For present purposes, the identity of these bodies is not relevant if payments to them are compulsory, provided only that they are state, or state-regulated, bodies. Nonetheless, the primary focus of the chapter is on state social security funds rather than on state-regulated private bodies.

Regardless of whether social security contributions are treated as taxes under the constitution and laws of a particular country, they are justifiably considered as taxes for purposes of this book because the contributions are imposed by legislation that involves the same issues as other tax legislation and that interacts with other tax laws, particularly the individual income tax law. Therefore, the approach to drafting such laws and other tax laws should, to the extent the laws fulfill parallel functions, be a common or parallel one.

The definition of when a contribution is, for present purposes, a tax, also does not resolve the question of terminology. Two contrasting pressures apply in practice. In some states, social security taxes are neither called "taxes" nor treated as such in the legislation. Terms such as "contributions," "insurance contributions," or "premiums" are used instead. The standard general term in English is "contribution," the term used in this chapter.[37] In contrast, other states avoid the use of "social security" and use tax terms, such as "payroll tax," that do not refer to the purpose of the tax.[38]

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[35]As in Russia. Restructuring Social Security in Central and Eastern Europe, *supra* note 7, at 242.

[36]As in France, where control is exercised through the *Commission des comptes de la sécurité sociale*. The French system pools contributions to fund current beneficiaries, but others, such as the Singapore system, hold individual funds for individual contributors. Under the Singapore arrangements, a contributor may only benefit to the extent of contributions made by or for the contributor. This leads the Singapore authorities to argue that their system is a savings scheme not a social security scheme. *See Letters,* The Economist, May 11, 1996, at 10.

[37]This is the term usually used by the ILO and ISSA. It is used in the United Kingdom, Ireland, and Canada. However, the United States refers to social security or payroll taxes (for constitutional reasons). The French equivalent term is *cotisation*. It may be noted that the U.K. income tax (one of the world's first) used to refer to the income tax as a "contribution"! In the United Kingdom, the term "contributions under the Social Security Acts," is sometimes used, *see* Social Security Contributions And Benefits Act, 1992, ch. 4, § 1, but the term "national insurance contributions" is popularly used by government departments, even though this ceased to be the technical term in 1973.

[38]For example, the payroll tax in the United States. However, the formal name in the U.S. legislation is "contribution," and the schemes are often referred to by the initials of the enabling legislation as FICA (Federal Income Contributions Act) and SECA (Self-Employed Contributions Act). The terminology used in the United States was adopted in 1935 specifically to avoid possible historical constitutional problems. This terminology raises a further issue in tax theory, namely, the identification of these taxes as direct or indirect. One relevance of this classification is whether the taxes are within the scope of double tax conventions. Article 2 of the OECD Model Tax Convention on Income and on Capital of 1992, *reprinted in* Philip Baker, Double Taxation Conventions and International Tax Law (2d ed. 1994), states that "payroll taxes" are within the scope of the model, but paragraph 3 of the commentary on that article makes it clear that it does not extend to social security taxes if there is a direct link between the contributions and the individual advantages received from the contributions. Alternatively, if they are indirect taxes, they may be within the scope of the General Agreement on Tariffs and Trade. *See* Richard A. Musgrave, Fiscal Systems 174 (1969)(noting that many considered payroll taxes to be indirect, in his view wrongly).

C. Is the Legislation for Contributions Tax Legislation?

Responsibility for legislation on social security contributions varies between states, and so does its form. Sometimes, the legislation is presented as part of the general social security legislation, so that the contributions and the benefits are presented as an entity.[39] Alternatively, the legislation may be treated as social security legislation, but kept apart from the details of benefits payable.[40] In contrast, the legislation imposing contributions may be treated as tax legislation and kept entirely separate from benefit legislation.[41] Is that important? The practical answer is that the matter is unimportant unless there are either special constitutional or legislative procedural requirements for taxation. If such requirements exist, it may be possible to avoid them by presenting contributions law as part of general social security law. In other states, social security contributions may be given the form of taxes so as to take advantage of broad taxation powers under the constitution or general tax legislation.[42]

A final constitutional issue is that of the level of imposition within federal states. In some states, elements of social provision take place at the local rather than at the national level, thus preventing a state scheme from operating.[43] This may also mean that social security taxation is operated at a different level of government than the income tax.[44]

D. What Are the Forms of Social Security Tax?

The inconsistencies of national practices about social security funding are reflected in the varying forms of contribution adopted. States have a series of choices in deciding the form that contributions take.[45] These choices are influenced by two conflicting pressures, the fiscal context of the contributions and the linkage between contributions and benefits.

A key decision about the contribution structure of a scheme is whether there is to be one global contribution to all forms of funded social security[46] or separate contributions for each separate form of social protection.[47] This issue is usually decided

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[39]As in the United Kingdom. *See* Social Security (Contributions and Benefits) Act, 1992, ch. 4.

[40]As in the Netherlands. *See* Gerrit te Spenke, Taxation in the Netherlands ch. 6 (1995).

[41]As in the United States. *See* Steward Machine Co. v. Davis, 301 U.S. 548 (1937).

[42]This approach has been considered by a number of states of the former Soviet Union.

[43]This happens in Canada and Switzerland. *See* International Tax Program, Harvard Law School, World Tax Series: Taxation in Switzerland 94 (1976).

[44]In Canada, both income tax and social security contributions are levied at both federal and provincial levels.

[45]For two recent general policy discussions, *see* Kopits, *supra* note 7; Messere, *supra* note 1, at 167-84.

[46]As in the United Kingdom. Although as noted in note 16, *supra*, a part is transferred to help fund health costs.

[47]Or, alternatively, for groups of benefits. Multiple schemes are the most common form of system adopted in developed countries with full social security systems.

by the institutional structure of the social security system. If different funds or institutions are responsible for the different elements of social security, there is strong pressure to provide different contributions to each institution.[48] There are also policy arguments for separating, at least in name, the contributions to different funds so that different policies may be followed about whether, and how much of the contribution is paid by the employer and how much by the employee.[49]

This raises a further issue. Is the contribution treated as a series of separate contributions[50] or as a single payment to be made by the contributor but consisting of separate amounts for different funds?[51] Having separate amounts of contribution for each separate form of benefit reflects the view that there should be separate contributions to each fund and also separate accounting and actuarial analysis.[52] The rationale is that the independence of the separate funds is recognized by separation of the contribution payments. This is, it is suggested, neither necessary nor an efficient use of contributors' money.[53] The collection of a composite contribution is usually more efficient, and therefore less expensive, than multiple collections. The authority acting as agent in collecting the contributions can, of course, arrange subsequent distribution of contributions to those organizing the individual funds. In this discussion, only one contribution is assumed to be collected from any contributor for any contribution period, regardless of how the contribution is calculated or shared out after collection.

Second, contributions are collected in a variety of ways. They may be collected from the groups covered by the schemes only[54] or from taxpayers generally.[55] They may take any form adopted in general taxation or in insurance and pension practice. The cost

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[48]This is reflected in the way contributions are set in many European states, for example, in France, Germany, and Russia.

[49]This can result in quite complicated patterns of contribution. For example, in Austria, in 1995, there are five elements in an employer's contribution, four of which are also elements in an employee's contribution. Of these, two are shared equally between employer and employee; one is heavier on the employer; one is heavier on the employee; and one (as noted) is borne only by the employer. In addition, employers make two other separate contributions to social funds. C&L 1995, *supra* note 1, at A-55.

[50]In France, the contributions are to separate funds with individual powers to set contributions; no mechanism exists to unite the contributions.

[51]As in the Netherlands. *See supra* note 40.

[52]This is seen, for example, in France and Russia. In Russia, each area of funding is independent of the others.

[53]Against this argument, the point must be made that settled, but separate, systems, such as those in Germany, can operate most efficiently. In part, this is because the necessity of the social security funds is widely accepted by those paying contributions, so that there is a high level of voluntary compliance and a low level of disputes. These factors may more than compensate for the absence of other forms of efficiency.

[54]This is the most common pattern. If the contributions are not covered by the groups affected, there is an argument that they are not "proper" social security contributions, but are general taxes. *See supra* note 38 (noting the working definition in the OECD Model Tax Convention).

[55]As in the Netherlands. *See supra* note 40.

of social protection for employees tends to be imposed on employers generally and sometimes on their employees. However, there is no consistent pattern of the share of the contribution burden between the employer and the individual. The payment is usually a payroll tax on the employer or a form of income tax imposed on the individual or the employer (or both). By their nature, these forms of tax are income related. Sometimes contributions are risk related at a generalized level of risk. The ultimate form of tax on this basis is a poll tax. All those within the scheme pay the same contribution in money terms and so share the risks.[56] The self-employed may also be asked to make an income-related contribution or a flat-rate contribution (or both); this may be set to imitate the contributions of employers and employees.

If the employee or employer's contribution is income related rather than risk related, it may take the form of a second income tax. This could be—and sometimes is—collected with the main income tax.[57] It can be set perhaps as an extra rate of income tax.[58]

It is frequently assumed that contribution liability arises in respect of the earnings of the contributor. Although the definition of earnings is relatively straightforward for most employees, it is less obvious for the self-employed (or for those who are both employed and self-employed).[59]

Whether individuals should pay contributions on unearned income is a complex question of policy. If the social security system is designed essentially as an income replacement system for earners, then principle suggests that contribution liability should be based only on earnings. The extreme case is that of the individual who has no earned income, but has a significant source of investment income. Such an individual will in __st states fail to qualify for social security benefits on the ground that he or she is not a member of the social security scheme. There is no risk of loss of income through unemployment, sickness, disability, or retirement, and, therefore, no need to ensure against these risks. Use of health facilities can be made subject to payment. Social security is therefore largely irrelevant to the limited number of individuals in this group, and principle suggests that they should be excluded from both benefits and contribution liability. Similarly, the unearned income of those within the system can be ignored for both benefit and contribution purposes, which simplifies administration. However, it demands a clear distinction between forms of income inside and outside the scope of contribution liability. There is also a contrary argument based on social solidarity and the

[56]Flat-rate contributions used to be common, but have tended to be replaced by income-related contributions. This chapter therefore assumes that contributions are income related rather than flat rate.

[57]This is common practice in most Western European states. For surveys of the practices in Western Europe, *see* the works cited in note 1 *supra*.

[58]The extreme case is perhaps the Netherlands, where the main rate of income tax on most taxpayers is the social security tax, and the "proper" income tax is at a much lower rate on those taxpayers, reaching higher rates only on the taxpayers earning the highest incomes. *See supra* note 40. The rates in 1994 were 31.075 percent social security tax and 7.05 percent income tax on the first f. 43,267, with no social security tax but a 50 percent marginal income tax rate applying to income immediately above that level. C&L 1995, *supra* note 1, at N-3.

[59]*See infra* secs. II(A), III.

use of income taxes to redistribute wealth between citizens. This argument leads some states to use nonearned income that is liable to income tax as a base for charge to social security contributions as well.[60]

In the discussion that follows, it is assumed that only earned income is used for contribution liability. Some problems of definition of earned income are discussed in connection with the contribution liability of the self-employed. The discussion of the liability of employees ignores any income other than employment income.

While other forms of social tax are possible, such as the social equivalent of a VAT or sales tax[61] or a levy on company profits,[62] these are not usual. The link between such a tax and the benefits it funds is far from transparent, except to the extent that the name of the tax clarifies the link. With these forms of tax, there is no clear relationship between those paying the tax and those benefiting from it, except that both are within the tax and social security jurisdictions of the state. There is little reason, save political expediency, to identify a general tax with social security expenditure. In addition, it is doubtful that the link could be maintained in the longer term. For example, a link between a sales tax and the cost of state health services may lead to inappropriate changes of tax rate or inappropriate levels of funding of the health service. While budget pressures may suggest use of these forms of social taxes in the short term, no special design or drafting issues arise because of the "social" labeling of the tax. Therefore, they are not discussed further in this chapter.

E. Links Between Contributions and Benefits

There is an inevitable linkage in any social security scheme between contributions to the scheme and benefits paid from the scheme. If contributions to the scheme and the income that the scheme itself generates do not match the total level of benefits that must be paid from the scheme, then the scheme will fail. Either further forms of funding must be found or benefit levels must be reduced. It is impossible, except in the very short term, to have a viable social security scheme if the benefits and contributions are decided independently of each other. In consequence, the level of funding of a scheme must be

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[60]In the Netherlands, the social security tax is levied on most forms of income, including investment income. *See supra* note 40. In France, a special levy was placed on several forms of investment income and capital gains to provide extra revenues to support social security funds running into deficit. The Solidarity Contribution is imposed at 0.1 percent of turnover of companies whose turnover exceeds F 3 million. C&L 1995, *supra* note 1, at F-32.

[61]A "social VAT"—in effect an extra levy on VAT—has been discussed recently in France. However, a compulsory Danish employment levy enacted in 1987 was ruled to be in breach of EC law by the European Court of Justice. Case C-234/91, Commission v. Denmark, (December 1, 1993), *summarized in* Proceedings of the Court of Justice and the Court of First Instance of the European Communities, No. 34/93, at 8 (Nov. 29–Dec. 3, 1993). The tax was essentially on the same basis as a VAT but did not comply with the general prohibition on EU states against introducing other forms of turnover tax. This effectively stops the adoption of social taxes in this form in the European Union.

[62]As in Brazil, where companies have to pay a 10 percent levy (23 percent for financial companies) to the solidarity fund. C&L 1995, *supra* note 1, at B-56.

decided by primary reference either to the intended levels of contribution or to the intended levels of benefit. The method selected will influence the structure of the fund. The existence of the fund does not of itself determine how the contributions of any one contributor relate to the benefits to be received by that contributor unless the fund has only that contributor as a member.

Links between contributions and benefits can be of two kinds, reflecting the differences between funded and unfunded schemes. A funded scheme is a scheme in which the contributions paid in are used to create a fund from which benefits will, in due course, be drawn. If the fund has numerous contributors, the level of contributions required by the fund is based on actuarial advice about the probable pattern of contributions, fund income, and benefits in the predictable future.

In funded schemes, the contributions paid in by an individual are saved to fund that individual's pension, on either an actual or an actuarial basis. In either case, the relationship between the contributor's contributions and benefit entitlement is provided in the structure of the scheme. Benefit entitlement, therefore, is based on the total actual contributions of or for the contributor, or the assumed total of contributions. The assumption of total contributions is often decided by reference to the length of service of the contributor in employments covered by the scheme. The actuarial basis of a fund will assume full pension entitlement only for a contributor who has contributed on all earnings throughout a set maximum period working for the employer, such as 30 or 40 years.[63]Aug. 27, 1993). Those who contribute for less than that period will not receive a full pension.

An unfunded scheme does not retain contributions to meet future obligations to pay benefits to those making the contributions. Instead, it is run on the basis that current contributions meet current benefit expenditure.[64] This is subject perhaps to the maintenance of a buffer or reserve to ensure a smooth flow of both contributions and benefit payments. In an unfunded scheme, there is no economic link between an individual's contributions and the benefit entitlement of that individual. A person's pension contributions this year fund this year's pensioners. This person's own pension will be funded, it is to be hoped, by those contributing during the person's retirement.

[63]States sometimes choose shorter periods than this or have no periods at all. For example, until 1994, the Finnish system had no qualifying period of residence for Finnish citizens. Since 1994, the period is five years after age 16. Further, the period of residence now affects the level of benefit, with a citizen receiving one-fortieth of the total pension in respect of each year of residence. Previously, there was no such requirement. *See Finland: Changes in Benefits,* Trends in Social Security (ISSA), Nov. 1995, No. 9, at 10 (referring to the Finnish National Pensions Act, 1993). Similar moves have also taken place under the Italian scheme. The French scheme increased the period for a full pension entitlement from 150 quarters to 160 quarters (40 years) on an incremental basis. *See France: Measures for Safeguarding Social Protection*, Trends in Social Security (ISSA), Nov. 1995, No. 9, at 12 (referring to Decree of

[64]This is the form of state scheme most commonly found in Western European countries, as well as in economies in transition. For a comparative survey, *see* Emmanuel Reynaud, *Financing Retirement Pensions: Pay-As-You-Go and Funded Systems in the European Union*, 48 Int'l Social Security Rev. 41 (1995).

Funded schemes therefore need links between the contributions and benefit entitlements of individuals, while unfunded schemes do not necessarily need such links. There are, however, good reasons to establish links within unfunded schemes as well. A formal link between benefit entitlement and contribution ensures that only those who have contributed can benefit from the fund. It is both a justification to contributors of why they are expected to contribute and an inducement to voluntary compliance with the obligations of contribution. It also reduces the effective cost to the fund of those who avoid or evade contributions.

The link between contributions and benefit entitlements may be either direct or indirect. A direct link requires a contributor to have made a defined level of contributions before receiving benefits.[65] That requirement may be small in the case, for example, of entitlement to benefit for industrial injury.[66] For long-term benefits, such as retirement pensions or survivors' benefits, the requirement may be for payment of contributions at a set level in each year of the contributor's working life (or until death before retirement). Assuming that contributions are related to earnings, the total of contributions may affect not only entitlement to any benefit, but also the level of benefit. A direct link imposes administrative requirements for an accurate record of the contributions of every individual who may have benefit entitlement. It also requires that the contribution record be readily available for the determination of any claim to benefit. This requirement may create problems if a complex contribution condition is imposed in respect of short-term benefits, such as benefits during sickness or unemployment.

A scheme may also use an indirect link, of which there are two effective forms. The first is the period during which the contributor is employed in employment subject to contributions.[67] In effect, this link measures the total time during which the contributor has contributed, but uses the contributor's employment record to decide this rather than the contribution record. The other form of link is by reference to the contributor's residency status.[68] To comply with entitlement under this form of link, the contributor is required to show that he or she resides in the territory covered by the scheme for a required period or periods. This basis can work if the territory is covered by only one scheme for the contributor. It also assumes that residents pay their contributions or taxes. A direct link between contributions and benefit entitlements may be more effective than the indirect alternatives in ensuring that contributions are paid.

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[65]This approach is used in the United Kingdom and Ireland. The U.K. contribution conditions are set out in the Social Security (Contributions and Benefits) Act, 1992, ch. 4, sched. 3.

[66]A single payment may be enough to ensure coverage from the beginning of employment. Many states sidestep even this minimal problem by imposing the requirement to contribute on the employer alone.

[67]The French scheme depends on a wide range of individual schemes. The linkage is achieved in individual schemes by reference to periods of insurance of individuals, which is directly related to their having employment that is insured through the appropriate fund. *See supra* note 63 regarding the recent change in the linkage rules.

[68]The approach adopted, for example, in Denmark and Finland. *See supra* note 62.

II. Issues in Social Security Taxation for Employees

A. General Terms

For the reasons discussed previously, the terminology used in this chapter follows that normally used by social security lawyers.[69] The terms set out in this section are those used in the chapter. Most require definition, and these definitions are discussed in the following paragraphs.

Contributions: payments of social security tax, whether made directly by potential beneficiaries or by others. Contributions are assumed throughout to be compulsory. Any contributions that are not compulsory are termed "voluntary contributions." In this part of the chapter, "tax" therefore refers only to general taxation.

Contributor: a physical or legal person making or required to make a contribution is a "contributor," rather than a "taxpayer" or "insured person."

Employee: an individual working for another person is an "employee," and the nature of the work that the "employee" undertakes is "employment." Employees are sometimes also termed "workers," but that term is ambiguous because it may include workers who are not employees. The alternative phrase sometimes used for employment (particularly in civil law countries) is that of "dependent personal services," but this has only limited use in English. It contrasts with "independent personal services" or the services supplied by an "independent worker" or "self-employed person."

Employer: the person employing the employee is the "employer."

Self-employed: a person working independently, or engaged in independent economic activities of any kind (other than those of managing investments), is referred to by the usual English term of "self-employed person."

Unemployed: an individual who is neither an employee nor self-employed is said to be "unemployed." "Unemployed" is used to describe those not engaged in employment or self-employment. If the individual, because of independent resources, dependency, marriage, or for any other reason, is not seeking employment, it may be better to term the person "nonemployed."

Working age: employees and the self-employed are of "working age" if they are over the age at which the state requires everyone to attend school on a compulsory basis and under the age at which an old-age pension becomes payable. States normally have general rules deciding the school-leaving age and the age at which the old-age pension becomes payable. It is normal to expect employees and the self-employed to pay

[69]There is no standard vocabulary. However, the U.S. Department of Social Security has published glossaries of terms in its *Handbook of Social Security around the World* (annual).

contributions throughout the period when they are of working age, except while unemployed. Contributions might not be required below or above that age.

Old-age pensioner: an individual over the retirement age (or pensionable age, as it is sometimes called) is normally called an "old-age pensioner" or, simply, a "pensioner."

Contribution period: contribution liability arises with respect to defined periods, as does income tax liability. The standard income tax approach defines liability by reference to a fiscal year (often a calendar year), but it may also do so by reference to the calendar month or to the amount of a payment. Contribution liability may also arise with reference to a year. The analogy to labor relations law may mean that the period to which the contribution is related is the primary period for payment at work, usually a week or a month. The question of the length of this period is addressed below.[70] For ease of discussion, the term "earnings period" describes the period used to decide the amount of a contribution. An earnings period can be as short as a day or as long as a year depending on the administrative policy of the scheme involved.

B. What Is Employment?

The distinction between economic activities that are characterized as employment and those that are considered self-employment is fundamental to the laws that impose liability to contribute to a social security system and to the laws providing for benefits from a system. The distinction is found in the laws of countries of all legal traditions save those where the whole economy is regulated and the roles of individual workers are controlled.[71] It is widely used for social security purposes, although some states deal, instead, with categories of economic activity.[72]

The distinction is also important for several reasons other than social security. For example, it is often important in defining the liability of an individual to the income tax.[73] It is important for VAT purposes because an employee is not a taxable person for VAT.[74] The rights of an individual under employment law or labor relations law depend on the individual establishing that he or she is an employee. Civil contract and liability rights, and rights under insurance legislation, also depend on the same distinction.

[70]*See infra* sec. II(L).

[71]This used to be the case in countries such as China and the Soviet Union.

[72]For example, those engaged in agriculture and fisheries are given separate treatment in Iceland. C&L 1995, *supra* note 1, at I-4; *see also* for Norway, 6 IBFD European Taxation, *supra* note 1, at Norway 43. In Belgium and Luxembourg, manual workers are treated separately from office workers. 6 IBFD European Taxation, *supra*, at Belgium 46–47; C&L 1995, *supra*, at B-27, L-44. In both cases, the rates for industrial workers payable by employers are higher than those for office workers. Spain has different minimum and maximum levels of earnings within which contributions have to be paid for different activities. 6 IBFD European Taxation, *supra*, at Spain 65–66.

[73]*See* vol. 2, ch. 14.

[74]*See supra* chapter 6, section III(E).

Although the concept of employment or dependent personal services is most important, it has generally proved difficult to define. For some groups, the definition is relatively easy. For example, those working in government service can usually be regarded without difficulty as state employees if they are under the authority of the state. This includes those working for the armed forces of the state and the state's diplomatic service. This is so for other large employers. The employees work on standard terms and within a clear structure that sets out the duties of each employee and the wages or other benefits received by the employee.

There are other groups of workers for whom the position is less clear. Are professional workers regarded as employees, or are they regarded as members of a profession and treated as self-employed whether actually employed or not? Should those working for several employers be regarded as engaged in part-time employment for a series of employers or as self-employed (or both)?

The definitions of employer, employee, and employment are all linked. The key to these definitions is the employment relationship between the employer and the employee and the other terms are best defined by reference to it. It is also important to ensure that the definition of these terms is the same for both contributions to the social security scheme and entitlements from it, so that the link between contributions and benefits is clear. In this way, a state may establish a more formal link, such as making benefit entitlement dependent on the payment of contributions.

The social security meaning of employment has traditionally been linked to the meaning of employment that is accepted as a matter of labor relations law (often called "employment law").[75] This means that an individual who is regarded as an employee for general labor relations purposes is also regarded as an employee for social security purposes. This definition will often also be used for other legal purposes. For example, it is used for civil liabilities of the employer to the employee (and the reverse), or of either to third parties.

As a point of both practice and principle, the definition of employment should be the same for both liability to pay contributions and entitlement to receive benefits. Any differences weaken the link between contributions paid and benefits received and may also increase the administrative burden of running the system. It is particularly important that the system ensure that a contributor cannot avoid contributions and then claim benefits. For example, the contributions due from or for employees are usually higher than those for the self-employed. If an individual can claim to be self-employed while contributing, but then claim to be an employee to obtain higher benefits, then the system is open to abuse.

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[75]The laws of different nations view the key terminology as linked in different ways. The U.K. definition of "employed earner" is "a person who is gainfully employed . . . either under a contract of service, or in an office. . . ." Social Security Contributions and Benefits Act, 1992, ch. 4, § 2(1)(a). Similarly, in French law, an employee is defined as "a person working for another person called the employer who supervises and controls his or her activity in exchange for which the employee receives a salary." Code de Sécurité Social art. L 311.2. Both definitions rely on undefined references to general labor relations law.

There is also a clear linkage between the definition of employment for social security purposes and the use of the same term to define the liability to other taxes. For example, income tax law also requires a definition of the status of an employee and of income from employment.[76] A person can register for VAT, or be required to register, only if the person is, in the terminology used here, self-employed.[77]

There is much to be said for establishing a common approach to definition across all these laws and taxes, although the different laws will require specific provisions to deal with problems specific to each tax. A common definition ensures that those who claim rights as an employee must also be shown to have paid tax and contributions as an employee. This does much to stop abuse of the system.

If a common definition is used, clear references should be introduced between the laws ensuring that key definitions are applied uniformly. This simplifies the application of the law, but it does not by itself ensure uniform resolution of disputes. Even with a common definition, it must be decided who is to handle a disputed question about the status of an individual. In practice, different authorities must decide for their own purposes, and their conclusions may not be consistent. While there are obvious advantages in defining and applying laws consistently, it may not be easy to accomplish. For example, the labor relations courts or tribunals decide disputes for labor relations purposes. If a labor relations tribunal is not involved, the parties to a relationship decide by mutual agreement whether they treat a relationship as employment or not. For income tax and VAT purposes, the tax authorities may be called upon to decide how an individual is to be taxed, subject to appeal to tax courts or tribunals. This may result in divergence, particularly because tax tribunals and labor relations tribunals are likely to be involved at different stages of an employment. It is difficult to ensure consistency among the different courts and tribunals without affecting their jurisdictions or independence. A practical alternative may be to secure agreement between administrators. For example, the tax and social security authorities may agree that they will normally respect each other's rulings in individual cases.[78] If there is a common definition, the superior courts can also ensure consistency and, at this level, bring together the approaches of lower tribunals.

This general approach to the definition of employment raises some difficult issues for social security. Problems particular to social security contribution liability are discussed below.[79] Two general issues need further attention here: problems of contribution avoidance and the status of officeholders. A third issue is that of excluded categories of employee or employment.

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[76]*See* vol. 2, ch. 14.

[77]The terminology used for VAT purposes is different, and the reference is to a person engaged in independent economic activities. *See supra* ch. 6, sec. IV(B).

[78]This approach has been adopted in the United Kingdom and the United States.

[79]*See infra* sec. II(C–N).

C. Independent Workers: Are They Employees?

Experience in many countries[80] shows that employees will be strongly tempted to claim to be self-employed if the liability to tax and social security contributions is greater for an employee than for a self-employed individual. This temptation is particularly marked when a high level of contributions or payroll taxes is levied on the employer. If an employer employs an employee, the employer contribution is payable. If the employee is instead taken on under a contract as a self-employed person working independently, there is no payroll tax. The saving to the employer may be considerable, even if the "employee" receives more money. It is also harder for the social security authorities to obtain a full contribution from a self-employed individual than from an employer. One solution to the noncollection problem is to levy a flat-rate tax on all payments made to persons in these categories, whether they are employees or self-employed. However, if the rate of withholding tax applied is too high, a genuinely self-employed person may be overtaxed because this approach makes no allowance for business expenses. This may not be a problem with genuine employees.[81]

This problem may require a case-by-case approach, with rulings being made for, and agreements being secured with, different groups of employers or employees. These agreements can reflect the fact that contributions and benefits are linked, at the state level if not at the individual level.

Experience also shows that the problem of sham self-employment is more likely to occur in some areas of activity than others. One solution is to provide special rules under which an individual is treated as an employee whatever the actual legal status of the person. This is done, for example, with those whose work involves neither high levels of skill nor the use of tools or equipment provided by the "employee." Examples are casual staff in a catering establishment or on a building site.

D. What of Officeholders?

The other general problem in defining employment is the status of an officeholder. An individual appointed to an office is not an employee and is not self-employed because of the appointment. This applies to public offices such as judges, government ministers, or members of parliament. It applies to noncommercial positions, such as trustees of a charity or senior members of a religious organization. In addition, it applies to commercial organizations, in particular, to the directors of a company.

Many officeholders are in broadly the same position as an employee in that they earn their income by working in the positions they hold. Others are in the position of a self-employed person. For example, a lawyer who holds a part-time directorship in a

[80]This has been experienced widely in the economies in transition, where there has been a sharp growth in alleged self-employment and a reduction of employment by large employers.

[81]This approach has been adopted in some states of the former Soviet Union and has been discussed in the United States.

company that is a client of the lawyer's firm so that the client may be given legal advice is in reality a holder of that office only as part of the lawyer's professional activities. Rules must be provided to deal clearly with these cases.[82]

The most difficult area is that of the individual who runs a small business through a company. An extreme, but not uncommon, situation is the individual who had a small business that she ran on her own and then turned into a small company. The individual owns all the shares in the company, is the managing director of the company, and works full time in the business of the company. The individual takes money out of the company as director's fees. She may also be paid as an employee of the company under an employment contract in addition to her status as director. She can also receive dividends. Is the individual employed, self-employed, both, or neither? If the company also employs the individual, then clearly there is an employment. However, what is the position of the individual as company director? Again, a clear rule is needed.[83]

E. What Categories of Employees May Be Excluded?

Employees may be excluded from a state's social security scheme for a variety of reasons. However, in any national scheme the reasons for exclusion should be objective. If the scheme is truly compulsory and universal, no one has a right to exclude an individual for personal or voluntary reasons. Therefore, those groups of employee that may be excluded from schemes must be noted. In each case, the rules for exclusion may apply differentially to the employee and the employee's employer. In this section, the exclusion of employees is addressed. The effect on their employers is discussed in the next section.

1. Age-Based Exclusions

A general reason for exclusion is age. A scheme can apply an upper age limit and a lower age limit. In most schemes, those over retirement age (or pensionable age) become entitled because of age to a pension. Those receiving pensions are not required to contribute from those pensions. A series of subsidiary issues must also be decided to determine whether a person over pensionable age has any liability for contributions. For example, if a person is allowed to draw a pension but also continues to work, are the earnings from the work liable to contributions? A similar point arises when a person who could draw a pension on age grounds chooses not to, but decides instead to continue in

[82]International practice is inconsistent. Countries such as the United States and the United Kingdom treat officeholders in the same way as employees. *See supra* note 75. Some states, for example, Belgium, Germany, and Ireland, exclude directors (in Ireland, controlling directors) from the schemes for employees, but may bring them within the schemes available for the self-employed. 6 IBFD European Taxation, *supra* note 1, at Belgium 45, Germany 42, Ireland 49. This recognizes the problem in the text in the most general way.

[83]*See supra* note 82. The United Kingdom has a more specific rule under which director's fees paid to the director's firm (and not to the director personally) are not regarded as imposing contribution liability on the director, although for general purposes a director is treated in the same way as an employee. *See* Social Security (Contributions) Regulations, 1979, Regulation 19B.

full-time work. Should that individual pay contributions after reaching pensionable age? Again, what of the individual who, on reaching pensionable age, is, for some reason, not entitled to a pension and is therefore obliged to keep on working? In each case, the answer reflects both issues of funding and issues of fairness. It may be decided that, upon reaching pensionable age, an individual should, on age grounds, not pay any further contributions. On the other hand, it may be decided that contributions should be paid on all earnings, regardless of the identity (and therefore age) of the earner. The answer may also reflect any linkage between contributions and benefits. If the contributions of an individual over retirement age cannot earn the individual any further pension, then it may be questioned if they are truly contributions.[84] They may have become an income tax to be justified on other policy grounds. Alternatively, if the employee remains covered for some risks but not for others, a different rate of contribution may be appropriate.

Similar issues arise with young earners. Schemes may have a lower age limit. This may reflect a general rule of law preventing children below a certain age from remunerative work. As any child working below that age is working illegally,[85] it is administratively simpler to exclude any social security involvement in such cases. A second reason for a low age limit is an assumption of a lower limit to the working age used for the scheme. A lifetime scheme is based on all earnings of an employee of working age. The state, or the scheme, may assume that the working age starts at a certain age or when the individual is no longer required to attend school. If so, it may be appropriate on grounds of fairness and administrative efficiency to exclude an employee below that age, or still at school, from a requirement to contribute. Such contributions will not, in the normal course of events, be needed for the individual to get a full pension entitlement. Inclusion of such earnings may also encourage evasion or nondeclaration.

2. Education and Training

An issue related to a lower age limit is that of continuing education or training. This covers those continuing to pursue a full-time education or training after reaching the minimum age of the scheme and after having left school. In particular, those attending university or full-time professional training should be considered. The income of a student from a government or private scholarship is not usually regarded as earnings. A student may have a low level of casual earnings from, for example, part-time catering work, and it is for consideration whether such earnings should be within a system. A related question, beyond the scope of this chapter, is whether a student or trainee should be able to pay voluntary contributions to make up any "missing" years of contributions,[86] or whether contributions should be credited to the individual during training.[87]

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[84]This is recognized in Sweden, where no contributions are required from or for pensioners, but where instead a salary equalization tax is payable. 6 IBFD European Taxation, *supra* note 1, at Sweden 49, 50, 52.

[85]With some exceptions; *see, e.g.,* Fair Labor Standards Act § 13 (as amended), 12 U.S.C. § 213(c) (USA)(in certain circumstances, exempting from the child labor provisions children working on farms or as actors).

[86]An individual who has a deficient contribution record because no liability to contribute arose (e.g., because the individual was on an extended holiday or had private income) is sometimes allowed to

3. Voluntary and Nonremunerated Workers

Other groups of employees (or those who might be regarded as either employees or officeholders) may also be excluded if they have no earnings or minimal earnings only. For example, members of religious orders or other organizations to which individuals offer their services voluntarily while having their immediate personal needs met, such as voluntary development workers, may be excluded.

4. Recipients of Benefits

A decision must also be taken about the contribution liability, if any, that arises from someone in receipt of benefits. For example, is someone who receives sickness benefits in place of earnings during a period of sickness liable to continue paying contributions toward a retirement pension? This can be a complex question in a state that has separate schemes for separate benefits and also depends on how a benefit is paid. If an individual is ill, her or his earnings may be kept in payment in several ways. The employer may allow the employee a number of days of sickness a year without loss of pay, the employer may have a specific private insurance scheme that makes good the pay, or the pay may be made good by the employer, who is then entitled to recoup from the state the amount paid. Finally, the employee may be entitled to claim a benefit direct from the state. This may or may not come from the same fund as that from which the retirement pension will be paid. Each method of providing the employee's benefit during sickness may suggest different policy reasons for requiring, or exempting, contribution liability on the sums received. There seems no strong reason to exempt if the funds come from the employer. Whether exemption should apply when sick pay comes from the same fund as a retirement pension may depend on how the real value of the sick pay compares with the pay before sickness.

5. Specific Employments

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contribute voluntarily in order to make good the deficiencies in the contribution record. For example, the United Kingdom has a category of contributions (Class 3) payable on a voluntary basis in these cases. Social Security Contributions and Benefits Act, 1992, ch. 4, § 13. There may be advantages to the state in allowing this form of additional contribution as it may remove any obligation to provide means-tested benefits for an individual.

[87]If benefit entitlement in a scheme is subject to contribution conditions, consideration should be given to the crediting of notional contributions to the contribution record of an individual if the individual, for good reason, is not contributing. One example is the crediting of notional contributions during approved periods of education and training. If a contribution test for a benefit requires a minimum level of contributions in any period, or a minimum period of contribution, before benefit entitlement arises, then it may be necessary to allow for notional contributions in a scheme. Otherwise, for example, an individual who has just started work after an extended period of education or training may not be entitled to benefits. Similar problems arise for those who have been receiving benefits, for example, for illness or unemployment, for mothers on maternity leave, and for those who give up work to look after sick relatives. The provision of a notional contribution replaces the requirement that the individual pay a contribution either as compulsorily or voluntarily.

Approaches differ markedly among countries as to the scope of employments covered by social security schemes. In some countries, all employees are included in one universal scheme.[88] The one scheme therefore covers both public servants and private sector employees. At the other extreme are systems where each industry or profession has created its own scheme.[89] Decisions must then be taken about the coverage of each scheme. Intermediate positions may be adopted if some employments or industries have special schemes,[90] with those not covered by special schemes being within the general scheme.

If separate schemes exist for individual professions or industries, a separate approach may be taken to individual professions. For example, all those who practice a profession may be expected to join their professional scheme whether they are self-employed or are professional employees.[91] This approach forms an exception to the usual distinction between employees and the self-employed.

6. Employment Within the Family

As a result of income tax rules, it is convenient in some countries for one spouse to employ the other in order to deduct the salary paid. This may reduce the family's general liability to income tax. The same is true when parents employ their children or, more generally, when employment takes place within the family. It is to be considered whether such employments should also be regarded as employments for social security purposes. It might be decided that some forms of employment within the family should be ignored, for example, when one member of the family is paid to do the housework. This may technically be an employment, but it is unlikely to be a true commercial contract of employment. Therefore, it may be appropriate to provide for the exclusion from social security schemes of employments within the family other than genuine employment in a family business.

7. Jurisdictional Exclusions

A scheme needs to have rules for the inclusion or exclusion of employees whose work is not solely confined to the jurisdiction of the territory covered by the scheme. This topic is discussed separately below.[92]

F. Who Are Employers?

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[88]For example, Ireland and the United Kingdom.

[89]This is the French approach.

[90]For example, agricultural workers or members of the armed forces. *See supra* note 72.

[91]For example, Portugal, where the self-employed may choose which professional scheme is appropriate for them (on the basis of their activities). 6 IBFD European Taxation, *supra* note 1, at Portugal 61.

[92]*See infra* sec. IV.

It is necessary to identify the employer in respect of any employment because the law imposes contributions directly on employers. The law also requires employers to act as agents for the social security authorities to collect contributions from employees. There is little difficulty in identifying the employer once the employee and the employment are identified. The employer is the other party to the contract of employment with the employee. If a definition is needed, then it might be simply stated that the employer of an individual is the person who employs the individual.

Inevitably, there are legal and practical difficulties with this approach. For an officeholder, there is no employer in the legal sense. If officeholders are treated as employees, then the organizations of which they are officeholders must be assumed to be the employers.

Another practical difficulty occurs when an employee appears to have two employers. For example, Val works for company *A*. Company *A* instructs Val to work for company *B* for six months in another part of the state. Company *A* pays Val's expenses in moving temporarily to work with company *B*, but company *B* pays the salary and costs and instructs Val on the duties to be undertaken. Formally, company *A* is the employer, but in practical terms company *B* has become the employer, at least for the time being. Rules are needed to deem the paying company to be the employer. Alternatively, they may allow the paying company to act as agent for the employer, or the employer may recover the relevant social security contribution from the other company.

As a result of the jurisdictional rules,[93] an employee will sometimes be within the jurisdiction of a scheme, while the employer is outside the scheme. This problem may be dealt with by imposing the liability to pay the employer's contribution on the employee (besides the employee's own contribution). Alternatively, if the employee has been seconded by a foreign employer to work with a business within the state, that business may be deemed to be the employer. The principle is that the person benefiting from the services within the jurisdiction should be treated as the employer although not technically in that position. This prevents abuse of the system and prevents employees from being uninsured when a risk is realized.

G. Allocating Contributions between Employer and Employee

Almost all schemes place the cost of social security for employees on those employees and their employers. However, agreement has not been reached on the share of the contribution to be borne by the employee rather than the employer; nor do all schemes within a state follow the same pattern.[94] Some schemes, as a matter of principle, divide the contribution evenly between the employer and the employee and collect half from each.[95] Some share the contributions between employees and employers, with the

[93]*See infra* sec. IV(B).

[94]*See supra* note 49 (regarding the example of Austria).

[95]This is the practice in the United States.

state—or taxpayers generally—also contributing.[96] Several countries, including some economies in transition, share the contribution, but impose nearly all the burden on the employer.[97] Others impose the entire burden on the employer.[98] It is less usual to find the employee bearing the larger part of the burden, but this also happens.[99]

Some states have sought to add economic factors to the decision about the level of contributions imposed on employers.[100] In effect, this approach introduces an indirect state subsidy to certain employers, the burden of which can be borne by other employers (thereby further increasing the element of subsidy). It runs against both the insurance principle of social security schemes and the trend of reducing the elements of tax expenditures in direct taxes.[101]

Requirements for imposing contributions on employers and employees are examined below, but two issues of principle need to be addressed at this point. First, are employers and employees liable to pay contributions on the same base? The answer may vary from one scheme to another. In a system in which the state is not involved, and in which contributions are divided evenly between the employer and the employee, principle suggests that the same tax base should apply to both contributors. This is less evident in other cases. However, the answer may relate to a separate issue, that of the linkage—if any—between the contributions paid by or on behalf of an employee and the

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[96]This approach was originally pioneered by Bismarck in Germany in the last century and has been adopted by a number of other European states. It was also the approach in the United Kingdom, confirmed in the Beveridge Report in 1946, *Social Insurance and Allied Services*, 1942, Cmd 6404, although the Government began to phased out the public contribution in 1979, only to reintroduce it recently to deal with a pending deficit in the National Insurance fund.

[97]For example, Russia imposes all but 1 percent of the contribution on the employer. C&L 1995, *supra* note 1, at R-9. In Hungary, social security contributions are paid by employees (at 10 percent of their gross salary) and by employers (at 44 percent of gross salaries) up to certain limits. *Id.* at H-15. OECD members that impose the main contributions on employers include Canada and Finland. *Id.* at C-9, F-15-16. Current rates for each country are set out in 6 IBFD European Taxation, *supra* note 1, and C&L 1995, *supra*.

[98]For example, Bulgaria and Poland. This is also widely used as an approach for schemes to compensate workers for injuries at work.

[99]For example, this happens in Ireland and in the United Kingdom (in both of which the balance between employer's contributions and employee's contributions has varied from time to time). A particularly interesting example is the Netherlands, where the main burden was recently shifted from employers to employees. To compensate, employers were required to make an extra transitional payment to each employee. This payment is, for general purposes, treated as extra earnings, although its amount is laid down by the Government.

[100]For example, Norway is for this purpose divided into five geographical areas, with different employer contributions in each area (0 percent in the far north). Argentina has abatements of contribution for employers in specific industries. The United Kingdom recently introduced a reduction in the employer's contribution when the employer takes on someone who has been unemployed for over two years.

[101]It is possible that such distortions might also amount to state aids or subsidies for international trade purposes. Treaty Establishing the European Community, art. 92. This may happen if the combined effect of the contributions and the benefits payable from those contributions involves a hidden subsidy of a national industry against foreign competitors or amounts to nationality-based discrimination. Such discrimination could be in breach of EU law. It is less clear whether it would fall to be reviewed under a nondiscrimination provision in a double taxation convention.

benefit entitlements of the employee. The linkage for benefits, such as pensions, normally relates to the employee's contributions only. That being so, any contribution liability of an employer that is not reflected in a matching liability of an employee means that funds are being collected with no related benefit entitlement.[102] If that happens, the state should be able to justify this in the context of the general funding and benefits of the scheme.

The other issue is whether the employee can be made liable for the employer's contribution if the employer does not pay. This relates to enforcement provisions and is covered later. It is similar to the problem, important for income tax, of collecting tax from a taxpayer who has already paid tax by withholding at source, but whose withholder has failed to pay the tax to the tax authorities. An additional question in social security law is whether, if contributions are not paid but should have been paid, the employee loses benefit. In a fully contributory system, nonpayment of contributions results in nonreceipt of benefit. It is then in the employee's own interests to ensure either that the employer pays the contribution or that the employee can make good the default or can be treated as having made it good.

H. Should the State Contribute?

Contrasting views are taken about contributions paid by the state to a social security scheme. One view is that it is appropriate for all three parties to the employment relationship—employee, employer, and state—to contribute to social security funding.[103] The opposite view is that the state should be excluded from social security funds, which are financed by employees and employers without outside involvement.[104] The choice of approach is a matter for political decision. Recent experience shows that the threat of social security schemes going into deficit has sometimes required temporary state subsidies from general tax revenues.[105] The key issue is the extent, if any, to which it is considered appropriate to fund part of the social security scheme from general tax revenues. At the same time, how involved should the state be in running a scheme? The two extreme approaches tend either to involve the state heavily or to exclude it. In practice, the effect of the tax system on a social security scheme means that the position is less straightforward than these extremes suggest. For example, a state may subsidize a social security fund indirectly through tax allowances and exemptions. It may also

[102]An example is the recent imposition in the United Kingdom of a social security contribution on employers, but not on employees, related to the provision by employers of company cars to their employees. This reflects the absence of a general charge on benefits in kind in the United Kingdom. The employer contribution gives rise to no benefit entitlement. The charge is imposed by a Class 1A contribution. Social Security Contributions and Benefits Act, 1992, ch. 4, § 10.

[103]This is the original German model of social security, adopted by a number of other European countries.

[104]This is the approach adopted for the U.S. federal social security funds.

[105]In France, this was done through a new old-age solidarity fund levy. *France: Measures for Safeguarding Social Protection,* Trends in Social Security (ISSA), Nov. 1995, No. 9, at 13 (referring to law of Dec. 30, 1993). In the United Kingdom, it was done by reintroducing the subsidy to the National Insurance Fund from general taxation that had been abolished a few years before. *See supra* note 96.

control social security funds through conditions attached to such allowances and privileges.[106]

I. Basis of Contribution Liability

The liability to contribute may be decided either on a flat-rate basis or on a basis related to the income and (if they are subject to contribution liability) benefits paid to the employee by the employer. Flat-rate schemes were once common practice among developed countries, but they have largely been replaced by earnings-related contributions and are not discussed further here.[107]

1. Gender Discrimination

Many schemes used to differentiate between the rates charged for male employees and the rates charged for females. As the working conditions for males and females come closer together, and benefit entitlement rules such as retirement ages are made uniform,[108] any economic justification for this form of discrimination is removed. It is often prevented by general principles of law[109] or by general labor laws that prevent discrimination based on gender. This and other forms of discrimination may also be subject to human rights equality provisions.[110]

2. Earnings-Related Contribution Rates

Earnings-related contributions are justified by a need for revenue to finance benefits. They are also justified on the same basis as progressive income tax, by reference to redistribution through the tax system. However, the redistribution does not usually involve progressive rates of contribution. Rather, it occurs through the combined effect of

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[106]These issues are raised in the final part of this chapter. *See infra* sec. V(C).

[107]Denmark is the only OECD member now using a major flat-rate scheme is Denmark for its Labor Market Supplementary Pension (ATP). The rate is not related to pay levels, but reflects the length of the work week of the individual. Those working over 27 hours pay the full premium (in quarterly installments), while those working from 18 to 27 hours pay two-thirds, those working 9 to 18 hours pay one-third, and those working fewer than 9 hours pay nothing. Public sector employees pay a lower contribution than others. ATP, Annual Report 4 (1993).

[108]One justification for the distinction could have been the lower retirement age of women in many countries. However, in practice, men were required to pay higher contributions despite having the higher retirement age, indicating that this was not the reason for the discrimination. Another factor could be policies to encourage employment of females. If so, that policy aim has now been fulfilled in several developed countries.

[109]For example, under the constitutions of individual countries. It is prohibited in the EU member states, inter alia, by the Treaty Establishing the European Community. EEC Treaty art. 119. The equal treatment policy is more fully implemented by EC Council Directive 79/7 of December 19, 1978, on the Progressive Implementation of the Principle of Equal Treatment for Men and Women in Matters of Social Security, 1979 O.J. (L 6) 24. Article 4 deals explicitly with contribution liability. *Id.* art. 4.

[110]General statements about nondiscrimination in social security are set out in the European Social Charter, Oct. 18, 1961, art. 12, 529 U.N.T.S. 89; the United Nations International Covenant on Economic and Social Rights, Dec. 16, 1966, art. 9, 993 U.N.T.S. 3; and similar agreements.

the contributions system and the benefits available. In practice, because of links between contributions and benefits, a progressive rate structure would be irrelevant to many schemes. However, some states have a progressive element in the rate structure.[111] The effect of thresholds and caps (see below) can be progressive or regressive, but this is best viewed along with the benefits available to contributors and with the tax position of these individuals to get the full picture.

Income tax systems commonly have thresholds below which payments are not required. This approach is also used in some social security schemes. Income tax laws usually specify an amount that can be earned annually before tax is payable. Alternatively, the law may grant a refundable credit against tax payable. A refundable credit system is not appropriate to social security, as it in effect combines liability and benefit. A social security system with a threshold, therefore, uses an exclusion of liability if income totals less than a set sum during the relevant period.

The adoption of a threshold is a compromise between the insurance role of a social security scheme and the recognition of both the administrative burden of imposing contributions on all earnings[112] and the effect this may have on the lowest earners. Insurance considerations suggest that all earnings should be included, while thresholds are justified by both practical reasons and policies of supporting the poorest earners. In many states, the insurance approach prevails and there is no threshold. If thresholds are adopted, the conflict of policies may result in a level of threshold that is lower than that operating for income tax.[113]

A threshold may work in two ways.[114] The most straightforward way is to exclude from liability to contribute anyone earning less than the amount set as the floor. Once that person's earnings exceed that sum, the floor is ignored and contribution liability is based on total earnings. This method has a distorting effect when earnings are near the level of the floor. The imposition of full contribution liability on someone whose earnings just exceed the floor may appear to penalize that person compared with someone whose earnings are slightly lower and who has no contribution liability. A small increase in

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[111]Colombia imposes on the highest-paid employees an extra 1 percent contribution to the state Social Security Institute . C&L 1995, *supra* note 1, at C-61. More unusual is the approach of the United Kingdom, which has a single rate for most employees (with a lower rate for earnings below the threshold), but has five rates of contribution (including zero) for employers, dependent on the level of total earnings of each employee. Social Security contributions and Benefits Act, 1992, ch. 4, § 9 (as amended from year to year).

[112]The burden is less important if contributions are collected entirely from employers (or through employers) and are based on payroll levels. In such schemes, the introduction of an individual threshold adds to employer compliance costs.

[113]In the United Kingdom, the income tax threshold and contributions threshold were set on different bases in 1975. Their levels are determined from year to year mainly on the basis of indexation, so the difference has been maintained.

[114]Another alternative is the provision of a credit against income tax, which may be related to a greater or lesser extent to the amount of social security contributions. *See* USA IRC § 32 (regarding the earned income credit).

gross earnings will result in a reduction of net earnings. This step effect would also exacerbate the poverty trap.[115] To avoid this, earnings below the threshold are typically exempted from contribution liability for contributors at all levels of earnings. Alternatively, there may be a special lower rate of contribution for earnings below the floor level. The price of this method of avoiding the step as earnings exceed the floor is a major reduction in the earnings base. This will require a higher rate of contribution on earnings above the floor level.

A threshold to contribution liability has two effects. At the general level, it avoids collecting small amounts and levying contributions on the poorest members of society. In this way, it has broadly the same effect as a personal allowance for income tax purposes. It also excludes a low-paid individual from the social security fund. This may mean that the individual is unable to claim from the fund, either because the individual is not a contributor or because the individual is unable to make enough contribution payments to meet the conditions for a benefit. Whether a threshold represents the best compromise of efficiency and justice then depends on any means-tested or universal benefits available in place of the contributory benefit. Exploration of that issue is beyond the scope of this chapter.

Unlike income tax, social security schemes often have upper limits, sometimes known as caps or ceilings. Capping occurs primarily with benefit entitlement, because schemes need to have an upper level of replacement earnings payable to contributors. This often results in the adoption of a cap or ceiling on earnings covered by contribution liability.[116] A cap on earnings is the upper amount of earnings on which contributions are based for the year or other period of liability. Any earnings over the cap are therefore not subject to contributions.[117] In a contributions-based and earnings-related benefit scheme, a cap ensures a maximum level of benefits to any individual or from any one source of earnings. This prevents a disproportionate amount of benefits from being paid to those with very high incomes.[118] However, if benefits are capped but earnings are not, an

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[115] *See infra* sec. V(D).

[116] Two examples are the U.S. federal scheme and the German schemes. The German schemes have higher upper earnings levels for the former west German states than for the former east German states. C&L 1995, *supra* note 1, at G-10; *see also* Messere, *supra* note 1, tbl. 8.1, at 183 (listing caps in the following OECD states: Austria, Canada, France, Germany, Greece, Japan, Luxembourg, Turkey, and the United States); *see also* Messere, *supra* note 1, at 177-78.

[117] A variant on this is to exclude entirely those employees whose earnings exceed the cap, on the ground that they do not need compulsory insurance cover. For example, in Malaysia, employers are required to pay to the state scheme for employees whose earnings are below a set level and are required to take out local liability insurance for those above the level. C&L 1995, *supra* note 1, at M-28 (citing the Malaysian Employees' Social Security Act, 1969); for current rates, *see id.*

[118] For example, if directors of small but profitable private companies are regarded as employees, they may be in this position, as may highly paid expatriates working in low-wage economies. These problems are sometimes dealt with by excluding such groups entirely from the schemes. For example, Belgium treats directors as self-employed. 6 IBFD European Taxation, *supra* note 1, at Belgium 45. Ireland excludes controlling directors from the social insurance scheme. *Id.* at Ireland 49.

overtly redistributional element is included in the scheme.[119] Conversely, caps may have a regressive effect on the overall tax/contribution position of employees.[120]

3. Earnings Bands

An alternative to applying a percentage to earnings is to determine the amount of contributions by using a banding system.[121] This scheme sets a series of levels of premiums, each applying to a band of earnings. For example, those earning between, say, \$30,000 and \$39,999 pay a premium of one level (perhaps based on a given percentage of \$35,000). Those earning between \$40,000 and \$49,999 pay a higher premium (perhaps the same percentage of \$45,000). The lowest band may start at a bottom figure other than zero, thus incorporating a threshold into the system. Similarly, the top band will expressly or indirectly build an upper limit into the system.

A banding system may be seen as having advantages in that it avoids an excessive need for accuracy. Earnings of \$35,000 and \$37,000 both give rise to the same premium. This effect reverses near the limits of the bands and can have very sharp consequences. Someone earning \$40,000 will pay a higher premium than someone earning \$39,990. Further, the extra amount of premium may be greater than the extra earnings. As a result, the person earning \$40,000 may actually receive less than the person earning \$39,900. This effect can be reduced by having a larger number of bands and a smaller difference in premium between bands. Any attempt to increase the number of bands will also increase the administrative complexity.

J. What Are Earnings?

A compulsory earnings-related contribution is in all but name an income tax if imposed directly on the employee. It is essentially a payroll tax if imposed directly on the employer. How much should the definition of "earnings" that are liable to an earnings-related contribution vary from the definition used for liability to income tax? There is little reason in principle why the measurement of income used for income tax purposes and that used for contribution purposes should differ. This is so whether the reason for basing the contributions on income is that it reflects ability to pay or that the benefits are earnings related. In both cases, income should include benefits both in cash and in kind. Again, in principle, any deductions permitted should be parallel, save perhaps for deductions for the payments of income tax and contributions themselves.

1. Links with Income Tax

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[119]Caps may sometimes apply to employers but not to employees (as in the United Kingdom) or the reverse (as in Ireland).

[120]This is expressly dealt with in the Netherlands scheme, which applies higher rates of income tax to those not paying the social security tax, to produce a combined rate of payment of both income tax and contributions on a progressive basis. 6 IBFD European Taxation, *supra* note 1, at Netherlands 43.

[121]For example, in the Philippines. For current Philippine bands, *see* C&L 1995, at P-58-59. The banding system is analogous to the use of tax tables for individual income tax. *See* vol. 2, ch. 14.

There is a strong practical reason for ensuring a close identity between earnings for income tax purposes and that for contribution purposes. It minimizes the legal, administrative, and compliance burdens of collecting two parallel payments from employees. This identity should, if possible, be provided for in the law itself. The legislative terms used for imposing the income tax and the social contributions should be the same unless a difference is intended. Careful consideration should also be given to ensuring that the terms receive consistent interpretation and application by those responsible for administering and supervising the collection process. Failure to ensure this will almost inevitably lead to variations appearing in the operation of the income tax and contribution rules. This is an added level of complexity for both employer and employee, as well as a duplication of official effort. Unless dictated by clear policy reasons, any differences of approach are inefficient.

An additional level of complexity may be introduced by an appeals process. If decisions about the application of income tax legislation and social contribution legislation are dealt with differently, differences in interpretation may appear. One solution is to link the contribution legislation to the income tax on earnings. This link can be comprehensive, with the same rules operating for both income tax and contribution purposes.[122] If this link is established, an appeal on an income tax question is automatically an appeal on the contribution question (and the converse is also true). The same position must then be maintained for any official rulings and guidance. That might best be achieved by providing that the guidance offered by the income tax authorities also applies to contributions.

2. Reaching Settlements

Objectives of income tax systems and social security systems are different. If the income tax authorities have power to deal with practical contribution questions in this indirect way, should they be aware of the different objectives and requirements of the contribution system? This issue is important if the income tax authorities can reach settlements and compromises with an employer over the tax liabilities of the employer's employees. For example, an employer may be found to have misrecorded and underpaid employee income tax and contributions, accidentally or otherwise. The interests of the tax authorities are to make good the loss to the public revenue, for example, through a global settlement of liability with the employer, including a penalty element. The same approach may not be sufficient for contribution purposes because the contributions that should have been paid for or on behalf of the employees can count toward their benefit entitlements. A global settlement does not make any provision for attributing lost contributions to individual employees. That can be done only through a series of individual settlements. It is probably not in the interests of the tax authorities to engage in

[122]This is subject to specific differences caused by the different natures of the two payments. This approach is used, for example, in Sweden. 6 IBFD European Taxation, *supra* note 1, at Sweden 49. This applies in the United Kingdom to contributions paid by the self-employed, where the amounts are expressly based on the assessed profits for income tax purposes. Social Security Contributions and Benefits Act, 1992, ch. 4, § 15 (regarding Class 4).

that level of supervision and negotiation. However, it is in the interests of the individual employees and, therefore, of the social security authorities.[123]

The example of compromises affecting the integrity of the contribution records of individual employees applies equally to any process of estimation or compromise in the tax system. It may also apply when the tax authorities declare an amnesty or otherwise decide not to enforce the law strictly. It may be in no one's interest to seek the strict enforcement of the income tax law. Contribution liability has the added dimension of the need to protect the employee's contribution record. A compromise may therefore involve the employee paying contributions but receiving no benefits. In practice, many such compromises result in little unfairness to individuals because little benefit is lost. The main concern is that the extent of this loss cannot be calculated at the time. The loss of only a small part of a contribution record may have major effects on one individual, but no discernible effects on others. In any system that collects contributions over the lifetime of a contributor, there is no easy solution to this clash of principles. It can be avoided in part by ensuring that the liability rules are effective and consistently applied and that the temptation to cut corners is avoided. However, it must also leave open the position of the social security authorities not to accept compromises of the income tax authorities that are not consistent with the principles of the social security system.

3. Benefits in Kind

Identical treatment of earnings paid in cash for income tax and contribution purposes generally poses no major problems and is desirable. Further attention may be needed to the treatment of benefits in kind and of any allowances and deductions from earnings. In part, this depends on the details of the income tax system, discussed in volume 2 of this book, and not repeated here.[124] It may possible to use for contribution purposes the same method whereby benefits in kind are made liable to income tax, including the timing rules.

4. Specific Expenses and Allowances

Different issues of policy may arise for the allowance of deductions for specific expenses and allowances. The personal allowances in income tax are sometimes designed for social purposes, and their replication in social security schemes may serve to defeat rather than reinforce those social purposes.[125] Other allowances, such as those for certain forms of saving or expenditure, may be regarded as inappropriate in a social security context. Genuine expenses of employment if allowed for income tax purposes should

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[123]These questions have recently been the subject of unpublished, interdepartmental review in the United Kingdom. It was concluded that the scope for further combining these aspects of the tax and contribution schemes was limited.

[124]*See* vol. 2, ch. 14.

[125]For example, a disabled person may receive additional income tax allowances. If the person also receives a reduction in contribution liability, then the individual may also receive reduced benefits when it would be better for the individual to pay the contributions and receive the full benefits.

probably also be allowed for contribution purposes. If deductions are allowed, then efficiency argues for allowance on identical terms and subject to the same procedures.[126]

One area of difference cannot normally be avoided. This is the income tax treatment of contributions and contribution treatment of income tax.[127]

5. *Practical Effects*

The use of different definitions of earnings for tax and contributions purposes either in law or in practice imposes practical problems on employers. This is because any differences result in the need for the employee or employer to keep different sets of records for each employee. They must also provide different returns to the two authorities. This may be only a limited problem for an employer with an automated payroll if the two sets of rules are clear and easily administered. However, it neither avoids the cost associated with the need to supervise a continuing duplicated operation nor deals with the resulting problem of having two teams of officials wishing to audit the employer's records for their own purposes. The problem of accurate compliance is significantly greater for smaller employers who lack trained staff and facilities for automation.

As a general matter, the importance of achieving uniformity among income tax and contributions, in terms of both legal provisions and administrative arrangements, will vary from state to state depending on the operation of both the income tax and the contributions systems. The discussion in this chapter assumes a substantial overlap in the groups that contribute to the two systems. One can, however, envisage situations where this is not the case, for example, where contributions cover wage earners generally while income tax may involve only a small number of individuals because of a large zero-rate threshold. Because of differences in local circumstances, the considerations discussed in this chapter may have different implications for different states.

K. How Should Rates of Contribution Be Determined?

A major difference between income tax and contributions lies in the rates of payment, including any allowances. There is no direct correlation between income tax rates and contribution rates. As noted previously, rates of contribution liability are not usually progressive. Their levels will depend above all on how the overall social security scheme is funded. At one extreme are pay-as-you-go schemes that fund existing benefit entitlements from existing contributions. At the opposite extreme are schemes which fund a person's benefits only from contributions made by or for that person. Between these extremes are funded schemes where contributions are pooled and schemes that rely on reserves held against future liabilities.

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[126]For example, an employee may be allowed to deduct any genuine employment costs, such as special clothing or travel costs. It is clearly most efficient to check on the extent that such claims should be allowed in the same way for both income tax and contribution liability.

[127]*See infra* sec. V.

Rates are also linked with thresholds or caps to liability. Unlike general taxation, the rate or rates of contribution are based on the revenue needs of the fund to which the contributions are paid. There is normally a direct link between the actuarial estimates of liabilities of the fund and the estimated income to the fund for any given rate of contribution. The rate is dictated by professional advice on the required levels of contribution to fund the outgoings for the period.

Determination of the rate or rates of contribution is therefore not a matter of fiscal policy under a funded benefit scheme. Rather, it should be the result of the exercise of expert judgment of the actuaries, who will base their estimates on relevant demographic data relating both to the contributing membership of the fund and to the benefiting membership. Their decisions will allow those in charge of the funds to identify actual and likely income and expenditure over both the immediate future and the long term. A decision on the precise recovery of costs in any one year is a political decision to be based on actuarial advice.[128]

L. Earnings Periods

Direct taxes are normally determined annually. However, income tax on earnings is often collected by means of a preliminary or withholding tax. There may or may not be an annual adjustment to ensure that the proper amount of tax is paid over the year.[129]

1. The Income Tax Year

There are obvious advantages to using the same basis of collection for income tax and for social contributions.[130] The advantages apply whether the contribution liability is that of the employer, the employee, or both. When the same base periods are used, income tax and contributions are collected together and follow one set of calculations, thereby reducing administrative and compliance costs of collection. If identical rules are used for income tax and for contribution liability, the annual calculation of social security contribution liability will share most of the other advantages and problems of income tax liability. It is easier to ensure an accurate and fair total assessment of contribution liability for the year. For example, the use of identical rules allows for easier adjustments for benefits in kind provided by the employer, with minimal administrative burdens on either the collection authorities or the employer. It is also easier to provide an accurate and transparent record of the total contributions to be paid and the basis for that total.

[128]This has two awkward effects for those collecting contributions. One effect is regular changes in contribution rates. The other effect is that contribution rates are often expressed to one or two decimal points. For example, in Sweden, the 1994 rate for employees was 31.36 percent, and that for the self-employed was 29.75 percent. It also leads to small changes of rate from year to year.

[129]*See* vol. 2, ch. 15.

[130]Many countries, including the United States, Germany, and Sweden, base contributions on annual earnings (often linked to the calendar year).

These advantages may be offset by a need to relate contribution periods to benefit computation periods. If the benefit year and the income tax year are not the same, administrative problems may arise in calculating benefit entitlement of contributions. It may also be necessary to ensure that contribution liability gives rise to benefit entitlement where entitlement depends on contribution conditions.

If, because of annual calculation, contributions are collected only after an assessment has been made, there are significant disadvantages to all concerned. Collection with each payment of earnings has obvious cash-flow advantages for the scheme. It also minimizes the delay between receipt of earnings and the contributions payable on those earnings and reduces problems of avoidance and bad debts. Furthermore, it ensures that an individual has a full contribution record at any time for claiming a benefit entitlement subject to a contribution condition. This suggests that a preliminary or withholding tax has significant advantages for contribution liability.

2. Separate Earning Periods

An alternative approach is to collect contributions on a final basis as earnings are paid.[131] Each earnings period is treated as a separate assessment period, either exactly or by reference to a weekly, monthly, or similar period. If a pure earnings period basis is used, then each payment of earnings is subject to deduction of the appropriate contribution liability. If a flat-rate contribution is used, the weekly or other period for which each contribution is paid can be imposed over the payment pattern used for the employee with little difficulty. When contributions are related to earnings, adjustments are needed. If earnings-related liability to contributions is based on anything other than a straight percentage of the total earnings of the contributor, the liability in respect of any payment of earnings must be calculated by reference to the precise period for which the earnings are paid. Often, payment is by reference to a day, a week, or a month, on a recurring basis, presenting few difficulties. The earnings period basis causes problems when there is no clear pattern of payment and when contribution liability can be avoided through manipulation of the relationships between payments and earnings periods. For example, the existence of lower earnings limits and upper earnings limits creates distortions if uneven payments or earnings periods are used.

The main advantage of an earnings period base for calculation is that payment of contributions for each earnings period is final and not subject to adjustment, eliminating the need for an annual return. A contribution can therefore immediately be counted toward satisfaction of contribution conditions for benefits. The main disadvantage is that it is not possible to make an annual adjustment to reflect uneven patterns of earning or uncertainties. Similarly, if the income tax system contains annual adjustments, these cannot easily be assimilated into a pattern of short earnings periods. One practical result may be the need for antiavoidance provisions to override the finality of contribution payments when it is established that payments are being manipulated for avoidance or

[131]This approach is used in the United Kingdom.

evasion.[132] This may require an annual review period. In effect, it solves the problem of avoidance by removing the earnings period basis. The same is true if annual adjustments are made to reflect, for example, benefits in kind.

One way of dealing with the conflicting advantages and problems of the annual basis of income tax and an earnings period basis for contributions is to apply two or more kinds of contribution to earnings. Cash earnings can be assessed separately with each payment. Other benefits and adjustments can be collected on an annual basis.

A further complication with the earnings period basis of collection is that many employments have inappropriate earnings periods or, alternatively, no regular basis of payment. A daily basis is unlikely to be practicable; for practical reasons a minimum earnings period of a week should be established. Monthly payments are technically not regular, but may be assumed to be such. A pay pattern that is part weekly and part monthly (e.g., a weekly basic wage with a monthly profits-based bonus) causes practical problems. Also, irregular payments or payments made for regular periods at irregular times cause problems. A scheme adopting the earnings period basis for collection must also adopt a clear set of rules to decide in every case the relevant earnings period in respect of any payment made. Further, these rules must be easy to implement with a minimum of official guidance. It is likely that both antiavoidance rules and a default rule will also be needed.

The complications of operating an earnings period basis of contribution liability are, however, likely to be confined to the unusual case. In the usual case of regular weekly or monthly payments of earnings that are subject to contribution liability on a set percentage basis, the imposition of contribution liability on a final earnings period basis has several advantages. The balance between what is usual and what is unusual must clearly be important in deciding on the balance of advantages for the choice of contribution liability period.

The identity of income for both income tax and contributions purposes is also subject to any practical restraints imposed if there are different timing rules for the two payments. Income tax is usually an annual tax. If contribution liability is based on shorter periods,[133] then the system needs methods of determining income that do not involve annual adjustments of the kind found in income taxes. For example, annual personal allowances or credits cannot be operated for shorter periods without some form of amendment or annual adjustment. Similarly, adjustments to take account of benefits in kind must be capable of being made within the contribution period. The timing rules will themselves depend in part on the method, if any, used to link contributions to benefit entitlement. One practical issue is that a benefit entitlement cannot be based on a contribution test that remains indeterminate at the time of benefit claim.

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[132]For example, directors are treated in the United Kingdom as employees. However, because they can often control the way in which their companies pay them (e.g., by loans, rather than earnings, or by erratic pay practices), they are assessed on an annual basis and not by relation to earnings periods.

[133]*See supra* text accompanying note 131.

M. Multiple Employments

The traditional pattern of work in most forms of economy has been that individuals are engaged in full-time work with one employer for extended periods. In economies with strong service elements, and economies experiencing high levels of unemployment in recent years, this tradition has weakened. Individuals are more likely to change employments, and areas of employment, than in the past. There are also many more part-time jobs. Both raise issues that need to be considered in formulating contribution policy.

Often, a change of employment by an employee creates no problems. If there is a period of unemployment, then unemployment benefits may be payable. Contributions may not be payable with respect to the unemployment benefits.[134] Problems may arise if, because of the change of employment, the individual comes to be employed in a different scheme from the one in which he or she was previously employed. This may involve a need either to transfer funds between schemes or to provide for some overlapping or cross financing between schemes. The fewer the schemes run by a state, the lower the number of problems caused by such changes.

An associated change for which procedures may be necessary involves a person who ceases to be employed and becomes self-employed. This is dealt with in the next part of the chapter, as is the case of a person who is both employed and self-employed at the same time.

Another problem is that of an individual employed in two employments at the same time. This may occur at all levels of the employment market, from the person who is a director of several companies to the casual worker providing his or her services—for example, as a cleaner or temporary office worker, to several different employers during a work week. Some individuals who supply services to several employers at once are properly regarded as self-employed, but this is often not so. For example, someone providing cleaning services will usually be under the direct control of the person paying for the services and is properly regarded as an employee. In principle, an employee with several employments should be separately liable for contributions from each. Consequently, each employment during the week requires separate consideration. This is potentially a heavy administrative burden. It is also likely to lead to avoidance of contributions.

When the employments are all by the same employer (or employers that are connected with each other), the simplest answer may be to treat all the employments as if they are one employment. The problem may also be avoided if one employment is, or is nominated as, the "main" employment, with the obligations of contribution being imposed on the employer for that employment. If the scheme has a cap for contributions, this may be met in full by the main employment. Other employments can then be ignored (but only if the scheme is prepared to lose the employer's contribution in respect of those

[134] *See infra* sec. V(C).

employments). The problem may also be avoided if there is a minimum level of earnings from any one employment before contribution liability arises.[135]

Special rules can be used to deal with those who provide their services through an agency. If individuals, although technically not employed by an agency, provide their services to their employer through an agent, then the agent may be deemed to be the employer and may be required to account for contributions on behalf of all those paying the individuals. This may be effective if the agent (as often happens) collects fees from the employer and is responsible for paying the individuals.

However, these are only partial solutions. They require a complex set of rules, but the liability of employees and employers to contribute in respect of multiple employments of an employee at the same time must also be established to avoid revenue loss and inequity.

N. What Records Are Necessary?

Special consideration needs to be given to the records to be kept of contribution payments.[136] Employers are subject to the normal requirement, in parallel with income tax, to keep records of all payments to employees and contributions collected from employees. In addition, central records must be kept of each contributor's contributions. This may require additional record keeping by the employer. It needs a fully coordinated single record-keeping facility for each scheme and protection of the integrity of the data recorded. These requirements should be reflected in the legislation. The data recorded must reflect all contributions paid by or for individuals that are or may be relevant to benefit entitlement. If notional contributions are added to the individual's record, these should be recorded as well.

The central recording requirement means that the social security administration needs to have a unique identifying number for each contributor. This is usually achieved by assigning each contributor a number, the individual's social security number. The number will also be of use to the social security benefit administration. In practice, employees also need identifying numbers for income tax purposes. It is much simpler if the same number is used for both income tax and social security purposes. The number may be assigned by either the social security administration or the tax administration.[137] A

[135]However, a consequence may be that the individual is left with a reasonable level of total earnings, but with no obligation to contribute and possibly no entitlement to benefit.

[136]ISSA has produced a series of useful booklets on these topics. *See Collection of Contributions* (1994), *Enforcement and Compliance* (1994), *Maintenance of Records* (1994), and *Registration Procedures* (1994). ISSA also provides training courses and support materials on these issues.

[137]For example, it is assigned by the social security administration in the United Kingdom and the United States. Because of the social security and health needs of children, it is likely that the social security authorities will need a number for an individual before any requirement arises for income tax purposes. Further, it is unlikely that an individual will get by without needing a social security number at some stage in her or his life. Many individuals may never become income tax payers. The use of a single identification number may raise privacy concerns in some countries, as it has done in Hungary according to

further alternative is to assign a national identification number to the individual, perhaps when the birth of that individual is registered or when the individual reaches school-leaving age.[138]

Each individual needs to be assigned her or his number personally. All employees should be required to supply their social security numbers to their employers. The records kept by employers can then be related to the central records with the minimum of problems. The numbers can also be used as a useful cross-check between income tax records and social security records.

The need to protect the integrity and accuracy of the contribution record of individuals over their lifetimes imposes a significant administrative burden on those administering a contribution-based social security system. The level of accuracy required depends on the precise relationship between contributions and benefits. Any close relationship imposes an original and continuing need for accuracy. It means that the data on the record should not be open to alteration or adjustment for any reason save by due process of law.

III. Issues for the Self-Employed

A. What Is Self-Employment?

The self-employed form a significant[139] sector of every national workforce unless the national economic system imposes a state monopoly on conducting business. The sector includes both those who are genuinely in business on their own and those who conduct their economic activities in partnership or joint venture with others. Only if the form of business structure used itself has legal personality will the position of the proprietor of a business be converted into that of an employee or officeholder (director) rather than that of an independent worker. The position of the self-employed is particularly important in the service industry. Some professions, for example, lawyers, may prevent their members from becoming employees. In other areas, for example, small farms or restaurants, companies are not the usual form of conducting business. The technical distinction between employment and self-employment in marginal cases has been discussed previously.[140]

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a recent ruling of the supreme court. In such cases, special protections for privacy may have to be provided in the legislation to meet these concerns.

[138]Many of the issues are the same as those for income tax, VAT, and other official numbers, also discussed elsewhere in this book. *See supra* ch. 6, sec. II(D).

[139]It is a growing sector in many economies and is large in many developing economies, particularly if account is taken of those engaged in farming and fishing. For example, Korea, in 1995, decided to bring farmers and fishermen within its compulsory schemes for the first time, increasing the number of scheme members by 2 million. *The Republic of Korea: Proposal to Extend Compulsory Coverage,* Trends in Social Security (ISSA), Apr. 1995, No. 7, at 9.

[140]*See supra* sec. II(B).

In addition to those who are fully self-employed, there are also those who provide consultancy or other services aside from and in addition to their ordinary employment. This applies equally to anyone who, for example, makes money by writing or engaging in artistic or creative activities or who engages in farming activities in addition to paid employment elsewhere.

The social security risks involved in insuring a self-employed contributor may be different from those for an employee. For example, a self-employed individual cannot become unemployed in the normal way, because he or she cannot be dismissed from or resign a job. Closing a business down is legally a different action and may lead to the realization of a capital gain or loss. However, a self-employed individual whose business fails may be unemployed. There is no set retirement age for a self-employed person. The self-employed frequently carry on working into older age. Further, they may have capital invested, or earned by way of goodwill, in the business that can be realized to provide a personal retirement fund. These considerations have led states to provide more limited schemes for the self-employed or to remove them from the scope of compulsory schemes altogether.[141] However, the tendency is to broaden schemes to include them.[142]

Both the income tax liability and the social security contribution position of an individual who is self-employed are fundamentally different from that of an employee. There is no employment relationship and therefore no employer who can be asked to pay or collect income tax or contributions; nor, in most cases, can an employer be deemed to exist.

As a technical matter, some individuals who are employees may be treated as self-employed for contributions purposes. In schemes that impose some or all of the contribution liability on the employer, some employers may be exempt from tax generally, so that a contribution liability either cannot, or cannot conveniently, be imposed on them. Their employees can therefore be treated as self-employed so that they become responsible for contributions.[143]

B. What Is the Income of the Self-Employed?

The earnings of a self-employed individual are defined by reference to the actual or assumed net profits of the business. Income tax is payable on these, as defined by the relevant tax laws. At a policy level, there is little reason to define the profits of a self-employed individual differently for contributions purposes from the definition used for income tax purposes, save for the effects of the tax and social security systems

[141] For example, the Netherlands requires the self-employed to be members of some schemes but not others (health and disability insurance are excluded as is unemployment insurance). Spenke, *supra* note 35, at 87-89. The self-employed who were previously wage earners in Denmark may, on a voluntary basis, continue their membership of the state supplementary pension scheme. ATP, *Annual Report, supra* note 107, at 4.

[142] As, for example, in Korea. *See supra* note 139.

[143] *See, e.g.,* USA IRC §§ 1402(c)(2)(c), 3121(b)(15) (regarding employees of international organizations).

themselves.[144] A consistent definition is particularly appropriate if the income tax law itself relies on the definition of profits used for commercial accountancy purposes.[145] The idea of separate definitions of "income" for social security purposes and for income tax purposes seems unnecessarily complex for the individual, but also devoid of justification by reference to the principles on which profit is normally defined. However, the underlying income of the activity may need adjustment between tax and social security liabilities to deal with specific allowances and provisions.

It follows that the definition of both income included and business deductions allowed under income tax law is entirely relevant for social security purposes, save for three aspects. The most important of these is that the focus on earned income as against investment income of the self-employed in income tax laws varies.[146] If social security benefits are designed to be earned income replacements, then the nonearned income of an individual is irrelevant. The profits of an active partner in a business are relevant, but the profits of a sleeping or inactive partner are not. Similarly, the profits of an individual actively renting or leasing accommodations to others (e.g., short-term holiday accommodation) may be regarded as earned. The profits derived from investment property (e.g., an office building leased on the terms that the tenants carry out all repairs and pay all service charges) may be different. These differences may also be relevant for income tax purposes (e.g., they may affect eligibility for capital gain treatment on disposition of the property used, or in a schedular system may affect the schedule under which income is taxed). A clear definition of the scope of income to be included in, and excluded from, the contribution liability of an individual is needed to remove all cases of doubt.

The other distinctions are the treatment, in defining profits, of the payments of contributions, income tax, and any related insurance or pension contributions or premiums, and special allowances for tax purposes that are inappropriate for social security purposes.[147]

C. How Is Contribution Liability of the Self-Employed Based?

For the reasons just outlined, the social security contribution position of a self-employed individual is often different from that of an employee. Insofar as it depends on the income tax laws, the calculation of earnings must reflect the different income tax rules. The effect in most cases is to delay any contribution liability until the net profits of the individual for each accounting or tax year can be established. The only ways to claim

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[144]For example, when a self-employed individual claims allowances for tax purposes that do not form part of the commercially determined profit of the business, such as a tax holiday.

[145]For example, in Germany. *See* vol. 2, ch. 16, appendix.

[146]*See* USA IRC § 1402(a), (b) (defining self-employment income). Compare the approach of IRC § 911(d)(2) (definition of earned income), which limits earned income to 30 percent of net profit in the case of a business in which capital is a material income-producing factor.

[147]For example, tax holidays.

a contribution in advance of this are to demand a flat-rate contribution or to attribute a notional income to the individual.[148]

Because the entire contribution of a self-employed individual must be paid by that individual, it may seem to be a higher rate than that of employees. It may prove inappropriate to impose full contributions on the self-employed for reasons noted previously. For example, the self-employed may be required to contribute only to basic minimum pensions and not to a full earnings-related scheme. If the self-employed receive the same benefits as employees, any reduction in the contribution of the self-employed may amount to a cross-subsidy by employees and their employers. If the net cost of contributions of the self-employed is reduced by allowing income tax relief, the effect is partly to shift the cost to general taxpayers.

D. What Records Are Necessary?

The same general points about record keeping and registration apply to the self-employed as to employees. The duties to register and to pay the contributions must be placed on the self-employed themselves. The collection of contributions cannot generally be imposed on those making payments to the self-employed.[149] Excessive deduction might take place, and the contributions might not find their way to the contribution collection authorities. In addition, it is not incumbent on a customer of a self-employed individual to inquire whether contributions are required from that individual. They will not be required from a company or other legal person in a similar position.

A policy consideration in demanding records from the self-employed for social security purposes is whether this approach is consistent with that followed for income tax purposes. For example, if the tax authorities have decided to dispense with bookkeeping for categories of the self-employed,[150] it is inappropriate to demand detailed records for social security purposes. Similarly, simplification of tax administration by adopting a high threshold for income tax purposes may be defeated if those below the threshold still have to meet onerous social security requirements.[151]

IV. International Aspects

A. What Limits Do Schemes Impose?

[148]*See, e.g.*, USA IRC § 6513 (regarding the timing of advance payments).

[149]Some payments to the self-employed may be subject to withholding for income tax purposes. It may be possible to coordinate this with social security by allowing taxpayers to credit amounts withheld against their contribution obligation.

[150]For instance, by using presumptive income or by accepting estimates or very simple records.

[151]This is a reason why, as noted previously, the self-employed are only brought within voluntary social security schemes in some states.

All countries find it necessary to impose limits on the jurisdiction of a compulsory social security scheme. A scheme requires two sets of limits: (i) those applying to individuals claiming benefit, and (ii) those applying to persons liable to contribute. The limits may not be the same, but both normally require some continued economic activity, or at least some continued presence, in the territory of the state. The comparable direct tax rules are the residence of the employee or self-employed person and the residence of (or permanent establishment by) the employer within the state.[152] Labor relations principles do not follow this basis. For labor relations law purposes, the usual rule is that a state claims competence over employment if the place of employment is in the territory of the state. An employee who resides in one state and works (or whose work is based) in another state is treated on these principles as working in the state where the work is based. Income tax is generally charged where the worker lives, but may also be charged where the employment is carried out. Particularly in areas bordering two states or in states with many migrant workers, the tax and labor relations rules may frequently have different and conflicting effects on an employee.

Claims to jurisdiction for social security schemes are usually based on labor relations principles because these schemes have been designed primarily by analogy with employment-based insurance. A scheme therefore aims to cover those who work at a relevant activity within the jurisdiction of the state. Although benefit questions and contribution questions can be decided separately, the rules determining contribution liability are normally coextensive with benefit entitlement. This is because at any one time entitlement to benefit and liability to contribute are normally regarded as coextensive. This follows from the fundamental idea that a benefit is funded by contributions rather than from general tax revenues. Unless a contributor stands to benefit from a scheme, why should there be a contribution? If there is no linkage, is not the contribution a disguised form of general taxation?[153]justified on another basis, for example, to ensure that, on the ground of solidarity, the few children not covered by the general scheme are not deprived of support. Other general issues also arise when there are significant numbers of migrant workers who regularly work outside their "own" state, but whose families remain at home, or who are likely to return at several points during their working lives and on retirement.

If the state's social security provision is divided into several different schemes, it may be thought that the jurisdictional rules of schemes should differ. For example, a scheme providing benefits to families in respect of children could define entitlement to benefits by reference to whether a child is present or resident in the jurisdiction. The administrative complexity of having different jurisdictional limits to different funds should not be underestimated. If, as suggested above, there is one composite contribution payable by any contributor, there is a strong argument for having a common set of jurisdictional rules for liability to contribute. Further, if the scheme has common rules for

[152]*See* vol. 2, ch. 18.

[153]The situation is less clear when the scope of benefit entitlement is wider than contribution liability. If all contributors are entitled to benefit, and in addition other persons are also entitled to benefit, then the link exists alongside a form of cross-subsidy. The cross-subsidy may be

the liability to pay contributions and has links between contributions and benefits, then there should also be common rules for benefits. A decision to widen the scope of benefit—for example, for family benefits—requires a change or removal of the linkage rules. Alternatively, it needs rules providing for arrangements, such as deemed contributions or contribution credits.

States in which contributions and benefits are linked may wish to ensure that a beneficiary can claim benefits only if the beneficiary is within the jurisdiction of the scheme, both as potential beneficiary and as former contributor. Unless the contributor has been within the scope of the scheme and has therefore actually contributed when potentially a contributor, there is no entitlement to benefit. This focuses attention on the continuing importance of the jurisdictional limits of a scheme. For example, if a contributory pension is payable only if an individual has contributed for 25 years, then the individual must, by definition, be within the jurisdictional test for that period to qualify.

The main policy and administrative constraints, therefore, argue for a common set of jurisdictional rules for both benefits and contributions and for all funds. The forms that these rules can take are discussed below, as are the problems of overlapping claims to jurisdiction by schemes in two or more countries.

B. What Jurisdictional Rules Are Used?

There is no required international set of provisions deciding the jurisdictional limits of social security schemes. Principles and practice have been developed through the activities of the ILO and the ISSA, but these amount to best practice only. The adoption of an international approach to coordination of schemes has occurred only in the European Economic Area (EEA), as addressed in detail below. The steps taken in the EEA are important because they follow the forms of best practice accepted more generally. Aside possibly from nondiscrimination provisions, double taxation conventions do not apply to social security contributions.[154]

1. Nationally Determined Limits

Each scheme establishes its own jurisdictional coverage. For reasons set out previously, the rules for jurisdictional coverage may reflect the jurisdictional rules adopted by the state to define when an individual is employed within the jurisdiction of the state and when the employee's employer is within the state. For employees, the individual must be within the jurisdictional reach of the state for any rules applied by the state to operate realistically. This is because, without international agreements, the

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[154]*See* OECD Model Tax Convention, *reprinted in* Baker, *supra* note 38, at Commentary on Article 2 (Taxes Covered), ¶ 3 (providing "[s]ocial security charges, or any other charges paid where there is a direct connection between the levy and the individual benefits to be received, shall not be regarded as [within the scope of the convention].") Although the "direct connection" is less apparent in some schemes than was the case when this wording was first adopted in 1963, the general proposition has not been questioned. However, article 24 of the OECD model, unlike the rest of the text, is not subject to article 2 and applies to all taxes. Otherwise, the provisions of the model and conventions that follow the model apply only to income taxes. The author is not aware of any practical application of, or specific argument for, any part of article 24 applying to social security taxes and contributions.

contribution authorities are unlikely to have either information or powers to enforce contribution liability beyond the territory covered by the national laws. Absent specific agreements, there are no information powers equivalent to those on which tax authorities rely.[155]

The practice of states is to set jurisdictional limits within these practical limits and without direct reference to any overlap with any other social security system. The key test is whether an employee is employed within the jurisdiction. For this to be shown to be the case, the employee's economic activities must occur, or primarily occur, within the territory covered by the scheme. The employer does not have to be within the jurisdiction of the state for this to occur. The issue of where an employment occurs is primarily a question of fact, but will also take the requirements of the contract of employment into account. Employment within the jurisdiction will require the presence of the employee in the jurisdiction and probably her or his residence. However, for the reasons noted previously, the employee may be regarded as resident for this purpose even though the employee is regarded as resident elsewhere for income tax purposes.[156]

2. Specific Problems

Most employments cause no jurisdictional problems, because there is no doubt about where the employment occurs. Doubts are likely to occur only in a few particular cases. One group is frontier workers, those who work in one country and live in another, crossing between the two frequently and perhaps daily. Another is migrant workers, those whose long-term homes are in one country but who are absent from those homes for limited periods for work reasons only. Others are transport workers (those whose jobs involve traveling on international transport) and government employees (e.g., diplomats and members of the armed forces on foreign tours of duty). Best practice has been to evolve special rules for each of these groups of employees as exceptions to the general jurisdictional rules. Separate provision is made for them in bilateral agreements. States may wish to restrict their claims to jurisdiction in this way by agreement. It is suggested that they should also provide for an underlying claim to jurisdiction over these groups of employees in case of doubt or in absence of an agreement.

3. Migrant Workers

It may be appropriate to follow a general practice regarding migrant workers, that is, those who come into the country to work or who leave it to work. Most countries have workers in both categories. Rules can be applied in the same way to both immigrants and emigrants. The simplest rule is to ignore immigration and emigration unless the change of country lasts more than a set time, for example, one or two calendar years. A time limit

[155]The information exchange powers traditionally included in double taxation conventions do not apply to social security contributions. *See supra* note 154.

[156]Residence for income tax purposes will, in the case of disputed resident status, be determined under the rules of the relevant double taxation convention. This makes the home of the individual the residence rather than the place of work.

rule will exclude immigrants from liability to and entitlement from the state's schemes until they have been present in the state for the defined time. A year is likely to be the shortest practical time for a limit of this kind. One year may prove to be too short for many employees, and a period of two years, or even longer, is being adopted by agreement between countries or in individual cases. Because the rule is exclusionary, it may be appropriate to allow the period to be extended when an employee is in the country temporarily, but for more than one year.

The time limit rule also applies to those leaving the country. Here, an employee remains within a scheme for, say, one year after leaving the country to work elsewhere. If the employee returns within the year, then the absence is ignored. The employee's liability to contribute and entitlement to benefit remain in place throughout the period, subject to any additional requirements, such as presence imposed on any claim to benefit.

4. Rules for Employers

Inclusion of an employer within the jurisdiction of a scheme is separate from inclusion of an employee of the employer. The presence of the employer needs to continue for the scheme to be applied. In practice, this may require a degree of presence similar to that of a permanent establishment for other tax purposes.[157] This requires a continuing presence of an economically active part of the business of the employer, normally a branch or an agency. The concept of permanent establishment may not be enough in itself. For example, the activities of the employee in question may amount to a permanent establishment of the employer, but with no other active presence in the state. To regard the employee's presence as establishing jurisdiction over the employer for social security purposes may be ineffective.

Special rules may be needed when employees are within the scope of a scheme but their employer is not. It may be necessary to provide that the employees are responsible for meeting the employer's obligations to pay the employees' contributions. It may be difficult to go further and impose the employer's contributions on that employee. Instead, if the employee is associated with any other employer in the state, that employer might be deemed to be the employee's employer for contribution purposes. This is an appropriate approach when the actual employer and the deemed employer are associated. It is particularly so when it is believed that the precise employment arrangements are designed to avoid contribution liability.

5. Rules for the Self-Employed

Separate jurisdictional rules are needed for the self-employed. As with employers, the analogy with the income tax rules is more valuable than for employees. The rules

[157]Permanent establishment is defined in article 5 of the OECD and UN Model Tax Conventions in similar but not identical terms. OECD Model Tax Convention on Income and on Capital of 1992, art. 5, *reprinted in* Baker, *supra* note 38; UN Dep't of Int'l Economics & Social Affairs, UN Model Double Taxation Convention Between Developed and Developing Countries, art. 5, UN Doc. ST/ESA/102, UN Sales No. E.80.XVI.3 (1980). The same pattern of definition occurs in most individual tax conventions. A similar concept may also apply for other taxes. *See supra* ch. 6, sec. II(A).

require that the individual conducting a profession have a fixed base. A permanent establishment is required for an individual trading directly. For income tax purposes, the rules decide how much, if any, of the profits of the individual are earned within the jurisdiction. For contribution liability, the key question is whether the individual is carrying out economic activities in his or her own name within the territory of the scheme to the extent that he or she should be within the scheme. The nationality of the individual will normally not be relevant to that decision, nor will the level of economic activities or their success (as measured by profitability). At the practical level, if the individual is not making any profits within the territory of the scheme, then no income-related contributions are due in any event.

Finally, a scheme may allow those who fall outside the obligatory contribution provisions to continue to contribute voluntarily. This may apply even if the individual is compelled to contribute to another scheme. The voluntary extension of a scheme in this way raises no issues of jurisdictional law.

C. Rules in the European Economic Area

The countries within the European Economic Area (the members of the European Union and some neighboring countries) have common rules to deal with international aspects of the jurisdictions of social security schemes. Although the common rules do not apply as such outside the EEA, the rules follow the recommended approach of the ILO. They provide a comprehensive approach to the problems of contribution liability of both employees and the self-employed when two or more countries are involved in determining liability. They must also influence the approach of candidate members of the EU or EEA. In each case, they will also affect the policy choices of those countries in reaching bilateral agreement with other countries outside the EEA.

The main principles and rules for all EU member countries are laid down in Council Regulation 1408/71, as amended frequently since adoption.[158] Because the rules are contained in a regulation, its text applies directly in all members. It is also subject to official interpretation by the European Court of Justice. The Oporto Agreement establishing the European Economic Area applied these rules (including court decisions at the date of adoption) also to the other members of the EEA. Consequently, the regulation (and its supporting administrative regulation, 542/72)[159] applies throughout the 15 members of the EU (and some of their dependent territories), along with Norway and Iceland. The regulation covers all key issues relating to both contribution liability and benefit entitlement. The extensive rules about benefits are not discussed here, but provide

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[158]Regulation 1408/71 of June 14, 1971, on the Application of Social Security Schemes to Employed Persons and Their Families Moving within the Community, 1971(II) O.J. Special Edition (Dec. 1972), as amended. For the text and analysis, *see* David W. Williams, The National Insurance Contributions Handbook, FT Law and Tax at ch. A5, part D.1 (looseleaf). For an account of the rules in the context of relevant EC law, *see* Stephen Weatherill & Paul Beaumont, EC Law at ch. 18 (1993).

[159]Council Regulation 574/72 of March 21, 1972, Fixing the Procedure for Implementing Regulation 1408/71 on the Application of Social Security Schemes to Employed Persons and their Families Moving within the Community, 1972(i) O.J. Special Edition (Dec. 1972), as amended.

the context of the rules relating to contribution liability. They allow states to ask each other for a transfer of contributions in appropriate cases.

The general rule, applicable to both employees and the self-employed, is that an individual is liable to contribute to the social security scheme of only one state at any one time. That state is the state in which he or she is employed, even if his or her residence is elsewhere and the employer is based elsewhere.[160] This is consistent, as noted previously, with the general principles of labor relations law. For this purpose, the individual is employed where he or she normally carries out the duties of the employment. If those duties are normally carried out in two or more countries, a tiebreaker rule applies. This allocates the individual to the country in which he or she is habitually resident, if some duties of the employment are carried out there.[161] The habitual residence test also applies to multiple employments. The liability of the employer follows that of the employee. The employer must comply with the employer's obligations under the laws of that country in which the employee is found to be employed.

The regulation provides seven specific exceptions to the general rule, as follows:

(a) Employees leaving one state for another for a temporary assignment remain within their home state's schemes if the absence is a year or less. States have power to extend this period and are encouraged to do so for longer temporary assignments.

(b) If the undertaking of the employer itself crosses a frontier, the employment occurs in the state in which the employer is registered.

(c) Public servants and members of the armed forces of a state remain subject to the jurisdiction of that state.

(d) Diplomats and consular staff are entitled to the usual immunities from local jurisdiction and remain potentially subject to their home state jurisdictions. EU staff may elect to be covered either by the state where they work or by the state of nationality.

(e) International transport workers are treated as being within the jurisdiction of the state where they are based. However, if they are principally employed where they reside, then they fall within the jurisdiction of that state even if they are based elsewhere.

(f) Members of the merchant marine based on a ship registered in a member state are subject to the social security system of that state, unless an individual resides in a state and the employer is also registered in that state. In that case, the individual's state of residence has jurisdiction.[162]

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[160]Regulation 1408/71, *supra* note 158, art. 13.

[161]*Id.* art. 14. The concept of habitual residence is one of EU law and is therefore subject to determination by the European Court of Justice. *See, e.g.,* Case 76/76, Di Paolo v. Office national de l'emploi, 1977 E.C.R. 315.

[162]Regulation 1408/71, *supra* note 158, arts. 13-17.

Regulation 1408/71 also contains rules dealing with refugees and stateless persons. More generally, the regulation works within the framework of the fundamental and general principles of EU law. The two most important general rules are that states and public authorities may not discriminate within the EU either on grounds of nationality of any member state or on grounds of gender. These rules therefore apply alike to females and males and to all nationals of all member states of the EEA.

D. What Other Treaty Rules Exist?

Save for the EEA provisions, there is no general international agreement dealing with social security contribution liability. Some agreements make specific provision for particular cases. Specific agreements have been adopted to deal with international transport workers, with diplomats, consuls, and employees of international organizations, and with refugees and stateless persons. Apart from these provisions, agreement is usually by bilateral convention.[163]

The outline of the EU provisions also serves as an outline of the contribution provisions in the usual form of bilateral agreement. Within the scope of a bilateral agreement, the key principle is that the law of only one of the two states applies on a compulsory basis. The rules for deciding which of the two states has jurisdiction are usually similar to those outlined for the EEA and are based on the same approach. In practice, the time limit rule may have a period longer than one year; two years is increasingly common, and the United States is seeking a five-year period. The pattern of bilateral agreements is far from complete and falls far short of the otherwise similar patterns of double tax conventions or of trade and investment agreements. Within the European Union, bilateral agreements have been superseded by the Council Regulation in situations where the two texts overlap.

V. Interaction of Income Tax and Social Security Schemes

A. General Principles

A funded social security system is designed to collect funds for disbursal within a closed group of people, usually those who contribute and their dependents. Income tax is

[163]Networks of bilateral agreements are growing slowly, but are far smaller than the equivalent networks of double tax conventions. For example, the United Kingdom, which has the largest network of double tax conventions (over 100) has one of the most extensive networks of social security conventions, covering reciprocal arrangements with the other 16 members of the EEA, and bilateral agreements relevant to contributions with the following other states: Barbados, Bermuda, Cyprus, Gibraltar, Israel, Jamaica, Malta, Mauritius, Philippines, Switzerland, Turkey, the United States, and Yugoslavia (plus British territories such as Northern Ireland and the Channel Isles where internal jurisdictional limits require agreements). It has a number of other social security agreements (e.g., with Australia), which have no provisions dealing with contributions. Poland and other countries with economies in transition are now negotiating these conventions. Poland has concluded several new conventions, including those with Belgium, France, and Germany.

an open system, taking funds from all those within the scope of the law and releasing them to be spent as general public expenditure. Any transfer between the funds collected by income tax and the funds collected in the social security system is therefore a transfer between two disparate groups. As a matter of general principle, it is assumed that these transfers should not happen except as a result of explicit policy decisions.

Interactions between income tax and social security are unavoidable. They can also be expensive in terms of funds forgone or transferred because of the large numbers involved in both schemes at any time. In practice, the rules of income tax systems and social security systems often interact in unintended ways. These interactions may result in transfers either from the open system to the closed system or the reverse. This section is designed to draw attention to these interactions so that policymakers and drafters have them in mind in considering the effects of their laws.

Interactions occur between income tax and contributions as competing methods of collecting funds. They also occur between income tax and benefit entitlement. The income tax treatment of private social security arrangements (e.g., occupational schemes and retirement benefit plans) must also be noted.

B. Interactions Between Contributions and Income Tax

The income tax and contributions systems are independent, even if both are collected by the same means. Without explicit provisions in either law, it may appear that the two systems therefore do not interact. In practice, they do.

1. Rules for Deductibility

The simplest case is that of income tax and contributions being collected under the same rules for defining liable income and for the same periods. This assumes that there are no differences in liability or timing between contribution liability and income tax liability. Each applies at a given percentage rate on the earnings. Will each be collected on the total amount of earnings or on the net amount after deduction of the other? This depends on the deduction rules for the two taxes.

There is no strong reason to grant to employees a deduction for either of the payments against the other if they are both at reasonable overall levels. The total system is simpler and easier to administer if no deductions are allowed. It is also more transparent and has lower marginal rates. If a deduction for contributions is allowed against income tax, then the total income tax collected from most individuals is reduced. Making good that loss can only be achieved by raising either the rate of income tax or some other tax. It is better to ensure that neither system allows a deduction for the employee's payment to the other.[164]

[164]Practice varies. In 1990, social security contributions could be fully deducted as expenses against income tax for employees in the following OECD members: Austria (subject to a ceiling), Belgium, Denmark, France, Germany (subject to a ceiling), Greece, Italy, Japan, Luxembourg, Spain, Switzerland, and Turkey. Partial deduction was allowed in Canada, Ireland, and Portugal. Deduction was not allowed

For example, the rate of income tax in state *D* is 25 percent at the level of average earnings, and the employee's contribution is also 25 percent. If no deductions are allowed, the employee pays $50 on marginal earnings of $100. If state *D* allowed a deduction for social security contributions to be made against income tax, then, on earnings of $100, $25 is paid as contributions. The amount of earnings for income tax liability is $75. If state *D* wishes to collect $25 from the employee, the rate of income tax must be increased to 33 percent. The amount collected is the same, but the total marginal rate appears to be not 50 percent but 58 percent. If state *D* does not raise the rate to 33 percent, there may be hidden transfers between those paying contributions and other taxpayers. This is because, in effect, the income tax relief for the contributors has to be paid for elsewhere in the system. Some of it is therefore likely to be paid by non-contributors, who are essentially being asked indirectly to subsidize the contributions. What if state *D* adopted the converse rule? Instead of allowing a deduction for income tax, it allows it for contribution purposes. Here again the lost revenue would have to be made good. This would force up contribution rates because there is no other way of meeting the income loss. Further, unless care is taken in the way in which the income tax is relieved, the result could be unfair between different contributors. Those paying more income tax could pay lower contributions. Why should that be so?

2. Measurement and Timing Issues

The assumptions made in the above example are that the measurement and timing of the income tax and contribution liabilities on earnings are identical. That is frequently not the case. There may be timing differences in the collection procedures, and there may be differences in definition in the two laws. Each difference may cause a distortion between the two systems. For example, a particular benefit in kind is taxed to income tax but not to contributions.[165] The overall burden of tax on that benefit is therefore less than on other forms of income. It is therefore likely that employers will use that benefit when they can to pay employees. This will not affect the amount of income tax collected, but will reduce total contributions. The effect is to cause a shortfall in contributions. This may require a rate rise that will, of course, not fall on those receiving the nonliable benefit in kind. What has happened is a shift of liabilities from some contributors to others caused by the mismatch of income tax and contribution rules. This problem is compounded if allowances are made in the income tax system for contribution payments (or the converse).

These complexities can be avoided for contributions by employees. They are harder to avoid for employer's contributions because the employer's contribution is usually regarded as a cost of labor. To prevent the employer from deducting the

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in Finland, Iceland, the Netherlands, Norway, the United Kingdom, and the United States. *See* Messere, *supra* note 1, tbl. 10.7 at 272-73.

[165] For example, a deduction may be denied to the employer for the cost of certain fringe benefits provided to employees. Although not ideal, this may be more or less acceptable for income tax purposes (*see* vol. 2, ch. 14) but, as the text indicates, will create a problem for the contributions base. This illustrates the importance of thinking about the income tax and contributions together.

contribution is to increase the post-tax cost to the employer of that contribution compared with the employee's pay, which is difficult to justify in income tax terms. The result may be different if considered in terms of social security funding. For example, state *D* requires employers to pay an employer's contribution of 30 percent of earnings. This is deductible as an expense for business income tax purposes. One effect is that the employer recovers part of the cost of the contribution from general taxation. It may be argued that it is better, therefore, to deny employers a deduction for contributions, although this is not common practice.

3. Treatment of Employer's Contributions

Should the employer's contribution be treated as part of the earnings of the employee? The usual approach adopted by states is that it is not. If the employer's contribution is regarded as part of the earnings of the employee, the social security fund is not affected. However, an income tax problem arises. Income tax becomes due on the employer's contribution as well as on that of the employee. There may be no net gain to the system from this tax if, as a result, the rates of tax are lowered. There is an implicit tax privilege that benefits contributors as compared with other taxpayers.

4. Treatment of the Self-Employed

If the self-employed are to be treated as receiving profits for income tax purposes, there is an argument that contributions should be deducted against profits for income tax purposes. Against that, comparison with the position of the employee might argue for nondeduction. These arguments will apply to the alternative treatments for the self-employed contribution. The most appropriate treatment may depend on whether the self-employed are paying a flat-rate contribution or an earnings-related one. It also depends, as noted above, on the total intended cost to the self-employed of their contributions.

C. Should Benefits Be Subject to Tax and Contributions?

The interaction between social security benefits and the income tax and contribution treatment of those benefits involves several complex issues.

1. Making Benefits Subject to Contributions

The first issue is whether benefits are subject to contribution liability. When benefits and contributions are related to the same fund, the simplest approach is to treat benefits as not subject to contributions. The fairness of this policy depends on how the rate of benefits compares with the income being replaced by the benefit. If, for example, the benefit fully replaces the income, the beneficiary will gain by having saved the contribution. The easiest approach to avoid overcompensation is to reduce the level of benefits by the amount saved. If the benefit only partially replaces the income, then exempting the benefit from contribution increases the net value of the benefit.

If the benefits and contributions do not relate to the same fund, broader policy issues arise. A failure to collect contributions amounts to preferential treatment of a benefit funded by other means. If the benefit is a safety net benefit, then contribution may not arise because the level of benefit is below the lower earnings level for contribution liability. That raises another policy question. How should the threshold for contribution liability relate to the level of social assistance benefits? Should the relationship be taken for each earnings period or be calculated to include a full year at a time? If the lower earnings level is below that of benefits received, then the state must decide if these benefits are to be subject to contribution liability in the same way as earnings. It may be argued that income-replacement benefits should be treated in this way. One reason for this is that exempting benefits from contribution liability may mean that the beneficiary accumulates no contribution record while receiving a benefit. Because of this, the beneficiary might appear to gain in the short term, but will lose in the long term.

2. Notional Contributions

A solution to the problem of imposing contributions on benefits is to use notional contributions. Benefits can be treated as subject to contributions, but the beneficiary is not expected to pay the contributions. Instead, he or she is granted a credit of a notional contribution. In this way, the beneficiary continues to accumulate a contribution record but does not have to pay for it directly. This raises another policy question. Who pays for the benefit receivable because of the credit? If the cost is met from within the general social security fund, then it amounts to a cross-subsidy, which is entirely appropriate if the benefits are paid from the fund. It may not be appropriate if the benefits are paid from other funds. Generally, it is desirable to subject benefits to either actual or notional contributions, both as a matter of administrative simplicity and to protect the long-term position of individual beneficiaries.

3. Imposing Income Tax on Benefits

With respect to the income tax treatment of benefits, there are two issues of principle. The first is whether benefit income should be liable to income tax. The second is the legal nature of the benefit income if it is to be subject to income tax. It is not earnings, although it will normally be of an income nature. It may or may not be paid to replace earnings.

A broad-based income tax should, as a general rule, be imposed on benefits.[166] This is the simplest and least distortive approach and is consistent with the view that problems of social security and social assistance should be left to the social security system. It also prevents overcompensation of beneficiaries. If the income tax system has personal allowances or credits, the effect may be to remove those receiving minimum benefits

[166]National practice varies (as does treatment within a state of different benefits). In the OECD, most countries tax public pensions, while treatment is inconsistent with unemployment pay. Most countries do not tax invalidity payment, and almost all refrain from taxing family benefits. Some countries tax them in part. *E.g.,* USA IRC § 86. Canada and the Netherlands have few exemptions from tax, while Turkey has a considerable number. *See* Messere, *supra* note 1, tbl. 10.1, at 264-65.

from the charge to income tax. This depends, of course, on the level at which allowances or credits are set. If a personal allowance is set at a level above that of the safety net benefit entitlement of an individual, then no tax is payable unless the beneficiary has other sources of income. For instance, if a person is sick or unemployed for part of the year, but at work and earning during the rest of the year, then income tax is calculated on the total income of the individual for the year. The cumulative value of the benefits is therefore taxable. Imposing tax on benefits in this way prevents overcompensation. That will occur, for example, if a taxpayer receives sick pay free of tax in a year when income tax is payable on total earnings. In some cases, however, it may be appropriate to exclude benefits from income tax for administrative reasons, particularly when the value of benefits is low.

Assuming that benefits are to be taxed as income, how should they be taxed? Strictly, benefit income does not fall within the usual main forms of income. It may be most appropriate to treat it in the same way as earnings, although the beneficiary is unlikely to have any deductible expenditure in "earning" the income. This is because most forms of benefit are designed to replace income, particularly retirement and survivors' benefits, unemployment pay, and sickness benefits. Family benefits and benefits to the severely disabled are different but are most easily taxed in this way. For the sake of clarity, the income tax legislation should specifically authorize the taxation of taxable benefits.

These arguments suggest that benefits should be taxable and also subject to actual or notional contribution liability, although this policy may conflict with the policy toward private social security provision. Countries often give preferential treatment to private pension and insurance schemes. For example, there are three ways in which some countries may treat private retirement funds preferentially. First, the contributions of the employee (or self-employed individual) to the fund are deductible from earnings before the imposition of income tax. This can be argued to be a tax deferral, because the pension, when paid, is treated as taxable (and usually as deferred earnings).[167] Second, the employer's contribution is not treated as part of the employee's income.[168] Third, the income of the pension fund is itself exempt from tax.[169] A treatment of public social security funds inconsistent with this treatment of private funds creates a distortion between the state system and the private systems. The desirability of such a distortion is a policy issue. The hidden state support for retirement schemes in this income tax treatment, measured as tax foregone, is very expensive. The level of support is compounded if exemption is extended also to public social security schemes. The

[167]This is common, but not universal practice. *Id.* at 168. Instead, in some states the pensions are not taxed (e.g., Turkey). A problem arises when the contributions are made to a pension scheme based in one state by a contributor liable to income tax in another state. In such cases, the tax authorities often refuse to recognize the contribution as deductible. The European Court of Justice, in Case C-80/94, Wielockz v. Inspecteur der Directe Belastingen, 1995 Simons Tax Cases 876, ruled that in some cases this could amount to unlawful discrimination under EU law.

[168]This is national practice throughout the OECD. *See* Messere, *supra* note 1, tbl. 10.1, at 264-65.

[169]National practice is not consistent.

generosity of the tax treatment of private pensions is being reviewed in many places because of its expense, and it is suggested that there is little reason to increase the problem by any extension to the public sector.

D. Implicit Tax Rates on Benefit Programs

The complex patterns of interaction of contributions, income tax, and benefits rules can cause hidden traps in the general system of tax and support.[170] Two forms of trap may exist. The first is the poverty trap. This is the situation where an individual is trapped in poverty because he or she is unable to increase his or her net earnings through extra effort. Linked with this is the unemployment trap. This happens when an individual is unable to obtain a job that pays enough to make the claimant better off than receiving benefits. Both these effects deter individuals from seeking to improve their position and can be argued to trap them into receiving benefits. The argument is that the individual has no incentive to do anything other than continue to receive benefits. Other policies are also involved. Income tax is often regarded as a progressive tax. The tax system may also be regarded as partly designed to redistribute income. Poverty and unemployment traps distort the rate structure of the tax system as a whole and cause redistribution from the wrong individuals.

For example, state *F* has a progressive income tax. The lowest rate of income tax is 15 percent. It has a contributory social security system, with a set rate of contribution, the current employee's rate being 20 percent. It provides benefits in two ways. First, the social security fund provides a replacement income for the sick and the unemployed. Second, the state finances a rent benefit that meets the rent of those whose income is below the state poverty level. Those with incomes above that level receive no benefit.

Ben is currently unemployed. Ben receives $150 a week benefit from the state fund, and has the rent of $100 paid by the rent benefit. The state benefit of $150, and the rent benefit, are both free of income tax and contributions. To replace current benefits, Ben must earn enough so that, after deduction of income tax at 15 percent and contribution liability at 20 percent, the amount left is at least $250. Ignoring any contribution thresholds and income tax allowances, the minimum replacement income Ben needs is $392. To escape from the unemployment trap, Ben must therefore increase

[170]The terminology used in this section is derived from English public welfare economics literature. An early account is A.R. Prest, Social Benefits and Tax Rates (1970). An excellent series of essays on the topic based on a seminar bringing together officials and commentators is in Taxation and Social Policy (Cedric Sandford, et al., eds., 1980). The term "poverty trap" is sometimes used as a generic term to cover all forms of effect of the kinds described here. The reference to trap indicates a value judgment. The adoption of the convenient phraseology of that literature in this account is not meant to imply an adoption of those value judgments by the author. A neutral description of the trapping effect is that the interaction of each of the separate rates and thresholds for taxes, social security contributions and benefits, and social welfare receipts affecting an individual with little or no earned income produces a net negative marginal increase of total income to, or benefit for, that individual from all sources when adjustments are made to all receipts and deductions to take account of a unit of increase of earnings of the individual (poverty trap) or for a unit of replacement of benefit or other income with earnings (unemployment trap).

income from the $100 paid in cash by $292. Can that be done? Unless Ben earns more than $392, there is no point in his seeking work. Ben is caught in the unemployment trap.

Por has a part-time job because of the need to look after her two young children. Por's total income is below the state poverty level for a parent and two children. Consequently, Por receives the rent benefit, which is worth $150. Por has just been asked to work one more day a week, which will earn her $50 more. However, Por notes that this extra $50 will take her earnings over the state poverty level. She will therefore lose the state rent benefit and will not receive the full $50 because of income tax and contribution liability. At present rates, Por will receive only $33 of the $50. The extra day's work will therefore leave Por $117 a week worse off. Por refuses to work the extra day. Por is caught in the poverty trap.

E. Can High Implicit Tax Rates Be Avoided?

Can these traps be avoided? The examples given are deliberately very simple. In practice, examples are often considerably more complex. However, a benefit like the rent benefit in the example always creates a trap for those who cannot afford to lose the benefit by increasing their earnings. One answer is for the allowance to be tapered. The allowance could be granted as a maximum of $150, with lower benefits to those with earnings in the "trap" area.

Suppose that the rent benefit had a "taper" of 70 percent. That is, for each $100 over the poverty level a beneficiary earns, $70 of the benefit is lost. This would still trap Por. Por pays income tax of 15 percent and contributions of 20 percent on the extra earnings, and loses 70 percent of the rent benefit under the taper rule. This amounts to a composite tax rate of 105 percent. It is not worth paying. Ben may be assisted. Tapering lowers the sum Ben must earn to improve his total income. If the taper were 60 percent and not 70 percent, then Por would gain by taking the extra work, although not by very much. Alternatively, the taper could be based on Por's income after deduction of income tax and contributions. The taper would then be 70 percent of the net increase in earnings, not of the full increase. Of course, a taper in either form also means that benefit must be paid to those above the poverty level. This may have a considerable cost. The income tax and contribution rates may also be tapered. The allowances may also be set so that they cut the trap effect on low earners. Removal of any threshold for social security contributions will further dampen the effect of changes. Support to low earners from the income tax system could be given through credits rather than through allowances, thereby changing the effect of an increase in earnings. Sometimes traps may be made less significant by removing a tax exemption, but increasing the underlying level of benefit so that the most deserving beneficiaries do not lose. Further up the income scale, the value of the benefit will decrease because of the tax. At the lower end, there is no net cost or benefit to the state.

How can traps like this be avoided? The most important issue is to ensure that all tax, contribution, and benefit provisions are examined to ensure that trapping effects are identified and, if possible, minimized. Sometimes this can be done through the way a benefit is worked, rather than through a simple increase in value. For example, a taper based on net income rather than gross income keeps the total effective tax rate from exceeding 100 percent. This shows that a solution to a trap may lie in the way a benefit is paid rather than the way it is taxed or made subject to contribution liability. It may be that the nature of the benefit has to be changed. Alternatively, it may help to pay a larger benefit that is taxable rather than a smaller benefit that is exempt from tax, so that the beneficiary receives the same amount, but the distortions are avoided. There is no simple solution.[171]

VI. Conclusion

The issues outlined in this chapter are receiving considerably more attention than in the past, largely for demographic reasons—the adverse shift in most countries in the dependency ratio of those receiving state benefits compared with those paying for them. This has forced schemes to increase contributory funding and to look for more effective ways of raising funds. The discussion shows that there is no clear consensus of how this should be done. Important issues are clearly regarded as based on tradition and history to a greater extent than with other taxes. Nonetheless, there is a need in many countries to address the issues raised in this chapter and to seek best practices both in the forms of contribution liabilities adopted and in the methods by which they are collected and enforced.

[171] The discussion under this head is based on the U.K. experience, in which the rent benefit (called housing benefit) and the help for poor families (known as family credit) are tapered in the way illustrated. This has reduced the highest implicit tax rates in the system to below 100 percent, but still leaves them far higher than the highest express income tax rate (40 percent). It is still widely regarded as unsatisfactory.

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Presumptive Taxation

Victor Thuronyi

> Acetylene, Achievement awards, Acts of God, Affidavits, Age 55 or over, Age 65 or over, Agricultural irrigation projects, Agricultural labor, Aircraft, Air force, Alaska, Alcohol fuel credit, Aliens, Alimony and separate maintenance payments, Alternative minimum tax, Ambulances, Ammonia, Amortization, Amusement expenses, Anti-cruelty organizations, Apostolic associations, Apothecaries, Aquatic resources trust fund, Arbitrage bonds,...
> —Index to Internal Revenue Code (Research Institute of America 1993).

I. General Concepts

Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts.[1] The term "presumptive" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method. As discussed below, this presumption may or may not be rebuttable. The concept covers a wide variety of alternative means of determining the tax base, ranging from methods of reconstructing income based on administrative practice, which can be rebutted by the taxpayer, to true minimum taxes with tax bases specified in legislation.[2]

This concept does not cover all instances of the use of legal presumptions in taxation. More generally, a presumption can be said to be involved anytime a mechanical definition is used in place of a more open-ended rule based on the facts and

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Note: This paper has benefited from comments by Bertil Wiman, Rebecca Rudnick, Michael Engelschalk, Günther Taube, and Zühtü Yücelik.

[1]A useful description is provided by Ahmad & Stern: "The term presumptive taxation covers a number of procedures under which the `desired' base for taxation (direct or indirect) is not itself measured but is inferred from some simple indicators which are more easily measured than the base itself." Ehtisham Ahmad & Nicholas Stern, The Theory and Practice of Tax Reform in Developing Countries 276 (1991).

[2] For further discussion and analysis of presumptive taxation, *see* Indira Rajamaran, *Presumptive Direct Taxation: Lessons from Experience in Developing Countries,* Economic and Political Weekly (forthcoming); Arye Lapidoth, The Use of Estimation for the Assessment of Taxable Business Income (1977); Kenan Bulutoglu, *Presumptive Taxation, in* Tax Policy Handbook 258 (Parthasarathi Shome ed., 1995); Russell Krelove and Janet Stotsky, *Asset and Wealth Taxes, in id.* 181; Vito Tanzi & Milka Casanegra de Jantscher, *Presumptive Income Taxation: Administrative, Efficiency, and Equity Aspects* (IMF Working Paper, 1987) (see also sources cited in these works).

circumstances of each case. The focus in this chapter is the use of a presumption to supplant the entire tax base, or an entire category of taxable income.

Presumptive techniques may be employed for a variety of reasons.[3] One is simplification, particularly in relation to the compliance burden on taxpayers with very low turnover (and the corresponding administrative burden of auditing such taxpayers). A second is to combat tax avoidance or evasion (which works only if the indicators on which the presumption is based are more difficult to hide than those forming the basis for accounting records). Third, by providing objective indicators for tax assessment, presumptive methods may lead to a more equitable distribution of the tax burden, when normal accounts-based methods are unreliable because of problems of taxpayer compliance or administrative corruption. Fourth, rebuttable presumptions can encourage taxpayers to keep proper accounts, because they subject taxpayers to a possibly higher tax burden in the absence of such accounts. Fifth, presumptions of the exclusive type (see below) can be considered desirable because of their incentive effects—a taxpayer who earns more income will not have to pay more tax. Finally, presumptions that serve as minimum taxes may be justified by a combination of reasons (revenue need, fairness concerns, and political or technical difficulty in addressing certain problems directly as opposed to doing so through a minimum tax).

This chapter deals with certain minimum taxes but does not discuss minimum taxes in general. Some minimum taxes are accounts-based taxes; they involve the use of different accounting methods than regular tax or they may involve the denial of certain deductions. These types of minimum taxes, along with the general concept of minimum taxation, are beyond the scope of this chapter.

Presumptive taxation can be used for any tax that is normally based on accounting records—income tax, turnover tax, and value-added tax (VAT) or sales tax—although it is most commonly used for the income tax. A number of different types of presumptive methods exist in different countries. The discussion below first considers some general characteristics of presumptive methods and then discusses particular cases. It is apparent from this discussion that different types of presumptive methods can have quite different incentive effects, revenue effects, distributional consequences, levels of complexity, and legal and administrative implications. This makes it dangerous to generalize about presumptive taxation.

The extent to which presumptive taxes are used varies greatly from country to country. Some countries (e.g., the United States) employ almost no presumptive taxation,[4] while others (e.g., France[5]) use presumptive taxes extensively.

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[3]*See* Lapidoth, *supra* note 2, at 25.

[4]The main exception being rebuttable methods used as an alternative means of assessment. *See infra* sec. II(A). The United States has for about 30 years used minimum taxes involving calculation of the tax base according to accounting methods different from those used for the regular tax. As mentioned, this type of accounts-based minimum tax is beyond the scope of this chapter.

[5]In France, the importance of presumptive taxation is on the decline, compared with a few decades ago. *See infra* sec. III(D)(2).

Possible legal constraints on the adoption of presumptive methods should be considered in drafting legislation for their application, including constitutional constraints, such as equality before the law and a prohibition on confiscation of property.[6] They might also include obligations under international agreements. For example, some double tax treaties may prohibit taxing a nonresident on a presumptive basis without allowing the taxpayer to prove its actual income and be taxed accordingly.[7]

The use of withholding taxes is sometimes discussed together with presumptive techniques. Withholding taxes can also achieve the effect of taxation based on an alternative simplified base. Withholding is commonly used for the income tax and is usually based on the gross amount of a payment. Withholding can also be imposed on other bases, for example, on the amount of imported goods, with a credit allowed against income tax. The legal nature of withholding taxes is normally not the same as that of presumptions, because taxpayers normally have the right to file a return and receive a refund of excess amounts withheld. Therefore, although there is some commonality between withholding and presumptive techniques, the former is not considered in this chapter. If taxpayers are not given the right to claim a refund, then the withholding tax is in effect a minimum tax collected by withholding, which does not differ conceptually from other minimum taxes.

II. Legal Characteristics of Presumptive Methods

A. Rebuttable vs. Irrebuttable

Presumptive methods can be rebuttable or irrebuttable. Rebuttable methods include administrative approaches to reconstructing the taxpayer's income, and may or may not be specifically described in the statute. If the taxpayer disagrees with the result reached, the taxpayer can appeal by proving that his or her actual income, calculated under the normal tax accounting rules, was less than that calculated under the presumptive method.

By contrast, irrebuttable presumptive assessments should be specified in the statute or in delegated legislation. Because they are legally binding, they must be defined precisely.

Rebuttable presumptive assessments are a universal feature of tax assessment procedure, required in order to deal with cases where taxpayers either do not fully disclose their financial situations on their returns or fail to file a return. In these cases, the law normally authorizes the tax authority to use indirect methods to determine the

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[6]*See supra* ch. 2, sec. II; *infra* note 40.

[7]*See* OECD Model Convention art. 7(1), *reprinted in* Klaus Vogel, Double Taxation Conventions 308 (1991); U.N. Model Convention art. 7(1), *reprinted in id.,* at 309; U.S. Model Convention 7(1), *reprinted in id*. These provisions allow taxation of only the profits that are attributable to a permanent establishment. Imposition of a presumptive tax might result in a tax even where there are no such profits, and might therefore violate the treaty, if the presumptive tax is a tax covered by the treaty.

taxpayer's income, based perhaps on arbitrary criteria or on whatever data are available. Because presumptive assessment is intended as a means of ascertaining the taxpayer's income in the face of inadequate data, the taxpayer should be allowed to present better data to refute the determination of the tax authorities. This type of presumptive assessment therefore does not represent a fundamental departure from the normal rules for determining tax liability, but is a fallback when these rules do not work because of noncompliance by the taxpayer.

The *forfait* applicable in France[8] is a hybrid between rebuttable and irrebuttable methods. It is rebuttable in the sense that the taxpayer may elect to use the normal accounting rules instead of the *forfait*. Under the *forfait,* the determination of income is a matter of negotiation between the taxpayer and the tax inspector. However, once it is agreed on for the specified period of two years, it applies automatically regardless of the taxpayer's actual income for the period.

B. Minimum Tax vs. Exclusive

Irrebuttable presumptions can be divided into two types: minimum tax, where tax liability is no less than that determined under the presumptive rules, and exclusive, where tax liability is determined under the presumption alone, even if the regular rules might lead to a higher liability. An example of the latter would be a tax on agricultural income based on the value of the land, with no reference to actual crop experience for the year.

The incentive effects of exclusive presumptions differ substantially from those of the income tax. Exclusive presumptions create no disincentive to earn income. Rather, the incentive effects of the tax will depend on the factors used to determine presumptive income. These incentive effects will be minimal when the factors on which the presumption is based are in inelastic supply, land being the quintessential case. An exclusive presumption is in fact not an income tax at all, but is a tax on whatever is used to determine the presumption. Depending on the factors used, it may be more like a tax on potential income (if based on factors of production) or on consumption (if based on lifestyle).

Exclusive presumptions are administratively simpler than presumptions of the minimum tax type, because minimum tax presumptions require two tax bases to be calculated and compared.

While exclusive presumptions have the advantage of simplicity and minimal disincentive effects, they suffer from a lack of equity. Taxpayers with substantially differing amounts of actual income must pay the same amount of tax if their presumptive tax base is the same.

C. Mechanical vs. Discretionary

[8] *See infra* sec. III(D)(2).

Presumptive methods can also be distinguished according to the degree of discretion that they allow tax officials. Some presumptive methods are quite mechanical, allowing no discretion, for example, methods based on a percentage of gross receipts or of a firm's assets. Other methods, such as the net worth method,[9] involve a large degree of discretion for the agent applying them.

Methods involving a large measure of discretion will generally be rebuttable, because otherwise too much power, and potential for arbitrary action, would be given to the revenue authorities. Mechanical methods may or may not be rebuttable. In some cases, a method will be mechanical (and irrebuttable) if applied, but the tax authorities have discretion as to whether to apply it. This was the case, for example, with the presumption based on signs of lifestyle in France, which was irrebuttable (although it has subsequently been changed to a rebuttable presumption). Tax agents were directed not to apply the presumption when its application would be harsh, although they were not legally bound to refrain from applying the method.[10] A taxpayer could perhaps in rare cases successfully argue that being subjected to the presumption constituted an abuse of discretion if the presumption were being applied under circumstances where the tax authorities were instructed generally not to apply it.

As in other areas of tax law, the choice between mechanical and discretionary rules will involve factors such as the following: the potential for corruption in the case of discretionary rules, the potential harshness of mechanical rules, the reduced administrative resources needed to apply mechanical rules, and the potential for expressing the particular matter as a mechanical rule.

D. Scope of Application

Presumptive taxation is commonly used in the context of the income tax. Some presumptive methods completely supplant the income tax for particular taxpayers. In other cases, the presumptive method may determine a portion of the tax base, for example, the income from a particular business or agricultural activity. Presumptions are also used for taxes other than the income tax. Thus, the *forfait* methods for small traders often cover both income tax and VAT liability.[11] Presumptive methods have also been used for the excise tax.[12]

E. Taxpayers Targeted

Presumptive methods can be distinguished according to the types of taxpayers who are targeted. In general terms, three groups of taxpayers have been the source of problems

[9]*See infra* sec. III(A)(2).

[10]*See infra* sec. III(E).

[11]*See* FRA CGI arts. 50, 265; ESP IVA art. 122 *et seq.*; VAT Regulations arts. 34—42 (ESP), *reprinted in* 2 Leyes Tributarias: Legislación Básica 1298–1305 (5th ed. 1992).

[12]*See* Sijbren Cnossen, Excise Systems: A Global Study of the Selective Taxation of Goods and Services 74–83 (1977).

against which presumptive methods have been directed. The most common problem is noncompliance by small businesses and professionals. A second problem is noncompliance by individuals (this may be related to the first, but the focus is on amounts that individuals have taken out of their businesses or received from other sources and used for consumption). A third group of targeted taxpayers is businesses as a whole, including large companies.

The appropriate design of a presumption will depend on the particular problems it is seeking to address. Therefore, before a particular presumptive method can be recommended or designed for a specific country, it is necessary to ascertain what types of taxpayers are giving rise to problems under the normal rules for determining the tax base and the nature of those problems. Presumptive taxation may or may not be an appropriate solution. For example, if a particular group of taxpayers is unable to comply with the tax system, consideration should be given to whether it is possible to remove that group from the tax system altogether.

III. Particular Presumptive Methods

A. Reconstruction of Income

1. In General

If the taxpayer has failed to file a return or has substantially understated his or her income, and the transactions giving rise to income cannot be traced, the tax authorities are usually authorized to assess income on their best judgment. This could involve use of a method such as net worth, or bank deposits, or some other approach that has a factual basis for the particular case. As long as the assessment is based on reasonable facts, it will be upheld, subject to the taxpayer's right to come forward with proper evidence of income; no specific methodology is prescribed.[13]

The legal authority to make best judgment assessments is usually provided in general terms in the statute. In some countries, there are no particular thresholds for use of indirect methods. Thus, in Israel, the assessing officer has the power to "determine to the best of his judgment the amount of the person's chargeable income and assess him accordingly, if he has reasonable grounds for believing that the return is not correct."[14] In

[13]"The Officer is to make an assessment to the best of his judgment against a person who is in default as regards supplying information. He must not act dishonestly or vindictively or capriciously, because he must exercise judgment in the matter. He must make what he honestly believes to be a fair estimate of the proper figure of assessment, and for this purpose he must, their Lordships think, be able to take into consideration local knowledge and repute in regard to the assessee's circumstances, and his own knowledge of previous returns by and assessments of the assessee, and all other matters which he thinks will assist him in arriving at a fair and proper estimate; and though there must necessarily be guess-work in the matter, it must be honest guess-work. In that sense, too, the assessment must be to some extent arbitrary." 1 N.A. Palkhivala & B.A. Palkhivala, Kanga and Palkhivala's The Law and Practice of Income Tax 1154 (1990) (quoting CIT v. Laxminarain Badridas, 5 ITR 170, 180 (1937)).

[14]ISR IT § 145(2)(b).

the United States, the Internal Revenue Code gives the IRS general authority to make assessments and determine deficiencies in tax;[15] no distinction is drawn in the statute between direct and indirect methods of determining a deficiency.[16] The permissible bases for proving a deficiency using indirect methods have been elaborated in judicial decisions.[17]

In other countries, indirect methods may be applied only under certain circumstances specified in the statute. In India, the statute requires best judgment assessments when the taxpayer has failed to file a return or to produce information, and authorizes such assessments when the taxpayer's accounts are incorrect or incomplete or when no method of accounting has been regularly employed by the taxpayer.[18] In Argentina, the *determinación de oficio* applies whenever the taxpayer has failed to file a return or when the return is inadequate.[19] In France, the procedures for *imposition d'office* are set forth in the *Livre des procédures fiscales*.[20] This procedure applies when the taxpayer has failed to file a return, has failed to furnish information to the tax authorities upon request, or in the case of a nonresident taxpayer, has failed to designate a representative in France.

The drafter of statutory authority for indirect methods must make a basic choice between a general authority (which provides the greatest flexibility to the tax administration) and a restricted authority (which may provide procedural defenses to the taxpayer). If a restricted authority is chosen, it should be drafted in such a way as to minimize disputes between the taxpayer and tax authorities as to its application.

Under normal circumstances, a tax administration can afford to process relatively few cases on the basis of indirect methods of proof because of their labor intensity. However, the threat of a best judgment assessment can be used against nonfilers (or those who file obviously inadequate returns): an assessment can be made on a very crude basis, not to develop an accurate determination of income, but to induce the taxpayer to come forward with a complete return. This power has been misused in some countries whose tax administrations rely too heavily on the best judgment assessment, with a consequent possibility of corruption. To prevent this type of problem, supervisors in the tax authority should monitor the use of best judgment assessments.

2. Net Worth Method

[15] *See* USA IRC §§ 6201, 6204, 6212.

[16] *See* Holland v. United States, 348 U.S. 121, 131–32 (1954) (use of net worth method not restricted to cases where the taxpayer kept no books).

[17] *See id.* at 124–29 (discussing matters where exercise of care is needed in applying the net worth method in criminal prosecutions for tax evasion).

[18] *See* IND IT §§ 144, 145(2).

[19] *See* ARG APFI art. 23.

[20] *See* Livre des Procédures Fiscales, arts. L. 65– L. 76A. *See generally La Taxation d'office à l'impôt sur le revenu,* 31 Annales de la Faculté de Droit et des Sciences Politiques et de l'Institut de Recherches Juridiques, Politiques et Sociales de Strasbourg (1980) (*Taxation d'office* is a form of *imposition d'office*.)

In the absence of substantial information about the taxpayer's actual income, a commonly employed method is to estimate income by determining the change in the taxpayer's net worth over the year and adding to this amount the estimated personal consumption expenses, determined by examining the taxpayer's lifestyle.[21] In principle, any use of funds other than those that would be reflected in increased net worth should be included as personal consumption expenses for this purpose (e.g., gifts made to others). As a matter of income tax theory, this approach cannot be faulted, since income can be defined as consumption plus change in net worth.[22]Victor Thuronyi, *The Concept of Income,* 46 Tax Law Review 45 (1990). The difficulty is typically the lack of evidence and the consequent need to make rather imprecise estimates. Courts have nevertheless allowed this method to be used on the basis that the taxpayer brought it on him- or herself by failing to furnish particulars of the taxpayer's income.

The net worth method is often not based on specific statutory authority, but rests on the broad power of the tax administration to make best judgment assessments.[23] Some countries have codified the net worth method, but sometimes with insufficient attention to the details of its operation. For example, in Colombia a rebuttable presumption stipulates that income is no less than the increase in net worth, reduced by items of exempt income. However, this formula fails to take into account consumption, so that it results in a substantial understatement of income where, as is usual, most of the taxpayer's income is consumed.[24] In India, the Income Tax Act specifically states that if, in any financial year, a taxpayer is found to be the owner of money, cash credits, property, or other investments and cannot explain their source, then their value may be assessed as income for that financial year.[25]

In terms of the typology set forth above, the net worth method is usually rebuttable; it replaces the entire tax base; and it involves a limited but still substantial degree of discretion, in that the reconstruction of net worth at the beginning and end of the year, and of consumption expenses during the year, requires the exercise of judgment. The taxpayer is normally allowed to rebut the results under the net worth method, either by furnishing full details and evidence of actual receipts or by showing that the consumption plus increase in net worth was financed by nontaxable receipts (e.g., gifts, bequests, or, in a country with a territorial system, foreign-source income).

The net worth method is labor intensive, requires sophisticated auditors, and is therefore not suited for mass application. The elements on which it rests are often

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[21]*See* Annotation, Use of Net Worth Method in Prosecution for Evasion of Federal Income Tax, 99 L. Ed. 167 (1955).

[22]*See* Henry Simons, Personal Income Taxation 50 (1938). *See also*

[23]*See* Lapidoth, *supra* note 2, at 110.

[24]*See* Charles E. McLure, Jr. et al., The Taxation of Income from Business and Capital in Colombia 47, 144–45 (1990).

[25]*See* IND IT §§ 68-69B; Palkhivala, *supra* note 13, at 863–69; Lapidoth, *supra* note 2, at 114–17.

difficult to apply, requiring information on the taxpayer's wealth holdings and consumption expenditures in a situation where by hypothesis the taxpayer has not been cooperative in furnishing information. Rather, it can be used to go after a few taxpayers who have totally failed to comply with their tax obligations. It cannot be relied on as a significant revenue source in itself, and is better thought of as part of the arsenal of tools that can be used to induce compliance. These observations apply with equal force to the bank deposit method and the expenditures method, described below.

3. Bank Deposit Method

Another method auditors use to determine income in the absence of an adequate declaration is to secure records of deposits into the taxpayer's bank accounts (in both foreign and domestic banks) and to presume, unless the taxpayer can show the contrary, that the deposits constitute income. Depending on the taxpayer's financial and business practices, this can, of course, lead to either a grossly exaggerated or a grossly understated estimate of net income.[26] Nevertheless, courts have allowed this method of estimating income, again on the principle that if the taxpayer considers it unfair, he or she can furnish details of actual income.[27]

The effectiveness of this method obviously depends on the state of development of a country’s financial institutions. In countries where most amounts are transferred in cash, it is not likely to be very helpful.

4. Expenditures Method

When evidence of the taxpayer's net worth is not available, income can be presumed on the basis of total cash expenditures. In countries where methods of indirect proof of income are not codified, this can be one possible approach under the authority to make best judgment assessments. It may be impossible to use the net worth method because evidence of net worth is unavailable. In some countries, taxation on the basis of personal expenditures has been codified, in which case a difference in result can occur from the best judgment assessment in the sense that personal expenditures, instead of being an indirect method of proving taxable income, become a tax base in their own right in situations contemplated by the statute.[28] Previously in France, individuals could be taxed on the basis of their "open and notorious" personal expenditures,[29] but this method has now been repealed.[30] A similar rule has also been repealed in Germany.[31]

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[26]A substantial underestimate results in cases where most of the taxpayer's income is received in cash and never finds its way into the taxpayer's bank account. An overestimate results where the deposits reflect gross receipts or transfers from other accounts.

[27]*See* Michael I. Saltzman, IRS Practice and Procedure ¶ 7A.02[1][d] (2nd ed. 1991).

[28]*See* Lapidoth, *supra* note 2, at 60–63.

[29]*See id.* at 61-63. *See* FRA CGI former art. 180, then LPF art. L 71.

[30]*See* Loi No. 86-1315 du 30 décembre 1986, art. 82-11.

[31]DEU EStG § 48. *See* International Program in Taxation, Harvard Law School, World Tax Series: Taxation in Germany 325-26 (1963).

B. Percentage of Gross Receipts

The legislation of some countries[32] provides a minimum-tax type of presumption, whereby the taxable income of a business can be no less than a specified percentage of the gross receipts of the business. For businesses paying tax on this basis, the tax has the same economic effects as a turnover tax, rather than an income tax, although the situation is more complicated when a company alternates between paying tax on gross receipts and paying tax on income.

It is difficult to see the attractiveness of this type of tax beyond the facts that it is relatively easy to administer and raises revenue. These characteristics are shared by sales taxes. If a sales tax is desired, it should be adopted explicitly, rather than in the guise of a minimum income tax. As a sales tax, the gross receipts tax is defective, because it involves substantial cascading.

The cascading effect of the tax has two dimensions. First, when most firms are taxed on a gross receipts basis, rather than on income, the tax becomes like a sales tax and involves the familiar cascading problem of such a tax. Second, the degree of integration of a firm may determine whether the firm pays tax on a presumptive basis. For example, suppose that the statute provides that minimum taxable income is 5 percent of gross receipts. Firm *X* produces a product at a cost of 96 and sells it to Firm *Y* for 100. In turn, *Y* incurs expenses of 10 and resells the product for 114. In this situation, *X*'s and *Y*'s profit of 4 each would be less than the statutory percentage, and each would instead pay tax on the presumptive basis. However, if the firms merged, producing at a cost of 106 and selling for 114, they would pay tax on the profit of 8, and the presumptive tax would not apply.

A further problem with this type of minimum tax is that there is no close correlation between a particular year's income and turnover.[33] Moreover, net income is likely to represent widely varying percentages of gross receipts depending on the industry concerned, the degree of integration of the particular enterprise, and the type of product or service provided (e.g., a boutique may require a higher profit margin to cover its costs than a high-volume sales operation). Using the same percentage for all companies will therefore be highly inaccurate as a means of approximating net income.

The problem can be addressed, as some countries have done, by classifying taxpayers according to their business and by specifying a profit percentage to be applied to gross receipts, based on industry studies for each type of business to be covered.[34] This kind of presumption can be applied as an exclusive way of taxing income, as a minimum tax, or as a *forfait*. This more sophisticated approach reduces the inaccuracy of the presumption, but makes it more complicated to apply, particularly to taxpayers whose

[32] *E.g.,* SLE IT § 23; COL ET § 180, 188 (repealed as of 1990).

[33] *See* McLure et al., *supra* note 24, at 144.

[34] *See infra* sec. III(D)(3).

operations cross industry lines. Moreover, to be accurate this method requires research into actual profit margins, an effort that involves significant resources and may be difficult to accomplish in conditions of general economic instability. Therefore, it would be more suitable for some countries than for others.

The receipts-based presumptive tax can also encounter enforcement problems and result in unevenness of application. If taxpayers fail to declare their gross receipts, they can avoid the presumption. So the basic audit problem of determining gross receipts is not addressed by this type of tax. Accordingly, it is not likely to be effective in raising revenue from the types of taxpayers whose gross receipts are difficult to ascertain, such as independent professionals, and is more likely to impinge on those taxpayers who cannot hide their gross receipts.

As with other minimum taxes, the apparent simplicity of the receipts-based minimum tax is undermined by the need to make complicated adjustments for taxpayers who alternate between paying tax on a presumptive basis and paying the regular income tax.[35] If such adjustments are not made, then the presumptive regime can involve a disproportionally high tax liability for taxpayers whose income tends to fluctuate substantially from year to year.

In drafting rules for such a minimum tax, it is necessary to specify which taxpayers are subject to the tax and what items are included in gross receipts. For example, one could specify that gross receipts include all receipts of a business and that both individuals and corporations are subject to the tax. This requires determining what receipts are business receipts. Should items such as interest, dividends, and rents be treated as business receipts and, if so, under what circumstances? It may make sense to exclude such items from business receipts for purposes of the minimum tax, in part because the profit margin is likely to be higher than for other business receipts. It would be most accurate to compare the specified percentage of business receipts against taxable business income, and then to tax investment income separately. Under such an approach, expenses must be allocated among business and investment income, not always an easy exercise. On the other hand, if all receipts are lumped together, then it is easier to engage in tax planning to avoid the tax. For a taxpayer whose profit margin is low, so that it has to pay the gross receipts tax, the game would be to earn enough financial income (where the profit margin is higher), so as to bring the average profit margin up to the level specified by the gross receipts tax.

An alternative that some countries have adopted[36] is to make the gross receipts presumption rebuttable. Although this alternative takes care of many of the problems of the gross receipts tax, it also takes most of the teeth out of this type of minimum tax.

C. Percentage of Assets

[35] *See* McLure et al., *supra* note 24, at 142–43. *See also infra* sec. III(C)(6)(b).

[36] *E.g.,* SLE IT § 23(3).

Several countries, including Argentina, Colombia, Mexico, and Venezuela, have adopted minimum taxes based on a fixed percentage of the assets of a business.[37] In Bolivia, such a tax replaced for a time the corporate income tax; that is, it was an exclusive presumption.[38] The tax base varies from gross assets (Argentina) to net assets—assets minus debts (Colombia)—with the Mexican tax taking a middle position whereby certain debts are deductible. The economic rationale for the assets tax is that investors can expect ex ante to earn a specified average rate of return on their assets. Of course, such taxation could be considered unfair because the ex post return will differ from what was expected. Moreover, the minimum asset tax can discourage risky investments under circumstances where it denies the taxpayer the benefits of carrying over the losses resulting from the investment.

To evaluate whether it makes sense to have an assets tax and how such a tax should be designed, it is necessary to establish the purpose that such a tax is to serve. An assets tax can be justified as a permanent part of the tax system only if it can help resolve problems with the administration of the income tax that are difficult to address directly.

For example, the assets tax might be useful as an indirect way of addressing transfer pricing problems. Suppose that the tax administration finds it difficult to police transfer pricing cases directly and that multinationals are using transfer pricing to seriously undercut the tax base. The assets tax allows the collection of revenue regardless of reported transfer prices. However, this strategy works only if the resident companies subject to the assets tax have substantial assets in the country. Often, the problem with transfer pricing cases is the existence of intangible values that are not included in the balance sheet of the domestic subsidiary. Moreover, the question can be raised whether the relatively narrow problem of transfer pricing warrants such a broad response.

In addition to transfer pricing problems, the income tax may suffer from generalized underreporting of income and other evasion. If so, the assets tax may help, the question being whether the same conditions that allow evasion of the income tax would also allow evasion of the assets tax. For example, if the basic problem is corruption of tax inspectors, it is unlikely that introducing an assets tax will correct the problem, because inspectors can be bribed in the same manner under both legislative schemes.

Finally, the assets tax may be used to address problems of timing in the income tax.[39] Under the general assumption that over the long term a holder of wealth would expect to earn at least the risk-free rate of return on that wealth, the assets tax is a reasonable proxy for ex ante economic income, while the accounting rules for the income tax may lead to deferral of that income. Despite its theoretical underpinnings, this

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[37]The assets tax came into effect in 1989 in Mexico, 1990 in Argentina, 1974 in Colombia, and 1993 in Venezuela.

[38]*See* BOL IRPE. The tax on presumed income was replaced by a tax on business profits at the end of 1994. *See* Gonzalo Ruiz Ballivián, *Bolivia Introduces General Profits Tax*, 11 Tax Notes Int'l 1087 (1995).

[39]*See* McLure et al., *supra* note 24, at 140.

argument has two principal flaws: (1) it leads to taxation of ex ante income, while fairness considerations call for taxing ex post income, and (2) it depends on a reliable valuation of the taxpayer's wealth. Moreover, this argument would justify a tax based on net assets, not on gross assets.

The specific design questions that come up for the assets tax will differ from case to case, but some common issues are highlighted in the following sections. The discussion is relatively more detailed than in the rest of the chapter, given the complexity of the drafting issues involved.

1. Gross or Net Assets?

Perhaps the most critical question in designing the assets tax base is whether there is to be any deduction for debt. Argentina has provided no deduction for debt. In Mexico, debts to resident companies (other than financial institutions) are generally deductible and financial institutions are exempt from the assets tax.[40] The net worth tax in Colombia allows a full deduction for debt.

Because the assets tax serves as a backstop for the income tax, it makes sense to coordinate the rules for deducting interest between the two taxes. If thin capitalization is perceived as a problem under the income tax, the appropriate remedy is to fashion limitations on the deduction of interest under the income tax. Corresponding rules can apply for purposes of the assets tax. For example, there can be a concern that loans from related foreign persons are in the nature of equity rather than debt, or that certain loans are fraudulent. If these concerns justify denying a deduction for these loans under the assets tax, they would presumably also justify a denial of the deduction for interest on these loans for income tax purposes.

[40]Except for the tax on leased property and inventories. In a decision of Feb. 22, 1996, the Supreme Court of Justice of Mexico held the exemption of financial institutions from the assets tax to be unconstitutional. Article 31 of the Constitution provides that all are equal before the law. The court found that, in tax matters, the legislator can only draw distinctions if these are based on an objective and reasonable ground. The court found that there was no distinction between financial institutions and other companies that could justify exemption of the former. The dissent argued that an important purpose of the assets tax was to serve as a minimum tax for the income tax. Because financial institutions were under strict supervision of the financial authorities, their latitude to minimize their income tax liability was minimal. Therefore the legislator could rationally exempt them from the asset tax. While this argument has some merit, the majority pointed out that financial supervision did not completely rule out tax avoidance on the part of financial institutions and moreover did not justify exemption from the tax, since the tax had a revenue-raising purpose beyond safeguarding the income tax. In my view, the Mexican court failed to adequately examine the operation of the assets tax as a whole. Exemption of financial institutions (coupled with nondeductibility of debt to such institutions) is a rational legislative approach that should pass muster under the principle of equality. The opinion illustrates that courts often have difficulty in dealing with matters of tax policy and further illustrates that it is easy to justify both sides of an argument about whether a distinction made for tax purposes can be justified under the principle of equality. If courts are willing to test tax laws against the principle of equality in a vigorous manner, many aspects of tax legislation could be overturned by the courts. The decision of the Mexican court on the assets tax shows that seriously misguided results can be reached in cases of this kind. One possible legislative defense against such an eventuality is to spell out in a preamble or in explanatory material the justification for any provisions that may be considered discriminatory.

Mexico's approach in allowing a deduction for debts except those to financial institutions, and then exempting financial institutions from assets tax, maintains the aggregate assets tax base at a value equal to total assets in the corporate sector. The size of the total assets tax base is not too relevant, however, because many companies are in a position of paying income tax, rather than assets tax. Moreover, the Mexican rules can give rise to tax planning opportunities. A company that pays assets tax rather than income tax and that is indebted to a financial institution can instead borrow from a company that pays income tax, who would in turn borrow from the financial institution (the transaction would have no effect on the income tax liability of either company). Net lending from the banking sector would be the same. The debt of the assets tax payer would now be deductible. The lender's assets tax base would increase, but its tax liability would not, as long as it remained in a position of paying income tax rather than assets tax.

If it is decided to impose the assets tax on gross assets, then it would be necessary to provide an exemption for financial institutions, which would otherwise be subject to a huge tax burden.

2. Who Is the Taxpayer?

The specification of the taxpayer and the tax base should also be linked to the purpose of the tax. If the purpose of the assets tax is to serve as a minimum income tax for taxpayers with business income, then the taxpayers and assets within the scope of the tax should be specified accordingly.

For example, the Mexican tax applies to resident physical persons on all their assets used in a business, as well as to all the assets of resident juridical persons. It extends to assets wherever located (this is consistent with the income tax being based on worldwide income). The tax also applies to the assets of a nonresident's permanent establishment in Mexico.[41]

3. Tax Rate

If a tax on gross assets were applied in lieu of an income tax, setting the rate would be a relatively precise exercise, designed to capture the average rate of return on assets. When the tax is a minimum tax, however, there is a much greater scope for maneuver in setting the tax rate. The higher the rate, the larger the number of enterprises that will be subject to the minimum tax, as opposed to the regular tax. The tax rate is 2 percent in Mexico and Argentina and 1 percent in Venezuela.

4. Tax Base

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[41]MEX ATL art. 1. The term "nonresidents" presumably encompasses both physical and juridical persons. Nonresidents without a permanent establishment (P.E.) are nevertheless subject to tax in Mexico on inventory to be processed in Mexico. *Id.* This provision is no doubt directed at companies who plan their affairs so as to avoid being treated as having a permanent establishment in Mexico. If they did have one, then its inventory would be subject to assets tax, whereas if they avoid P.E. status no one would, absent this rule, have to pay assets tax with respect to this inventory.

Assuming that the assets tax serves as a minimum tax for business income, the tax base should include all assets used in the business.

a. Average Value vs. Opening or Closing Balance

A key issue is when the assets are to be valued. The simplest approach is to value the assets at the beginning or the end of the year. If this rule were adopted, however, taxpayers could engage in window dressing. Companies who are assets tax payers could shift assets for one day to companies who are income tax payers.[42] Moreover, either beginning-of-year or end-of-year valuation will lead to some inaccuracy if it is not representative of the value of income-generating assets over the course of the year.

Accordingly, the tax base in Mexico is the average value of assets. The use of average values leads to a more accurate application of the tax; if there were a substantial change in a firm's assets during the course of a year, it would be unfair to base the tax for the entire year on the opening asset value.

Valuing assets on the basis of average value leads to complexity, although the additional complexity involved is minimized to the extent that the same rules are used for the assets tax as for the income tax generally.

In Mexico, for example, financial assets are generally valued according to average monthly value (based on value at the beginning and end of the month). Financial assets expressed in terms of foreign currency are valued at the exchange rate prevailing at the beginning of each month. Fixed assets are valued as for income tax purposes, including an adjustment for inflation, and taking into account only a pro rata share of assets that are acquired or disposed of during the course of the year. Inventory is taken into account at the average of closing and opening inventory value for the taxable year.

b. Integration

Should the assets tax base include shares or other interests in legal persons that are themselves assets tax payers? To include such interests seems to be double counting, in that the underlying assets of a business would be counted twice (or more than twice if there are additional tiers of corporate ownership). Whether this is appropriate should be determined with reference to the corporate integration rules of the income tax. For example, under a system whereby intercorporate dividends are fully taxed, including corporate shares in the assets tax base would be consistent with the income tax treatment. By contrast, under a system where corporations obtain a full exclusion for dividends received for income tax purposes, shares in domestic corporations should also be excluded from the assets tax base. If there is only partial integration, then only a partial

[42]For example, a company with too many assets could sell some assets to an income taxpayer. The sales proceeds could be used to pay off nondeductible bank debt. The transaction could then be reversed on the following day. Such a transaction might, of course, be subject to legal challenge under abuse-of-law or other anti-avoidance rules. *See supra* ch. 2, sec. III.

exclusion would be appropriate. In Argentina[43] and Mexico,[44] shares in domestic companies, that is, companies that are themselves subject to assets tax, are excluded from the shareholder's tax base.

c. Leasing

In the absence of special rules for leasing, taxpayers can avoid the assets tax by leasing property instead of purchasing it. The lessor could be a company that pays income tax rather than assets tax, and that is therefore indifferent to the increase in its assets tax base resulting from the lease transaction. Assuming debt finance, the two options of leasing or buying property can be economically very similar, but they will have completely different tax consequences for purposes of the assets tax, if the debt is not deductible from the tax base. If a company leases an asset, the asset will show up among the assets of the lessor and will hence be included in the overall assets tax base unless the lessor is not an assets tax payer. The lessor could, for example, be a foreign company, an exempt organization, or an individual not in the business of leasing. Partly forestalling this avoidance possibility, the Mexican law subjects to the assets tax a person who otherwise would not be subject to assets tax but who leases property to a person who is subject to assets tax.[45] Tax planning is still possible under this regime because some taxpayers will pay income tax, while others will pay assets tax. The latter can save tax by leasing assets from the former at no additional tax cost to the former.

d. Special Rule for Expanding Companies

Like any tax on capital, the assets tax has disincentive effects for investment. To address this concern, the Mexican law allows a taxpayer to make an irrevocable election to pay assets tax on the basis of assets as determined for the second year preceding the taxable year. This amount is adjusted for inflation. This election mitigates the disincentive effects of the tax for taxpayers making the election, but leads to some tax planning possibilities, particularly for growing companies.

A similar incentive could be provided by allowing companies to pay on the basis of the lesser of the opening or closing asset balance.

5. Exceptions for Nonproductive Periods

At certain times, assets may not generate income, for example, during construction. In response to this problem, assets tax laws often exclude assets from the tax base for specified periods of time before the generation of income. For example, in Mexico, the assets tax provides for certain periods during which no assets tax is due: (i) what the law calls the preoperative period, (ii) the first two years in which activity is begun, and (iii)

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[43] ARG IA art. 3(d).

[44] MEX ATL art. 4.

[45] MEX ATL art. 1. The liability extends only to the property leased.

the year of liquidation.[46] These exemptions can be criticized as a matter of theory: economic income can be expected to accrue even before there is cash flow.[47] However, the exception is understandable inasmuch as it matches the realization rules of the income tax and is consistent with the taxpayer's cash flow available to pay the tax. The exception complicates the assets tax, however, because it requires the determination of sometimes difficult questions of fact over which the taxpayer can exercise considerable control. Tax planning (including transfer pricing) opportunities are also created by the exemption of certain taxpayers, even if they are exempted for only a limited time.

6. Relation Between Assets Tax and Income Tax

a. Qualification for Foreign Tax Credit

Assuming that the assets tax takes the form of a minimum tax, the general principle is that the taxpayer pays the greater of the two levies. Implementation of this principle requires some care, however. To preserve the maximum foreign tax credit in the United States (or other countries with similar rules), it is desirable to structure the assets tax so that payments of income tax are creditable against it, rather than the other way around or rather than having the taxpayer pay the greater of the two amounts.[48] No foreign tax credit is allowed in the United States for the excess of the assets tax over the income tax. It is also necessary to specify how the rules for payment of estimated assets tax and income tax are coordinated.

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[46]The Colombian law contains exceptions for assets affected by force majeur and assets related to enterprises in a nonproductive period. *See* COL ET § 189.

[47]*See* McLure et al., *supra* note 24, at 141.

[48]*See* Rev. Rul. 91-45, 1991-2 C.B. 336.

b. Carryovers and Carrybacks

Perhaps the most difficult question is what to do about the problem of taxpayers who switch between paying the regular income tax and paying the minimum tax. There is no reason to require a taxpayer to pay more overall tax if its actual income fluctuates from year to year instead of remaining constant. In Mexico, taxpayers are allowed to carry forward the excess of assets tax over income tax to years when they have an excess of income tax over assets tax, and to be refunded assets tax to this extent.[49] Of course, this approach is complex, especially if the amounts of tax for the years in question are changed on audit, because all the years have to be recalculated if one is changed. Nevertheless, a carryover mechanism is necessary in order to provide equity between taxpayers in similar economic positions.

The amount of assets tax carried forward is adjusted for inflation in Mexico and should be adjusted in countries that generally practice inflation adjustment.

Because the Mexican tax allows a carryforward, but not a carryback, of assets tax in excess of income tax, it does not take care of all problems involving fluctuation in income. For example, suppose that assets and income tax liability of two Mexican taxpayers *X* and *Y* are as follows:

	X	*X and Y*	*Y*
	Income Tax	Assets Tax	Income Tax
1985	80	60	60
1986	90	85	85
1987	100	89	89
1988	110	100	100
1989	50	100	96
Total	430	434	430

Taxpayer *X* pays income rather than assets tax in all years up to 1989. Suppose that in this year it suffers a drop in business because of unfavorable trade conditions. Under a three-year carryback rule (which is not available in Mexico), it could carry its excess assets tax liability of 50 back to the 3 preceding taxable years. It would obtain, therefore, a credit of 10 for 1988, 11 for 1987, and 15 for 1986, for a total of 36. Therefore, in 1989, it would pay income tax of 50 and assets tax of 14.

Compare the situation of *Y*, which has the same total income tax liability as *X*, except that it is distributed in a different pattern from year to year. Because *X* is not allowed a carryback under the rules in effect in Mexico, it is disadvantaged relative to *Y*, which has a steadier stream of taxable income.

c. Nondeductibility of Assets Tax

[49]*See* MEX ATL art. 9.

It is generally provided that the income tax itself is nondeductible for income tax purposes. Payments of the assets tax should similarly be stated to be nondeductible in determining taxable income for income tax purposes, because the assets tax serves as a minimum income tax.[50]

7. Foreign Tax Credit

Assuming that the assets tax base includes assets held abroad, it is necessary to prevent double taxation, along similar lines as double taxation is avoided under the income tax by granting a foreign tax credit. Because the assets tax is a minimum tax, the relief for double taxation must be coordinated with the allowance of a foreign tax credit under the income tax.

In Mexico, a foreign tax credit is allowed against the assets tax for foreign income taxes paid by subsidiaries of the taxpayer.[51] Foreign taxes that are paid by the taxpayer itself are in effect creditable against the assets tax in that the amount of income tax that is credited against the assets tax is the amount of income tax liability, without reduction for the foreign tax credit.[52]

8. Valuation

Valuation is the Achilles heel of the assets tax. The tax would work reasonably well if the base were the fair market value of the taxpayer's assets. But if, as is customary, the value used is the tax cost for income tax purposes, then there can be a substantial deviation from fair market value. In the case of real property, one could use the assessed value for purposes of the real property tax, but the effectiveness of doing so depends on the quality of the assessments that are made for purposes of the property tax. The practical limitations on valuing property for purposes of the presumptive tax will ordinarily result in a substantial understatement of its value. Taxpayers will complain about overvaluation but will keep silent in the case of undervaluation.

Using the valuation of property for income tax purposes favors taxpayers who can avoid realizing gains, because such realization will lead to a permanent increase in future assets tax liability. As far as the assets tax is concerned, taxpayers who hold substantially appreciated property are in an advantageous position until they sell the property.

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[50]*See* VEN ATL art. 12.

[51]MEX ATL art. 9.

[52]For example, suppose that the domestic tax rate is 50 percent, foreign income is 40, foreign tax is 20, and total income is 100. If assets tax liability is 53, then the amount of assets tax to be paid is 3 (i.e., 53 reduced by pre-credit income tax of 50), and the amount of income tax to be paid is 30 (50 reduced by the foreign tax credit of 20). If the amount of foreign tax were higher—say, 25—then the taxpayer would still pay the same amount domestically because the foreign tax credit limitation would be 20.

If the income tax is explicitly adjusted for inflation, the inflation-adjusted values can be used directly for the assets tax. Often, instead of the income tax being adjusted for inflation explicitly, ad hoc methods are used to compensate for inflation or to grant favored treatment for particular investments. Thus, inventories may be valued under the last-in-first-out (LIFO) method, and depreciable assets may be accounted for using accelerated depreciation. Such methods understate the value of the assets in question, sometimes substantially so. If these values are used for assets tax purposes, distortions will result. Conceivably, assets could be valued differently for assets tax and income tax purposes, but this would involve some complexity. Valuation is a particular problem for intangible assets (such as goodwill and the results of research and development) whose cost is expensed for income tax purposes.

9. Exemptions

If it is desired to maintain certain income tax exemptions, analogous exemptions must be provided for assets tax purposes. For example, suppose that the income from state bonds is exempt from income tax. The value of the bonds would have to be excluded from the assets tax base in order to maintain the effectiveness of the exemption.

10. Tax Planning

Tax planning opportunities have been mentioned in several contexts in discussing the assets tax. In general, because some taxpayers pay income tax rather than assets tax, others pay assets tax, and yet others are exempt from assets tax for periods of time, incentives are created for shifting property, loans, or income from one taxpayer to another (or, in some cases, from one year to another). Some possible techniques for shifting assets and loans have already been described. Income can also be shifted from taxpayers who pay income tax to taxpayers who pay assets tax via transfer pricing and other techniques (such as acceleration or deferral of payments). Indeed, it is inevitable under a minimum tax such as the assets tax that some taxpayers will pay it and some will not, so that tax planning opportunities cannot be eliminated completely, although they can be diminished by adopting an assets tax with a minimum level of exceptions. As the discussion above demonstrates, the design of an assets tax involves complex issues. No matter how the tax is designed, taxpayers can be expected to engage in transactions to minimize their tax liability. Therefore, adopting this tax increases the transactional complexity of the system. On the other hand, assuming that the tax rate is fairly low, one has to shift a lot of assets to show a significant tax savings. Given a certain level of transaction costs for tax planning techniques, the extent of tax planning can therefore be expected to be limited.

11. Assets Tax with Partial Scope

A variant on the gross assets tax is a presumptive tax based on particular assets, which supplants only a portion of the income tax base. This approach has been applied to income from immovable property, whereby instead of taxing actual income a specified percentage is applied to the value of the immovable property.[53] While the presumption may be more or less valid over the long term, it can be quite inaccurate as applied to the income of a particular year if the income from the land tends to fluctuate. This suggests that there would be advantages to structuring such a tax as an exclusive presumption, which would also have better incentive effects. Such a tax would, however, be quite crude and unfair if valuation were not accurate, nor would it correspond to the criterion of ability to pay.

D. Industry-Specific Methods for Small Businesses

Minimum taxes based on turnover or assets can be applied to all taxpayers, including large companies. When the focus is on the taxation of small businesses, a number of presumptive methods that are more tailored to specific industries have been applied in various countries. Some of these are described below; other variants exist.

1. Fixed Amounts Based on Profession or Trade

Some countries apply a minimum tax based on an individual's profession or trade.[54] To avoid serious inequity, the presumptive amounts must be set at rather low levels. They are thus ineffective in taxing higher-income professionals. Indeed, if the presumptive tax raises substantial revenue, this is a sign that there is something seriously wrong with the regular tax. Perhaps these presumptive amounts are better than nothing, however. A slightly more refined alternative is to divide taxpayers within a given industry into two or three classes based on turnover, with a fixed tax for turnover within each band.[55] Taxpayers may also be divided into categories based on the type and amount of capital equipment used in the business; for example, owners of slot machines could be taxed on a fixed amount for each machine owned.[56] A distinction is also sometimes drawn based on the number of years a person has been out of school. If the presumption is applied as an exclusive rather than as a minimum tax, it is important to specify a turnover ceiling above which it no longer applies.

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[53]This method was formerly applied in the United Kingdom. *See* Income Tax Act, 1952, 15 & 16 Geo. 6 & 1 Eliz. 2 c. 10, sec. 82 (sched. A). Under this scheme, certain rented property was taxed according to the actual rental.

[54]*See, e.g.,* ALB SBT art. 3; KAZ TC art. 138(1). *See* Lapidoth, *supra* note 2, at 33-35 for discussion of standard assessments in Ghana, which were fixed amounts for specific trades.

[55]*See* Richard A. Musgrave, *Income Taxation of Hard-to-Tax Groups in* Taxation in Developing Countries (Richard M. Bird & Oliver Oldman eds., 4th ed. 1990).

[56]*See* Lapidoth, *supra* note 2, at 34.

2. Contractual Method

The contractual method (*forfait*[57]) used in France is a presumptive method that strives for a fair degree of accuracy. For a time, the *forfait* was widely applicable in France, covering some one million individual business persons as of the 1960s,[58] although its importance has dwindled more recently. Taxpayers are eligible for the system if their annual turnover is below a specified amount. The contractual method differs from other presumptions in that its application is based on advance agreement between the taxpayer and the tax authority to base tax liability on estimated income instead of on actual income.[59] The rules for eligibility for the *forfait* and for the procedure of its application are set forth in the statute.[60] The methodology for determining taxable income for purposes of the *forfait* to be applied by tax inspectors is set out in administrative manuals and circulars.

To apply the *forfait*, the taxpayer must furnish the following information with respect to the preceding year: purchases, sales, value of closing inventory, number of employees, amount of wages paid, and number of cars owned by the taxpayer. The tax administration then calculates the *forfait*, which is supposed to be an estimate of the "income which the enterprise can normally produce." As can be seen, the information furnished by the taxpayer requires a substantial amount of record keeping and, in fact, constitutes virtually all the information needed to determine taxable income, except for general business expenses. These are furnished by the tax administration, on the basis of industry-specific estimates. Once the administration supplies its estimated income, it is then subject to agreement with the taxpayer. The agreed figure applies for two years, that is, the preceding year and the current year. It may be different for each of these years, and the figure for the second year may be extended for one or several successive one-year periods.

The taxpayer has the option to use regular income accounting instead of the *forfait* method but, if electing the regular method, is bound to use it for three years.

Similar approaches apply in some other countries.[61] In Belgium, the tax authorities may agree with the taxpayer on a presumptive assessment that remains valid for three

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[57]The term *forfait* is linguistically confusing, because it can refer both to a contract and to a lump-sum payment. According to International Tax Program, Harvard Law School, Taxation in France 345–62 (1966), the term means “contract” in this context. Because *forfait* is also used to refer to other presumptive methods used in France, the term "contractual method" is used here to refer to this particular kind of *forfait*. *See* Précis de fiscalité ¶¶ 1341–62 (1994) for a description of its current operation in France. The discussion above draws from the more detailed discussion in Taxation in France.

[58]*See* Taxation in France, *supra* note 57, at 345.

[59]*See* Lapidoth, *supra* note 2, at 89.

[60]*See* FRA CGI arts. 302 *ter,* 302 *quinquies,* 302 *sexies*, 302 *septies.*

[61]*See, e.g., Note, The Tachshiv in Other Countries,* 31 Bulletin for International Fiscal Documentation 101 (1977) (describing provisions in the tax laws of several European countries that allow the taxpayer and the tax authorities to agree on a tax assessment).

consecutive years.[62] The method is restricted to taxpayers not in a position to keep proper accounts.

The estimation methods for determining the amount of the *forfait*, which are based on extensive statistical analyses conducted by the tax administration and on a detailed classification of industries, involve a lot of sophisticated work. Moreover, the application of the *forfait* depends on high-quality and honest tax inspectors:

> Since it is the local tax inspector who has authority to reach an agreement with the taxpayer, the caliber of the administration, especially the ability and honesty of the local inspector, is important to the success of the agreed income system.... In sum, the essence of the agreed income system is strong administration at the local level, with supervision at departmental and national levels.[63]

These factors suggest that the *forfait* may not be appropriate for many countries, and that careful consideration and planning should be undertaken before contemplating the introduction of such a scheme.

3. Methods Based on Turnover

Some countries tax particular types of income or income from specific industries on the basis of turnover, with presumptive deductions based on ratios developed for the industry or type of income in question.[64] This method responds to criticisms of the gross receipts method that there are different profit rates in different industries. However, it requires more research (and distinction among industries) to apply. This more finely tuned method is, however, suitable only for smaller businesses. Large companies would find it difficult to apply because they may operate in many lines of business. Their more complex structures also make it difficult to calculate an appropriate profit percentage.

4. Standard Assessment Guides

Standard assessment guides (*tachshivim* as used in Israel,[65] subsequently replaced by *tadrihim*) and similar methods are used in several other countries.[66] The *tachshiv* is

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[62]*See* BEL CIR arts. 342 § 1er, 343 § 1er.

[63]Taxation in France, *supra* note 57, at 357.

[64]For example, in France, in the case of income from the rental of immovable urban property, a deduction fixed as a specified percentage of gross receipts is allowed in lieu of an itemized deduction for depreciation, insurance expenses, and management expenses. Other expenses are, however, deductible in their actual amount. FRA CGI art. 31(I)(1)(e).

[65]The discussion here is based on Arye Lapidoth, *The Israeli Experience of Using the Tachshiv for Estimating the Taxable Income*, 31 Bulletin for International Fiscal Documentation 99 (1977). Other countries using similar methods include Spain and Turkey. The Musgrave proposal is also similar. *See* Musgrave, *supra* note 55.

[66]*See, e.g.,* ESP IRPF art. 69 (determination of income of small and medium enterprises on the basis of objective factors).

based on various ascertainable factors, which are developed for particular industries. For example, a restaurant may be taxed on the basis of location, number of seats, and average price of items on the menu. The objective is to determine net profit. The *tachshiv* does involve an element of agreement between taxpayers and the tax authorities, but the agreement is on the *tachshiv* in general (being negotiated with industry representatives), not on its application to particular taxpayers.

Although the general approach of the *tachshiv* is similar to that of the *forfait*, its legal status in Israel is different. It was not specifically authorized by the statute, other than being covered by the general authority to make best judgment assessments. Since the *tachshivim* were published, taxpayers in practice have relied on them, failing to keep or disclose adequate records in situations covered by a *tachshiv*, particularly when the results were advantageous to the taxpayer. One implication is that the *tachshiv* system resulted in understatement of tax, since it was a one-way street: taxpayers would rely on the *tachshiv* where favorable but keep records where that would be more favorable. While the existence of the *tachshiv* system did not relieve taxpayers of their obligation to keep adequate records, in practice taxpayers were not penalized for such failure. In reviewing cases involving assessment based on a *tachshiv*, courts held that the assessment could be altered by the court if the taxpayer could show that it was arbitrary in the particular case.

Another important difference between the *tachshiv* as applied in Israel and the *forfait* is that the latter is available only to taxpayers with a turnover below a specified amount, whereas the *tachshiv* is not so restricted.

Use of a method such as the *tachshiv* may be effective in extracting tax from small taxpayers in certain industries, but it is not easy to apply. Considerable background work is required by the tax authorities in specifying the factors to be used for particular industries and the relevant multipliers for each factor. Application of this method thus requires an investment in administrative infrastructure and adequate preparatory time. The method will be more suitable for some industries than for others. The key is whether the business is such that turnover can be ascertained from external evidence. Where it can, a *tachshiv*-type approach may be appropriate, provided that adequate administrative preparation is made.

In drafting provisions for standard assessments, it would be better to avoid the uncertain legal situation experienced by Israel and instead to provide statutory authority for their use. Because the determination of standard assessments involves considerable detail and empirical research, the details for their application cannot be contained in the statute. Taxpayers for whom the standard assessment is applicable should be specified, preferably on the basis of a turnover test along the lines of that used for VAT or for the requirement to use accrual accounting under the income tax. An important issue is whether for these taxpayers the standard assessment should be elective or mandatory. The preferable solution is to provide for mandatory use of the standard assessment for taxpayers with turnover below the threshold, but to allow the taxpayer to make an irrevocable election to use the normal accounting rules instead.

5. Taxation of Agriculture[67]

In many countries, income from agriculture is taxed on a presumptive basis if it is taxed at all.[68] The usual approach is to base the tax on the area of land and its quality. An estimate is made of the normal income that can be earned, given the productivity of that type of land, average costs of production, and the price of products. Relief may be provided for when the harvest in an area is bad. Certain activities may be excluded from presumptive taxation, and larger enterprises may be taxed on the basis of actual income.

For example, in France, farmers with a turnover of 500,000 francs or less are eligible for the presumptive basis of taxation.[69] The taxable income from agriculture is determined according to (1) the area of land that is under cultivation or could be placed under cultivation, (2) the type of crop, and (3) the region. For each region, the average profit for each type of crop is determined annually by a committee composed of representatives of the tax administration and farmers. If a natural disaster leads to crop loss in a region, then individual farmers who suffered from the calamity may apply for a reduction in tax on that basis. The basic rules for the presumptive taxation of agriculture are set forth in the statute.[70]

E. "Outward Signs" of Lifestyle

A presumptive minimum tax based on outward signs of lifestyle has operated for a long time in France. Similar systems apply in several Francophone countries of Africa as well as in some other countries.[71] In France, the presumption applies to all individuals, regardless of profession. Its application is discretionary, and the tax authorities have been instructed not to apply it when it would result in an exaggerated tax burden.[72] The presumption is based on certain outward signs of conspicuous personal consumption, which are specified in the statute. The signs of lifestyle of the taxpayer's spouse and dependents are aggregated. Not only ownership, but effective enjoyment, of items such as

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[67]*See* Ahmad & Stern, *supra* note 1, at 252–59; Richard Bird, Taxing Agricultural Land in Developing Countries 63–66, 147–50 (1974); Lapidoth, *supra* note 2, at 37–40.

[68]*See, e.g.,* DEU EstG § 13a (presumptive assessment of certain agricultural enterprises).

[69]This description of the French system is based on Précis de Fiscalité ¶¶ 314 to 342-3 (1994).

[70]FRA CGI art. 64.

[71]*See, e.g.,* GIN CIDE art. 31 (rebuttable presumption based on rental value of principal and secondary residences, domestics, and automobiles). In Mali, presumptive taxation is based on rental value of principal and secondary residences and automobiles. *See* MLI CGI art. 13. In Mauritania, presumptive taxation is based on the rental value of the principal and secondary residences, domestic servants, and automobiles. *See* MRT CGI art. 105. In Togo, presumptive taxation is based on rental value of principal and secondary residence, domestic servants, automobiles, motorcycles, tourism planes, travel abroad (plane tickets), pleasure boats. *See* TGO CGI art. 124. Lesotho has recently adopted a presumptive tax based on lifestyle factors. *See* LSO IT § 16.

[72]*See* Francis Lefebvre, Documentation Pratique des Impôts Directs, Série Impôts sur le Revenu des Personnes Physiques V (Feuillet no. 2) ¶¶ 290, 300 (March 1, 1983). Francis LeFebvre, Documentation pratique - Fiscal §§ 850-1080 (July 1, 1989).

vacation homes and yachts, is taken into account; brief possession, for example, for one month or less, is usually ignored.

Under article 168 of the General Tax Code of France, the following items are taken into account: rental value of the principal residence, rental value of secondary residences, number of domestic employees, automobiles, motorcycles, pleasure boats, airplanes, horses, hunting rights, and golf club memberships. For each item, a fixed amount per unit (in the case of domestics, boats, airplanes, and horses) is taken into account or the amount spent or value of the item is multiplied by a specified figure. The total is then compared with taxable income computed under the normal methods. If the presumptive calculation exceeds the normal calculation by more than one-third in both the current year and the preceding year, then the taxpayer is taxed on the amount resulting from the presumptive calculation. The presumptive calculation only applies, however, if the result exceeds an amount specified in the statute. For items taxed according to a fixed amount that have been at the taxpayer's disposition for only part of the year a pro rata portion is taken into account, and situations involving a brief time only are ignored.[73]Impôts sur le revenu des personnes physiques V (Feuillet no. 6) ¶¶ 1130, 1140 (July 1, 1985). Francis LeFebvre, Documentation pratique—Fiscal § 4285 (July 1, 1989). If an item is attributable to the taxpayer via a dependent and if the dependent attains majority during the year, again a pro rata portion of the item is taken into account.[74] If several persons are entitled to use a particular item, the base for the item is divided proportionally among them according to their respective rights.[75]

Losses carried forward from earlier years cannot be used to reduce the presumptive taxation, but they may be carried over to subsequent years. In drafting a rule of this kind, it may be helpful to spell out this result. Losses incurred in the year of application of the presumption may be carried over to future years.[76] The treatment of losses generated in the year of application of the presumption can be resolved by providing that taxable income for the year is no less than the amount specified according to the presumption; in this case there will be no such loss.

Because the comparison was to be made between presumptive and declared income, the French courts have held that article 168 applied only in cases where the taxpayer had filed a return.[77] To avoid this result, the drafter should make application of the rule independent of whether the taxpayer has filed a return or not. The French statute was so amended in 1986. The French courts have also held that adjustments to income

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[73]*See* Francis Lefebvre, Documentation pratique des impôts directs, Série

[74]*See id.* § 1150; Francis LeFebvre, Documentation pratique—Fiscal § 4450 (July 1, 1989).

[75]See FRA CGI art. 168(1), para. 3.

[76]*See* Francis Lefebvre, Documentation pratique—Fiscal, Série impôt sur le revenu des personnes physiques V (Feuillet no. 19) §§ 10510–10590 (May 1, 1995). The situation was previously less clear. *See* Conseil d'État, July 26, 1978, 5,679 Lebon 328. *Compare* Conseil d'État Oct. 15, 1980, 16,603 Lebon 367 *with* Francis Lefebvre, Documentation pratique des impôts directs, Série impôts sur le revenu des personnes physiques V (Feuillet no. 17) ¶¶ 3660, 3670 (Mar. 1, 1983).

[77]*See* Conseil d'État Mar. 21, 1975, 85,496 Lebon 217; Conseil d'État July 2, 1975, 83,242 Lebon 397.

made by the tax authorities are not to be taken into account in determining whether the presumptive income exceeds the declared income by at least one-third.[78]

The presumption was for a long time irrebuttable in France. In 1986, article 168 was amended to allow taxpayers to challenge its application by proving that their actual income was less than their presumed income. Which approach makes sense in a particular country is a matter of judgment. If the presumption is made rebuttable, taxpayers may bring court challenges that the tax administration will not win if it does not have sufficient information about the taxpayer. If the presumption is irrebuttable, its application will be unfair in some cases. In France, this problem was dealt with by instructing tax inspectors to apply the presumption only in cases where it was justified and by requiring a senior tax inspector to approve the application of the presumption.[79]

The French system results in an increase in tax for some taxpayers, but the number of cases involved is small and has decreased over time. For example, in 1960, the French Ministry of Finance reported that this regime resulted in a tax increase for 1,300 individuals,[80] but only several dozens of cases can be reported today.

As a matter of procedure, it may be helpful to the application of the method to require taxpayers to include on their returns the necessary information to establish the presumption, and even to self-assess the resulting tax in the cases of countries with self-assessment for the income tax. The obligation to include this information on the return can be limited to taxpayers whose factors for applying the presumption exceed specified amounts, so that in practice only a small number of taxpayers would have to supply this information.[81]

In drafting provisions for such a system to apply in a particular country, consideration should be given to the consumption patterns of wealthy individuals in that country, and as to whether there are any factors of a mechanically determinable nature that can be added to the list. Possibilities include the amount of electricity consumed and the amount paid for private school tuition.[82] The whole formula for applying the presumption, including the factors to be used and the amount of income to be imputed on the basis of each factor, should be set forth in the statute. This is because, unlike with the standard assessment guides, there is no need to make a detailed analysis of different industries and to delegate this work to the tax authorities. As an illustration of a set of

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[78]*See* Conseil d'État, April 24, 1981, 9,665 Lebon 189.

[79]*See* Francis Lefebvre, *supra* note 72, at ¶ 310; Francis Lefebvre, Documentation pratique-Fiscal, Série impôt sur le revenu des personnes physiques V (Feuillet no. 16) § 8910 (July 1, 1989). The requirement relating to an approval by a senior tax inspector has been maintained after the presumption became rebuttable. *See* LPF art. R 63-1.

[80]Taxation in France, *supra* note 57, at 364 n.286.

[81]This is the rule in Lesotho. *See* LSO IT § 16. It was previously the rule in France, but the requirement to include information about the presumption on the return was eliminated. *See* Précis de fiscalité ¶ 181.

[82]*See supra* note 71 for other factors used in various African countries.

rules adopted in an African country, a description of the relevant provisions from the Income Tax Act of Lesotho is set forth in Appendix A.

F. Conclusion

Some countries make little use of presumptive methods of taxation, given that such methods inherently involve unfairness, because they involve a departure from the normal accounting methods used to determine the tax base. Taxpayers who genuinely have no income might end up having to pay tax under a presumptive method that is not rebuttable.

On the other hand, if compliance with and administration of the income tax is so uneven that the normal rules do not lead to equal treatment of taxpayers with equal income, then presumptive methods may prove attractive. Of fundamental importance is the capacity of the tax administration to handle the particular presumptive method. For example, where corruption of tax service personnel is a serious problem, then an approach along the lines of the French contractual method is a recipe for disaster. To take another case, the *tachshiv* approach, which involves detailed study and preparation, should be undertaken only if the necessary groundwork has been laid.

Attention must also be paid to how a particular presumptive method will work in practice. If taxpayers can hide the factors on which the presumption is based as easily as they can hide income, then the presumption will not be of much use. This is an empirical question, which also depends on the administrative capacity of the tax authorities, and the appropriate methods will therefore differ from country to country.

Another element to take into account in evaluating whether and how presumptive approaches should be used is that presumptions can involve the granting of a tax preference. Depending on how a presumption is determined and applied, it can result in a reduced burden for particular kinds of taxpayers. This is particularly the case where the presumption is elective, as in the case of the French contractual method. Thus, the purpose of the presumption can become the protection of a certain group of taxpayers (e.g., small business or farmers) rather than protection of revenue. In cases where the presumption is preferential, its application is often limited. For example, it may be available only for taxpayers with a turnover below a certain amount. In some cases, the availability of the presumptive method may depend on the legal form of business organization. For example, if all legal persons are required to keep books under the commercial code, then the use of presumptions may be restricted to physical persons. While this approach has some justification, it has the disadvantage of discouraging incorporation in situations where the presumptive method is advantageous to the taxpayer.[83]

As the discussion in this chapter shows, once a decision has been made to adopt a particular presumption, the design and drafting problems are the same as those for any other tax: in effect one has made a decision to impose a new tax, which involves its own

[83] *See* Lapidoth, *supra* note 2, at 93-96.

problems and which may or may not be linked with another tax (in most cases, the income tax) as a minimum tax. Purely from the point of view of complexity of statutory language, adding presumptions is not a simplification, even if it is designed to ultimately simplify administration. As with any tax, if care is not taken in drafting, problems will be experienced when the new regime is put in place.

Appendix A. Lesotho Provision on Outward Signs of Lifestyle[84]

Section 16 of the Income Tax Act of Lesotho provides an alternative method of calculating the chargeable income of those taxpayers with low reported chargeable income but visible signs of substantial wealth. Under section 16, a taxpayer's minimum chargeable income is calculated on a presumptive basis having regard to visible signs of wealth to which objective values are assigned. The indicators of wealth used in determining minimum chargeable income are air travel, electricity consumption, value of the taxpayer's principal residence, school fees, the value of a secondary residence, and the value of the taxpayer's motor vehicle.

If the chargeable income of a resident individual calculated under the normal rules is less than the minimum chargeable income calculated under section 16, then the individual's chargeable income is the minimum chargeable income.[85] This method of taxation is included in the new law in response to the low level of compliance that has been detected among some wealthy taxpayers. The provision applies automatically without any need for proving that income has been concealed.[86]

Minimum chargeable income is calculated in such a way that it does not apply to most resident individuals. For example, this section does not apply to a resident individual whose income (other than income subject to a final withholding tax such as interest) consists solely of employment or pension income.[87] The justification for this rule is that this type of income is generally difficult to hide; it simplifies the system by removing most taxpayers from the scope of the presumptive tax. In this respect, the system in Lesotho differs from that of France, where no distinction is drawn among sources of income. Further, this section does not apply to a resident in receipt of

[84]Adapted from the Explanatory Memorandum to the Income Tax Act 1993.

[85]In this respect, the scheme differs from that applicable in France: the French system takes the previous year into account and applies only if the presumptive calculation exceeds the regular calculation by more than one-third. The French rule results in additional complexity, but it responds to the situation where there is a temporary reduction in income for the taxable year (the previous year's income being high enough so that the presumption does not apply).

[86]Except that, in the case of a taxpayer who declares only employment or pension income, the tax administration must prove that the taxpayer received some income from other sources in order for the presumption to apply. The amount of this other income need not, however, be proved.

[87]Under this rule, it is possible that a taxpayer with income other than employment or pension income could escape the scheme by completely hiding such other income. It is assumed that it would be quite difficult to completely hide a substantial source of income. To apply the scheme, the tax authorities would have to prove only that the taxpayer received some income other than from employment or pensions.

employment or services income that is entitled to diplomatic or similar exemption or that is exempt under a treaty or other international agreement. In the case of a husband and wife where neither spouse is excluded under the above rules, this section applies to the spouse with the greater chargeable income calculated under the normal rules. Finally, each of the indicators of wealth is taken into account only if it exceeds the threshold prescribed in a schedule to the act.[88] Most taxpayers will not have amounts that exceed the thresholds. Even where a taxpayer does have amounts that exceed the threshold for one or more indicators of wealth, the presumptive calculation will have no effect on tax liability where it is less than the taxpayer's chargeable income calculated under the normal rules.

A taxpayer's minimum chargeable income is the sum of the amounts calculated with respect to each of the indicators of wealth. No deductions are allowed in calculating the minimum chargeable income of a taxpayer. This means, for example, that the deduction for dependents, or deduction for a loss carried forward are not taken into account in calculating minimum chargeable income.

In general, the indicators of wealth taken into account include those for the spouse and minor children. The French rule substitutes "dependents" for "minor children." Reference to minor children is a simpler rule and prevents taxpayer arguments that certain children should be excluded from the calculation because they do not qualify for the dependency allowance (e.g., if their income exceeds the specified threshold for the dependency allowance).

The first component of minimum chargeable income is the air travel amount. The air travel amount of a taxpayer is the total cost of air or sea travel of the taxpayer, the taxpayer's spouse, and the taxpayer's minor children. The air travel amount does not include travel on the taxpayer's employer's business, but does include travel on the taxpayer's own business. The air travel amount is taken into account only if it exceeds M 2,500[89] for the year of assessment, in which case the whole amount is considered.

The second component of minimum chargeable income is the electricity amount. The electricity amount is the value of electricity consumed in the taxpayer's principal residence and secondary home. If there is more than one secondary home, then the electricity amount includes the value of electricity consumed in each home. The electricity amount is determined by reference to accounts rendered for electricity consumption during the year of assessment. The electricity amount is only taken into account if it exceeds M 3,000 for the year of assessment, in which case the whole amount is considered.

The third component of minimum chargeable income is the principal-residence amount. The principal residence of a taxpayer is the residence (whether in Lesotho or

[88]This is another point of difference with the French system. Under the French system, all the factors are taken into account and added up before applying a threshold.

[89]US$0.28 = 1 loti (plural maloti; currency abbreviation, M).

elsewhere) at which the taxpayer spends most of his or her time during the year of assessment. The calculation of this amount depends on whether the principal residence is owned or rented by the taxpayer or the taxpayer's spouse. If it is owned, then the amount is the greater of the adjusted cost base of the residence or the value of the residence for the purposes of property rates. Where the residence is rented, the principal-residence amount is the greater of eight times the actual annual rental or eight times the annual fair market rental for the year of assessment. The principal-residence amount is taken into account only if it exceeds M 150,000. If it does exceed this threshold, 5 percent of the principal-residence amount is included in minimum chargeable income.

The fourth component of minimum chargeable income is the schooling amount, consisting of tuition and related fees incurred in respect of the taxpayer's minor children during the year of assessment. Related fees include, for example, the cost of books, excursions, and after-hours tutoring. The schooling amount is taken into account only if it exceeds M 1,000 per child, in which case the whole amount is included in minimum chargeable income.

The fifth component of minimum chargeable income is the secondary-home amount. The secondary home of a taxpayer is a residence (whether in Lesotho or elsewhere) available for use by the taxpayer or the taxpayer's spouse or minor children.[90] If the taxpayer has more than one secondary home, then each is taken into account under this head. The secondary-home amount is calculated in accordance with the same principles as for the calculation of the principal-residence amount and is only taken into account if it exceeds M 20,000. If it does exceed this threshold, 5 percent of the amount is included in minimum chargeable income.

The final component of minimum chargeable income is the vehicle amount. This is the value of a motor vehicle[91] or vehicles owned or used by the taxpayer, the taxpayer's spouse, or the taxpayer's minor children. It does not include, however, the value of a vehicle that is wholly used for business purposes.[92] The value of a motor vehicle is determined in accordance with tables that are to be published by the Commissioner, and is taken into account only if it exceeds M 20,000, in which case 25 percent of the amount is included in minimum chargeable income.

The application of section 16 is illustrated by the following example:

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[90]In France, a residence has been held as available for use even when it has been offered for sale and in fact is not used, *see* Conseil d'État Oct. 15, 1980, 16,605 or when the taxpayer has allowed a relative to live there. *See* Conseil d'État July 10, 1981, 21,354, *available in* LEXIS, Intlaw Library, FRPBCS File. When the taxpayer puts the residence up for rent, it is considered as being at his or her disposal until it is actually rented. *See* Conseil d'État March 29, 1978, 3,856, *available in* LEXIS, Intlaw Library, FRPBCS File.

[91]In France, only passenger automobiles are included. *See* FRA CGI art. 168. By administrative practice, automobiles older than 10 years or that no longer function are not taken into account. *See* Francis Lefebvre, Documentation pratique—Fiscal, Série impôt sur le revenu des personnes physiques V (Feuillet no. 12) § 6800 *et seq.* (July 1, 1989).

[92]A similar rule applies in France. *See* Conseil d'État, Oct. 21, 1981, 23,679, *available in* LEXIS, Intlaw Library, FRPBCS File.

> Taxpayer is married with a spouse who does not derive any income and a ten year old child. The taxpayer receives a salary of M 60,000 and rental income of M 15,000, and has M 10,000 in deductions for the year of assessment (including the personal abatement). Taxpayer, therefore, under the normal rules has a chargeable income of M 65,000.
>
> During the year of assessment, taxpayer
>
> • spends M 10,000 in private air travel to Mauritius for his wife and child;
>
> • consumes electricity in the family home to the value of M 2,500;
>
> • has only one family home with an adjusted cost base of M 200,000 (this is higher than the value for the purposes of property rates);
>
> • incurs school fees of M 15,000 for his child; and
>
> • has a vehicle available for private use with a value of M 25,000.

Because taxpayer derives rental income in addition to his salary, he is subject to section 16. If the other income were interest, and subject to a final withholding tax, and not rental income, then section 16 would not apply.

For the purposes of calculating minimum chargeable income, taxpayer has amounts for air travel, principal residence, schooling, and vehicle. Because the value of electricity consumed is less than M 3,000 (the threshold set out in the Fifth Schedule), no electricity amount is taken into account in calculating minimum chargeable income. Taxpayer's minimum chargeable income for the year of assessment is M 40,000 (being M 10,000 + (5 percent x M 200,000) + M 15,000 + (25 percent x M 25,000)). Because this is less than the chargeable income calculated under the normal rules, section 16 does not increase taxpayer's chargeable income.

13

Adjusting Taxes for Inflation

Victor Thuronyi

If we could but learn to number our days...we should adjust much better our other Accounts.
—Abraham Cowley (1667)

Most countries do not adjust their tax systems for inflation, or do so only partially. When inflation reaches significant levels, however, its effects on the tax system cannot be ignored. The best remedy is to bring inflation under control; when this is not possible, it is often desirable to adjust the tax system to inflation in some manner.

This chapter discusses mechanisms of inflation adjustment for different taxes.[1] For taxes other than the income tax, the method of adjustment is relatively simple as a conceptual matter and does not require extensive discussion.[2] Inflation adjustment of the income tax base is more complex, being related to the questions of timing that make the income tax so difficult to operate. Section III, which forms the bulk of this chapter, is devoted to the income tax. Global adjustment of the taxation of business income in an environment of high inflation is given particular attention for the following reasons. First,

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[1]There is a large body of literature on inflation adjustment of taxes. To try to cite it all would be beyond the scope of this chapter, which focuses on global adjustment along the lines of that adopted in Latin America, which most of the literature in English does not directly consider. For a survey and analysis of inflation adjustment in Latin America, *see* Organización de los Estados Americanos, Inflación y Tributación (1978). *See* Keith Rosenn, Law and Inflation 295-370 (1982) for a survey of both partial and global adjustment of the income tax in a number of countries. Vito Tanzi, Inflation and the Personal Income Tax: An International Perspective (1980) is a comprehensive study from an economic perspective. Some recent articles of relevance to developing countries are Dale Chua, *Inflation Adjustment, in* Tax Policy Handbook 142 (Parthasarathi Shome ed., 1995) and Milka Casanegra de Jantscher et al., *Tax Administration and Inflation, in* Improving Tax Administration in Developing Countries (Richard Bird & Milka Casanegra de Jantscher eds., 1992). The interested reader can find references to most of the literature by consulting the citations contained in the books and articles cited throughout this chapter.

[2]*See infra* sec. II.

it is the only method that can work reasonably well under conditions of high inflation. Second, while it is well understood in the countries that use this method, it is less well known to tax experts in other countries. Third, once one understands global adjustment, one has a solid framework for analyzing partial adjustment methods (which include all adjustment schemes for taxpayers that do not practice double-entry bookkeeping). These differ substantially from country to country, and it would take lengthy discussion to do them justice, because their operation depends very much on how they fit in with the other tax rules of the country in question. This chapter therefore treats partial methods briefly, leaving their detailed analysis to others. Illustrative statutory language and technical commentary on global adjustment are contained in the appendices.

I. Effects of Inflation on Tax Liability—in General

To understand adjustment for inflation, it is helpful to distinguish among three effects[3] that inflation may have on real[4] tax liability. These are (1) erosion of amounts expressed in national currency, (2) erosion of the value of tax obligations, and (3) other effects on the measurement of the tax base. The techniques for compensating for each of these effects are different. They are discussed in sections A through C below. All, some, or none of these may apply to a particular tax. An example of a tax to which none of them applies is an ad valorem excise tax that is collected immediately; such a tax is unaffected by inflation and hence does not need adjustment. By contrast, the effect of inflation on the income tax is particularly complicated because all three effects are present.

A. Erosion of Statutory Amounts Expressed in National Currency

Every time a tax law contains an amount expressed in national currency, the value of this amount is eroded by inflation. Examples are (a) the levels at which the various tax rate brackets for the income tax begin and end, (b) the amount of the personal deduction for the income tax, (c) the amount of excise tax per unit (if this is stated in terms of national currency), (d) the amount of turnover according to which the requirement to register for the value-added tax (VAT) is measured,[5] and (e) specific amounts for penalties. In the income tax (or any other tax with a progressive rate schedule), the most important amounts expressed in national currency will usually be the exemptions and the rate brackets.[6]

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[3]These are similar to the categories identified in Hans G. Ruppe, *General Report, in* LXIIa Cahiers de droit fiscal international 89, 119 (1977). *See also* Tanzi, *supra* note 1, who draws conclusions similar to those outlined here.

[4]"Real" refers to an inflation-adjusted value, as opposed to "nominal," which is an amount in national currency without adjustment for inflation.

[5]*See supra* ch. 6, sec. II(B).

[6]Inflation erodes the value of the income that falls within each of the rate brackets, thereby increasing average rates of tax and increasing the number of taxpayers subject to higher marginal rates. This phenomenon has been called "bracket creep": individual taxpayers whose real earnings do not increase from year to year find themselves in higher and higher income tax brackets, because their nominal incomes have increased owing to inflation. The same erosion takes place for other amounts in the statute that are

The effects of inflation on revenue caused by the erosion of amounts expressed in national currency do not all run in the same direction. Pushing taxpayers into higher income tax brackets raises revenue. Reducing the real value of fines reduces revenue. In the case of the income tax, because the exemptions, other personal deductions expressed in fixed money amounts, and the rate brackets are so important for revenue, the net effect of the erosion of amounts expressed in units of currency is to increase revenue. In the case of an excise tax with specific rates[7], inflation reduces revenue.

The erosion of amounts expressed in national currency can be dealt with in a number of ways, the choice among these being largely a political one.[8] The most neutral and straightforward approach is to provide in the statute for automatic[9] adjustment, on a periodic basis, of any amounts expressed in terms of national currency. Another possible approach is to remove amounts expressed in national currency from the statute. For example, excise tax rates can be expressed ad valorem instead of as specific amounts.[10]

Inflation adjustment can be limited to specific items, while the value of others is allowed to erode.[11] The legislature can also enact periodic adjustments to rate brackets and other items instead of an automatic adjustment mechanism. But, in making these adjustments, the legislature would not be confined to exactly compensating for inflation. It could enact a "tax reduction" that would be spread among different interest groups as the legislature decided.[12] Moreover, by acting with delay, the legislature can allow inflation to have an effect over an interim period.

B. Erosion of Tax Obligations

Taxes are obligations of the taxpayer to the government. Inflation erodes the value of these obligations because of collection lags, which represent the difference between the time that a tax obligation arises (i.e., the time that the taxable event occurs) and the

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expressed in national currency, for example, limits on various deductions, limits of annual turnover below which simplified accounting methods can be used, or amounts of fines.

[7]That is, where amounts of tax payable per unit of product are specified in units of national currency.

[8]There are also some technical issues, the main one being the frequency of adjustment. The appropriate frequency is largely a function of the inflation rate. At low rates, annual adjustment is adequate. At higher rates, wage withholding tables or specific excise tax amounts should be adjusted every month or even more frequently.

[9]"Automatic" refers to a mechanism whereby the tax administration, or the ministry of finance, is directed to publish, at specific intervals (usually annually or monthly), tables setting forth the inflation-adjusted figures, based on a specified price index. *E.g.,* USA IRC § 1(f). There would be no discretion in preparing the table, other than a limited discretion to round amounts up or down.

[10]Whether this is wise or not is debatable. *See supra* ch. 8, sec. I(D).

[11]For example, a limitation on the deduction of home mortgage interest may be enacted. If this amount is not adjusted for inflation, then it is in effect phased out over time.

[12]This was done, for example, in the United States in the 1970s until the brackets were adjusted starting in the early 1980s.

time that the tax is paid.[13] The length of collection lags varies from tax to tax and often for different transactions covered by a single tax. With the income tax, the taxable event occurs at the time that income is received. The collection lag for the income tax varies according to the type of income. The tax may not be paid until after the end of the year, when the return is due. The tax on wages may be paid right away if it is collected through withholding. In this case, the collection lag may only be a few days, that is, the difference between the time the wages are paid and the time the withholding agent pays the withheld taxes to the budget. For the VAT, the collection lag is the difference between the date the sale occurs and the date the tax is due (typically, some time in the following month). Unless the obligation is indexed or unless interest must be paid for the period of the lag, inflation causes the real value of the tax obligation to erode, the extent of the erosion being dependent on the length of the collection lag.

The opposite can also occur. The government often ends up owing an obligation to the taxpayer, for example, when it must make a refund or when the taxpayer is entitled to carry over a deduction, such as a net operating loss deduction. If these are not indexed, their value is eroded.

The effect of inflation on tax revenues caused by collection lags is evident in the case of a sales tax. The taxable event is the sale. One should probably consider the sale as taking place in economic terms at the time when the benefits of use transfer to the purchaser. Depending on the scheme for when tax is due, there will be a certain lag between the sale and the time the tax is paid. The lag can arise, for example, because a sales tax return is filed, and tax paid, sometime after the end of the month (the lag is quite serious at high inflation rates when returns are filed on a quarterly or annual basis).[14]

A higher rate of inflation will decrease the effective rate of tax, the decrease being greater the longer the collection lag. If collection lags differ, inflation will decrease the relative yields of those taxes with longer lags. The same effect is produced by an increase in real interest rates, although the effect of inflation is typically more dramatic.[15]

The collection lag effect can be dealt with in different ways depending on the type of tax. One approach is to shorten the lag, particularly for those taxes with longer lags, by pushing forward the due date for payment of the tax or by requiring advance payments of tax. Collecting the tax through withholding, instead of through requiring payment with a return filed after the taxable event, will also shorten the collection lag. Another approach

[13]*See* Vito Tanzi, *Inflation, Lags in Collection, and the Real Value of Tax Revenue,* 24 IMF Staff Papers 154, 155 (1977).

[14]Another question is the definition of when the sale takes place for tax purposes. A collection lag may arise if the law defines the taxable event as taking place after the economic occurrence of the sale. For example, the taxable event may be defined as the time of issuance of an invoice, which may be issued sometime after services are performed and paid for. If the taxable event is delayed to the time of payment, this may not be a problem (as long as interest payments for consumer credit are included in the tax base), since the amount of the payment (including interest) can be expected to be determined taking inflation into account.

[15]*See* Tanzi, *supra* note 13, at 159 n.7.

is to index tax liabilities for inflation occurring between the taxable event and the time the tax is paid.[16] This is particularly important for taxes (e.g., income tax) for which the collection lag is long and cannot be shortened as a practical matter. A short collection lag, particularly if it is uniform in length for different transactions subject to the tax in question, can also be compensated for by raising tax rates. However, the result will be accurate only if the inflation rate holds constant. To cover cases when tax is paid after the due date, it is important that an adequate rate of interest be charged between the due date and the date the tax is paid.

C. Measurement of Tax Base

When the tax base is measured in historical units, inflation distorts the measurement of the base.[17] This is easy to see, for example, in the case of a tax such as the real property tax, which is based on historical valuations. On the other hand, the real value of the base of some other taxes, such as sales tax or an ad valorem excise tax, is not affected by inflation at all. This is because the tax base is current market value, which automatically keeps up with inflation.

The income tax presents one of the more complicated cases under this heading. Determination of the income tax base involves adding and subtracting accounting entries made at different times during the year in units of national currency. In the absence of inflation, adding and subtracting these amounts is straightforward, but under inflation the units are not comparable.

It is complicated to conceptualize inflation adjustment of the income tax, because both collection lags and tax base measurement are involved. In abstract terms, the income tax base can be conceived of as consumption plus change in net worth between two points of time that are infinitesimally close.[18] The delay between collecting tax immediately and waiting until the end of the year is a collection lag. The effect of inflation on tax base measurement arises because in order to ascertain the change in net worth, one must subtract net worth at the beginning of the period from net worth at the end of the period.[19] When there is inflation, this exercise should be performed by adjusting the beginning value for the inflation that has occurred during the period. To do so is central to the motivation for the income tax base. The base measures how much the

[16]Obligations owed by the government to the taxpayer should also be indexed.

[17]Strictly speaking, only the effects of inflation on the measurement of the tax base, other than effects arising from the erosion of amounts expressed in the statute in terms of national currency, are included under this heading. For a discussion of effects of inflation and some policy alternatives, *see* Daniel Halperin & Eugene Steuerle, *Indexing the Tax System for Inflation in* Uneasy Compromise 347 (Henry J. Aaron et al. eds., 1988).

[18]The rationale for this is spelled out in Victor Thuronyi, *The Concept of Income,* 46 Tax L. Rev. 45, 65–68 (1990); *see also* Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 Yale L. J. 1817 (1990).

[19]The effect of inflation on the measurement of taxable income was recognized by Simons, but he considered that "any attempt to allow systematically for monetary instability in the measurement of taxable income seems altogether inexpedient." Henry C. Simons, Personal Income Taxation 206 (1938).

taxpayer could have consumed during the period without altering the value of his or her wealth. A merely nominal increase in wealth should not be counted as giving rise to consumption potential. Only a change in wealth above and beyond inflation can be consumed while leaving the taxpayer's stock of wealth unchanged in real terms.[20]conditions, particularly when the inflation rate is very high, because under these circumstances relative prices tend to change more dramatically than when the general price level is fairly stable. Conceptually, however, the index number problem is of the same nature as the problem of using national currency to measure income where the general (average) price level is stable, given differences in consumer preferences and changes in relative prices. The extent to which the consumer price index overstates inflation and, hence, may be an inappropriate index to use without adjustment, is beyond the scope of this chapter. I will assume for purposes of this chapter that appropriate adjustments are made so that there is no such overstatement.

D. Reason for Categorization

In one sense, it can be said that inflation has only one effect on taxation, as on anything else, which is to erode values expressed in units of national currency. The above categories are therefore all subcategories of this one effect. What distinguishes them is not so much mathematical logic as it is the practicalities of how taxes work. It is helpful to distinguish among these categories in order to understand the effects of inflation on taxation in a concrete and practical way and in order to formulate workable solutions to counteract these effects. For example, one often hears complaints that inflation causes people to be taxed at higher and higher marginal rates (so-called bracket creep). It may seem, therefore, that this is a problem with the rates and that the remedy is to reduce the rates. In fact, it is a problem of the rate brackets being stated in terms of national currency, and the remedy to exactly compensate for this effect would be to adjust for inflation the levels defining the rate brackets, not to adjust the tax rates. In another example, if, as with a VAT under which there are no tax credit carryovers (i.e., where any excess credits are refunded immediately), the only effect of inflation arises from the erosion of the tax obligation (collection lag), then a practical remedy to reduce the effect of inflation would be to shorten the collection lag.

[20]To convert the value of beginning wealth expressed in beginning-of-the-period currency into end-of-the-period currency, some index must be used. If there has been no change in relative prices, all indices will be the same. Absent this assumption, the choice of index will make a difference. Use of a consumer price index (CPI) is appropriate because it looks at the value of the currency from the point of view of an individual consumer, which makes sense because the income tax is based on considerations of equity between individuals. This is also true of the tax on income of entities, because the owners of entities are individuals. The CPI will only be accurate for the average consumer whose consumption pattern matches the assumptions of the index. Other consumers will assign a different value to the national currency, based on their consumption patterns. Because it does not reflect changes in consumption patterns resulting from relative price changes, the CPI as usually constructed may overstate inflation. *See* Mark A. Wynne & Fiona D. Sigalla, *The Consumer Price Index,* Economic Review, Federal Reserve Bank of Dallas 1 (Second Quarter 1994). *See also* Vincent Koen, *Price Measurement and Mismeasurement in Central Asia,* IMF Working Paper (WP/95/82 Aug. 1995). Although this problem of choice of index is not peculiar to inflationary conditions, it tends to be aggravated under such

II. Adjustment of Taxes Other Than Income Tax

Inflation adjustment of taxes other than the income tax is straightforward and need not be discussed here in detail. In the case of the VAT, for example, there is not much of a problem, even at high inflation rates, given that the tax is usually collected every month. In a credit-method VAT, the tax base is sales minus purchases taking place during the month. If inflation is high, one might want to index the tax liability for inflation taking place between the occurrence of the taxable event and the payment of tax. If tax is due on the fifteenth of the following month, it would be appropriate to adjust tax liability for one month's worth of inflation, assuming that the average sale and the average purchase take place in the middle of the month. If inflation is really high (more than, say, 20 percent a month), one could require taxpayers to account for sales and purchases weekly or even daily, adjusting each amount for inflation. Of course, this would complicate administration of the tax and may be impracticable. If the VAT law does not allow an immediate refund of excess credits, but instead requires them to be carried over, the carryover needs to be adjusted to maintain the value of this obligation owed by the government to the taxpayer.

The personal consumption tax is not in operation in any country, but has been the subject of academic discussion. This tax can take several forms; here the form discussed by Graetz is assumed;[21] taxable consumption for a year equals total receipts minus total amounts invested. Such a tax does away with the need to ascertain the cost of particular assets and the time when gains are realized for tax purposes. It might seem, therefore, that no inflation adjustment is required, because there are no cost recovery deductions based on historic values. There remains, however, the problem of intrayear timing. Consider a simple example. Two taxpayers each receive $100 in cash, which they immediately spend. The only difference is that one taxpayer receives this amount earlier in the year. The tax base for each will be $100. However, the taxpayer who receives the amount earlier is able to purchase more valuable goods than the person who receives the same nominal amount later in the year. These problems can be dealt with by calculating the tax base on a monthly basis (or more frequently, if there is significant monthly inflation) and adjusting the tax liability for each month to the time of payment.

III. Adjustment of Income Tax

A. General Issues

The effect of inflation on the income tax is complex because it consists of a combination of the three effects described above. First, inflation erodes amounts expressed in national currency in the statute, most important, the tax brackets and personal deductions. Second, there is a collection lag, being the difference between the

[21] *See* Michael Graetz, *Implementing a Progressive Consumption Tax,* 92 Harv. L. Rev. 1575 (1979).

time income is received and the time the tax is paid. Third, the tax base is distorted, because inflation erodes the historic cost of the taxpayer's assets and liabilities.

Costs of acquiring property are accounted for in historical terms. The determination of income from property requires accounting for the cost of the property and allowing the taxpayer to recover this cost. Accounting for the cost in historic terms erodes the value of the cost recovery and overstates the tax base. For example, if property is sold, calculating the gain by subtracting the acquisition cost (measured in historic terms) from the sales price (measured in current units) will inflate the amount of the gain. In the case of depreciation, the amount of depreciation is understated if it is measured on the basis of historic cost. In the case of holding cash, there is no sales event, but cash held at the end of the period will have a lesser value than its historic cost stated at the closing price level, so that there is a loss in inflation-adjusted terms, but no loss if historic cost is used.

In the case of liabilities, inflation distorts the treatment of interest paid on debt. In fact, interest should be divided into two components: real interest and compensation for inflation. The latter is really not interest at all, but is repayment of a part of the principal of the loan.[22] Thus, the inflation adjustment of loans requires the inflationary component of interest to be subtracted in determining interest income and expense.

If the tax base is not adjusted for inflation, substantial over- or undertaxation can occur. The overall revenue effect of inflation on the tax base depends on a number of factors. Inflation can increase the tax base (this is particularly likely to happen if the scope for deducting interest expense is limited). In the absence of limitations on the deduction of nominal interest, inflation can erode the tax base, particularly if there is free access to credit and if much interest income escapes taxation, as taxpayers arrange their affairs so as to eliminate instances of overtaxation, and maximize opportunities for undertaxation.[23] On a more abstract level, inflation can be seen as destroying the integrity of all forms of accounting, including tax accounting, based on historic costs. Inflation makes it impossible to add or subtract amounts such as receipts, expenses, inventory balances, and so on, stated at historic costs and occurring on different dates. It is as if these numbers were expressed in different currencies. At high levels of inflation, the tax base becomes virtually meaningless.

So much is common knowledge. What is not so commonly understood is precisely how the income tax base should be adjusted for inflation and whether inflation

[22]The repayment of principal occurs because inflation reduces the real value of the debt. If the value of the debt has gone down, it must be because part of the debt has been repaid. Strictly speaking, under this analysis, the portion of the "interest" payment that should be regarded as repayment of principal should be determined with reference to the anticipated rate of inflation; if the actual rate differs from the anticipated rate, there will be a gain or a loss on the contract to either the debtor or the lender. Thus, there are three elements involved in what is nominally designated as interest expense: (1) interest, (2) repayment of principal, to the extent that the principal is eroded by inflation that was expected by the parties, and (3) to the extent that inflation is less than expected, a payment by the borrower to the lender reflecting the lender "winning the bet" on what inflation would be (the opposite if inflation is greater than expected).

[23]*See* Efraim Sadka, *An Inflation-Proof Tax System?*, 38 IMF Staff Papers 135, 140–41 (1991).

adjustment is feasible in the actual administration of an income tax. These points are explored below.

The method of adjustment for inflation must be tailored to the methods of accounting that are used under the income tax. In general, one would not want to allow a deduction for an inflation adjustment before the associated inflationary component of income is taken into account in determining taxable income. For example, if an asset is purchased at the beginning of year 1 and is sold at the end of year 5, at which time the gain is taxed, a deduction for the inflationary component of the gain should be allowed only in year 5.

If the asset is financed through debt, and if the interest expense incurred to finance the asset is currently deductible in years 1 through 5, it would be appropriate to adjust the interest deduction for inflation on an annual basis as well, that is, to deny a deduction for the portion of the debt that represents amortization of principal.[24] If, however, deduction of the interest expense is deferred until the asset is sold, then it would also be appropriate to defer the inflation adjustment of the interest expense.[25]

The general implication is that there is no unique, technically "correct" way of adjusting the income tax for inflation. The design of inflation adjustment rules appropriate for a particular country's income tax should be consistent with (1) the expected inflation rates in the country; (2) the rules for determining taxable income, particularly rules relating to the timing of income and deductions; (3) the ability of taxpayers and administrators to apply inflation adjustment rules of different degrees of complexity and the administrative and compliance costs of various alternatives; (4) revenue needs; and (5) transitional and other political accommodations required.

In general, one can classify inflation adjustment methods into three groups:[26] (1) ad hoc adjustment, which is an attempt to eliminate the effect of inflation wholly or partly on particular items, but which is not explicitly based on the current rate of inflation; (2) partial adjustment, which involves explicit inflation adjustment of particular items; and (3) global adjustment, which is a comprehensive adjustment to the taxpayer's accounts and is generally based on the accounting balance sheet.

B. Ad Hoc Adjustment

[24]*See supra* note 22.

[25]In general, where the inflation adjustment mechanism involves subtracting debt from the opening balance, an adjustment would have to be made for interest expense that is not currently deductible. Inflation adjustment based on the opening balance is the general approach of countries that use "global adjustment." *See infra* sec. III(D).

[26]For those readers who wish to compare the treatment here with that in Charles E. McLure, Jr. et al., The Taxation of Income from Business and Capital in Colombia, ch. 7 (1990), the term in the McLure book "integrated adjustment" corresponds here to "global adjustment," and "ad hoc adjustment" corresponds here to "partial adjustment." That is, McLure uses two terms, while this book uses three.

Ad hoc adjustment is effected through measures that are not explicitly based on calculating the amount of inflation, but that are designed to offset the effects of inflation on particular transactions. Examples are applying a lower rate of tax on capital income, accelerated depreciation, a partial exclusion for capital gains, last-in-first-out (LIFO) inventory accounting, and limitations on the deduction of interest expense or inclusion of interest income. Reducing the length of collection lags is also an ad hoc adjustment. This can be done by speeding up requirements for advance payments, accelerating the due date for final payment, or imposing withholding taxes.

None of these measures is based on the actual rate of inflation for the year. Depending on how they are structured, they may offset the effects of inflation with greater or less accuracy. Most also have other justifications. For example, both accelerated depreciation and preferential treatment of capital gains have been supported on grounds that have nothing to do with inflation, but have also been justified as ad hoc responses to inflation.

The realization rules of the income tax can also act as an ad hoc offset to inflation. At certain holding periods and inflation rates, the benefit to the taxpayer of being able to defer taxation of the gain until realization roughly offsets the detriment of having to pay tax on the inflationary component of the gain.[27]

Some countries with high inflation rates have required enterprise income tax to be calculated and tax to be paid on a quarterly or monthly basis.[28] In a rough way, this has the effect of protecting the tax base from inflation. It is reasonably accurate, for example, for service businesses, where capital is not a material income-producing factor. It does not, however, deal with problems such as the erosion in value of fixed assets or the inflationary component of interest income or expense.

Depending on how they are designed, ad hoc methods compensate for inflation to varying degrees. If the inflation rate is stable and fairly low, it is possible to largely offset the effects of inflation on taxable income by playing around with such adjustments. Ad hoc adjustments can be relatively simple because they do not require explicit calculation of inflation. In general, however, ad hoc adjustments are problematic because they are not completely accurate and, moreover, will retain their accuracy at only one rate of inflation. If the rate of inflation varies, ad hoc approaches will end up over- or undercompensating. Ad hoc adjustments cannot hold the system together if the inflation rate is high or variable.[29] Moreover, some types of ad hoc adjustments do not work accurately even if

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[27]*See* C. Eugene Steuerle, Taxes, Loans, and Inflation (1985); R.J. Vann & D.A. Dixon, Measuring Income Under Inflation 81 (1990).

[28]*See, e.g.,* Lege privind impozitul pe profit, art. 3, Monitorul Oficial, Jan. 31, 1991 (Romania, profit tax law—repealed 1994); Law of the Kazakh Soviet Socialist Republic of February 14, 1991, Concerning Taxes on Enterprises, Associations and Organizations, art. 8 (repealed 1995)(quarterly calculation of income and payment of tax).

[29]*See* Yishai Beer, *Taxation Under Conditions of Inflation: The Israeli Experience,* 5 Tax Notes Int'l 299 (1992).

inflation stays the same. Thus, for example, excluding one-half of nominal capital gains from tax will only by coincidence correspond to the inflationary portion of the gain (not to mention problems that arise from the deferral of tax and the leveraged financing of capital assets).

C. Partial Adjustment

Partial adjustment involves adjusting for inflation with respect to particular items of income or deduction, usually by indexing the cost of the capital involved. Most countries that adopt some form of inflation adjustment employ partial or ad hoc adjustments. Because these can take a countless variety of forms and because their design depends heavily on the specific features of the income tax law of the particular country, this chapter does not discuss in detail the problems involved. Instead, it focuses on global adjustment, because the relevant rules provide a conceptual framework within which partial and ad hoc adjustments can be evaluated.

Partial adjustments adopted by various countries include, for example, explicit indexation of the basis of depreciable property and indexation of the basis of property in computing capital gains.[30] Interest income or expense may also be adjusted for inflation. Another possibility is a onetime revaluation of the balance sheet, thereby allowing depreciation and capital gains to be computed on the basis of an indexed cost.[31] Japan allowed several write-ups of the value of fixed assets in the 1950s. *See* Mitsuo Sato, *National Report—Japan,* LXIIa Cahiers de droit fiscal international 411, 413 (1977).

Unless they are rather comprehensively applied (perhaps in combination with ad hoc methods), partial methods are dangerous because they can exacerbate imbalances in the system.[32] For example, if the only adjustment for inflation consists in indexing the basis of capital assets, then a preference for investment in such assets is created; financing of such investments through debt is encouraged; and an unfair preference is created.

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[30]*See* Finance Act 1982, secs. 86–87 (U.K.); J. Andrew Hoerner, *Indexing the Tax System for Inflation: Lessons from the British and Chilean Experiences,* 2 Tax Notes International 552 (1990) (indexation of capital gains); AUS ITAA §§ 160ZH, 160ZJ (indexing of capital gains); Tanzi, *supra* note 1.

[31]*See* Ruppe, *supra* note 3, at 105. Such a revaluation has been permitted twice in France. The upward valuation of assets was tax free, but a low level of tax was imposed on distributions made out of the revaluation reserve. *See* Pierre Beltrame, L'Imposition des revenus 120–22 (1970); Loi No. 59-1472 du 28 déc. 1959 portant réforme du contentieux fiscal et divers aménagements fiscaux, J.O. Dec. 29, 1959, art. 39 (FRA); FRA CGI art. 238 *bis* I, 238 *bis* J. Such a revaluation of the balance sheet clearly does not attempt to properly measure the income of an inflationary period, but it leads to a more realistic measurement of income for a period of stable prices following inflation. Paradoxically, therefore, the only time this inflation adjustment method may be justified is when inflation has ceased. The approach is also defective because it corrects for inflation in favor of the taxpayer, but not in favor of the fisc.

[32]*See* New York State Bar Association Tax Section, *Report on Inflation Adjustments to the Basis of Capital Assets,* 48 Tax Notes 759 (1990); *see also* vol. 2, ch.16.

Partial adjustments are complicated because the balances of assets or debts involved can fluctuate from day to day. For example, the balance of a loan (or of a bank account) can change from day to day, so that an accurate determination of the partial adjustment would require computing the inflation adjustment for each day. A similar problem occurs with inventory. Further, the acquisition cost of an asset may be incurred over a number of different transactions. Shares, for example, can represent reinvested amounts of dividends, which might be received each month over a number of years. Indexing the cost of the shares would require a separate calculation for each of these transactions. And some assets represent improvements that are incurred frequently.

If carefully implemented, partial methods can work as long as inflation remains moderate. At significant inflation rates, partial methods become problematic, so that they must either be extended to everything or replaced by an explicitly global method.

If partial adjustment is applied broadly enough, the result can begin to resemble global adjustment. Conceptually, it is possible to approach inflation adjustment from the point of view of removing the effects of inflation on each transaction that goes into the determination of tax liability—a partial approach applied comprehensively.[33] But the difficulty of this approach is that it requires inflation adjustment of countless transactions. Even a simplified approach would require taking inventory at frequent intervals, such as monthly, which may be commercially impracticable.[34] The only feasible way of accounting for each transaction in terms of inflation-adjusted units is to keep accounts in currency of constant purchasing power.[35]

D. Global Adjustment

1. General Issues

Global adjustment refers to a method for comprehensively removing the effects of inflation on the tax obligation as well as the effects on the tax base.[36] Similar methods of inflation adjustment are often used for accounting purposes in countries with high inflation rates. *See, e.g.,* International Accounting Standards Committee, *International Accounting Standard 29, Financial Reporting in Hyperinflationary Economies in* International Accounting Standards 1995, at 497 (1995). IAS 29 appears to reach approximately the same result as the global adjustment method described in this chapter,

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[33]This is, for example, the general approach of Vann & Dixon, *supra* note 27. John Bossons, *Indexing for Inflation and the Interest Deduction*, 30 Wayne L. Rev. 945, 960–61 (1984), takes a similar approach, calling for the indexing of the cost of all assets. *See also* Reed Shuldiner, *Indexing the Tax Code*, 48 Tax L. Rev. 537 (1993). However, no country has adopted such a "comprehensive partial" approach.

[34]*See* Vann & Dixon, *supra* note 27, at 90–99.

[35]*See infra* sec. III(D)(4).

[36]Previous discussions (in English) of global adjustment include McLure et al., *supra* note 26, at 189–273; Milka Casanegra-Jantscher, *Chile, in* Adjustments for Tax Purposes in Highly Inflationary Economies (proceedings of a seminar held in Buenos Aires in 1984 during the 38th Congress of the International Fiscal Association); Arnold C. Harberger, *Comments, in* Aaron et al., *supra* note 17, at 380.

but the means of getting to that answer seems to be more complicated, in that "all amounts [in the income statement] need to be restated by applying the change in the general price index from the dates when the items of income and expenses were initially recorded in the financial statements" and, in addition, the "gain or loss on the net monetary position is included in net income." *Id.* at 506. The latter "may be estimated by applying the change in a general price index to the weighted average for the period of the difference between monetary assets and monetary liabilities." *Id.* Global adjustment restates taxable income in terms of the price level prevailing at the close of the year. Global adjustment is based on adjusting items in the taxpayer's opening and closing balance sheet, rather than on particular items of income or deduction. Because it is based on a balance sheet, it can be applied only to taxpayers who account for their income using double-entry bookkeeping.

The elegance of global adjustment is that it achieves the same effect as adjusting each transaction for inflation during the year, but accomplishes this result by relying mainly on the opening and closing balance sheet. It requires adjusting only a selected number of the transactions that take place during the year, which are much easier to keep track of than movements of inventory and items of income and expense generally.

Global adjustment has been practiced for some time in countries that have suffered from chronic high inflation.[37] The method of global adjustment discussed below is based on the rules applicable in Chile, which have been in force since 1974. The rules in other Latin American countries with global adjustment are broadly similar.[38] In 1994, Romania adopted global adjustment for its profit tax.[39]

Because it is based on the balance sheet, global adjustment is easiest to understand as part of the net worth method of determining taxable business income.[40] In simplified terms, this method determines the taxable income of a business as the difference between the taxpayer's net worth at the end of the year and its net worth at the beginning of the year, with some adjustments. The method is described briefly below and in greater detail in chapter 16 of volume 2.

In an inflationary environment, all the elements of the net worth calculation must be adjusted for inflation. The global adjustment does this by restating each element of the net worth calculation in end-of-the-year prices. In very general terms, therefore, the global adjustment works because the net worth calculation works. This is not to say that the global adjustment method can be introduced in an income tax only if income is determined on the basis of a net worth calculation—it is easy to specify the global adjustments to an income tax that determines taxable income as the difference between

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[37]The countries employing global adjustment include Argentina, Brazil, Chile, Colombia, Israel, Peru, Mexico, and Venezuela.

[38] *See, e.g.,* VEN IR arts. 90–113; COL ET arts. 329–55.

[39]See ROM PT art. 5. The inflation adjustment became effective in 1995.

[40]*See* vol. 2, ch. 16, appendix.

income and expenses;[41] indeed, Chile itself uses the income-less-expenses method, rather than the net worth method, in defining taxable income.[42] The main requirement to apply the global adjustment is the drawing up of an annual balance sheet. When taxable income is determined as the difference between gross income and expenses, the global adjustment can be expressed as a series of additions to and subtractions from taxable income.

2. Global Adjustment in the Context of the Net Worth Method

This section explains a set of rules for global inflation adjustment in the context of an income tax that uses the net worth method to determine taxable income. These rules are closely modeled on those of Chile, although they are not identical to the Chilean rules in all respects. Alternatives to some of the rules described in this section are discussed in section 3 and in Appendix A. Appendix A consists of a more detailed statement of the global adjustment, in the form of illustrative statutory language and commentary.

a. Summary Explanation

The global inflation adjustment rules apply to enterprises that prepare, or are required to prepare, financial statements in accordance with accounting or commercial law (accounting balance sheet). The businesses that are required to do this are (in civil law countries) usually specified in the commercial code and may be both legal persons and physical persons.

The net worth method uses the net worth (assets minus liabilities) in the opening and closing balance sheets for the taxable year. The closing balance sheet is based on the accounting balance sheet and reflects both the assets and liabilities of the taxpayer at the close of the taxable year. The opening balance sheet for the taxable year is the same as the previous year's closing balance sheet. The values of items included in the closing balance sheet are adjusted for inflation taking place during the year.

Under the net worth method, taxable income is determined as the difference between closing net worth and opening net worth. It is also, however, necessary to subtract those items that increase closing net worth but that should not be included in taxable income, and to add items that decrease closing net worth but that should not be deductible in determining taxable income.

Accordingly, taxable income for the year is

(i) the amount of net worth reflected in the closing balance sheet, less

(ii) the inflation-adjusted amount of net worth reflected in the opening balance sheet, less

[41] *See* Appendix B.

[42] *See* CHL IR art. 31.

(iii) inflation-adjusted contributions to capital and inflation-adjusted incomes that are not taxable, plus

(iv) inflation-adjusted withdrawals made in favor of the owners and inflation-adjusted expenses that are not deductible.

Example

The opening balance sheet of an enterprise consists solely of 100 units of inventory purchased at $10 each. The firm has no other assets or debt. The consumer price index for the preceding December is 100. On July 1, (consumer price index for June is 200), the enterprise sells its inventory for $2,500 and invests the proceeds in a bank deposit that earns $2,500 to the close of the year. As of December, the consumer price index has risen to 400. The closing balance consists of $5,000 in cash.

Taxable profit is calculated as follows:

Closing net worth,	$5,000
Less inflation-adjusted opening net worth	$4,000
Equals taxable profit	$1,000

b. Adjustment of Opening Net Worth

The amount of opening net worth is adjusted for inflation for the taxable year. The amount of opening net worth is the value of total assets in the opening balance less the value of total debts and reserves in the opening balance. The reserves taken into account for this purpose are only those for which a deduction is allowed for income tax purposes. The opening balance is the same as the closing balance for the previous taxable period. See paragraph (j) below for rules on what is included in the balance. See paragraph (k) below for rules on how to determine inflation for the taxable period.

The inflation-adjusted opening net worth is subtracted in determining taxable income (item (ii) of the formula in paragraph (a) above). In the event that the opening net worth is negative (i.e., debts exceed the book value of assets), this operation results in an increase in taxable income, because a negative number is being subtracted.

c. Adjustment of Increases in Net Worth

Transactions that increase net worth, described below, are adjusted for inflation occurring between the month in which the transaction takes place and the close of the taxable period. The total inflation-adjusted amount of these transactions is subtracted in determining taxable income (item (iii) in the formula in paragraph (a) above).

These transactions consist of contributions to capital and nontaxable income. Contributions to capital are amounts contributed to the capital of the enterprise by its owner or owners.[43] Nontaxable income is any receipt of the enterprise that is not included in determining taxable income.

d. Adjustment of Decreases in Net Worth

Transactions that result in a decrease in net worth, described below, are adjusted for inflation occurring between the month in which the transaction takes place and the close of the taxable period. The total inflation-adjusted amount of these transactions is added in determining taxable income (item (iv) in the formula in paragraph (a) above).

These transactions consist of distributions and nondeductible expenses. Distributions are dividends, any other withdrawals of property from the enterprise by its owner or owners, and distributions in liquidation of the enterprise. Nondeductible expenses are expenses of the enterprise that are not allowed as deductions in determining taxable income, except for expenses that are added to the capital account of property.

e. Valuation of Items in Closing Balance

The value of items in the closing balance is adjusted for inflation as provided in paragraphs (f) through (i) below. The closing net worth is determined according to this adjusted balance sheet (item (i) in the formula in paragraph (a) above).

f. Valuation of Depreciable Property

Assume that the value of depreciable property in the closing balance is determined according to the pooling method,[44] except for property (such as immovable property) that is valued separately for each asset. Under such a system, depreciation for the year is calculated as a percentage of the pre-depreciation balance for each class of assets. This is equal to the opening balance[45]

(i) adjusted for inflation for the taxable year,

(ii) increased by the cost of any property in that class placed in service during the year, adjusted for inflation between the month in which the property is placed in service and the end of the year, and

(iii) reduced by the proceeds of disposition of any property disposed of during the year, adjusted for inflation between the month of the disposition and the end of the year.

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[43]As well as amounts contributed by nonowners if these amounts are considered nontaxable contributions to capital under the country's income tax law. *See* vol. 2, ch. 19.

[44]*See* vol. 2, ch. 17.

[45]The opening balance is determined as the closing balance for the preceding year, which takes into account depreciation for that year.

g. Valuation of Inventory

The purpose of the inventory valuation rules is to come up with a value that will approximate prevailing prices as of the end of the year while following rules of thumb that are easily administered.

Goods of a particular type are valued at the cost of the item of that type that has the highest nominal cost, adjusted according to the percentage change in the consumer price index between the month in which the item was acquired and the end of the taxable year. Where there is significant inflation, the item in question will usually be the last-acquired item.

When none of a particular type of goods has been acquired in the taxable year, the goods are valued at their opening balance value, adjusted according to the percentage change in the consumer price index for the taxable year.

Elements included in closing inventory that are produced, rather than purchased, including work in progress, are valued according to the same principles, in relation to the costs incurred in their production. When costs of producing an item of property are incurred in more than one month, each month's costs are adjusted according to the percentage change in the consumer price index between that month and the end of the taxable year. However, depreciation or amortization of intangibles that is included in production costs is not adjusted because it is already calculated in prices prevailing at the end of the year. When the inventory consists of both finished goods and work in progress of the same type, the work in progress may be valued as a proportion of the value of the finished goods.

h. Valuation of Foreign Currency Items

Holdings of foreign currency, debt claims or other securities denominated in foreign currency, and debts denominated in foreign currency are adjusted in accordance with prevailing exchange rates as of the end of the year.

i. Valuation of Other Items in Closing Balance

The value of other assets included in the closing balance is adjusted for inflation between the month the asset was acquired and the close of the year or, in the case of assets that are included in the opening balance, for inflation occurring during the taxable year. Assets whose value is fixed in terms of national currency are not adjusted (e.g., cash, debt instruments). Liabilities are adjusted as well. Thus, liabilities denominated in foreign currency or those with an adjustment clause would be adjusted, while those denominated in national currency would not be adjusted.

j. Items to Be Included in Balance

The balance sheet used for inflation adjustment is based on the accounting balance sheet, adjusted as necessary for tax purposes. For an enterprise owned by an individual, only the assets and debts of the enterprise are included in the balance sheet (i.e., not the personal assets and debts of the individual).

The assets included in the balance sheet are only those that have a value for tax purposes and are effectively owned by the taxpayer. Thus, for example, assets leased to the taxpayer under a finance lease[46] are included in the taxpayer's balance sheet because they are effectively owned by the taxpayer even though they are nominally owned by the lessor. The balance sheet does not include entries on the financial balance sheet that represent nominal, transitory, or pro forma values that do not constitute an effective investment. Nominal assets might include, for example, assets on the financial balance sheet such as know-how, trademarks, patents, and concessions that do not reflect capitalized costs incurred by the taxpayer. Pro forma accounts reflect responsibilities or other information for the financial accounting of the enterprise (e.g., shares under guaranty, endorsed bills, or discounted bills).

k. Measurement of Inflation

Inflation is determined according to the officially published CPI, which typically reflects prices as of the end of a particular month and is published early in the following month. To adjust opening net equity to the end of the year, it is therefore appropriate to use the index for December. Thus, inflation for 1996 is determined according to the change in the index between December 1995 and December 1996. Transactions occurring during a particular month that need to be adjusted to the end of the year are appropriately adjusted using a mid-month convention that assumes that, on average, transactions occur in the middle of the month. Thus, a transaction occurring in November 1996 that needs to be adjusted to the end of the year is adjusted according to the percentage change between the average of the CPI for October 1996 and November 1996 and the CPI for December 1996 (reflecting 1 1/2 months of inflation).[47]

l. Adjustment of Advance Payments, Tax Liability, and Loss Carryovers

The above-described inflation adjustment rules result in a measurement of taxable income in prices prevailing at the end of the taxable year. The amount of tax due is adjusted for inflation between the end of the year and the time of tax payment. Advance payments of tax that are credited against the tax liability are adjusted from the date they

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[46]I presume that the law sets forth rules describing the circumstances under which a lease will be treated as a finance lease as opposed to an operating lease. *E.g.,* KAZ TC art. 43. *See generally* International Fiscal Association, *Taxation of Cross-Border Leasing,* 75a Cahiers de droit fiscal international (1990). Assets leased under an operating lease would be included in the nominal owner's balance sheet.

[47]For example, suppose that a dividend of $500 is paid in November. Suppose that the CPI is 105 for October, 115 for November, and 121 for December. The average of the October and November indices is therefore 110, so that the applicable correction factor is 10 percent (121/110). Therefore, the adjusted amount of the dividend is $550.

are due until this same time. (If an advance payment is paid late, the taxpayer is liable for a penalty.)

Losses that are carried over from one year to the next are also adjusted for inflation. Thus, a loss of $1,000 for 1995 that is deducted against taxable income for 1996 should be adjusted according to the change in the CPI between December 1995 and December 1996.

m. Effect of Global Adjustment on Deduction for Interest Expense

The use of debt finance reduces the opening net worth by the nominal amount of the debt, and the closing net worth by the nominal amount of the debt plus accrued interest on the debt. The effect of global adjustment is that, in determining taxable income, the *inflation-adjusted* amount of opening net worth is subtracted. Because the debt decreases the opening net worth, the effect of the inflation adjustment is to increase taxable income by the amount of the debt, multiplied by the rate of inflation. This has the effect of denying a deduction for the inflationary component of interest expense. For example, consider the simple case where the taxpayer starts the year off with zero assets and a debt of $11,000,000. The closing balance is a debt of $22,500,000, representing the initial debt plus accrued interest of $11,500,000 (suppose there is 100 percent inflation, so that this amount of interest is reasonable). Under an unadjusted system, the taxpayer has a loss of $11,500,000, representing the deduction for interest expense. Under global adjustment, taxable income equals closing net worth (—$22.5 million) minus inflation-adjusted opening net worth (—$22 million), that is, a loss of $500,000. One would obtain the same result from denying a deduction for the inflationary component of interest expense.

3. Alternative Approaches

Under global adjustment, the elements of the closing balance are valued in prices prevailing at the end of the year. However, there is more than one way of doing this. One approach is to try to value property at its fair market value. Another approach is to value the property at book value (usually based on acquisition cost), adjusted for inflation occurring since the last valuation (i.e., inflation occurring since the date of the opening balance sheet or since the property was acquired, if acquired during the course of the year). Strictly speaking, only the second method—valuing property at its acquisition cost plus inflation—is "pure" inflation adjustment. Valuation at fair market value involves not only inflation adjustment, but also the taxation of gains or losses attributable to changes in relative prices. If the fair market value is used for the closing balance sheet, then these gains and losses are taxed, even if they are not realized. This approach may seem desirable to some and undesirable to others.

Some argue that if one is designing inflation-adjustment rules, market valuation should not be employed because this goes beyond inflation adjustment.[48] If, however, the

[48] *See, e.g.,* Harberger, *supra* note 36, at 383.

mandate is to design sensible income tax rules, regardless of whether they are called inflation adjustment, then it is necessary to decide on the merits whether inflation adjustment of the book value or a valuation that approximates fair market value is more desirable. This inquiry must be made separately for each type of asset.

Consider foreign currency. It is most straightforward to value foreign currency included in the closing balance at the exchange rate prevailing at the end of the year. It would, of course, be possible to instead adjust for inflation the acquisition cost of the particular currency. This would require one to keep track of the acquisition dates of foreign currency that is included in the closing balance. If acquired during the taxable year, it would be valued according to the change in the price index between the month of acquisition and the end of the year. If it was on hand at the beginning of the year, then it would be adjusted for the entire year's worth of inflation. For foreign currency, the mark-to-market rule is simpler than pure inflation adjustment. Moreover, valuation at the end-of-year exchange rate makes sense from a policy point of view because it leads to a more accurate reflection of the economic income from foreign-currency-denominated financial transactions.[49]

Instead of trying to devise a "pure" set of inflation adjustment rules, it is better to think in terms of an "inflation-adjusted" system, that is, a set of valuation and accounting rules that, together with the other features of the income tax, ensures that the system is relatively impervious to inflation and is also administrable and desirable under general principles of tax policy. Indeed, it may make little sense to pick out particular rules, call them the inflation adjustment rules, and evaluate their structure separately from the rest of the system. The entire set of rules for the income tax should be considered as a whole and evaluated under general principles of tax policy.

4. Equivalence Between Net Worth Calculation and Accounting in Constant Currency

Another way of comprehensively adjusting for inflation is to account for all transactions relevant to income tax in currency of constant value. This has the same effect as global adjustment. Accounting in constant currency means using an artificial currency determined by adjusting the national currency by the change in the CPI. It would be the same as accounting in foreign currency, assuming that the exchange rate for the foreign currency exactly corresponds to the CPI. Of course, this assumption will not hold, and so accounting in constant currency differs from accounting in foreign currency.

Constant currency accounting means that each transaction a taxpayer enters into is accounted for by converting it to constant currency at the exchange rate prevailing on the date of the transaction. In addition, every day the amount of cash held by the taxpayer throughout that day has to be determined, and the resulting loss from holding this cash is determined by subtracting its value in constant currency at the beginning of the day from its value at the end of the day. The books are kept in this constant currency. This means

[49] *See* Vann & Dixon, *supra* note 27, at 71–72.

that depreciation, gains and losses, inventory accounting, and so forth are all accounted for in this constant currency, so that the determination of taxable income is not affected by inflation. At the end of the year, the taxable income determined in this constant currency is converted to national currency at the exchange rate prevailing at the end of the year.

A relatively simple example can illustrate the operation of the net worth method and its equivalence to accounting for each transaction in units of currency with constant purchasing power. The facts are set forth in Table 1. The company in question starts out with $1,100 in cash at the beginning of Day 1. Each day, at the end of the day, it purchases inventory and sells inventory. The number of units bought and sold each day is set forth in columns 5 and 6, and the purchase and sales prices are set forth in columns 3 and 4. Total cash sales are in column 7 and inventory purchased is in column 8. The resulting cash flow is in column 9.

Taxable income is computed as follows on the basis of accounting in constant-value currency. Each transaction is recorded on the books in units of currency with constant value. The gain or loss from holding currency is also taken into account each day. The cost of goods sold is calculated on a first-in-first-out (FIFO) basis. As shown in columns 10 and 11, the units sold each day consist of items purchased on the preceding day and on the day itself. The cost of goods sold is accordingly given in column 12. This is derived by multiplying the number of units by their cost in constant currency. For example, for Day 2, the nine units have a cost of $130 divided by the price index of 1.3 (i.e., $100 apiece), and the two units dating from Day 1 have a cost of $110 divided by 1.1 (also, $100 apiece), for a total cost in constant currency of $1,100. Sales revenue is stated in constant currency in column 13 (i.e., each number in column 7 divided by the corresponding price index for that day). Sales profit (column 14) is sales (column 7) less the cost of goods sold (column 12). Column 15 shows the loss incurred from holding units of domestic currency, which is calculated by taking the amount of currency held during the day (the amount on hand at the beginning of the day), calculating its value in constant units at the end of the day, and subtracting its value in constant units at the beginning of the day. Adding columns 14 and 15 gives the total profit for each day (column 16). The total profit in constant currency for the four days is $15.79.

Table 2 shows the global adjustment/net worth method of calculating profit. The closing net worth consists of $1,320 in cash and four units of inventory. Both of these are valued in constant currency in column 1. The inventory is valued on a FIFO basis, with cost stated in constant currency (the units all happen to date from the last period, so their unit cost is $200 divided by 1.9). Total assets in constant currency are therefore $1,115.79. The opening net worth is $1,100 (the company having started out with cash only). The profit for the four-day period is determined by subtracting $1,100 from $1,115.79. This gives the same answer as that obtained in Table 1. The example illustrates that global adjustment gives the same result as keeping books in currency of constant value and requires far fewer calculations.

5. Determination of Specific Types of Income

Global adjustment is effective in determining the taxpayer's total taxable income. Things become more complicated if it is necessary to break income down into specific categories. The income tax law may, for example, contemplate special rules for capital gains, business income, or foreign-source income.

To create separate categories in an inflation-adjusted system, one would in effect have to allocate the inflation adjustment among different categories of income. Unfortunately, this cannot be done by allocating on a pro rata basis. What would be required to distinguish foreign-source income, for example, from domestic-source income is to create two different balance sheets. One would reflect the assets and liabilities related to the earning of domestic-source income, and the other, those relating to foreign-source income. Inflation adjustment would be separately applied to each, and domestic-source and foreign-source income could be correspondingly determined by applying the net worth comparison to each balance sheet. In some cases, this approach would be problematic because some items can be related to both foreign-source and domestic-source income.

Although it is therefore possible to determine separate inflation-adjusted categories of income, it obviously involves considerable complexity. This suggests that it would be better under an inflation-adjusted system to minimize the number of separate categories or to come up with simpler rules to determine the breakdown. For example, in the case of the foreign tax credit, if the foreign-source income is determined in a foreign currency (assuming that the currency does not involve substantial inflation), one could calculate the foreign tax credit limitation according to the ratio of foreign tax paid and foreign-source income in the foreign currency. (The equivalence of inflation adjustment and income determination in a foreign currency is discussed below.) If the income tax is fairly clean, and involves a substantial degree of mark-to-market taxation, then it should be possible to largely do away with special rules for separate categories of income. Indeed, it may be necessary to do away with most such rules in order to feasibly operate a global adjustment system.

6. Limitations on Expenses

Closely related to problems involved where income is broken down into different types are problems having to do with limitations on expenses. In a world without inflation, it is not too difficult to provide limitations on various kinds of deductions, expressed in terms of either an amount of money or a percentage of income. In an inflationary situation, such limitations are difficult to calculate, because expenses may be incurred at different times, so that the nominal amount of the expenses cannot simply be added up. What would be required is to itemize the expenses for each month, adjust these for inflation, and then compare them with the amount of the limitation.

Even more difficult is dealing with a limitation on the deduction for interest expense.[50] Because the global adjustment has the effect of denying a deduction for the

[50]*See* vol. 2, ch. 16.

inflationary element of interest expense, it would be incorrect to add up interest expense, compare it with the limit, and deny a deduction for the excess. What would be required is to calculate the amount of real interest expense and to subject only this amount to potential denial. This would require determining the average level of outstanding debt or, alternatively, a method of approximation.

While calculations such as these can be made, the message is that any limitation on deductions becomes substantially more complicated in the context of global inflation adjustment, so that if this method is to work properly, limitations should be kept to a minimum. This would not be true of limits based on a percentage of each expense. For example, if 75 percent of entertainment expense is denied, then the limitation is easy to determine because it applies to the amount of each expense. The amount of deduction denied in each month still has to be kept track of, however, because it is necessary to adjust each month's nondeductible expenses for inflation under the global method.[51]

E. Inflation Adjustment of Nonbusiness Income of Individuals

Countries employing global adjustment generally do not apply it to all taxpayers. Because it requires rather sophisticated accounting, global adjustment is restricted to taxpayers using double-entry bookkeeping. Although this would include some individuals with business income, the global adjustment is applied only to the assets and liabilities that are part of the business.

Various combinations of ad hoc and partial methods are applied in different countries to measure taxable income from capital of individuals (other than income subject to global adjustment). For example, in Argentina,[52] individuals may index for inflation the tax cost of property for purposes of computing gain on disposition and computing depreciation. Moreover, virtually all interest income of individuals is excluded from taxation. Part of the rationale for this exclusion was that it would be difficult to index interest income;[53] moreover, given the fact that historically interest rates had often been zero or negative in real terms, it was felt that taxation of interest income would be unnecessary. Interest expense is, however, fully deductible in Argentina if incurred in earning taxable income, and this has resulted in some anomalies, where the associated investment income is not fully taxed on a current basis.

Ad hoc or partial adjustments to the measurement of taxable income from capital of individuals may suffice in a country with moderate inflation. When inflation approaches annual levels of 100 percent or higher, though, there is the problem that an individual's income is computed on an annual basis, without adjustment for changes in the price level during the year. For example, a taxpayer who earns $100 at the beginning of the year and incurs a deductible expense of $100 at the end of the year pays no tax,

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[51]*See supra* Sec. III(D)(2)(d).

[52]The discussion in this paragraph reflects the law as of 1990.

[53]For example, the global adjustment does not attempt to separately identify the inflationary component of interest income.

even if the price level is much higher at the end of the year; the real value of the expense is therefore less than that of the income. A solution that has been adopted in Brazil is to require individuals to calculate their income and deductions on a monthly basis, and to index these amounts, together with amounts withheld and estimated tax payments made, for inflation occurring between the month in question and the end of the year. This system of monthly accounting works well for income from services, but the system would not suffice to adjust income from capital, because it does not index the tax cost of property. Combined with partial methods that provide such indexing, monthly accounting can provide an acceptable scheme for taxing individual income, the drawback being the administrative complexity involved in multiplying the number of accounting periods.

The monthly income of individuals does not need to be indexed to the extent that tax liability is satisfied by withholding. In many countries, taxpayers with income from wages have tax withheld currently and are not required to file a return at the end of the year.[54] Because the tax liability is satisfied currently, there is no need for inflation adjustment of the tax base. The amounts in the withholding tables that are stated in local currency (i.e., the brackets) must, however, be adjusted on a monthly basis, or even more frequently when inflation rates are very high. If there is over- or underwithholding, then monthly indexing of the over- or underwithheld amounts as described for Brazil would be necessary.

F. Collection of Tax

The above discussion of global adjustment implicitly assumes that tax is paid at the end of the year. In practice, however, the payment of tax is more complicated. First, the tax liability is generally due not at the end of the year, but at the time that the return for the year is due. Second, a considerable portion of income tax liability is satisfied during the year in the form of withholding and payments of estimated tax. The rules for indexing these advance payments of tax must be considered in conjunction with the inflation adjustment rules analyzed above.

Amounts withheld should not be indexed if the corresponding income is not indexed. If, however, monthly indexing of income and expenses is adopted, then amounts withheld and estimated tax payments should also be indexed up to the end of the year, and the net amount due should be indexed from the end of the year until the date of payment.

In the case of companies (and sole proprietorships subject to global adjustment), given that global adjustment expresses the taxpayer's income in terms of the price level prevailing at the close of the taxable year, it is appropriate to adjust amounts withheld and estimated tax payments made for inflation occurring between the time the payment is made and the end of the year. The balance due (tax liability less these indexed amounts), or refund due, if there is a refund, should then be indexed to the time when the tax is paid or the refund is made.

[54]*See* vol. 2, ch. 15.

Business losses and capital losses allowed as a carryforward deduction from previous years should also be indexed. In effect, these involve the taxpayer's claims for tax refunds against the government, the value of which should be maintained in real terms.

G. Foreign Currency Translation

An alternative way of looking at inflation adjustment is that it involves the same process as translating into domestic currency the income of a business that keeps its books in foreign currency. As shown above in section D(4), global adjustment is equivalent to keeping books in units of currency with constant purchasing power. The main difference between inflation adjustment and translation of accounts kept in foreign currency therefore lies in the index used to deflate domestic currency: the consumer price index versus the exchange rate.

The net worth/global adjustment method resembles the net worth method used to determine the income of a foreign branch, which has been in use in the United States since the 1920s.[55] Under the U.S. net worth method, the income of a foreign branch is determined as the difference between closing and opening net worth, with proper adjustment for profits distributed during the course of the year.[56] All of the terms of the formula are determined in foreign currency (assuming that the foreign branch keeps its books in foreign currency), but are then translated into U.S. dollars. Fixed assets are translated at the exchange rate prevailing at the time they were purchased. Current assets are translated at the exchange rate in effect at the close of the year. Distributed profits are translated at the exchange rate in effect at the time of distribution.

The purpose of the net worth method, which is to determine the income of the foreign branch or corporation in U.S. dollars, is exactly analogous to the purpose of determining the income of a domestic corporation in units of fixed purchasing power. In performing inflation adjustment, one is in effect translating one currency (nominal units of national currency) into another (currency of a fixed purchasing power); the "exchange rate" at any time is given by the CPI. The general problem, then, can be stated as one of determining in units of currency *x* the income of a business that keeps its books in currency *y*. Properly applied, the net worth method of translation into U.S. dollars would have exactly the same effect as the global adjustment rules in a situation where there is no inflation in the United States and where exchange rate changes exactly mirror price level changes in the foreign country in which the branch operates.

This analogy reveals the defects in the net worth method as it was previously applied in the United States. The primary problem is that "current" assets (other than foreign currency and debt) are translated at the year-end exchange rate. Instead, under the

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[55]*See* Donald R. Ravenscroft, Taxation and Foreign Currency 85–87 (1973). I will call it the "U.S. net worth method."

[56]*See* Rev. Rul. 75-106, 1975-1 C.B. 31; Rev. Rul. 75-134, 1975-1 C.B. 33.

inflation adjustment rules set forth above, such assets (e.g., inventory) should either be translated at the exchange rate prevailing at the time of purchase, or marked to market in U.S. dollars at year-end. Valuing them at their foreign currency acquisition cost, translated at the year-end exchange rate, can result in a gross deviation between their true value and their value in the balance sheet. The problem has long been known.[57] What is remarkable is that it remained uncorrected for so long.

Recently, regulations have been issued providing a revised methodology for the net worth method, called the "United States dollar approximate separate transactions method of accounting" (DASTM).[58] The regulations provide for a rather convoluted calculation for determining the profits of foreign branches that keep their books in a hyperinflationary currency. Total income is determined according to a net worth calculation performed in U.S. dollars. In general, the items included in the balance sheet that is used to determine net worth are valued at the U.S. dollar exchange rate as of the time that the item was acquired.[59] Certain items denominated in the hyperinflationary currency are, however, valued at the year-end exchange rate (bad debt reserves, prepaid income or expenses, holdings of hyperinflationary currency, and hyperinflationary debt obligations and financial instruments). This is appropriate for the same reason that items denominated in local currency are not indexed in applying global adjustment (see section D(2)(i) above). By contrast, other "current assets" are valued not at the year-end rate, as under the former net worth method, but rather at the rate obtaining at the time of acquisition. Therefore, the net worth method under Reg. sec. 1.985-3 should result in an appropriate measure of taxable income.

The regulation does not stop at measuring total income according to the net worth method. It also contemplates the translation of income and expenses of the branch (accounted for in foreign currency) into U.S. dollars at the exchange rate for the month in which the income and expenses are incurred. This is not exactly the same as keeping the books in U.S. dollars. For example, gains and losses with respect to foreign currency assets and liabilities are not taken into account under this calculation. The difference between this amount of income and the income determined according to the net worth method is called the "DASTM gain or loss" and, in order to determine the character of income for purposes of the foreign tax credit limitation, the controlled foreign corporations provisions (Subpart F), and the like, this amount is allocated to assets of the branch in a calculation (reminiscent of a Balkan line dance) called the "DASTM 9-step procedure."

The analogy between foreign currency translation and inflation adjustment suggests that another acceptable method of inflation adjustment in a hyperinflationary economy should be to keep books in U.S. dollars or another strong currency. (The year-

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[57]*See* Ravenscroft, *supra* note 55, at 278–79.

[58]*See* U.S. Treas. Reg. § 1.985-3. *See generally* Douglas Hassman et al., *A Practical Guide to Applying DASTM to the Current and Prior Taxable Years,* 10 Tax Notes Int'l 662 (1995); Charles Cope & Robert Katcher, *Final DASTM Regulations Provide Significant Advantages to Businesses Operating in Hyperinflationary Countries,* 9 Tax Notes Int'l 753 (1994).

[59]*See* U.S. Treas. Reg. § 1.985-3(d)(5).

end result would then be translated into local currency at the exchange rate prevailing at the end of the year.) If every transaction were accounted for in dollars rather than in local currency, the result would be the same as under global adjustment, except that the exchange rate may depreciate at a different rate from the inflation rate[60] and thereby lead to a substantially different result.[61] If this difference is considered acceptable as a matter of policy, and if there are business reasons for a company to keep its books in dollars, then dollar accounting could be authorized as an alternative mechanism of inflation adjustment. This approach may be complicated for many taxpayers because it requires every transaction to be converted into foreign currency. However, it would not be difficult for taxpayers who already keep their books this way for business reasons. Companies with substantial international operations may find it easier to keep books in one of the major currencies. Keeping foreign currency books is an alternative to inflation adjustment for limited categories of taxpayers in Israel.[62]

IV. Conclusion

In deciding what inflation adjustment methods to adopt, if any, their administrative costs for taxpayers and for the tax administration should be carefully considered.

For example, the global method of inflation adjustment can be adopted only for companies having access to well-trained accountants. A simplified version of the global method can be adopted if inflation rates are moderate. Partial adjustment can be more complicated than global adjustment, because it may require a greater number of calculations. Ad hoc adjustment requires no inflation calculation, and so is administratively the simplest to apply, although, as pointed out, it may involve serious distortions.

Collection lags can be dealt with by shortening the lag; this may require more compliance effort by taxpayers and tax administrators collecting the tax, for example, if more frequent tax payments are required. The collection lag problem can also be dealt with by adjusting tax payments for inflation up to the date of payment. This requires putting into place procedures for this calculation and complicates payment procedures. Such procedures may be required only at higher inflation rates. Similarly, advance payments can be adjusted for inflation, but this also involves additional complexity for taxpayers.

Only global adjustment can eliminate both effects of inflation on the income tax, that is, the erosion of tax obligations and the distortion of the tax base. Partial adjustment, although not a perfect solution, can, if comprehensively applied, eliminate the distortion of the tax base. It does not, however, deal with the collection lag problem because it is

[60]Another difference is that, depending on how the global adjustment is structured, the closing balance may involve marking some items to market rather than adjusting them according to the price index.

[61]A more complex alternative would be to use a basket of currencies.

[62]*See* ISR IT art. 130A.

confined to adjusting the historical cost of assets and debts. But if inflation is relatively low (i.e., say, about 30 percent a year or less), the collection lag problem on average is not that significant for the income tax and partial adjustments can be reasonably accurate. Partial methods can, however, be problematic at such inflation rates if they are not comprehensively applied. Thus, if some elements of the tax base are adjusted and others are not, serious distortions can arise. Indeed, the total distortion can be worse than if there is no adjustment. For example, if the only adjustment is to the cost of assets for purposes of determining taxable gain and depreciation, while interest is not adjusted, then a severe incentive is created to finance assets with debt. This can easily lead to "negative tax rates";[63] that is, instead of collecting tax on the income from a certain asset, the tax rules actually create a tax loss, which can be used to shelter other income and reduce the taxpayer's tax liability.

It is therefore possible in principle to adjust the income tax fairly accurately for inflation. However, accurate adjustment can involve considerable complexity. The degree of complexity depends on the underlying rules of the income tax. In a relatively clean system without a lot of special rules that require drawing distinctions among many different categories of income and expense, the inflation adjustment rules are not excessively complex. Perhaps the most complicated aspect is the inflation adjustment of indirect costs. For example, although inflation-adjusted depreciation by itself is not difficult to calculate, the absorption of depreciation and other expenses into the cost of items being produced by the firm in a context of rising prices is more complicated. If produced items are valued at the cost of production, but these costs are incurred over the course of several months, it is necessary to adjust the production costs incurred each month for inflation in order to express them all in comparable units. Such an exercise is complex, but the complexity is probably not substantially greater than that involved in absorption cost accounting generally.

Where inflation adjustment may become unworkable is in systems that are complex to begin with. If the rules of the income tax impose different substantive rules for different types of income (e.g., if different elements of foreign-source income are subject to separate foreign tax credit limitations), then each of the separate types of income must be calculated on an inflation-adjusted basis. Similarly, if special limitations apply to particular types of expenses, then these expenses must be calculated in inflation-adjusted terms. On the other hand, if the income tax law taxes all corporate income on an evenhanded basis, then the determination of total inflation-adjusted income under the net worth method is straightforward. To take the U.S. system as perhaps the extreme pole, where countless items of income and expense must be separately determined, one can imagine the effect of superimposing inflation adjustment rules onto such a system. In contrast, the corporate income tax laws of many developing countries with high inflation rates are relatively simple, taxing all corporate income at a uniform rate and making few or no distinctions among different types of income. In the context of such relatively simple laws, inflation adjustment is feasible.

[63] *See* McLure, *supra* note 26, at 67 (1990).

To the extent that there are concerns about complexity, the global adjustment method can be simplified by applying it only to the opening and closing balances. Instead of adjusting for inflation dividends, contributions to capital, exempt income, nondeductible expenses, and acquisitions of assets during the year according to the month of the transaction, a half-year convention for all these transactions could be used. The timing of transactions occurring during the year that involve either an increase or decrease in net equity (contributions to capital, dividends paid) or the purchase of property subject to inflation adjustment (such as depreciable property or land) is ignored under this approach. Alternatively, the half-year convention could be applied to items involving numerous transactions during the year (e.g., nondeductible expenses), with less frequently occurring items (e.g., dividends) being accounted for on a monthly basis.

Such a simplified approach is similar to the approach Argentina took when it first introduced comprehensive adjustment. Unfortunately, under the very high inflation rates that prevailed in the early 1980s, taxpayers were able to manipulate the inaccuracy of annual adjustment to their advantage. The so-called dynamic adjustment rules, which take into account transactions occurring during the year that involve an increase or decrease in net equity or in the balance of assets subject to inflation adjustment, were consequently adopted in Argentina in 1985. This took care of the problem on a prospective basis, although in the meantime substantial loss carryovers had built up owing, in part, to the inaccuracy of the previous inflation adjustment rules.

The lesson to be learned from the Argentine experience is that, while a global adjustment based on the opening balance sheet might be adequate at moderate inflation rates, once inflation gets close to or exceeds 100 percent a year, the inaccuracy of looking solely at the opening balance can have such a substantial effect on the computation of taxable income that a more sophisticated system is required.

Going in the opposite direction, a more accurate and slightly more complicated inflation adjustment scheme is needed at much higher rates of inflation (several hundred percent a year or more). The global adjustment system can be adapted by keeping track not only of the month in which a transaction occurs, but also the date of the transaction. Brazil adopted such an approach when inflation exceeded 100 percent a year.[64]

Countries experiencing inflation rates that have been typical of most member countries of the Organization for Economic Cooperation and Development (OECD) (averaging below 10 percent a year, with occasional peaks of up to 20 percent or so) must consider whether it is necessary to make any adjustments for inflation. Even a low rate of inflation can have a substantial effect on the measurement of taxable income. For example, if the inflation rate is 3 percent and the real rate of interest is 4 percent, the inflationary component is nearly half the nominal interest rate of 7 percent. The absence of inflation adjustment can result in a substantial incentive to borrow in order to earn tax-deferred income. Despite the substantial effects of inflation on taxable income, the complexity of explicit inflation adjustment makes ad hoc adjustments attractive. (As

[64]*See* Hiromi Higuchi & Fabio H. Higuchi, Imposto de Renda das Empresas 269-70 (1990).

discussed above, global adjustment in the context of a tax that is highly complex to begin with can involve substantial complexity.) If properly designed, ad hoc adjustments can work fairly well if the rate of inflation is both low and stable. If the inflation rate fluctuates, then ad hoc adjustments to the ad hoc adjustments may be required.

The global adjustment method is used in practice only by countries with relatively high inflation—30 percent or above—or countries that have had such levels in the past and have consequently already put global adjustment into place. For other countries, the study of global adjustment is important in understanding what would be required to comprehensively adjust business income for inflation. To gauge the consequences of any proposed partial or ad hoc method, its effects can be compared with those produced under global adjustment. If the results differ substantially from those that would obtain under global adjustment, then this would be an important argument against adopting such a proposal in that form.

Appendix A
Global Adjustment Method in Detail

This appendix discusses the global adjustment method, using hypothetical statutory language in the form of excerpts from an income tax law that determines business income under the net worth method. Also included are commentary on this statutory language and examples of its application. The appendix should be read in conjunction with section IV(D) above.

General Rules for Determining Taxable Business Income

The first element is the net worth calculation, which also serves as the basic rule for determining taxable income, set forth in article 1 as follows:[65]

Article 1. General rules for determining taxable business income

(1) Except as otherwise provided in this law, in the case of taxpayers who keep, or are required to keep, double-entry books, taxable business income is

(a) the value of net worth in the closing tax balance sheet for the taxable period, less

(b) the inflation-adjusted value of opening net worth, less

(c) inflation-adjusted contributions to capital and inflation-adjusted incomes that are not taxable, plus

[65] This article is based on FRA CGI art. 38 and CHL IR art. 41.

(d) inflation-adjusted withdrawals made in favor of the owners and inflation-adjusted expenses that are not deductible.

(2) Net worth is the difference between

(a) the total assets in the tax balance sheet, and

(b) the sum of the debts of the taxpayer and reserves taken into account under the provisions of this law.

(3) The inflation-adjusted value of opening net worth is the value of net worth in the opening tax balance sheet, adjusted according to the percentage change in the consumer price index for the taxable year. The adjustment is made even if opening net worth is negative. The opening tax balance sheet is the same as the closing tax balance sheet for the preceding taxable period.

(4) Inflation-adjusted contributions to capital are contributions to capital made during the taxable period, adjusted according to the percentage change in the consumer price index between the month in which the contribution is made and the end of the taxable period. Inflation-adjusted incomes that are not taxable are incomes that are not taxable under the provisions of this law, adjusted according to the percentage change in the consumer price index between the month in which the income is received and the end of the taxable year.

(5) Inflation-adjusted withdrawals made in favor of the owners are distributions or other transfers of property in favor of the owners made during the taxable period, adjusted according to the percentage change in the consumer price index between the month in which the distribution or transfer is made and the end of the taxable period. Inflation-adjusted expenses that are not deductible are expenses paid during the taxable period, other than capital expenditures, that are not allowed as deductions under this law, adjusted according to the percentage change in the consumer price index between the month in which the expense is paid and the end of the taxable period.

A few points about this article should be noted:

(1) The term "tax balance sheet" (sometimes "balance sheet" for short) refers to the balance sheet used for tax purposes. Because the accounting rules prescribed by the tax law differ in certain respects from the commercial accounting rules, the tax balance sheet will generally differ from the commercial balance sheet. In the case of individuals, assets and debts that are not related to the generation of business income are excluded from the balance sheet for inflation adjustment purposes. [66]

[66]*See* CHL IR art. 41(1).

(2) Because the global adjustment is based on the balance sheet, only taxpayers who keep such a balance sheet can apply it.[67] Therefore, the scope of application of the global adjustment will depend on the rules explaining what taxpayers are required to keep a balance sheet. In many countries, this is defined with reference to the requirements of the commercial code. Any taxpayer with a substantial business should be required to use double-entry bookkeeping and keep a balance sheet.

(3) Under paragraph (3), it is necessary to determine the amount of the taxpayer's liabilities. This requires a distinction between "debt" and "equity." Although rules on this issue must be provided, the problem is not as intractable as it may seem. The reclassification of an item as equity rather than as debt will not completely throw off the net worth calculation because the same item will normally appear in both the opening and the closing balances.

(4) In Chile, the law defines the opening net equity subject to adjustment as "the difference between the assets and debts on the date of the beginning of the commercial year, having removed intangible, nominal, transitory, and pro forma values and others as determined by the National Tax Directorate, that do not represent effective investments."[68] Circular No. 100 explains the references to nominal, transitory, and pro forma assets as those that result from estimated values.[69] It gives the following examples of assets that could be nominal assets (which it also calls intangible values): franchises, trademarks, patents for inventions, and concessions. Examples of transitory assets are provisional dividends and personal withdrawals. Pro forma accounts are accounts whose purpose it is to reflect responsibilities or other information for the financial accounting of the enterprise (e.g., shares under guaranty, endorsed bills, discounted bills, contracts in progress). In other words, the types of assets to be excluded in computing opening net equity are those that are either not really part of the taxpayer's assets, although they may be reflected on the balance sheet for accounting purposes, or, as in the case of intangible assets, are assets that in any event should have a zero tax book value. Presumably, it is not intended to exclude from the calculation intangibles that were purchased by the taxpayer and that accordingly have a positive tax book value.

(5) It is sometimes not clear whether an asset should be treated as owned by the taxpayer and hence whether it should properly be included in the balance sheet. Rules are needed, for example, on the circumstances under which property leased to the taxpayer is treated as owned by the taxpayer and therefore includable in the balance sheet (and conversely, the circumstances under which property nominally owned by the taxpayer and leased to someone else under a finance lease may be properly treated as not part of

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[67]*See* CHL IR art. 41; Circular No. 100, of Aug. 19, 1975 [hereinafter Circular]; *reprinted in* Hugo Contreras & Leonel Gonzalez, Manual de Corrección Monetaria 402 (1989). Inflation adjustment therefore does not apply to taxpayers who determine their income on a presumptive basis. *See id.* at 54; CHL IR art. 34.

[68]CHL IR art. 41(1).

[69]*See* Contreras & Gonzalez, *supra* note 67, at 413.

the balance sheet).[70] As with the debt-equity problem, the gravity of the problem is diminished by the offsetting effects of the opening and closing balances.

(6) The second sentence of paragraph (3) makes it clear that the adjustment should also be made when there is negative opening net equity. This is the opposite of the rule applicable in Chile.[71](Mar. 8, 1976) (Chile), *reprinted in id.* at 457–58. As a matter of logic, there is no reason to treat a negative amount differently from a positive amount as far as inflation adjustment is concerned.

(7) Paragraphs (4) and (5) refer to items being "received," distributions being "made," and items being "paid." The implication is that the time that a transaction is taken into account for purposes of inflation adjustment is according to the cash method, even if the taxpayer uses the accrual method of accounting. This issue has not always been dealt with clearly in countries with global adjustment. For example, with respect to dividends, in Chile it is considered that a dividend that is declared and available to the shareholder but not yet paid is a diminution of net equity on the date so available.[72] In such a case, however, the funds to be devoted to the payment of the dividend are still earning taxable income for the corporation; accordingly, paragraph (5) considers the distribution as not taking place until it is actually paid.

(8) Compare the wording of paragraphs (4) and (5) with the Chilean law,[73] which provides that "increases in net equity taking place during the year" are adjusted according to the difference in the price index between the last day of the month preceding the increase and the last day of the month preceding the month of the balance sheet. The same treatment applies to decreases in net equity. "Personal withdrawals of the entrepreneur or partner, dividends distributed by corporations, and any amount invested in goods or rights that the law excludes from the net equity are considered in any event decreases in capital and are adjusted in the manner described above." The above language has led to a problem of interpretation in Chile because it does not make clear whether the profits of each month of the current year should be treated as "increases in net equity."[74] Literally, these profits are increases in net equity, but the logic of inflation adjustment would not call for their adjustment.

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[70]*See supra* note 46.

[71]*See* Contreras & Gonzalez, *supra* note 67, at 88–89; Circular No. 27

[72]*See* Contreras & Gonzalez, *supra* note 67, at 207.

[73]CHL IR art. 41(1).

[74]*See* Contreras & Gonzalez, *supra* note 67, at 198, reporting a Supreme Court decision holding that monthly profits of the current year should not be treated as an increase in net equity for purposes of the inflation adjustment rules; Oficio No. 3,231 (June 9, 1976) (CHL), *reprinted in id.* at 460.

Article 2. Valuation of assets and debts in closing balance

(1) In applying article 1, assets (other than inventory) and debts included in the closing tax balance sheet are valued as prescribed in this article.

(2) The values of assets (other than assets described in paragraphs 3–8) are adjusted according to the percentage change in the consumer price index. The value of an asset on hand at the beginning of the year is adjusted according to the percentage change in the consumer price index for the taxable year. The value of an asset acquired during the taxable year is adjusted according to the percentage change in the consumer price index between the month in which it was acquired and the end of the taxable year.

(3) Assets for which depreciation is allowed under article [ ] (relating to depreciation deduction)[75] are valued according to the balance of the depreciation pools at the end of the taxable year, reduced by the depreciation for the taxable year.

The items in the preceding paragraph are adjusted for inflation as follows. Items (a) and (b) are adjusted for inflation for the current taxable year. Item (c) is adjusted for inflation between the month in which the asset is added to the pool and the end of the taxable year. Item (d) is adjusted for inflation between the month in which the asset is disposed of and the end of the taxable year.

(4) Debt claims and debts (other than those described in paragraph 6) are valued by including accrued interest (including original issue discount or market discount) and accrued adjustments to principal (including adjustments under an adjustment clause).

(5) (a) Foreign currency; and

(b) debt claims, other assets, or debts denominated in foreign currency

are valued at the prevailing foreign exchange rate at the end of the taxable year.

(6) Publicly traded securities are valued at their market quotation as of the end of the taxable year.

(7) Gold or silver bullion or coins are valued according to the market price as of the end of the taxable year.

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[75]Assuming that pooled depreciation with a declining balance method is used, the balance of each pool at the end of the year would be valued as follows under the depreciation article:
The balance of a pool at the end of the taxable year is the amount determined as follows (but not less than zero):

(a) the inflation-adjusted balance of the pool at the end of the preceding taxable year; less
(b) the inflation-adjusted amount allowed for the preceding taxable year as depreciation; plus
(c) the inflation-adjusted cost of assets added to the pool in the taxable year, less
(d) the inflation-adjusted amounts received from the disposal of assets in the pool during the taxable year.

(8) Cash and assets denominated in national currency are valued at their nominal value.

Article 3. Valuation of inventories and unfinished products

(1) In applying article 1, assets and unfinished products included in the closing inventory are valued as provided in this article.

(2) Goods of a particular type are valued at the cost of the last-acquired item of that type, adjusted according to the percentage change in the consumer price index between the month in which the item was acquired and the end of the taxable year. The preceding sentence applies only if the last-acquired item was acquired during the taxable year.

(3) If no item of such type has been acquired in the taxable year, the goods are valued at the value in the opening balance, adjusted according to the percentage change in the CPI for the taxable year.

(4) Goods included in closing inventory that are produced, rather than purchased, including unfinished products, are valued according to the same principles, in relation to the costs incurred in their production.

(5) For purposes of this article, an acquisition at an artificial price will be ignored.

Comments on Articles 2 and 3

(1) As discussed above, the general approach under articles 2 and 3 is to value items at prices prevailing at the end of the year. In performing this exercise, assets that are denominated in units of national currency, that is, cash, bank deposits, debt instruments, and the like (e.g., preferred stock) are not adjusted for inflation. The reason for this is that the value of such items does not increase with inflation. However, when a debt instrument contains an adjustment clause, whereby the nominal amount of the obligation is increased (typically, in countries with high inflation, the adjustment clause will be some formula related to inflation), then under article 2(4), the debt instrument is valued at its nominal amount.

(2) The general rule of article 2(2) is to adjust the tax cost for inflation occurring either during the year or since the time of acquisition. This is also the general approach for depreciable property. Valuation rules for other specific types of property are provided in paragraphs (4) through (8), and in article 3.

(3) In general, paragraphs (4) through (7) of article 2 provide for valuation at market value or an approximation of market value. In particular, paragraph (4) contemplates full accrual for financial instruments.[76] As Vann and Dixon point out, such accrual taxation is essential in an environment of global adjustment.[77] Of course, implementation of this principle is a challenge, requiring the development of detailed regulations.

[76]The same is contemplated under the rules of Chile. *See* Contreras & Gonzalez, *supra* note 67, at 301.

[77]*See* Vann & Dixon, *supra* note 27, at 78.

(4) The valuation at year-end prices of foreign currency, foreign-currency-denominated debt instruments, publicly traded securities, and gold and silver is easier because market quotations exist. There are some definitional issues: foreign-currency-denominated debt instruments need to be distinguished from equity, and "publicly traded" and "securities" must be defined.

(5) Under article 3, the closing inventory balance is valued according to a set of rules that have the general effect of valuing the inventory at the acquisition or production cost as of the end of the year.[78] These rules require the division of inventory into different products, because it is necessary to decide when the last item of a particular product was purchased. The most difficult problem is the specification of production costs and their allocation to different months. Taxpayers should be allowed a fair amount of flexibility to fashion cost accounting rules that are suitable to their production methods and accounting capabilities.

Examples

Example 1

At the beginning of the taxable year, a firm owns only one asset, land, with a book value of $100. It has indebtedness of $80, so that its opening net equity is $20. The stylized facts in this example are the following:

(a) The annual inflation rate is 50 percent;
(b) The nominal interest rate is 55 percent;
(c) At the end of the year, the firm earns $44 from the sale of services. The firm uses this money to pay interest on the loan in the amount of $44.

The firm's balance sheet at the beginning of the year and the inflation-adjusted balance sheet at the end of the year appear as follows:

Opening Balance Sheet

Assets		**Liabilities**	
Land	$100	Debt	$80
		Net equity	$20

Closing Balance Sheet

Assets		**Liabilities**	
Land	$150	Debt	$80

[78] *See* CHL IR art. 41(3). The rules for valuing inventory are more complicated than those stated in the text; the details are in the appendix.

Net equity	$70

Notice that without inflation adjustment, taxable income is zero. The gross income of $44 is offset by the interest deduction. The problem with this result is that $40 of the interest deduction is the inflation component of the debt. If a deduction for this amount is denied, the taxable income becomes $40.

To reach this result under the global adjustment method, we need to ascertain the taxpayer's opening net worth. This is the difference between the total value of the taxpayer's assets and its debts, as shown on the opening balance sheet.[79] This amount is multiplied by the change in the price index between the beginning and the end of the year.[80] In Example 1, inflation-adjusted opening net worth is 150 percent of $20, or $30.

Therefore, under the net worth calculation set forth in article 1 above, taxable income is as follows:

Closing net worth	$70
Less inflation-adjusted opening net worth	$30
Equals taxable income	$40

Example 2

This example illustrates a more complex case involving the calculation of depreciation and valuation of inventory under inflation. The following assumptions apply:

(a) the inflation rate is 100 percent;
(b) the real interest rate is 5 percent;
(c) given (a) and (b), the nominal interest rate, with interest payable at the end of the year, is 110 percent;
(d) the firm owns one machine, the depreciation rate on which is 20 percent; and
(e) at the beginning of the year, the firm has 100 units of inventory that cost $10 a unit.

Given these facts, the firm's opening balance sheet is as follows:

Opening Balance

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[79]*See* CHL IR art. 41(1).

[80]For simplicity, the example refers to adjustment for inflation occurring between the beginning and the end of the year (or between a given month and the end of the year). The actual adjustment mechanism in Chile does not use the price indices for the month of January (or any other month for transactions that occur during the year) and December, but rather uses the index for the last day of November of the current year and of the preceding November (or, in general, of the month preceding the transaction). *See* CHL IR art. 41(1). This is presumably done as a matter of convenience, so that tax liability can be calculated immediately after the end of the year without awaiting publication of the price index for December 31.

Assets		**Liabilities**	
Machine	$1,000	Debt	$1,000
Inventory	$1,000	Net equity	$1,000
Total assets	$2,000		

The only activity occurring during the year is that, on December 31, the company sells 90 units for $2,100 and manufactures 125 units at a cost of $2,100 in cash and $400 allocated depreciation,[81] for a total cost of $2,500. The taxpayer borrows an additional $1,100 on December 31 to cover the interest payment made on that date. The closing balance will therefore be as follows:

Closing Balance

Assets		**Liabilities**	
Machine	$1,600	Debt	$2,100
Inventory[82]	$2,700	Net equity	$2,200
Total assets	$4,300		

Taxable income therefore is $2,200 (closing net worth) less $2,000 (inflation-adjusted opening net worth), which equals $200.

In this case, without an inflation adjustment based on balance sheets, one could eliminate the effect of inflation by providing partial adjustments:

(a) calculate depreciation allowances using an indexed cost;
(b) calculate the cost of goods sold by using indexed FIFO (the same result would obtain in this case under LIFO); or
(c) deny a deduction for the inflation component of the debt.

With this set of partial adjustments, depreciation increases from $200 to $400 (because this is a cost of production, the depreciation is not currently deductible, but is included in the cost of inventory), the cost of the 90 units sold would double from $900 to $1,800, and the deduction for interest expense is reduced from $1,100 to $100. Accordingly, taxable income is determined as follows:

Sales	$2,100
Less cost of goods sold	$1,800
Less real interest expense	$100
Equals taxable income	$200

[81] Notice that the depreciation is computed on the basis of the inflation-adjusted tax cost of $2,000.

[82] The 135 units of closing inventory are valued at $20 each, which is the most recently incurred unit cost of production. In this example, the same result would be reached by indexed FIFO (i.e., adjusting the initial $10 cost for inflation to $20).

The result under comprehensively-applied partial adjustment is the same as under global adjustment, due to the assumption that all activity takes place at the end of the year.[83]

Example 3

This example is a little more complicated than Example 2, in order to illustrate the effect of the timing of transactions taking place during the year.

The opening balance consists solely of $1,000 of inventory, consisting of 100 units purchased for $10 each.

On July 1 (price level 200), the company sells its inventory for $2,500. Consider two variants. Under variant *A*, the company distributes a dividend of $2,500 on the same day. Under variant *B*, it invests $2,500 in the bank, receiving interest of $2,500 for the remainder of the year.

The closing balance on December 31, at a time when the price level has risen to 400, is therefore

Variant *A*: 0 cash and 0 net worth.
Variant *B*: $5,000 cash and $5,000 net worth.

Taxable income is computed as follows:

	Variant *A*	**Variant *B***
Closing net worth	$0	$5,000
Less inflation-adjusted opening net worth	$4,000	$4,000
Plus inflation-adjusted distributions	$5,000	—
Equals taxable income	$1,000	$1,000

Notice what difficulty a partial approach would have in dealing with this case. A profit of $500 on the sale of the inventory could be computed, but the calculation would require adjusting the opening inventory for inflation only up to the time of the sale rather than to the end of the year. This would not be difficult to do in this example, but what about more complicated cases involving numerous sales during the year? The $2,500 of interest income in variant *B* could be eliminated under a partial approach. This would leave taxable income of $500 under both variants, which would be fine if the tax year were closed and tax paid on July 1, but disastrous for the tax collector if tax were not paid until after the end of the year.

Appendix B
Global Adjustment in the Context of Income-Less-Expenses

[83]*See supra* sec. IV, fourth paragraph.

Method of Determining Taxable Income

Summary

In the case of an income tax where taxable income is calculated as the difference between gross income and expenses, the inflation adjustments to be made are the same as explained in Appendix A, but instead of being embodied in the net worth calculation they take the form of additions to and subtractions from taxable income. The result reached is the same as under the net worth method. (The adjustments are described here in summary form; for detailed explanation of the terms used, see Appendix A.)

The inflation adjustment rules apply to enterprises preparing financial statements and are based on the value of assets and liabilities included in the balance sheet of the enterprise. The values of items included in the closing balance sheet are adjusted for inflation taking place during the year. The total amount of these inflation adjustments is added to taxable income.

The amount of net worth (assets minus debts) in the opening balance sheet is adjusted for inflation, and this adjustment is subtracted from taxable income. The adjustment is corrected for certain transactions resulting in a change in net worth that take place during the course of the year. The inflation adjustment to transactions resulting in an increase in net worth is subtracted from taxable income. The inflation adjustment to transactions resulting in a decrease in net worth is added to taxable income.

The net effect of inflation adjustment on taxable income is the algebraic sum of these adjustments, which are described below.

Adjustment of Opening Net Worth

The amount of opening net worth is adjusted for inflation for the taxable year. The amount of this adjustment is subtracted from taxable income.

In the event that the opening net worth is negative, the above operation results in an increase in taxable income because a negative number is being subtracted.

Adjustment of Increases in Net Worth

Contributions to capital and nontaxable income are adjusted for inflation occurring between the month in which the transaction takes place and the close of the taxable period. The total amount of these adjustments is subtracted from taxable income.

Adjustment of Decreases in Net Worth

Distributions to owners and nondeductible expenses are adjusted for inflation occurring between the month in which the transaction takes place and the close of the taxable period. The total amount of these adjustments is added to taxable income.

Adjustment of Items in Closing Balance

The value of items in the closing balance is adjusted as described in Appendix A, depending on the type of asset or debt. The amount of the adjustment, that is, the difference between

(1) the adjusted value of the asset or debt; and
(2) its historical cost, if acquired during the year, or its value on the previous balance sheet,

is added to taxable income (subtracted in case of adjustment of a debt).

Table 1. Constant Currency Accounting

DAY	1. Price Index End of Day	2. Cash at end of day	3. Purchase Price	4. Sales price	5. Units bought	6. Units sold	7. Sales	8. Purchases
0	1	1100						
1	1.1	1000	110	125	10	8	1000	1100
2	1.3	1350	130	150	10	11	1650	1300
3	1.4	800	135	160	10	5	800	1350
4	1.9	1320	200	210	10	12	2520	2000
DAY	9. Cash flow	10. Goods sold, bought this period	11. Goods sold, bought last period	12.Total cost of goods sold	13.Infla-tion-adjusted sales	14.Sales profit	15.Curr-ency loss	16.Daily profit
1	-100	8	0	800	909.09	109.09	-100	9.09
2	350	9	2	1100	1269.23	169.23	-139.86	29.37
3	-550	4	1	485.71	571.42	85.71	-74.17	11.53
4	520	6	6	1210.15	1326.31	116.16	-150.37	-34.21
							TOTAL:	**15.78**

Note: Numbers have been rounded to two decimal places.

TABLE 2. Global Method

Closing net worth	
Cash	694.73
Inventory	421.05
Total	1115.78
Less opening net worth	1100
Profit in constant dollars	15.78

Note: Numbers have been rounded to two decimal places.

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14

Individual Income Tax

Lee Burns and Richard Krever

> I suspect that if a million monkeys were put in front of a million typewriters, by Wednesday one of them would have come up with an improved version of the Income Tax Act.
>
> *—Paul Gerber, Senior Member*
> *Administrative Appeals Tribunal*
> *(Australia)*

I. Introduction

This chapter addresses the design and drafting of the income tax law for individuals.[1] The discussion covers the structure of the income tax, the definition of the tax base, the tax unit (i.e., identification of the taxpayer), the tax rate structure, and the administrative and collection aspects of personal income taxation. The discussion of the tax base in this chapter focuses particularly on employment income, including fringe benefits. The taxation of business and investment income is dealt with in chapter 16.

II. General Design

A. Schedular Versus Global Income Taxes

Two theoretical models exist for the structure of the personal income tax—schedular and global. A schedular income tax is one in which separate taxes are imposed on different categories of income. A global income tax is one in which a single tax is imposed on all income, whatever its nature.

In the benchmark schedular system, gross income and deductible expenses are determined separately for each type of income; in some cases, limited deductions or no deductions may be allowed. The rates of tax applicable to each category of income are then applied to the taxable amount of the income. The rates of tax may vary from category to category. Different procedures may apply to each category of income for the reporting,

[1] This chapter uses the term "individual," commonly referred to in civil law countries as "physical person" or "natural person," and refers to the tax as individual income tax or personal income tax.

assessment, and collection of tax. Some types of income may be taxable only through withholding; others may involve the filing of returns. Schedular systems used to be more widespread; a few countries still have such a system, or one with substantial schedular elements.[2]

In the benchmark global system, there is no matching of particular types of income to the expenses incurred to derive the income. All income and expenses are considered together to arrive at a single net gain that is subject to tax. Thus, under a pure global system, the category of income is irrelevant.

Between pure schedular and pure global taxation, there are many possibilities. One of these has been called "composite," under which a global-type system is superimposed on a set of schedular taxes.[3] This approach involves combining some or most types of income for the purpose of imposing a progressive rate surcharge on top of the flat rates commonly imposed on the schedularized categories of income, as well as for the purpose of providing personal tax relief for family costs.

Many tax policy theoreticians consider the global income tax to be superior to the schedular system. It is commonly suggested that schedular taxation suffers from the following disadvantages:

(1) The separation of an individual's income into more than one tax regime may make it difficult or impossible to impose progressive taxation and to provide for personal tax relief (in the form of exemptions, deductions, or rebates). Progressive taxation is commonly seen as the most effective way of levying taxes on an ability-to-pay basis, and to the extent that ability to pay is indicated by an increase in total economic capacity, the tax should be levied on a taxpayer's total income. Under a schedular system, a progressive marginal rate structure may be applied to some categories of income only, leading to inequities between taxpayers who earn different types of income. Similarly, under a schedular system, personal tax relief must be either

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[2] According to the latest legislation we could find (see Bibliography of Tax Laws), Burundi, the People's Republic of China, Eritrea, Ethiopia, Lebanon, Romania, Rwanda, Somalia, Sudan, the Republic of Yemen, and the Democratic Republic of the Congo (formerly Zaire) have a substantially schedular individual income tax, in which different rate schedules apply to different major categories of income. Although Hungary has a global definition of income and a progressive rate schedule for the consolidated tax base (*see* HUN PIT §§ 4, 30), there are so many special rules and separate rates for different kinds of income that the tax should be considered substantially schedular. While the Philippines started out with a global system, a schedular system was adopted in 1981, with wages being taxed separately from other income. *See* Angel Yoingco, The Dynamics of Income Tax Reform (1985); and National Internal Revenue Code §§ 21, 28, and 29 (J. Nolledo, ed. (1985)). Since then, there has been some movement back toward a global system, although substantial schedular elements remain. Schedular taxes are imposed on foreign-source income derived by nonresident citizens, and on interest, dividends, and capital gains, while other income is aggregated and subject to tax under a progressive rate schedule. *See* PHL NIRC § 21. A number of other countries treat certain income from capital on a schedular basis, for example, CZE ITA § 36 (special rates of tax applicable to interest and dividends); KAZ TC § 13 (interest, dividends, and liquidation gains subject to final taxes); LSO ITA § 158(2) (final withholding tax on interest). *See also infra* note 12.

[3] *See* Sylvain Plasschaert, Schedular, Global and Dualistic Patterns of Income Taxation 17 (1988). Examples of composite systems are those in Chile and Mozambique. The superimposed global tax is typically called a global complementary tax.

applied wholly against one category of income, such as employment income—in which case the relief may not be fully effective—or divided among various categories of income, which increases complexity.

(2) The schedular system is potentially more difficult to administer. Scarce administrative resources may be wasted on classification issues arising at the borders between the various schedules. For example, if income from employment and income from business are taxed under different schedules, then it becomes necessary to characterize a particular income-earning activity as being one of employment or business (self-employment). The border between an employer-employee and a customer-consultant relationship is difficult to draw.

(3) Any differences in the final tax burdens imposed under a schedular system on income in different categories will be exploited by taxpayers engaging in tax planning and restructuring to ensure that their income fits within the most advantageous category. Tax-planning activities of this sort not only impose economic dead-weight losses as resources are diverted into unproductive planning activities, but may cause serious economic inefficiency as taxpayers opt for income-earning activities that may be less efficient, but more lightly taxed.

While a global income tax may be preferable from a conceptual perspective, the purest form remains a theoretical ideal only. In practice, all global income taxes contain some schedular elements and most existing income tax systems lie on the spectrum between schedular and global. While some countries with a global income tax define income without breaking it down into categories,[4] others have a schedular structure to the identification of taxable amounts, whereby such amounts are defined according to categories of income.[5] Such a definitional structure has two general implications. First, if an item is not included in any of the categories, then it is not included in income. Some countries may have a residual category, but even that is often not open-ended.[6] Second, it will often make a difference into which category an item of income falls, because each category has its own rules.[7] Even in jurisdictions that do not define income by reference to categories, judicial doctrines may classify income into different types.[8]

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[4] *See* COL TC § 26; HUN PIT § 4 (*but see supra* note 2); RUS IT § 2; USA IRC § 61.

[5] *See* AUT EStG § 2; BEL CIR § 6; CAN ITA § 3; DEU EStG § 2; FRA CGI § 13; ESP IR § 23; GBR ICTA §§ 15–20; JPN IT § 22; LSO ITA § 17.

[6] *See* DEU EStG § 22; LSO ITA § 17 (1)(d); SGP ITA § 10(1)(g). *See also infra* secs. III(A) and VI.

[7] *See, e.g.,* FRA CGI § 13(3).

[8] This approach is common in jurisdictions that have derived their income tax principles from the United Kingdom. For example, AUS ITAA (1997) § 6-1(1) provides that assessable income consists of “ordinary income and statutory income.” Statutory income is any amount that is expressly included in assessable income under a provision of the tax law (ITAA (1997) § 6-10(2)). Ordinary income is income classified according to ordinary concepts (ITAA (1997) § 6-5(1)). The definition of income classified according to ordinary concepts has been elaborated by the courts. An amount derived is ordinary income if it has its source in an earning activity. The earning activities identified by the courts are the employment of one’s labor, the investment of capital, or the application of labor and capital combined (i.e., the carrying on of a business). This has led to what is, in effect, a judicial categorization of income into employment, business, or investment income. The courts have recognized that an amount derived that

(continued)

Moreover, whatever the basic definition of income, distinctions are often made in the legislation for a range of policy and technical reasons. For example, if capital gains are included in the tax base, they may be treated differently from other types of income.[9] Similarly, different rules may apply to expenses incurred to derive different types of income,[10] or discrete sets of rules may be considered appropriate for particular types of income.[11]

Finally, the global systems of many countries have become partially schedularized by the use of final withholding taxes on certain types of income, particularly dividends and interest, and lower tax rates on capital income.[12] It has been suggested that in these jurisdictions partial schedularization may actually increase the progressivity of the income tax by eliminating opportunities for taxpayers to exploit timing differences and other preferential treatment that may apply to different types of income and expenses.[13]

B. Single or Separate Tax Laws

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exhibits some of the essential characteristics of employment, business, or investment income (such as periodicity and anticipation of receipt) may be ordinary income, although it does not have its source in an earning activity. Examples of such amounts are pensions and annuities.

[9] Capital gains may be distinguished because they are subject to preferential rates of tax, are partially exempt from tax, or are adjusted for inflation, or because restrictions are imposed on the deduction of capital losses.

[10] For example, many jurisdictions distinguish interest outgoings from other expenses for the purpose of imposing quarantining rules. *See infra* ch. 16. These rules may require further categorization of income types because interest expense incurred to earn a particular type of income may be deductible only against that type. Another expense-quarantining rule found in some jurisdictions is a restriction on the deductibility of employment expenses, which requires drawing a distinction between employment and business activity.

[11] An example is farming income, which is taxed on the basis of estimates in a number of countries. *See* FRA CGI § 64; DEU EStG § 13(1); AUT EStG § 21. In such countries, it will be important whether a particular activity is considered farming or nonfarming business. Obviously, this is also the case in countries where income from agriculture is exempt. *E.g.*, GEO TC § 43.

[12] Belgium effectively abolished progressive income tax on dividends and interest in 1985 and replaced it with a final withholding tax system; *see* BEL CIR §§ 171, 261, 269. Germany, which had a progressive tax on interest, collected very little on it and introduced a withholding tax in 1994 in order to be able to collect at least some revenue on interest income; *see* DEU EStG §§ 43, 43a. Scandinavian countries, led by Sweden, have recently moved toward schedularization and final withholding taxes on income from capital. *See* Leif Mutén, et al., Towards a Dual Income Tax? (1996). *See infra* sec. XII, for discussion of final withholding tax on employment income. *See infra* ch.16 for discussion of final withholding taxes on investment income.

[13] *See* Mutén, et al., *supra* note 12. The specific manifestation of this exploitation often is the deduction of interest expense and other losses against positive capital income. As a result of such deductions, the tax base for capital income may be very small without schedularization.

A basic structural question for income tax law is whether to have all income taxes in a single law or to have two separate laws, one for individuals and one for legal persons (companies and other taxable entities).[14]

A range of models exists.[15] In some countries, company income tax is levied under a separate tax law from individual income tax, and there is no cross-reference between these laws for the determination of the tax base.[16] A second model has company income tax levied in a law separate from that imposing tax on the income of individuals, but the rules for calculating the tax base are based on the rules in the individual income tax law,[17] or vice versa.[18] A third model has separate regimes for individuals and companies contained within a single act, with the company tax rules cross-referenced to the individual tax base rules so that the company tax rules in effect "piggyback" on those applicable to individuals.[19] A variation of this approach uses the same legislation and the same basic rules for determining the company and individual tax bases, but includes supplementary provisions with special rules applicable to companies or individuals.[20]

From a technical perspective, it is equally acceptable to use separate company and individual income tax laws or a single law, and both alternatives are compatible with either classical or imputation company and shareholder tax systems (these are described in chapter 19). It seems preferable, however, to abstain from separately setting forth the rules for individuals and companies, which would lead to duplication, complexity, and the risk of establishing divergent rules. More important than the form of the legislation is its substance. It is important that the tax base (and rates) of the company tax and the individual tax on business income be similar to simplify administration and discourage taxpayers from using a possibly less efficient business

[14] Schedular systems may even have separate laws for different categories of income. This was more common in the past, but currently applies in Romania, for example, although it is proposed to consolidate these laws.

[15] In addition to the basic structural alternatives described, a look at the Bibliography of Tax Laws, *infra,* shows that many countries have, besides the basic individual and corporate income tax laws, other tax laws that contain rules related to income tax. Some of the Scandinavian countries provide examples of this. The resultant structure contributes to the complexity of the system, although it must be said in fairness that other countries (such as the United States) have managed to achieve a comparable if not greater complexity even though they have only one tax law.

[16] This is, for example, the case in Latvia, Romania, and Russia. Japan also has separate laws for individuals and corporations, with independent rules for determining income. In Hungary, the individual income tax law contains its own rules for measuring business income and expenses; the corporate income tax law refers to the amount determined for financial accounting purposes in the case of taxpayers keeping double-entry books. *See* HUN CTDT § 6. The tax code of the Kyrgyz Republic contains separate rules for individuals and companies, repeating most of the income-determination rules.

[17] *See* AUT KStG § 7(2); DEU KStG § 8(1); NLD Vpb § 8. Technically, the German company tax is not an income tax, but a tax on profits, the concept of income being reserved for the taxation of individuals.—L.M.

[18] *See* ESP IRPF § 42.

[19] *See* FRA CGI § 209.

[20] *E.g.,* AUS ITAA; CAN ITA; COL TC; GBR ICTA; SWE SIL; USA IRC.

form only to secure tax savings arising from differences between the company and individual tax systems.

C. Charging Provision and Basic Terminology

The personal income tax is, as its name implies, a tax on persons, not on transactions or things. The charging provision in the income tax law should therefore impose the tax on persons. The tax is not imposed on all persons; rather, it is imposed only on those persons who have taxable income[21] for the relevant tax period.[22] Some countries impose the income tax on the taxable income of persons, rather than on persons having taxable income.[23] A charging provision of this type needs to be supported by a provision that imposes a liability to pay the tax on the person having the taxable income. The administrative provisions of the legislation will specify the due date for payment of the tax and include mechanisms for the collection and recovery of the tax due.

The charging provision sets out four central concepts underpinning the income tax. First, it identifies the *person* liable for tax, namely, any person who has taxable income for the tax period. The issues relating to identifying the taxpayer are discussed in section IX, below. Second, the charging provision imposes the income tax by reference to the *tax period*. This means that the taxable income of any person must be calculated separately for each tax period. Generally, the tax period for the income tax is a specific period of 12 months, commonly the calendar year or financial year of the relevant country. The periodic nature of the income tax means that it is necessary to provide accounting rules for allocating income and expenses to particular tax periods for the purpose of calculating a person's taxable income for the period. These rules are discussed briefly in section VIII, below, and in more detail in chapter 16.

Third, the concept of *taxable income* defines the tax base. Taxable income is a net concept determined by reference to the tax period. All income tax systems, whether global or schedular, generally seek to impose taxation on a net amount because this amount properly reflects a person's increase in economic capacity for the tax period.[24] The taxable income of a

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[21] The term "taxable income" is used in this chapter to refer to the amount against which the rates of tax are applied. An alternative term used in some countries is "chargeable income." *See* LSO ITA § 13; SGP ITA § 38.

[22] *E.g.*, LSO ITA § 4(1).

[23] *E.g.*, USA IRC §§ 1, 11. Until recently, the income tax law in Australia followed this pattern; however, as part of the progressive rewriting of that law, the income tax is now imposed on entities (which is defined to include individuals): *see* AUS ITAA (1997) § 4-1.

[24] There are exceptions to this general rule, the most important being withholding taxes that are imposed on gross receipts. However, there is often little or no expense involved in deriving some kinds of income commonly subject to withholding tax, such as interest income. Also, withholding tax rates are commonly lower than ordinary tax rates, the difference being in part attributable to the fact that expenses are not taken into account when withholding taxes are imposed on gross receipts. The application of a lower rate against income that commonly involves few deductions means that the withholding tax is effectively a proxy for tax on a net basis.

person for a tax period is therefore commonly defined as the gross income[25] of the person for the period less the total deductions allowed to the person for the period. A schedular income tax nets gross income and related deductible expenses on a schedule-by-schedule basis, while a global income tax nets gross income against total deductible expenses. The specification of the tax base is discussed in sections III–VII, below. Fourth, the charging provision should provide for the calculation of the amount of *tax payable.* In the ordinary case, this involves applying the relevant tax rates to the taxable income of the taxpayer and then subtracting any tax offsets that may be available to the taxpayer. Tax offsets are reductions in the amount of tax otherwise payable.[26] They are allowed primarily to reflect tax already paid through a special collection regime or as a concession to achieve certain social or economic objectives. Design issues relevant to tax rates are discussed in section X, below, and tax offsets are discussed in section XI, below.

By clearly specifying the central concepts, the charging provision will ensure that there is consistency in the use of terminology, thereby providing a coherent structure for the substantive provisions of the legislation. It is preferable that the charging provision be included at the commencement of the legislation so that the substantive provisions can then be developed as an elaboration of the central concepts specified in the provision. The importance of consistency cannot be emphasized too strongly. At best, failure to provide a coherent structure will lead to a confused application of the tax law; at worst, it will make the law unworkable. For example, it must be clear that charging provisions apply to taxable income and not to gross income.[27] Similarly, it must be made clear whether supplementary definition provisions include amounts in gross income or in taxable income.

III. Taxable Income

The concept of taxable income effectively defines the income tax base. It was stated above that the taxable income of a person for a tax period is commonly defined as the gross income of the person for the period less the total deductions allowed to the person for the period.[28] The gross income of a person for a tax period is the total of amounts derived[29] by the person during the period that are subject to tax. The gross income of a person, therefore, will not include amounts that are exempt from tax. The total deductions of a person for a tax period are

[25] Also sometimes called "assessable income." *See* AUS ITAA (1997) § 4-15.

[26] Tax offsets are known by a variety of technical labels, including tax credits, tax rebates, and deductions of tax. For a discussion of the terminology used in various countries to describe tax offsets, *see infra* note 205.

[27] Unless, of course, it is gross income on which the tax is levied as with withholding taxes. It must be clearly stated when tax is imposed on taxable income and when it is imposed on gross income.

[28] *E.g.,* AUS ITAA (1997) § 4-15 (1), (“taxable income = assessable income-deductions”); CAN ITA § 2(2) (taxable income defined as income plus certain additions and minus certain deductions); USA IRC § 63(a) (taxable income defined as gross income minus deductions).

[29] The word “derived” is used in this chapter to refer to the allocation of an amount to a particular tax period according to the application of tax accounting rules. *See infra* sec. VIII.

the total of expenses incurred by the person during the period in deriving amounts subject to tax plus any capital allowances and other amounts allowed as a deduction on a concessional basis (e.g., charitable donations). Consequently, there are three key elements in the definition of the tax base: first, the inclusion of amounts in gross income; second, the identification of amounts that are exempt income; and third, the allowance of amounts as deductions.

The definition of key concepts related to the determination of taxable income, drawing on commonly accepted understandings and notions in the jurisdiction, will depend in part on the structure of the income tax system to be adopted and in part on existing structures and concepts. Even when general definitions are used, they are inevitably supplemented by specific definitions, inclusion rules, exclusion rules, rules allowing deductions, and rules denying certain deductions. Thus, any consideration of general definitions must be made in the context of plans for specific rules.

A. Gross Income

Supplementary definition and inclusion provisions applying to the determination of gross income have proved increasingly important for the implementation of global tax systems. There are three reasons for this. The first is the circular definition of income that characterizes many global systems. As stated above, taxable income is normally defined as gross income less allowable deductions. But the definition of gross income may provide little guidance to the income concept, often including the term that it purports to define.[30] Second, and related to the first point, supplementary definition and inclusion provisions may be needed to overcome the otherwise restrictive concept of income that would be applied by courts, particularly in Commonwealth or former Commonwealth countries, where courts rely on U.K. judicial doctrines.[31] Third, supplementary definition and inclusion provisions may be required in response to the growing complexity and variation of legal forms and transactions.[32]

Consequently, even under a global income tax, the inclusion of amounts in gross income will often be specified by reference to particular categories of income. For this purpose, income is commonly divided into employment, business, and investment income. There are often supplementary definitions of each category of income and, in the case of investment income, definitions of amounts included in investment income (e.g. dividends, interest, rent, and royalties).

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[30] *E.g.,* AUS ITAA (1997) § 6-1(1) ("assessable income consists of ordinary income and statutory income"); CAN ITA § 3 (income defined as "the total of all amounts each of which is the taxpayer's income"); EST ITL § 9 ("the income of a resident taxpayer is all income derived...."); USA IRC § 61(a) (gross income defined as "all income from whatever source derived").

[31] *See supra* note 8.

[32] For example, special definitional provisions may be needed to define as interest income certain types of gain realized on financial transactions. *See infra* ch.16.

However, not all amounts derived by a taxpayer will fit neatly into one of these categories.[33] An issue arises, therefore, as to the specification of other amounts to be included in gross income. This is commonly done by separately listing out those amounts. As stated above, such a definitional structure means that any amount that does not come within one of the listed inclusions will not be included in gross income. This may be overcome by including a residual category of income. The residual category may itself be a separate category.[34] Alternatively, the list of amounts included in gross income may be expressed to be inclusive only so that a general formula may apply for including other amounts in gross income.[35] Regardless of how the residual category is identified, it is important that there be some certainty in the scope of its operation. Sometimes the word "income" is used to define the residual category.[36] In the absence of a definition of income,[37] such an approach can lead to uncertainty where the word is used in a jurisdiction in which it has no established meaning.[38] On the other hand, where it does have an established meaning, care must be taken to ensure that the use of the word income does not unduly restrict the intended scope of the tax base. A preferable approach may be to define the residual category broadly so that it covers all gains of whatever nature and rely on the definition of exempt income to limit its scope.[39]

The discussion of the tax base below and in chapter 16 follows an approach that divides income into four broad categories: employment, business, and investment income, and miscellaneous receipts.

B. Exempt Income

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[33] *See infra* sec. VI for examples of amounts that may fall outside a classification of income into employment, business, and investment income.

[34] *E.g.,* LSO ITA § 17(1)(d); SGP ITA § 10(1)(g).

[35] *E.g.,* EST ITL § 9(1) ("income of a resident taxpayer is all income derived by him/her from all sources of income during the period of taxation, including" seven specified categories of income. The inclusive nature of the provision means that any other amount derived by a resident taxpayer that is "income" is taxed); IDN LCIT Art 4(1) ("the Tax Object is income, meaning any increase in economic prosperity received or accrued by a Taxpayer...that may be used for consumption or to increase the wealth of such Taxpayer, in whatever name and form, including" 11 specified categories of income. Again, the inclusive nature of the provision means that any other amount that is "income" is taxed). "Inclusive" is used here to refer to a definition that takes the form of including specified items in a general concept, as opposed to offering an exhaustive definition of that concept.

[36] *E.g.,* EST ITL § 9(1); IDN LCIT Art 4(1); SGP ITA § 10(1)(g).

[37] IDN LCIT Art 4(1) is an example of a defined concept of income being used as a residual category. In that provision, income is defined to mean "any increase in economic prosperity." *See supra* note 35.

[38] In the Anglo context, as a result of judicial decisions, for an amount to be income, it must have its source in an earning activity or exhibit the essential characteristics of an amount that has its source in an earning activity (*see supra* note 8). This is also the case in some continental European countries. In the United States, a broader notion of income has been developed by the courts, including any realized accretion to wealth.

[39] *E.g.,* IDN LCIT Art 4(1) and (3); LSO ITA § 17(1)(d) and §§ 21–32.

There will be amounts that are not to be included in gross income. These amounts are usually identified as “exempt income.” In providing for the basic charging provisions, it must be made clear that amounts defined as "exempt income" are excluded from the definition of gross income and thus from the calculation of taxable income.

While many different amounts may be treated as exempt income, such amounts can be classified into several broad categories. First, an amount or an entity may be exempt for social compassion reasons. Examples of amounts that may be exempt on this basis are welfare payments, scholarships, and compensation payments.[40] Examples of entities that may be exempt on this basis are religious, charitable, or education institutions of a public character.[41]

Second, an amount may be exempt as a result of international convention, agreement, or practice. For example, a country that is a signatory of the Vienna Convention on Diplomatic Relations is obliged to exempt from tax the official employment income and foreign-source income of a foreign diplomatic officer, consular officer, administrative or technical employee of a diplomatic mission or consulate, consular employee, member of the service staff of a diplomatic mission or consulate, or a private servant of a diplomatic mission.[42] The exemption also extends to the foreign-source income of family members and consular staff. As a matter of practice (sometimes only on a reciprocal basis), a similar exemption may be extended to other foreign government representatives working in the country.

Third, an amount may be exempt for structural reasons. This is primarily to prevent double taxation under the income tax or other tax legislation. For example, some amounts (e.g., interest) may be subject to withholding of tax at source as a final tax on the income. It is necessary to exempt such amounts from inclusion in gross income so as to avoid double counting. Another example is gifts, which may be subject to gift duties or capital transfer taxes. While such amounts need to be excluded from gross income, whether they are treated as exempt income for all the purposes of the income tax legislation will depend on the circumstances in which the concept of exempt income is relevant under the legislation.[43]

Fourth, an amount may be exempt for political or administrative reasons. An example of such an amount is a windfall gain.[44] Finally, an amount may be exempt as an incentive to

[40] *See infra* sec. VI.

[41] *See infra* ch. 19. The exemption may not apply to all income of the entity. For example, business income derived by such an entity from carrying on activities that are not related to the entity’s religious, charitable, or educational purpose may be taxable.

[42] Vienna Convention on Diplomatic Relations (1961) Art. 34 (500 UNTS 95).

[43] For example, it is a feature (albeit unusual) of the Australian income tax that the amount of a loss carried forward for a particular tax period is reduced by the net exempt income of the taxpayer for that period, with the balance applied first against the net exempt income of the following tax period (AUS ITAA (1997) § 36-15). With such a feature, it is important that amounts treated as exempt income to prevent double counting be excluded from the calculation of net exempt income. Australian tax law has not always been consistent in this regard.

[44] *See infra* sec. VI.

encourage a particular activity. For example, the income of a retirement fund may be exempt from tax to encourage retirement savings. As indicated above, the concept of exempt income may be relevant for other purposes of the income tax law. For example, it is important in applying rules that deny deductions for expenditures incurred to derive exempt income.

C. Deductions

The third element in the determination of the tax base is the allowance of amounts as a deduction. The usual structure for allowing amounts as a deduction is to provide a general rule followed by supplementary definition and allowance provisions. The general rule commonly allows a deduction for expenses to the extent to which they are incurred in deriving amounts included in gross income. Consequently, the specification of amounts included in gross income also defines the basic parameters for the claiming of deductions. Supplemental provisions allow deductions for capital allowances (such as depreciation and amortization provisions) and as a tax incentive (such as charitable donations and retirement fund contributions).

D. General Principles

In specifying the basic structural rules of the income tax, there are some general principles for which provision may need to be made.

1. Apportionment

The categorization of income (including the treatment of some income as exempt) gives rise to the need for apportionment rules, particularly for deductions. It is possible that a particular expense (such as interest) may be incurred to derive more than one category of income. Where different rules apply to different categories of income (e.g., expenses incurred in deriving investment income may be deductible only against that income), it is necessary to apportion such expenses between the different categories of income. It is generally sufficient for the law to state a principle that deductions are to be apportioned reasonably among the categories of income to which they relate.[45] If necessary in a particular class of case, more detailed rules can be provided by way of regulation or administrative practice. As stated above, some deductions may be allowed as a tax concession to encourage a particular activity (such as the making of charitable donations or contributions to retirement funds) and, therefore, do not relate to the derivation of any income. It may be necessary to make special provision for the apportionment of such deductions. Such a rule could provide for the apportionment of such deductions ratably among each class of income derived by the taxpayer.[46]

It may also be necessary to have an apportionment rule for income, although the derivation of composite amounts is probably less likely to arise than the incurrence of expenses to earn more than one class of income. One type of composite amount that is likely to be derived

[45] *E.g.*, LSO ITA § 46(1).

[46] *E.g.,* LSO ITA § 46(2).

is a compensation receipt. It is possible, for example, in the personal injury context, that an undissected lump sum amount may be paid as damages for several losses, such as loss of earnings, physical impairment, and pain and suffering. In this example, to the extent that the amount is for loss of earnings, it should be included in gross income. A general rule of apportionment will achieve this result. In the absence of such an express rule, the courts may be willing to apply such a rule as a matter of general principle.[47] Alternatively, the courts may apply a single characterization to the whole amount.[48]

2. Recouped Deductions

Another example of an amount that may require a general inclusion rule is a recouped deduction (i.e., an expenditure or loss for which a deduction has been allowed that is subsequently recouped in whole or in part). It is common to find such rules in specific contexts, such as the recovery of amounts written off as bad debts or capital allowances recovered on disposal of the relevant asset; however, it is preferable that a general principle be stated to ensure that all possible situations are covered. Such a rule would provide that any expenditure or loss (including a bad debt) that has been allowed as a deduction in one tax period but is recovered by the taxpayer in whole or in part in a later tax period is included in the gross income in that later period to the extent of the amount recovered. It should also be stated that the recouped amount takes the character of the income to which it relates. For example, the recovery of a previously deducted bad debt incurred in carrying on a business should be treated as business income. In the absence of such an express rule, the courts in some countries may be willing to apply such a rule as a matter of general principle,[49] but this may not always be the case.[50]

3. Valuation

It will be necessary in some cases to take into account for tax purposes an amount in kind. This is most commonly the case where income is derived as a benefit in kind (e.g., an employee fringe benefit). However, there are other contexts under the income tax where this will also be the case. For example, a deductible outgoing may be paid in kind, or an asset may be acquired or disposed of for consideration given in kind. In each case, the in-kind item must be valued for the purposes of determining the amount to be taken into account for tax purposes.

It is common for detailed valuation rules to be provided in the income tax law for the valuation of employee fringe benefits. However, as indicated above, the derivation of an

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[47] *See, e.g.,* Tilley v. Wales [1943] A.C. 386 (U.K. courts).

[48] *See, e.g.,* McLaurin v. FC of T (1961) 104 CLR 381 (Australian courts have characterized such an amount as wholly capital).

[49] This is the position in the United States under the judicially developed tax benefit principle. *See* Hillsboro Nat'l Bank v. C.I.R. 460 U.S. 370 (1983); *see generally* Bittker & Kanner, The Tax Benefit Rule, 26 U.C.L.A. L.Rev. 265 (1978).

[50] *See, e.g.,* FC of T v. Rowe (97 ATC 4317) (Australia).

employee fringe benefit is not the only circumstance in which an in-kind item will have to be valued for tax purposes. It is suggested, therefore, that a general valuation rule be included in the income tax law.[51] It is important that such a rule be of general operation so that it can apply in all circumstances where it is necessary to value an in-kind item. In other words, the rule should not be confined to the valuation of benefits as income. It is also important that the general valuation rule be subordinate to any specific valuation rule or rules that may apply in a particular context (such as those that may apply for the valuation of employee fringe benefits).

It is suggested that the basis of valuation under the general rule should be fair market value.[52] Where consideration is given in kind, valuation will ordinarily be necessary for both sides of the transaction. For example, if a person pays a deductible expense in kind, then the in-kind item will need to be valued for the purposes of determining both the deductible amount to the payer and the income inclusion amount of the payee.[53] Similarly, if a person acquires an asset providing consideration in kind, the tax cost of the asset acquired should reflect the value of the consideration given.

Special rules may need to be applied to the derivation of nonconvertible benefits. In jurisdictions relying on U.K. doctrines, the derivation of a nonconvertible benefit raises two issues. The first is the characterization of the benefit as income and the second is the valuation of the benefit to determine the amount of income derived. For other jurisdictions, only the valuation issue arises.

The characterization issue arises in those jurisdictions relying on old U.K. doctrines because the judicial concept of income under those doctrines excludes benefits in kind that cannot be converted to cash.[54] In these jurisdictions, specific statutory inclusion provisions are necessary to bring nonconvertible benefits into the gross income of the recipient. While nonconvertible benefits are most commonly provided in the employment context, they may be provided in other contexts, and the nonconvertible benefit rule applies equally in those other

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[51] Countries with a tax code may specify such a rule as part of the general provisions applicable to other taxes as well (such as value-added tax (VAT)). *E.g.,* Germany has a separate tax law known as the Valuation Law (DEU BewG).

[52] *E.g.,* LSO ITA § 65(1).

[53] The in-kind payment may also involve the disposal of an asset (such as inventory) of the payer. Consequently, the valuation rule will need to apply also for the purpose of calculating any gain or loss on disposal of the asset by the payer. Similarly, the receipt of the in-kind item may also amount to the acquisition of an asset by the payee and the valuation rule will need to apply for the purpose of determining the tax cost of the asset. For example, suppose that *A* owes *B* \$100 for rent of business premises. Instead of paying cash, *A* transfers to *B* inventory with a market value of \$100 and that cost *A* \$80. Under a fair market value rule, *A* will be required to recognize a gain of \$20 on disposal of the inventory and will be allowed to claim a deduction of \$100 for rental expense. This means that *A* is in the same position as if he or she had disposed of the inventory for cash that was then used to pay the rent. Under the fair market value rule, *B* would be required to recognize \$100 as rental income and as the cost of the inventory acquired.

[54] This is a consequence of the doctrine from the decision of the House of Lords in Tennant v. Smith [1892] A.C. 150, where the taxpayer received free use of premises that he could not assign or let.

contexts.[55] Consequently, any statutory income inclusion rule applicable to nonconvertible benefits must be of general application and must not be confined to employee fringe benefits.

Where a nonconvertible benefit is characterized as income under either general principles or a statutory income-inclusion rule, the value of the benefit (and hence the amount of income derived) must be determined. In particular, the issue is whether there should be any discount for the nonconvertibility of the benefit. On the grounds of equity and neutrality, the fair market value rule should apply equally to nonconvertible benefits. That is, there should be no discount for any restriction on the transfer of the benefit to another person or to the fact that the benefit is not otherwise convertible to cash.

IV. Employment Income

The main category of income derived by an individual is employment income. A number of technical and administrative issues arise in the taxation of employment income. The technical issues are discussed below, and the administration issues are discussed in section XII.

A. Definition of Employment and Employment Income

The notion of employment is important in both schedular and global income tax systems. Under a schedular system, it is common for separate taxes to be imposed on income from employment and income from business, trade, or professional activities.[56] The rate of tax and the method of collection will generally differ depending on which tax regime applies. Consequently, the notion of employment under a schedular system is fundamental to the determination of the tax regime that is to apply to particular income derived. Under a global system, as stated above, there is often a schedular notion of income under which employment income is specifically included in gross income.[57] Even when there is a completely global notion of income, it is usual for there to be special rules applicable to employment income, particularly in relation to the collection of tax on such income.

In the absence of a tax law definition of employment, general law notions will apply. In civil law countries, employment will take the definition in the civil code or in a labor code.[58] In common law countries, employment will be defined by reference to tort jurisprudence applicable to determining an employer's vicarious liability. Neither type of definition will necessarily be appropriate for income tax purposes, where the objects of the legislation are quite different from those underlying the code or common law doctrines. For example, for income tax purposes

[55] *See* FC of T v. Cooke & Sherden 80 ATC 4140 (nonconvertible benefit provided in the business context); and Dawson v. Comm’r of IR (NZ) 78 ATC 6012 (nonconvertible benefit provided as the return for an investment).

[56] *E.g.,* ERI ITP arts. 7 and 20.

[57] LSO ITA § 17(1)(a); SGP ITA § 10(1)(b).

[58] DEU BGB (Civil Code) § 611 *et seq.*; ESP Código Civil § 1544; ITA Codice civile § 2096 *et seq.*

(particularly the collection of tax), it is preferable to treat as employment relationships all service relationships where the remuneration paid is essentially for the labor of the service provider. This is the case regardless of the legal characterization of the relationship as that of officeholder or customer-client. These are relationships where the service provider incurs few deductible expenses in providing his or her labor and, therefore, should be subject to the collection regime applicable to income from employment.[59] Generally, nontax definitions will not be broad enough to cover all relationships that should be covered by the notion of employment for tax purposes and, therefore, a special definition for tax purposes should be provided.[60]

As noted above, even under a global system, employment income may be expressly included in gross income. In this case, it is necessary also to have a definition of employment income. Again, in the absence of such a definition, nontax definitions may apply in determining what employment income is, and these definitions may not be appropriate for tax purposes.[1_otnote]
[1]*See, e.g.,* FRA Code du travail § 140-2 (definition of salary). For example, nontax definitions of "salary" or "wages" may not include many employment-related receipts that should be treated as employment income for income tax purposes.

The definition of employment income may serve a number of purposes in a global or schedular income tax system, and the appropriate definition may differ depending on the use to which it is put. The definition may be used, for example, to identify a category of income for which special deduction rules apply. It may also be used to establish the base for withholding of tax at source by employers.[61] An important purpose of the definition in jurisdictions with a less than comprehensive judicial concept of income is to broaden the tax base. This is particularly the case in those jurisdictions that rely upon U.K. jurisprudence. As noted earlier, the income concept developed by U.K. courts was a narrow one. In the context of income from employment, the tests required a strict nexus between the provision of services and the receipt of consideration for the services so it could be said that the receipt was a product or an ordinary incident of the provision of services.

Thus, many gains that would be considered employment income in other jurisdictions were excluded from the U.K. judicial concept of employment income and, consequently, from the global concepts of income used in jurisdictions adopting U.K. jurisprudence. Examples

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[59] *See infra* sec. XII.

[60] *E.g.*, FRA CGI §§ 80–80 *ter;* HUN PIT § 24 (nonindependent activities include those of employment, legislative service, participation in association, and office holding, and activities of contributing family members); USA IRC § 3121(d). There have been substantial difficulties in the United States in the classification of workers as employees or independent contractors. Rev. Rul. 87-41, 1987-1 C.B. 296, sets forth 20 factors in applying the common law test for an employment relationship. *See also* Revenue Act of 1978, § 530, Pub. L. No. 95-600, which imposed a moratorium on the issuance of regulations on this issue. *See* Staff of the Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, at 300–05 (1979).

[61] The withholding system applied to employment income is commonly called a pay-as-you-earn or PAYE system. *See infra* sec. XII; ch. 15. However, where employer withholding is a final tax on employment income, there should be complete identity between the definition of employment income for the purposes of the charge to tax and for the purposes of collection of tax.

include receipts that are characterized as being in the nature of a gift or "personal tribute" rather than as a product of the employee's labor and receipts that are characterized as being in return for some consideration other than actual performance of labor, such as the giving up of valuable rights under an employment contract. Alternatively, the receipts may be characterized as capital amounts, paid to secure "negative covenants" from a past, present, or future employee not to compete with the employer or to divulge the employer's confidential information. Particularly in jurisdictions that rely on U.K. jurisprudence, therefore, the definition of employment income will need to be broad to avoid these interpretations.

The basic definition of employment income should include any compensation directly or indirectly related to the employment relationship. Depending on the drafting style used, it may be appropriate to enumerate for further certainty specific amounts,[62] including the following:

- salary, wages, or other remuneration provided to the employee, including leave pay, overtime payments, bonuses, commissions, and work condition supplements, such as payments for unpleasant or dangerous working conditions;
- fringe benefits;[63]
- any allowance provided by the employer for the benefit of an employee or in respect of any member of the employee's family, including a cost of living, subsistence, rent, utilities, education, entertainment, or travel allowance;
- any discharge or reimbursement by an employer of expenditure incurred by an employee other than expenditure incurred in the performance of duties of employment;
- consideration provided by an employer in respect of the employee's agreement to any conditions of employment or to any changes in the conditions of employment;
- any payment provided by an employer in respect of redundancy, any payment for loss of employment or termination of employment, and similar payments;
- any compensation received for a total or partial loss of employment income;
- retirement pensions and pension supplements;
- any consideration paid to secure a negative covenant from a past, present, or future employee; and

[62] Many income tax laws contain a nonexhaustive enumeration of various elements of income derived from employment. *See* AUT EStG § 25; BEL CIR §§ 31–32; DEU EStG § 19; ESP IRPF §§ 24–26.

[63] *See infra* sec. IV(C).

- gifts provided by an employer to a past, present, or prospective employee in the course of or by virtue of employment.

The definition of employment income can exclude certain fringe benefits and social benefits provided to employees that do not represent net economic gains or that are to be exempted from the tax base in order to achieve certain social policy objectives.[64]

B. Employee Expenses

Because taxable income consists of net amounts, recognition of expenses incurred to derive gross employment income is as important to the definition of taxable income as are the inclusions outlined above. The rules regarding the deductibility of expenses incurred to derive employment income are relevant not only to the determination of net gains, but also to the design of the pay-as-you-earn (PAYE) withholding system applied to employment income. Recognition of employee expenses inevitably complicates the withholding system, making it difficult or impossible to use PAYE withholding as a final tax. Indeed, this is an example where tax policy may be dictated by decisions as to administrative design. If it is decided to make PAYE withholding a final tax for a majority of individual taxpayers, then it will be necessary to have either a standard deduction or a denial of employee deductions (perhaps compensated by rate adjustments)—see the discussion of this issue in section XII, below, and in chapter 15.

There are significant differences from jurisdiction to jurisdiction in the treatment of employee expenses. The trend, however, is to restrict employment-related deductions, given that they cause a number of significant administrative complications. First, as noted above, they make it difficult to apply withholding tax as a final tax on employment income. Also, they raise a number of difficult borderline questions—common trouble areas include expenses for education, commuting, travel, clothing, child care, and entertainment. Finally, given the large number of employees in any jurisdiction, it is inevitable that there will be many disputes over employment-related deductions—disputes that can tie up a disproportionate amount of administrative resources.

One solution that has been tried in some jurisdictions is simply to deny deductions for employee expenses[65] or to allow a flat deduction.[66] The impact of such rules will depend in part

[64] *See infra* sec. IV(C)(3).

[65] For example, in Canada, ITA § 8(1)(a) formerly allowed a standard deduction for employee expenses of 20 percent of employment income, to a maximum of Can$500. This provision was repealed in 1988, so that now there is no deduction for expenses incurred to derive employment income, except for very special categories of employment such as artists, clergy, and truck drivers. A similar position applies in New Zealand where no deductions are allowed for any expenditure or loss incurred in gaining or producing employment income (ITA § 105).

[66] *See* ESP IRPF § 28(2) (standard deduction of 5 percent with a cap of Ptas. 250.000 (approximately US$2,250) and a special standard deduction for handicapped employees; there is no provision for an itemized deduction).

on the relative bargaining strength of employees and employers and thus on whether the additional tax payable by an employee faced with a deduction denial or restriction is actually borne by the employee or can be shifted to employers who are required to gross up wages to offset the additional tax burden or assume responsibility for paying for the expenses formerly borne by the employee. If the employee bears all or some of the tax burden, two potential problems may arise. First, denying or restricting deductions for employee expenses may lead to inequities for some taxpayers, particularly those incurring large employment expenses. Second, it may open a significant distinction between employees who are not able to fully recognize employment expenses and self-employed persons and contractors who are. The latter phenomenon may result in a significant restructuring of employment contracts as employers seek to have their relationships with employees recharacterized as independent contractor arrangements.[67]

A compromise approach is to allow taxpayers to choose between a standard deduction for employment expenses and a deduction for actual documented expenses when the latter exceed a specified threshold.[68] This is the solution most OECD countries follow.[69] It does not solve the problem, however, of the temptation of many taxpayers to opt for itemized and substantiated expenses, particularly when the standard deductions are set at a low level,[70] resulting in an inordinate volume of work for the tax administration. Therefore, if a system allowing taxpayers to choose between a standard deduction and the optional deduction of itemized and substantiated expenses is adopted, there are advantages to be realized by setting the maximum limits for

[67] The incentive to convert an employment relationship into an independent contractor relationship will depend on the scope of the definition of employment that applies for this purpose. As stated above, a broad definition of employment will include independent contractor relationships where the remuneration paid is essentially for the labor of the service provider.

[68] Jurisdictions that allow employees to choose between a standard deduction and an option to claim a deduction for itemized and substantiated expenses include Austria: AUT EStG § 16(3), which provides a flat deduction of S 1800 (approx. US$180); Belgium: CIR § 51, which establishes a declining standard deduction of employment expenses ranging from 20 percent of employment income below BF 150,000 (approx. US$5,000) to 3 percent of employment income exceeding BF 500,000 (approx. US$16,500), subject to a maximum deduction of BF 100,000 (approx. US$3,300); France: CGI § 83 /3 , which provides an ordinary deduction of 10 percent of employment income, to a maximum indexed deduction (F72,250 in 1993) and an additional standard deduction for specific forms of employment (artists, journalists, miners, construction workers, and traveling salesmen), which varies from 10 percent to 30 percent of employment income, also subject to a maximum limit; Germany: EStG § 9a (flat amount of DM 2,000 (approx. US$1,400)); the Netherlands: NLD WIB § 37, which provides a standard deduction of 8 percent of employment income, subject to a fixed minimum and maximum deduction and a special standard deduction for sailors; and the United States: USA IRC § 63, which provides a combination of standard deductions. A special feature of the U.S. employment income deductions is the adoption of a floor on deductions for certain itemized expenses, set at 2 percent of "adjusted gross income." *See* USA IRC § 67. A U.S. employee opting for the standard deduction in lieu of itemized deductions also gives up the right to itemized deductions that are not connected with employment.

[69] I.e. countries that are members of the Organization for Economic Cooperation and Development. Two exceptions to this general rule are Australia and Canada. Australia permits deductions only for substantiated expenses and, as noted earlier, Canada does not allow any deduction for employment expenses.

[70] Examples of jurisdictions with relatively low standard deduction thresholds include Austria and the Netherlands.

standard deductions at levels that are high enough to dissuade all but a few employees from claiming deductions for itemized expenses.

A conceptually distinct problem is that of the so-called borderline expenses that have elements of both employment expenses and personal consumption. A number of legislative techniques have been used to minimize the problem, although none has eliminated it. To begin with, it is common for the general deduction rules to require a direct nexus between a deductible expense and the derivation of income.[71] This construction implies a distinction between expenses incurred to put a person in a position to derive income (e.g., commuting,[72] child care, and education), which are not deductible, and expenses incurred directly in the income-earning process, which are deductible. General rules of this sort are often also drafted to prohibit explicitly or implicitly deductions for personal expenses.[73] The general rules may be supplemented by specific ones addressing particular types of expenses.

Many jurisdictions have taken the position that social support is appropriate for some quasi-personal expenses such as child care or commuting expenses. At the same time, it is generally recognized that deductions for quasi-personal expenses will lead to an upside-down subsidy.[74] For this reason, some jurisdictions that wish to provide support through the tax system for quasi-personal expenses prefer tax offsets to deductions.[75]

An alternative approach for some quasi-personal expenses is to prorate the outgoings and allow a deduction for only a portion of the expenditure. This approach is taken, for example, with business entertainment expenses in some jurisdictions.[76] The proration approach has been criticized because of the administrative difficulties involved in substantiating entertainment expenses as legitimate business outgoings and because of equity concerns. Equity concerns are based on the indisputably high personal consumption value of the expenditure to the person incurring the cost, the fact that other persons benefiting from the expenditure will not be assessed on the value of the consumption benefit they receive, and the fact that the expenditures are

[71] *E.g.*, AUS ITAA (1997) § 8-1; AUT EStG § 16(1); BEL CIR § 49; DEU EStG § 9(1); ESP IRPF § 41.

[72] Commuting expenses may be regarded either as travel to and from work (deductible) or travel to and from home (nondeductible living expenses).—L.M. For a theoretical discussion, *see* William Klein, *Income Taxation and Commuting Expenses*, 54 Cornell L. Rev. 871 (1969).

[73] *E.g.*, AUS ITAA (1997) § 8-1(2)(b) prohibits deductions for expenses of a "private or domestic nature"; FRA CGI § 83/3 limits deductions to expenses "inherent to the office or employment"; GBR ICTA § 198 allows "the holder of an office or employment" a deduction for expenses incurred "exclusively and necessarily in the performance of those duties' [of the office or employment]; IDN LCIT Art 9(1)(h) denies a deduction for "costs incurred for the personal needs of the Taxpayer and his dependents"; USA IRC § 262 denies deductions for "personal, living, or family expenses."

[74] *See infra* sec. VII.

[75] *See* USA IRC § 21.

[76] *See* CAN ITA § 67.1; LSO ITA § 35; USA IRC § 274(n).

incurred disproportionately by higher-income taxpayers. These concerns explain the prohibition on deductions for entertainment expenses in several jurisdictions.[77]

Full or partial denial of a deduction for entertainment expenses requires this category of expense to be defined. The concept covers all expenses incurred for the purpose of socializing with business associates, such as for meals, drinks, theater tickets, hunting, and yachting. In some countries, the concept of "representation" or "protocol" expenses is more meaningful.[78] These may include, in addition to entertainment, transportation and lodging expenses for one's own employees or for the employees of another company (e.g., a potential customer). Expenses for lodging and transportation should be treated in the same manner as business trip expenses, rather than as entertainment expenses. Thus, if a company pays for representatives of a potential customer to visit its headquarters, the costs of transportation and lodging should be deductible, while expenses for meals and entertainment should not be deductible if a deduction for entertainment expenses is generally denied.

[77] AUS ITAA (1997) § 32-5; GBR ICTA § 577(1)(a); for a review of deductibility of entertainment expenses in several jurisdictions, *see* Hugh Ault et al., Comparative Income Taxation: A Structural Analysis 216–19 (1997).

[78] *E.g.,* GEO TC § 49(2) (representation); ROM PT § 6(2) (protocol).

C. Employee Fringe Benefits

1. Introduction

A "fringe benefit" is any monetary or nonmonetary benefit derived from employment that does not constitute cash salary or wages. Common examples of fringe benefits are employer-provided housing, the use of an employer-provided car for personal purposes, and the provision of discounted goods to employees.

The theoretical case for full inclusion of fringe benefits in the tax base is noncontroversial. Full taxation is a prerequisite to horizontal equity between taxpayers who are wholly remunerated in cash and taxpayers remunerated partly through fringe benefits. It is also a prerequisite to vertical equity because the incidence of fringe benefits tends to rise with taxpayers' economic incomes and employment status. Full taxation of fringe benefits is also a precondition to achieving an economically efficient tax system. It ensures that the tax system will be neutral between those employers able to provide fringe benefits and those not able to do so and removes the distortion in favor of providing goods and services that are not taxed. Finally, taxation of fringe benefits is important to protect the revenue base.

The overwhelming theoretical case in favor of fringe benefits taxation is countered by a number of conceptual and political problems. A fundamental problem is that many taxpayers, and for that matter some tax administrators, do not perceive benefits in kind to be income with the same economic capacity as cash wages or salaries.[79] Subsidiary problems arise from the definition of fringe benefits, the difficulty in allocating general benefits among employees, and the difficulty in distinguishing genuine benefits from benefits that are consumed in the course of employment or that are a necessary condition of employment. The conceptual difficulties that arise with the income taxation of fringe benefits have often resulted in low levels of taxpayer compliance with, and administrative enforcement of, the tax law applying to these benefits. This in turn has led to a "tax culture" in some countries that regards fringe benefits as tax-free remuneration so that attempts to expressly bring the value of fringe benefits within the tax base are subject to political resistance.

2. Choice of Tax Method

Three methods have been used to tax fringe benefits. The first, and by far the most common, is to include the value of fringe benefits in employees' assessable income.[80] In civil code jurisdictions, the definition of salaries in the labor codes will usually include fringe benefits, and this definition will in principle be applied for income tax purposes.[81] Similarly,

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[79] This is particularly the case with nontransferable benefits of a kind or quantity that the taxpayer would not have been interested in buying with his or her own money. An individual estimate of when this is the case is, however, too much for a mass procedure such as income tax assessment.—L.M.

[80] *E.g.*, AUT EStG § 25(1)1a; BEL CIR § 31(2); DEU EStG § 19(1)1; FRA CGI art. 82; ESP IRPF §§ 24(2), 26; USA IRC § 61(a)(1).

[81] *See* International Fiscal Association, The Taxation of Employee Fringe Benefits 18–19 (1995).

fringe benefits will automatically be incorporated into income from labor in common law jurisdictions where the judicial concept of "income" is broad enough to encompass all net gains. In common law jurisdictions that rely on U.K. precedents, the judicial concept of income excludes benefits in kind that cannot be converted to cash[82] and values benefits that can be converted by reference to their value as secondhand goods or services.[83] In these jurisdictions, specific statutory inclusion provisions and valuation rules are needed to include the full market value of nonconvertible fringe benefits into the gross income of employees.

A second method of taxing fringe benefits is to impose a surrogate tax on the benefits by denying employers a deduction for the cost of providing them. This method is used in a number of countries for selected benefits, especially those benefits that are difficult to allocate to particular employees, but is not used as a general method for taxing fringe benefits in any jurisdiction.[84] The principal disadvantage of denying deductions to the employer as a method of taxing fringe benefits is that it effectively taxes the benefit at the employer's marginal rate, which, for public sector employers or employers in tax loss positions, is nil. A deduction denial is equivalent to taxing the employee only if the same tax rate is imposed on employers and employees. Even then, equivalence is achieved only if the cost of providing a benefit is equal to its market value. Often, this will not be the case; some benefits, such as transportation on public transit vehicles operated by the employer, have little or no cost to the employer. The design of the company and shareholder tax system may also cause problems by "washing out" the effect of the deduction denial.[85]

A third method of taxing fringe benefits is to impose a separate tax (usually referred to as a "fringe benefits tax") on the employer, based on the value of benefits provided to employees. This method may be used as a basis for taxing specific benefits or as a general method of taxing fringe benefits. New Zealand was the first country to use a fringe benefits tax as a general method of taxing fringe benefits. The fringe benefits tax was adopted in New Zealand for political reasons in the context of a reform agenda based on a tax mix change.[86] The political

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[82] *See supra* note 54.

[83] Wilkins v Rogerson [1961] 1 Ch. 133 (an employee was provided with a suit worth £30, but was taxed only on its secondhand value of £7).

[84] It is used, for example, in Canada (ITA § 18 (1)(b)) and the United States (IRC § 274), to tax some entertainment and recreational benefits provided to employees. In Belgium, art. 53/14 CIR denies a deduction for certain fringe benefits that are exempt in the hands of the employees on the basis of art. 38/11 , because: (1) the beneficiaries of such benefits cannot be easily identified; (2) they cannot be considered as effective remuneration; or (3) they are small gifts and benefits at the occasion of weddings, birthdays, and other personal occasions.

[85] This is the case in Australia, for example. The deduction denial will cause the company to incur higher taxes, which in turn generates tax offsets (commonly referred to as “imputation credits”) under an imputation system that shareholders may use to shelter tax-exempt income derived by the company. For a general explanation of "washout," see Charles McLure, Must Corporate Income Be Taxed Twice? 94–95 (1979).

[86] The concept of a fringe benefits tax has its genesis in the Report of the Task Force on Tax Reform 154–56 (1992) prepared by the McCaw Committee in New Zealand.

authorities had concluded that the fringe benefits tax would be more viable politically than reform measures that included all benefits in employees' incomes. Similar considerations led to the adoption of a fringe benefits tax in Australia and to the adoption of separate fringe benefits taxes in some developing and transition countries.[87]

The fringe benefits tax imposed on employers as a general policy instrument for dealing with fringe benefits has been criticized.[88] It is particularly vulnerable to criticism that it undermines the measurement of employee income. While the employer-based fringe benefits tax might ensure that the benefits are subject to income tax, noninclusion in the employee's gross (and therefore taxable) income may allow the benefits to escape other taxes and contributions based on taxable income, particularly social security taxes. Also, employees' taxable incomes will be understated for the purpose of measuring eligibility for various means-tested benefits such as health benefits and education benefits. The understatement may also affect obligations based on taxable income such as support payments.

A separate problem with employer-based fringe benefits taxation is its inability to impose tax at the appropriate marginal rate for each employee.[89] A single rate must be applied to all fringe benefits, and this is usually the highest personal marginal tax rate on the assumption that most benefits are derived by persons in the highest marginal rate bracket. This approach presumes that employers will "cash out" benefits provided to employees in lower tax brackets, an approach that discourages the provision of benefits that might be provided more efficiently through employers. An example is medical insurance, which is less expensive when acquired through an employer-sponsored plan because of the discounts available to large group enrollments.[90]

There are two options as to the basic design of a fringe benefits tax. The first option is to design the fringe benefits tax independently of the income tax system, with no attempt to coordinate it. The second option is to carefully coordinate the income tax system to achieve the exact same overall tax burden on any given fringe benefit as would be the case if the employer paid cash to the employee instead of providing the fringe benefit. It is suggested that the second approach is preferable because it will ensure that the fringe benefits tax operates fairly and in a neutral fashion between those employees paid in cash and those paid in fringe benefits. If the tax burden is not the same for cash and fringe benefits, remuneration packages will be altered to

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[87] *See, e.g.*, EST ITL § 33; LSO ITA §§ 115–127; MWI §§ 94A–94D.

[88] *See* Richard J. Vann, *Some Lessons from Hussey and Lubick,* 7 Tax Notes Int'l 268, 268–70 (1993); Richard K. Gordon, *Some Comments on the Basic World Tax Code and Commentary*, 7 Tax Notes Int'l 279, 280–81 (1993).

[89] This is only a problem where, as is usually the case, a progressive marginal rate structure applies to individuals. Estonia is the only country that imposes a fringe benefits tax to also apply a flat rate of tax on individuals. In Estonia, the fringe benefits tax rate is aligned to the individual rate of tax, which is currently 26 percent (EST ITL § 7).

[90] For this reason, if a fringe benefits tax is used, it may be desirable to exempt benefits of this sort. *See* LSO ITA § 124(3). Safeguards could be provided to prevent abuse (*e.g.,* the Lesotho exemption applies only when the benefit is available to “all non-casual employees on equal terms”).

achieve the best tax result, thereby giving rise to economic distortions and revenue losses resulting from the tax-driven alteration.

Fringe benefit taxes are usually imposed at a flat rate. For those countries with a progressive marginal rate structure, the setting of the rate is designed (at least initially) to achieve parity in terms of the final tax burden between the fringe benefits tax and the tax that would have been paid had the benefit been taxed in the hands of an employee subject to the highest personal marginal rate. Parity may be achieved under a system in which the employer is allowed an income tax deduction for the cost of the fringe benefit, but not for the fringe benefits tax imposed on the benefit[91] or under a system in which the employer is allowed an income tax deduction for both the cost of the fringe benefit provided and the fringe benefits tax payable thereon.[92] In the latter case, adjustments must be made to offset the value to the employer of the income tax deduction for the amount of fringe benefits tax paid. This can be done in one of two ways. First, the value of the benefit can be grossed up before the fringe benefits tax rate is applied,[93] or, second, the actual value of the benefit can be used and a higher rate of fringe benefits tax (i.e., the maximum marginal rate grossed up by an appropriate formula to achieve the desired parity) imposed on that value.[94]

One potential drawback with the flat-rate employer-based fringe benefits tax is that parity between a fringe benefits tax and the alternative of taxing employees on the value of fringe benefits received can be achieved only with respect to one tax rate. That is, whichever system described above is used (nondeductible fringe benefits tax or deductible tax but subject to a gross-up of the value or rate), the parity formula is calculated to achieve parity with one tax rate only, usually the highest personal marginal tax rate for reasons explained above. If the employees receiving the benefits are subject to lower tax rates, the tax burden may be too high.

Another problem with an employer-based fringe benefits tax is its potential incompatibility with prevailing unilateral and bilateral international tax rules. If an individual from one country goes to work as an employee in a second country, both the country where the work is performed and the country where the employee is resident may claim taxing rights over the salary and fringe benefits derived by the employee. International tax rules to prevent double taxation have been devised on the assumption that fringe benefits are taxed to the employee in the country where the work is performed. If the employee's country of residence also seeks to tax the employee's remuneration, it will normally provide an offset[95] against the tax otherwise payable on employment remuneration (including fringe benefits) for any taxes imposed on salary

[91] This is the method that applies in Estonia and Malawi. It is also the method that originally applied in Australia and New Zealand.

[92] This is the method that applies in Australia, Lesotho, and New Zealand.

[93] This is the method that applies in Australia (FBTAA § 136AA) and Lesotho (ITA § 117).

[94] This is the method used in New Zealand.

[95] Generally, referred to as a "foreign tax credit"; *see infra* ch. 18.

and fringe benefits by the country where the work is carried out. However if the country where the work is carried out imposes a fringe benefits tax on the individual's employer and the employee's country of residence seeks to tax the employee on the value of the fringe benefits received, the employee may not be able to obtain any double tax relief for the tax already levied by the other country on the same fringe benefits. This is because the country of residence may not recognize the fringe benefits tax imposed on an employer in another country as an income tax paid by the employee. Since offsets are normally available only for foreign income tax actually paid by the employee, double taxation will result.[96] Similar difficulties arise in other cases where different countries assess different taxpayers for the same type of benefit.[97] Special treaty measures or unilateral rules can be devised to ameliorate the problem, although to date these problems have been largely ignored in those countries that impose a fringe benefits tax.[98] The international aspects of employer-based fringe benefits taxation are discussed further in chapter 18.

Another international law problem with an employer-based fringe benefits tax is that of imposing the tax on such employers as diplomatic and consular missions and certain public international organizations that are exempt from tax under a convention or other international agreement. It may be necessary to include a parallel regime for taxing employees of such organizations or entities; otherwise, the benefits provided to these employees may go untaxed.[99] The existence of parallel regimes for taxing fringe benefits means that the effective rate of tax on the benefits may differ depending on which regime applies. For developing countries with a significant presence by public international organizations that employ local staff, the need for parallel regimes may substantially detract from the advantages of the fringe benefits tax.

Notwithstanding these problems, a fringe benefits tax imposed on the employer does have the significant advantage of being more achievable politically in jurisdictions in which fringe benefits are not commonly perceived to be income that should be taxed in the hands of employees in the same manner as cash salaries. It may also be easier to implement in jurisdictions where cash salaries are low and employees would face liquidity problems if the cash

[96] The same problem can arise where the employee's country of residence provides relief from international double taxation by exempting foreign income from tax. This is because it is usually a condition of such relief that the employee has paid foreign tax on the foreign income.

[97] A leading example is in the area of pensions paid from pension or retirement funds, as the pensions may be double taxed if derived by a beneficiary in a country that taxes pension recipients from a country that taxes pension or retirement funds.

[98] One exception to this is the renegotiated Australia-New Zealand double tax agreement (signed Jan. 27, 1995), which was adopted in part to better coordinate the application of those countries' employer-based fringe benefits tax systems.

[99] Such taxation should, of course, apply only to those employees (typically, local staff) who are taxed on their employment income as a general matter. Another example of an employer who is generally excluded from a fringe benefits tax is a private individual who employs domestic staff (e.g., housekeeper, gardener, or chauffeur). However, in most developing and transition countries, the remuneration paid to such staff will generally be below the threshold for income taxation.

remuneration were reduced by tax on both the cash payment and the benefits received. This may also facilitate the making of PAYE withholding a final tax on employment income. The choice of a fringe benefits tax system is thus likely to turn on political considerations as much as on technical tax ones. If an employee-based fringe benefits tax system appears to be difficult to attain in the short term for political reasons, an employer-based tax may be considered as an interim solution. It may, however, be difficult to subsequently change to an employee-based tax. The New Zealand fringe benefits tax was originally recommended as a transitional tax, establishing the political acceptability of fully taxing fringe benefits, that would be phased out when taxation was shifted directly to employees.[100] The government did not accept the transitional aspects of the proposal, however, and there is no sign of an imminent or long-term future shift in approach in that jurisdiction.

One technical issue that may influence the choice of fringe benefits tax system is the difficulty of collecting the tax if fringe benefits are included in employees' assessable income. In theory, the tax may be collected on an assessment basis when the taxpayer's final liability for tax for the year is determined, or on a regular basis throughout the year by including fringe benefits in remuneration subject to PAYE collection. The effective administration of either method requires the employer to provide tax authorities with information on the value of fringe benefits provided. Thus, from a compliance perspective, an employer-based tax is often less costly than one in which the tax is imposed on employees, since in the former case the employer can consolidate the value of benefits provided and does not have to report the separate value for each employee's benefits.

The choice among the three methods of taxing fringe benefits need not be resolved the same way for all benefits. All three methods can be used at once for different kinds of fringe benefits. Thus, fringe benefits can generally be taxed to employees, subject to exceptions for those benefits that may be excluded from employees' income for administrative reasons (an example might be *de minimis* benefits) or because of the difficulty in valuing the benefit derived by a particular taxpayer (e.g., recreational facilities that are available to all employees). Such excluded benefits may be taxed by way of deduction denial to the employer or under a fringe benefits tax.

3. Identification, Valuation, and Exclusions

Assuming a policy decision is made to tax fringe benefits fully, one might be tempted to recommend simply a general provision that all benefits in kind are taxable to the employee and that their value for income tax purposes is the fair market value of the benefit at the time it is derived by the employee. Experience in many countries shows that this strategy is not likely to be successful. Even if a taxable benefit is identified, requiring taxpayers to determine fair market value without providing further guidance on calculating that value will be a serious problem in many cases. A more fruitful strategy has proved to be to deal with different types of fringe benefits one by one, with explicit rules distinguishing taxable benefits from those that are excluded from tax, and to provide easily applicable rules for the valuation of those benefits that

[100] *See* Report of the Task Force on Tax Reform, *supra* note 87.

are taxed. Valuation rules need not necessarily be in the statute, but could be provided in regulations. If most benefits are dealt with in this manner, then a residual catchall provision can provide for the taxation of benefits other than those specifically mentioned and further provide for their valuation at fair market value.

The first question to be resolved in the context of fringe benefits taxation by means of either an employee-based tax or an employer-based tax is whether the person receiving a benefit is an employee. In many cases, there will be an incentive for employers and employees to recharacterize the relationship as one of business and independent contractor.[101] Where fringe benefits are taxed at the employee level, characterization of the beneficiary as an independent contractor can take the person out of the PAYE system with respect to the benefits and enable the beneficiary to defer, and possibly reduce or avoid, tax payable on the benefit. Where fringe benefits are taxed at the employer level, characterization of the beneficiary as an independent contractor can defer tax and possibly reduce the rate if the beneficiary's marginal rate is less than the marginal rate used for fringe benefits tax purposes.

If fringe benefits are subject to a separate fringe benefits tax, either within the income tax legislation or as a separate tax, it is important that the definition of employee be used consistently throughout the legislation to ensure that there is neither overlap nor gaps between the tax applicable to other remuneration and that imposed on fringe benefits. Once it is determined that a person is an employee, it is necessary to see whether the person also enjoys another relationship with the employer (such as that of a shareholder of the employer, a friend of the employer, or a creditor of the employer) and whether the benefit is received in consequence of that person's employment or the other capacity.

A second issue to be addressed is the characterization of benefits, particularly cash benefits, as salary or wages or fringe benefits. The benefit that most often gives rise to difficulty is the payment of cash "allowances" or "bonuses." If these payments are considered salary, they will be subject to PAYE withholding. However, if they are treated as fringe benefits, they may not be subject to PAYE withholding if benefits are taxed at the employee level[102] and certainly will be exempt from PAYE withholding if benefits are taxed at the employer level. Specific rules will be needed to coordinate the tax imposed on cash benefits of this sort with any offsetting deductions that might be available to an employee as a result of the application of the amount received.

The third issue to be resolved is that of the value to be assigned to taxable fringe benefits. In theory, the preferable value for the taxation of a fringe benefit is the value of the benefit to the employee, because this is the cash or economic equivalent for the taxpayer. It is, however, impossible to levy a tax on the basis of the subjective valuation by a taxpayer, and so a surrogate must be used. The most appropriate value in this case is the market value of the benefit. It is

[101] *See generally* sec. IV(A).

[102] Where PAYE withholding is not a final tax, the value of fringe benefits provided may be excluded from the PAYE tax base, with the result that tax is deferred until assessment.

logical to assume that for most taxpayers the value of benefits derived equals the amount other persons would pay for those benefits in a market transaction. Valuation based on market value best achieves the equity and efficiency objectives of fringe benefits taxation.

Determining the market value for common benefits can be a costly and administratively complicated procedure for employees and employers. Accordingly, it is common for tax systems to provide rules of thumb for determining market value for most common benefits. Depending on the legislative structure of the tax regime, valuation rules may be set out in legislation, regulations, or rulings. They may be provided in the form of valuation formulas or specific values for particular benefits.[103] The major categories of fringe benefits that are usually subject to specific valuation formulas include cars, housing, low-interest loans, debt waivers, expense allowances, shares acquired under an employee share scheme, and subsidized goods and services. Residual valuation rules may apply to other benefits.

In some cases, the valuation rules set out presumptive values that are lower than market values where the market value could impose an unreasonable burden on a taxpayer. An example is the provision of accommodation in a remote work site. If the value of this benefit were calculated as a reasonable rental value based on the cost of providing accommodation, the value of accommodation in, say, a remote jungle, a desert camp, or an offshore oil drilling platform would be very high. But the value to the taxpayer is the amount the taxpayer is saving by not paying for accommodation in an ordinary setting where the taxpayer would be if not for the job. The same is true of board. The cost of meals in a remote location could be high, but the saving to the taxpayer is the cost of meals where the taxpayer would live if not for the employment. Thus, in this situation, the value of accommodation and board is likely to be set at a figure based on the market value of the benefit had it been provided at a nonremote location rather than on its actual market value.[104]

Finally, special valuation rules may be needed in jurisdictions where it is difficult to allocate among employees such benefits as a subsidized cafeteria or employer-provided recreational facilities. Where benefits are taxed by means of a fringe benefits tax imposed on the employer, a surrogate value based on total usage may be used,[105] but where benefits are taxed at the employee level, some formula must be adopted to allocate the benefit to individual users. The employer could be required to keep strict track of actual usage by individual beneficiaries, but this may be an administratively expensive procedure. An alternative is to consider the benefit provided to be the right to use the subsidized facility rather than its actual usage and to assess employees on the notional value of that right. This approach poses two difficulties—valuation of rights that might not be used and imposition of a tax on persons who may not have wanted to be

[103] For example, the value of automobile benefits may be determined by a formula that takes into account the cost of the vehicle, its age, and the distance traveled in the year.

[104] Some jurisdictions offer a range of exemptions for particular benefits for political reasons or to subsidize certain activities, particularly in remote areas. These exemptions take the form of indirect spending programs and, accordingly, are not considered in the context of devising a fringe benefits tax system.

[105] *E.g.,* AUS FBTAA §§ 37A–37CF.

offered the right. An exclusion for socially desirable benefits provided to all employees on a nondiscriminatory basis (see immediately below) may avoid the problem in the cases of some benefits, but the difficulty will remain with others. It is a problem inherent in the employee-based tax.

Fringe benefits tax regimes may contain a range of exemptions. A common exemption is one for *de minimis* benefits, the value of which, after taking into account the frequency with which the employer provides similar benefits, is so small as to make accounting for them unreasonable or administratively impracticable.[106] Exemptions are also provided for benefits taxed under an alternative regime (deduction denial to the employer or fringe benefit tax). Sometimes exemptions are provided for socially desirable benefits such as subsidized meals, medical benefits, or child care facilities that are provided on a nondiscriminatory basis to all employees. Finally, an exemption is usually provided for benefits that would have been deductible to the employee had the employee incurred the cost of acquiring the benefit directly.[107] An example is the provision of work equipment to employees. Similarly, that portion of an allowance for which the employee has provided receipts or other proof of payment of expenses that are in the nature of business expenses for the employer should also be excluded.[108]

V. Business and Investment Income

Most of the fundamental issues concerning the taxation of business and investment income (inclusion of gains, allowable deductions, calculation and remittance systems for tax collection, and tax accounting rules) are equally relevant to such income derived by individuals and to that derived through partnerships, companies, and other entities or relationships such as common law trusts. Accordingly, the examination of these issues in chapter 16 applies equally to the calculation of business and investment income derived by individuals.

As the discussion in chapter 16 points out, some particular issues raised in the context of business income can be of particular importance to individuals. For example, in jurisdictions that have adopted U.K. judicial doctrines, the judicial concept of business income is very narrow, and legislative base broadening in this area is necessary. Courts in these jurisdictions are often more likely to apply narrower concepts of income to individuals than to legal persons, so the statutory extensions can have a slightly greater impact on individuals than on companies. Similarly, some restrictions on deductions, particularly restrictions on personal and quasi-personal expenses, are sometimes more relevant to individuals than to incorporated entities, although these issues tend to be equally relevant to partnerships and, in many cases, to trusts. And finally, it is not uncommon to apply different tax accounting rules to small businesses, including most businesses

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[106] For examples of exemptions on this basis, *see* LSO ITA § 118 and USA IRC § 132.

[107] *See* USA IRC § 132(d). For purposes of applying such a rule, any special rules denying all or a portion of employee expenses (*see, e.g.,* US IRC § 67) should be ignored.

[108] *See* USA IRC § 62(a)(2)(A).

operated by individuals, than are applied to large businesses, particularly companies and larger partnerships. These exceptions aside, the basic rules setting out measurement of business income apply to all taxpayers deriving business income, and, accordingly, these issues are not discussed separately for individuals here. For more information on these issues, see chapter 16.

One important issue relevant only to individuals is the characterization of income from a trade or profession. Some countries make a distinction between income from commercial trading activities on the one hand and income from professions and vocations on the other.[109] These distinctions reflect older divisions in civil law countries between commercial traders and members of the liberal professions; these may linger on in some areas of law,l such as ethical rules and rules of professional organization.[110]

The definitions of business income in common law jurisdictions generally include income from professional activities,[111] and the distinction between business and professional income has not been maintained in all civil law countries.[112] There are no persuasive tax policy reasons for the distinction, which developed out of historical, nontax rationale; from a tax administration perspective, it is much simpler to have a single set of rules dealing with all business and professional activities. If necessary, targeted rules such as tax accounting rules for work in progress can be applied to professions without the need for a completely separate regime for professional income.

VI. Miscellaneous Receipts

The discussion above has centred around a schedularization of income into three categories: employment, business, and investment income. As stated above, not all amounts derived by a taxpayer fit neatly into one of these categories, and, therefore, an issue arises as to the specification of other amounts to be included in gross income. The legislative method by which this may be achieved is discussed in section III(A), above. The discussion below considers the treatment of some amounts that do not come within the categories of income discussed above.

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[109] *E.g.,* DEU EStG §§ 15 (*Gewerbebetrieb*); 18 (*Selbständige Arbeit*); FRA CGI §§ 34 (*Bénéfices industriels et commerciaux*), 92 (*Bénéfices des professions non commerciales*).

[110] *See* Klaus Tipke & Joachim Lang, Steuerrecht 334 (13th ed. 1991). The former were supposed to trade for a profit, while the latter performed their services without profit motive, for only an "honorary fee."

[111] AUS ITAA (1997) § 995-1: "Business includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee"; CAN ITA § 248(1); GBR ICTA § 18, sched. D, cases I and II.

[112] *See, e.g.,* ESP IRPF § 40 (both including professional income together with business income); NLD WIB § 6/2.

A. Windfalls

Windfalls constitute unexpected accretions to wealth. While windfalls may constitute income under a comprehensive judicial conception of income,[113] they are not included in gross income in many jurisdictions. In most jurisdictions with schedular definitions of income, windfalls simply fall between the categories of income included in gross income. They similarly fall outside the judicial concept of income in jurisdictions that rely upon U.K. judicial precedents (as they do not have the necessary connection to an earning activity) and have usually been excluded from the coverage of later base-broadening legislation in those jurisdictions.

Although there are no persuasive tax policy grounds for excluding windfalls from the income tax base, political considerations and practical difficulties in assessing these gains most often explain their continued noninclusion in gross income in many jurisdictions. At the same time, their noninclusion in the income tax base does raise some administrative issues. The most problematic exclusion is gambling and lottery winnings. It is common practice for taxpayers facing assessment on the basis of a surrogate income measurement test such as an assets betterment test (a test that presumes a taxpayer has derived enough income to explain the taxpayer's assets)[114] to claim their assets were acquired with nonassessable windfalls such as betting winnings rather than with unreported assessable amounts. While the assessment and enforcement rules may place the onus on the taxpayer to prove that gains are not taxable, the nonassessability of windfall gains does complicate the task of the administrators.[115] Other problems arise with taxpayers whose primary source of income is derived from gambling or betting activities, because tax administrators must then prove that taxpayers have crossed the threshold from persons who derive windfall gains from these activities to persons who carry out these activities as a business, thus generating assessable income.

The administrative solution to these difficulties in the case of gambling winnings may be to assess the gains but to collect the tax on most such winnings by imposing a final withholding tax at an intermediate rate.

A separate type of windfall payment is a prize or an award. Generally, tax systems distinguish between prizes and awards that are won by a taxpayer in a purely personal capacity, which are usually not taxable, and prizes and awards given in recognition of a taxpayer's business or employment activities, which are usually taxable. Thus, for example, the prize won by an architect who submitted a design to an architecture contest or a "player of the match" award won by a sportsperson would be assessable. The former is connected with an activity that is an integral part of the taxpayer's business (architects often enter design contests to achieve

[113] *See* Cesarini v. United States, 296 F. Supp. 3 (N.D. Ohio 1969) (cash found in used piano is taxable).

[114] *See* vol. 1, ch. 12.

[115] A taxpayer may, for example, produce evidence of substantial winnings while omitting evidence of amounts lost. The latter may be difficult or impossible for the tax authorities to reconstruct.

recognition and hence new clients), and the latter is an example of an award that enjoys a direct nexus with the taxpayer's employment responsibilities.[116]

B. Gifts

Although some have argued that gifts or bequests should be taxed,[117] they are generally not taxed as income. They may, however, be subject to gift or estate duties or capital transfer taxes.[118] Depending on the structure of the definition of income, it may not be necessary to provide an explicit exclusion for gifts. If the definition is schedular, gifts will likely fall under none of the schedules. If, however, there is a broad residual schedule ("any other income"), then providing an explicit exclusion for gifts bolsters a broad reading of this residual category.

If an explicit exclusion is provided for gifts, it should be limited.[119] It should not apply to the income from property that is transferred as a gift, unless the income is attributed to the transferor, as happens in some antishifting rules.[120] Also, an exclusion should not apply to a gift or bequest of an income stream, such as, for example, a gift of an annuity or of the right to a royalty unless (once again) the income is attributed to the transferor for income tax purposes as a result of the application of antishifting rules. In addition, an amount transferred by or for an employer to, or for the benefit of, an employee should not qualify as a gift but should be considered employment income. A similar rule could be provided for gifts made in a business context other than to an employee. Under such a rule, a gift made to a business associate would be treated as business income to the recipient.

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[116] In 1986, the United States, which had previously made distinctions such as those outlined above, adopted a rule under which prizes and awards would be generally taxable. *See* USA IRC § 74.

[117] *See, e.g.*, Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 Harv. L. Rev. 1177 (1978).

[118] *See* vol. 1, ch. 10.

[119] *See* LSO ITA § 31. Where the statute has excluded gifts without any statutory limitation, the courts have had difficulty determining whether certain transfers, particularly those occurring in a business context, qualified as excludable gifts. *See* Commissioner v. Duberstein, 363 U.S. 278 (1960).

[120] This is the case, for example, in AUS ITAA (1936) § 102B and CAN ITA § 74(1), where attributed income is excluded from the recipient's attributable income.

C. Scholarships

Scholarships are another type of income treated inconsistently in different jurisdictions. In some jurisdictions they are generally taxable[121] and in others they are exempt from assessment, perhaps subject to limitations.[122] Once again, there are no persuasive tax policy reasons for excluding these gains from assessable income. Where scholarships are assessable and a taxpayer derives only scholarship income, much of the scholarship may be lightly taxed or exempt under the ordinary progressive income tax rate scale. Where a taxpayer derives significant income in addition to a scholarship, the exclusion of the scholarship from assessable income can seriously undermine vertical equity. Excluding scholarships can also lead to administrative problems, as employers can seek to characterize employment income as scholarships. This has affected, for example, graduate students working for the university where they are studying and employees asked to complete higher degrees directly relevant to their work.

If scholarships are to be taxed, they may have to be specifically listed if the definition of income is a schedular one, because they would not fall into the usual general categories of income. They will in any event have to be specifically mentioned if it is desired to exclude certain scholarships.

D. Damages

The tax treatment of damages (compensation awarded in a legal action) and settlement payments (paid to settle a legal action) will depend on the nature of the damages. The character of the compensation depends on what is being compensated.[123] For example, compensation for loss of a capital asset should be treated in the same manner as the proceeds on a disposition of the asset, subject to any rules allowing deferral of recognition of such gain. On the one hand, damages (other than for personal injury) intended to compensate a taxpayer for loss of employment or business income are usually assessable as direct substitutes for assessable gains. Damages for personal injury, on the other hand, are usually exempt from taxation on the basis that they represent no real gain to the taxpayer—they are merely compensatory for mental or physical losses of, or suffering by, the taxpayer.

In some cases, damages for personal injury are exempt from taxation because they fall outside general or judicial concepts of income and are not caught by any base-broadening statutory provisions. Where base-broadening statutory provisions would include damages for personal injury, it may be necessary to explicitly exempt these receipts where this result is desired.

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[121] *See* CAN ITA § 56(1)(n).

[122] *See* AUS ITAA (1936) § 23(ya), (z), and ITAA (1997) § 51-10; USA IRC § 117.

[123] A specific rule to this effect can be included in the law. *E.g.,* LSO ITA § 70 ("compensation received takes the character of the thing that is compensated").

One type of damage or settlement payment that gives rise to difficulty in many jurisdictions is compensation for the loss of a taxpayer's ability to earn income in the future. If a payment is made for the loss of income-earning capacity because of physical injury occasioned by negligence, it may be characterized as nonassessable compensation, even when the amount of damages is determined in part to be compensation for loss of future earnings. However, when a payment is clearly made in contemplation of lost income (without a physical injury), such as a payment for premature termination of employment, the amount should be treated as an assessable receipt. Drawing the line in this area is difficult, and no fully acceptable solution exists.

E. Social Welfare and Analogous Benefits and Expenses

The tax treatment of social welfare payments and expenses differs markedly from jurisdiction to jurisdiction. It is an issue that can be evaluated only in the context of the jurisdiction's social payment system, because the tax treatment of benefits and expenses is an integral element of the overall social welfare system.

The development of theoretical tax positions is complicated by the different models for social welfare payments adopted by different jurisdictions. Some benefits are targeted to lower-income persons through means testing of income and assets. Others are provided on a near-universal basis. Some are funded from general revenues. Others are paid for from earmarked taxes or levies or from a combination of earmarked levies and general revenues. And in some jurisdictions, key elements of the social benefit system such as health are largely privatized and services are paid for either directly by the user or by private insurance.

Some broad generalizations for possible tax treatment can be made. To the extent that benefits are tightly means tested, it may be appropriate to exempt them from taxation, because the recipients are quite likely to fall below the minimum tax threshold. Thus, means-tested welfare payments, unemployment payments, old-age pensions, and similar payments will normally be exempt from tax. This result is also consistent with considerations of tax administration.

In the case of other benefits funded through earmarked taxes or levies, parallel treatment of costs and benefits will provide for a generally neutral tax regime. For example, if unemployment insurance levies are imposed on taxpayers and these are deductible for income tax purposes, benefits received under the program should be taxable.[124] If the levies are not deductible, it may be appropriate to exempt the benefit from tax. In many cases, where contributions are not deductible, the benefit will be means tested and, therefore, would be excluded from income under the first principle, above.

In some cases, deviation from this general rule may be appropriate. One such case is when taxpayers make nondeductible contributions to an income support plan, but the benefits

[124] *See*, *e.g.*, CAN ITA § 56(1)(a) (unemployment insurance benefits are included in computing the income of the taxpayer).

include an investment income component. An example of this arrangement is where taxpayers are required to make nondeductible contributions to a national old-age pension scheme. The benefits paid to members in this case in theory include investment income derived from the investment of the contributions. The most appropriate treatment of these benefits is as private annuity or pension payments, with the payments being fully taxed, subject to a deduction or exclusion for a pro rata return of the taxpayer's original nondeductible contribution.

Similar issues arise in the context of universally provided social benefits, such as free or subsidized public education, health services, higher education, and so forth. When the provision of these benefits is means tested, the preferable policy is to exclude the benefits from the income tax base, because benefits will accrue to lower-income taxpayers who are likely to be exempt from taxation. Exempting means-tested benefits will reinforce the vertical equity of the income tax system.

The appropriate treatment of such benefits as health care, public education, or higher education that are provided on a universal (i.e., non-means-tested) basis will depend on whether these are viewed as a social good, comparable to the provision of defense or police, or as social benefits intended to further the redistributive objective of taxation and expenditure. If they are viewed as social benefits provided in the context of redistributive objectives, including the value of the benefit in the income tax base can reinforce the progressivity of the income tax. Imposing a tax on the value of benefits effectively claws back the subsidy for middle- and higher-income earners that is inherent in the benefits. For a number of reasons, however, it is not efficient to use the income tax system to achieve or reinforce vertical equity in respect of these benefits. Most of these relate to the administrative difficulties in assessing benefits. These include problems of valuation (should the value of benefits be measured net of income tax previously paid?) and problems of attribution (is the value of, say, higher education a benefit to the student or the parents, and, if the latter, how should it be apportioned between the parents?). If the provision of these benefits is regarded as an element of the state's redistributive program, a far more effective and efficient solution to the problem of vertical equity is to means test the provision of benefits in the first place rather than to seek to claw back subsidies after the fact through the income tax system.

In terms of drafting technique, schedular definitions of income often do not include social welfare benefits, and their characterization also varies in jurisdictions that use global definitions.[125] When income is defined globally or with a broad catchall, and when an exclusion for some or all social welfare benefits is desired, it would be preferable to provide for such an exclusion explicitly in order to preserve a broad reading of the catchall, as suggested above for gifts.

F. Loans and Cancellation of Indebtedness

[125] The basis for their nontaxation in some global systems is sometimes obscure. The United States is an example of a jurisdiction where the rationale for exclusion is not articulated. *See* I.T. 3447, 1941-1 C.B. 191 (USA) (holding that social security benefits are not taxed, but no reason given).

While the receipt of loan funds does not give rise to a taxable event (there being no gain because of the corresponding liability to repay), cancellation of indebtedness may give rise to the derivation of income. Upon cancellation of a debt, the taxpayer is immediately better off to the extent that he or she is relieved of an obligation, even though the taxpayer may not have been in a financial position to satisfy the debt had it not been canceled.

While cancellation of a debt increases the taxpayer's net worth, whether this constitutes income depends on the nature of the transaction. If, for example, the transaction is a private one, where cancellation is analogous to a gift, cancellation will not give rise to income to the relieved debtor, assuming that gifts are generally nontaxable.[126] Cancellation of loans made in an employment context usually gives rise to a taxable fringe benefit to the employee. Cancellation of loans made in a business situation generally gives rise to a gain that is included in business income, subject to any applicable special rules that defer or exempt such income in certain cases.[127]

G. Imputed Income from Owner-Occupied Housing

Only a few countries tax imputed income from owner-occupied housing.[128] In principle, this could be an important revenue source and an important element in supplying progressivity to the income tax. However, practicalities suggest that this is generally not a feasible element for taxation for developing and transition countries because of administrative and valuation difficulties. This does not mean housing should be ignored. The provision of housing to employees should be taxed as a fringe benefit. Moreover, deductions should not be allowed for mortgage interest or other housing expenses. Finally, if preferential treatment is to be provided in respect of gains realized on disposal of a private residence, the preference should be narrowly circumscribed and subject to strict caps.

H. Illegal Income

It is likely that, as a matter of general principle, income from illegal activities would fall within the general inclusion provision under a global system or, in the case of a schedular system, one of the schedules.[129] However, if this is not the case, then it should be stipulated that income derived from illegal activities is still subject to tax. Where illegal income is taxed, a deduction should be allowed for amounts subsequently returned. In part, the possibility for taxing illegal income provides a tool for prosecution of crimes having nothing to do with

[126] For example, cancellation of private debts (incurred in a nonbusiness or nonemployment context) does not result in the derivation of income in Australia, Canada, France, Germany, Japan, the Netherlands, Sweden, the United Kingdom, and the United States. *See* Ault et al., *supra* note 78, at 182–85. It may, however, be subject to gift taxation.

[127] *See infra* ch. 16.

[128] *See* Ault et al., *supra* note 78, at 172–75.

[129] *See* Ault et al., *supra* note 78, at 186–87.

taxation. Because criminals typically fail to declare their illegal income on tax returns, they can often be successfully prosecuted for tax evasion even when there is no specific proof as to how they got the money.

VII. Tax Relief for Personal Expenses

Under a comprehensive income tax, the taxable income of a taxpayer is the measure of the increase in the taxpayer's economic capacity during the relevant tax period. The way in which the taxpayer exercises the economic power resulting from an increase in economic capacity is irrelevant for the purposes of calculating the taxpayer's taxable income. In other words, the income tax is indifferent to the manner in which a taxpayer chooses to spend money provided the outlay was not incurred to derive gross income[130] and, therefore, a taxpayer's taxable income should be the same regardless of whether the taxpayer saves the income derived, consumes it, or gives it to someone else to save or consume.

In addition to tax policy arguments, tax administration considerations also argue against allowing any tax relief for personal expenses, particularly in developing and transition countries. As discussed in section XII below, allowing such relief is inconsistent with a PAYE system under which most employees (and therefore most income taxpayers) pay tax through final withholding and do not file returns.

However, a number of countries do use the income tax system to provide relief for certain personal expenses. The main examples of such expenses are charitable contributions, interest, life insurance premiums, retirement fund contributions, and medical expenses. Tax relief for interest expense is discussed in chapter 16. The special nature of tax relief for charitable contributions warrants further consideration below.

Many countries wish to encourage the development of charitable organizations to fulfill various functions that are considered socially important. Some countries have chosen to do this through the tax system. While, as indicated above, strong arguments can be made that the tax system is not the appropriate means for granting such a subsidy, this is ultimately a political question that each country's legislature must address.[131] If tax relief is provided, then it may be provided in the form of either a tax deduction or a tax offset based on the amount of the contribution. Because a tax deduction is a subtraction from income, under a progressive tax system, the higher the individual's income, the greater the value of the relief. In other words, a tax deduction provides what is known as "upside-down" relief because the value of the deduction increases with the donor's income. In other words, the deduction is of greater value to those on higher marginal rates.

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[130] If an outlay is incurred to derive gross income, then it may be a deductible expense (*see* sec. IV(B), above).

[131] *See, generally,* Richard Krever, *Tax Deductions for Charitable Donations: A Tax Expenditure Analysis* in Richard Krever & Gretchen Kewley eds., Charities and Philanthropic Organisations: Reforming the Tax Subsidy and Regulatory Regimes (1991).

This has important implications for the subsidy given by the government for the contribution because the benefit of the tax savings resulting from the deduction does not flow exclusively to the taxpayer; rather it flows to another party, namely the charitable institution. Consider, for example, a taxpayer on the highest marginal rate (say, 50 percent) who donates $100 to a charity. The taxpayer is entitled to a deduction of $100, which at the 50 percent rate results in a tax saving of $50 for the taxpayer. This tax saving lowers the cost of the gift to the taxpayer by $50, yet the charity received $100 from the taxpayer. In effect, the government gave $50 and the taxpayer gave $50. The upside-down nature of the tax deduction means that the government's contribution increases with the taxpayer's income and, hence, with the taxpayer's marginal tax rate. It also means that the government is making a smaller contribution to those charities chosen by taxpayers facing lower marginal rates.[132]

To avoid these problems, some countries have moved recently from a tax deduction system to a tax offset system for charitable contributions. Under a tax offset system, the making of a charitable contribution would not affect the determination of a taxpayer's taxable income, but rather would directly reduce the tax payable on that taxable income. The amount of the offset could be set at any level;[133] once established, however, it would be the same for taxpayers in all tax brackets (i.e., the ratio of the government's contribution to that of the taxpayer would remain constant whatever the taxpayer's level of income). It is suggested that, if it is decided to provide tax relief for charitable contributions, then the relief be provided through a tax offset rather than through a tax deduction.

Whatever form of tax relief is chosen, certain limitations and restrictions should be considered so as to limit the administration problems that are likely to arise with such relief. First, a threshold can be provided below which charitable contributions are not deductible. The threshold, if set high enough, can prevent many returns from being filed while still encouraging individuals who make substantial gifts. Second, a cap should be placed on the amount of the relief available in any one year.[134] Third, in the case of contributions of property, it is important that the donation of the property be treated as a taxable disposal for market value so that the donor realizes for tax purposes all the gain for which a deduction or tax offset is sought. Otherwise the relief would be a vehicle for avoiding the capital gains tax and, moreover, can become a source of abuse by providing an incentive for overvaluation of property. If donations of property are not treated as taxable disposals for market value, the basis for the relief should be limited to the donor's tax cost of the property. Fourth, any scheme that allows relief for

[132] The experience in Australia is that about one-third of deductible gifts are made to private schools with a consequent benefit to the donor (Krever, *supra* note 132, at 20–21).

[133] *E.g.,* CAN ITA § 118.1 (amount of the tax offset is 17 percent of the first $250 of the gift and 29 percent of the excess above $250 subject to a maximum deduction of 20 percent of the taxpayer's total income for the tax period); NZL ITA § 56A (amount of the tax offset is 33 1/3 percent of the gift, subject to a maximum deduction of $500).

[134] *See supra* note 134.

charitable contributions must define qualifying charities,[135] probably with a registration and approval requirement and with limitations on what qualifying charities may do (e.g., they may not provide benefits to any person other than as part of the exercise of charitable programs). It is also important to limit permissible distributees upon liquidation (i.e., only other charities or government bodies).

[135] It is important that an organization qualify as a charitable organization only if it applies all or substantially all income and donations derived for charitable purposes so as to prevent individuals from using the exemption to build up a tax-free fund. In the United States, such a requirement is applied to private foundations, but not to all charities.

VIII. Timing Issues

A. Tax Period

As stated above, the income tax is imposed on a periodic basis. It is necessary for the legislation to specify the tax period, generally a period of 12 months, often set to coincide with the government's budgetary year or with the calendar year.[136] Some taxpayers may be permitted to use a substituted accounting period in particular circumstances. This is mostly relevant to business taxpayers and is discussed in chapter 16.

B. Persons Entering and Exiting the Tax System

Taxpayers may enter or exit the tax system during a tax period. Examples include persons immigrating or emigrating during a tax year, taxpayers leaving education for full-time employment, and taxpayers retiring from employment. Aspects of the tax system, such as tax concessions for the support of dependents (see section IX(D), below) and tax-free bands or progressive rate structures (see section X(A), below), are usually calculated on the basis of a taxpayer's total income over the tax period. When a person is effectively within the tax system for only part of the tax period, application of tax features such as concessions and tax-free zones to the taxpayer's income as if it were a full year's income can produce anomalous or inappropriate results. Accordingly, all structural aspects of the personal income tax should be reviewed and, if appropriate, adjusted so that a prorated formula will apply to taxpayers entering or exiting from the tax system in a tax period.[137]

C. Method of Accounting

The periodic imposition of the income tax requires a separate calculation of the taxable income of a taxpayer for each tax period. For this purpose, it is necessary to provide rules (referred to as tax accounting rules) for allocating income and expenses to tax periods. These rules identify the tax period in which income and expenses are to be taken into account in calculating the taxable income of the taxpayer for the tax period.

It is unlikely that a single tax accounting rule will apply to all taxpayers in respect of all items of income or deductible expense. Different rules will apply depending on the circumstances.[138] In general terms, income or expenses may be accounted for on a cash or an

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[136] Various tax systems refer to the tax year in terms such as the "fiscal year," "year of assessment," "taxable year," and so forth. In composite systems, there may be more than one taxable period. For example, in Chile the tax on wages is collected monthly, while the taxable period for the global complementary tax is the calendar year. *See* CHL IR §§ 43, 52.

[137] *E.g.*, AUS ITRA 1986 §§ 16–20 (proration of tax-free threshold); CAN ITA § 118.91 (proration of certain deductions); CZE ITA §15(7) (proration of tax allowances); FRA CGI §§ 166, 167 (treatment of income before establishment of residency and after departure); JPN ITL §102 9 (computation of tax where a nonresident becomes a resident in the course of the taxable year).

[138] The rules of tax accounting are discussed in greater detail in ch. 16, *infra*.

accrual basis. Ordinarily, salary and wage earners account for income and deductions on a cash basis, and business taxpayers above a certain size account for income and deductions on an accrual basis. Under the cash method, income is derived in the tax period in which it is actually received by, made available to, or, in the case of a benefit, provided to the taxpayer. Similarly, expenses are treated as incurred in the tax period in which the taxpayer actually pays them. Under the accrual method, income is derived in the tax period in which the right to receive the income arises and expenses are accounted for in the tax period in which the obligation to pay arises. Further, special rules may apply in particular cases (e.g., for long-term contracts or prepayments).

As different tax accounting rules may apply to the same type of income or expense depending on the nature of the taxpayer or to different types of income or expense of the same taxpayer, it is important that the charging and deduction provisions use generic terms to refer to the relevant tax accounting rules so as to properly accommodate all possibilities. The terms commonly used for this purpose are "derived" and "incurred." An amount is included in the gross income of a taxpayer in the tax period in which it is derived by the taxpayer. Similarly, an expense is allowed as a deduction of a taxpayer in the tax period in which it is incurred by the taxpayer.[139] The terminology therefore implicitly refers to the tax accounting rules, and which rule applies in a particular case depends on the circumstances. There should be consistency in the use of generic terminology in the charging and deduction provisions. For example, a situation where some charging provisions use the word derived while other provisions use other terminology such as "received" or "accrued" should be avoided because it may raise uncertainty as to whether all terms used are intended to be generic or are stating different tax accounting rules for different items of income. This is not intended to prevent use of specific tax accounting rules in particular cases; rather, specific rules should be provided for in the tax accounting rules and not in the charging provisions.

When an item of income is to be accounted for on a cash basis, it is important that the concept of "receipt" include a constructive receipt. This ensures that an amount that indirectly benefits the taxpayer or that is dealt with on the taxpayer's behalf or as the taxpayer directs is taken into account in calculating the taxpayer's income, provided the amount would be income of the taxpayer if it had been actually received directly by the taxpayer. Examples of situations that should be covered by a constructive receipt rule are an employer directly paying the school fees of an employee's child, the payment of part of an employee's salary or wages to the spouse of an employee, and the payment of part of an employee's salary or wages to a third party in discharge of a debt owed by the taxpayer to the third party. In each case, the application of a constructive receipt rule avoids the argument that, because the taxpayer does not actually receive the payment, there is no derivation of income by the taxpayer.[140]

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[139] In the United States, the term used for deductions is "paid or accrued." *E.g.,* USA IRC § 162(a).

[140] There may be a derivation of an amount by some person other than the taxpayer, but the circumstances may be such that the amount derived does not have the character of income in the hands of that other person. For example, if part of an employee's salary is paid to his or her spouse, the amount derived by the spouse will not be employment income of the spouse because the spouse provided no services to the payer. This amount would constitute a gift.

IX. The Taxpayer

The charging provision in the income tax law identifies the person liable for tax. A separate issue to be addressed in the case of individuals (as opposed to legal persons) is what individuals should comprise the appropriate tax unit. This section deals primarily with this issue. Initially, though there are questions of terminology that must be resolved.

A. Terminology

Taxation law imposes different obligations on different categories of persons. These include the obligation to provide information to tax authorities about a person's own or another person's affairs, the obligation to file a tax return, the obligation to pay tax, and the obligation to withhold tax from payments to other persons.

Clear terminology should be used consistently throughout the tax legislation to refer to persons with tax obligations. Tax laws often refer to "person" or "taxpayer," but there is sometimes uncertainty about what these terms refer to in certain situations.[141] For example, the term "taxpayer" need not connote a person obliged to pay tax in a particular year.[142] A taxpayer may be required to file a return and provide other information to tax authorities even though the person did not have any taxable income for the year (as would be the case, e.g., if the taxpayer's deductions exceeded his or her gross income) or is not required to pay tax upon his or her taxable income (as would be the case, e.g., if the taxpayer's taxable income fell below a tax-free threshold). A broad definition of taxpayer as a person deriving an amount included in gross income would be more appropriate in these circumstances. Even that will not cover the case, albeit rare, of a person who only incurs deductible expenses. To be all-inclusive, the definition of taxpayer could be drafted to include any person who has incurred a tax loss for the tax period.

Similarly, a person other than a taxpayer may be required to satisfy that taxpayer's tax liability. This is the case, for example, where a tax liability is met by withholding at source. If the payer of gross income who is obliged to collect withholding tax from the payment is not the taxpayer in respect of that income, then alternative appropriate terminology should be used to apply to that person (such as “withholding agent” or “representative taxpayer”). Another possibility is that the taxable income of a person may include the income and deductions of another person. However, both persons may be treated as taxpayers for the purposes of collecting the tax on the taxable income.[143]

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[141] *See, e.g.,* 1 William McKee et al., Federal Taxation of Partnerships and Partners ¶ 9.01[10] (3rd ed. 1997) (discussing whether reference to person or taxpayer includes a partnership).

[142] *See also* vol. 1, ch. 4, sec. II(B).

[143] This can occur, for example, under a system where a wife’s income and deductions are included in the calculation of the taxable income of her husband, but the tax owed by the husband on the wife’s income can be collected from both the husband and the wife (*see* ZMB ITA §§ 19(1), 85).

Given that taxable income is an algebraic concept determined periodically, it is appropriate to use a term such as "has" to describe the required relationship between a person and a taxable income. Terms such as "derived," "earned," "accrued," or "received" are not appropriate for this purpose because they describe the required relationship between a person and individual items of gross income.

B. Individual, Spousal, or Family Units

The tax unit is the basis on which a person's taxable income is calculated.[144] Although a wide range of tax units is used in different jurisdictions for imposing tax on individuals,[145] the main possibilities are to treat as the tax unit individuals, married couples, or families. If couples or families (however defined) are treated as the tax unit, then taxable income is calculated by reference to the income and deductions of all persons included in the tax unit. While many tax theorists contend that the individual is the most appropriate tax unit for a benchmark income tax system, there is no consensus on the issue. The range of units used is largely the result of historical and political considerations.

The question of tax unit is closely tied to that of the tax rate structure. When individual tax rates are relatively flat, the differences between income aggregation and income splitting are minimal. However, large tax-free zones at the bottom end of the rate scale or significant low-rate bands exacerbate the differences in tax burdens between aggregation, splitting, and separate unit systems, described below.

The earliest income tax laws, such as the U.K. Act of 1799,[146] treated unmarried individuals and married couples as equivalent tax units because at the time married women were not recognized as separate individuals for most legal purposes.[147] The Australian, Canadian, New Zealand, Swedish, and U.S. income tax laws, adopted more than a century later, recognized the individual, whether married or not, as the tax unit. The U.S. courts later allowed married persons in community property states to divide their income for tax purposes, and the U.S. Congress

[144]A different meaning of tax unit refers to the person or persons against whom tax is assessed, that is, the legal taxpayer. The two need not necessarily be the same. For example, in some systems the taxpayer is the individual, but the tax is calculated on the basis of the joint incomes. This was previously the system in Sweden. *See* Martin Norr, Frank J. Duffy, & Harry Sterner, Taxation in Sweden 83 (Harvard Law School, International Tax Program 1959).

[145]*See generally* Brian Arnold et al., Materials on Canadian Income Tax 39–44 (1993); John Head & Richard Krever eds., Tax Units and the Tax Rate Scale (1996).

[146]39 Geo. 3, c. 13 (repealed).

[147] For a historical review of family unit taxation and a comprehensive survey of the literature *see* Neil Brooks, *The Irrelevance of Conjugal Relationships in Assessing Tax Liability*, *in* Head & Krever, *supra* note 146, at 35. While the United Kingdom finally adopted the individual as the tax unit in 1990, some of its former colonies still provide the aggregation of a wife's income with that of her husband. See KEN ITA § 45 and ZMB ITA § 19 (1).

eventually extended to all married persons the right to divide income for tax purposes.[148] Equal splitting in the United States was eventually modified by the adoption of a special "joint filing" tax scale imposed on the combined spousal income.[149] The effect of this rate scale is that a married couple pays less tax than they would pay if their income were not combined, provided that their incomes are sufficiently unequal. If their incomes are relatively close together, then the couple pays more tax than they would pay if they were unmarried with the same incomes.[150] Married persons in the United States also have the option of filing separately rather than jointly, but the rate scale for married persons filing separately makes this option unattractive in almost all cases.[151]

Over the past few decades several members of the OECD that formerly used spousal units have moved toward compulsory or optional separate unit taxation for married persons. This shift has been made largely in recognition of social and legal changes granting equal rights to husbands and wives. In some jurisdictions, optional individual unit filing is available only for "earned" income, while investment income continues to be aggregated and taxed in the hands of the higher-income spouse.[152] In others, such as Germany, spousal incomes can be based on the individual unit[153] or on the couple,[154] with the rate scale applicable to joint filers yielding a tax burden similar to that which would ensue if incomes were equally divided for the purpose of applying the individual rate scales. The United Kingdom has an individual filing unit with a limited deduction that provides relief to married couples.[155]

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[148] Each state of the United States has its own system of private law, including property and family law. In community property states, the income of a married couple is treated for property law purposes as if it accrued to each spouse, whatever the actual derivation pattern.

[149] *See* USA IRC § 1(a).

[150] This is because the rate bands for an unmarried individual are broader than one-half as wide as the rate bands of a married couple filing jointly. *See* IRC § 1(c).

[151] This is because the brackets of the rate schedule for married persons filing separately (as opposed to unmarried individuals) are one-half as wide as the brackets for joint returns (*see* IRC § 1(d)), so that the tax would normally be higher in all cases except when the incomes are evenly split, in which case the tax would be the same. However, this rate scale can be advantageous in certain cases where limitations on certain deductions based on a percentage of income would otherwise apply (e.g., when one spouse has a low income but high medical expenses, the latter being subject to a floor of 7.5 percent of adjusted gross income).

[152] For example, in Belgium and the Netherlands. *See* Sommerhalder, *The Taxation of Families and Individuals in Europe,* in Head & Krever, *supra* note 146, at 163, 166–79. Both Belgium and the Netherlands have hybrid systems that tax married couples separately for earned income, but also provide tax relief for couples. *See also* COG CGI §§ 89–95; CMR CGI §§ 117–23.

[153] *See* DEU EStG § 26a.

[154] *See* DEU EStG § 26b.

[155] GBR ICTA § 257A. The relief is referred to as the married couple’s allowance and is provided to the husband, although under § 257BA the wife can elect to claim one-half of the relief. *See* Sommerhalder, *supra* note 153, at 186–92.

The most radical position in terms of family aggregation is expressed in the *quotient familial* of the French income tax. In this system, all family income is aggregated and subject to progressive rates.[156] Before these rates are applied, however, the total family income is divided by a denominator of 2 or more. The basic denominator of 2 applies to a couple without children, and this figure is increased by 0.5 for each child (up to 2 children) and by 1 for each additional child thereafter.[157] The progressive rate scale is then applied to the resulting fraction of total income, and this liability is multiplied by the denominator figure to determine the tax liability imposed on the total income. The amount of tax reduction under this scheme is, however, limited to a specified amount for each dependant.[158] One obvious effect of the French system, often cited as its intended purpose, is to bestow tax benefits on larger families.

If the married couple is the tax unit, then it is necessary to define whether the taxpayer is married.[159] A broad range of domestic circumstances can be identified. A taxpayer's civil law status may not always be clear. For example, two people may consider themselves married without entering into legal formalities, and they may or may not be considered married under the civil law of the jurisdiction where they live. A couple may also undergo a marriage ceremony without legal validity (e.g., if one of them is already married) or with questionable legal validity (if a divorce from a prior marriage of one of the parties has been obtained, but the validity of that divorce is uncertain). Two people may also marry, separate (without formal proceedings), and consider themselves no longer married, even if they are still married as a matter of law. Generally, where the married couple is the tax unit, the tax law relies on civil law rules for determining marital status. This means that couples (including same-sex couples) in marriage-like relationships not recognized under civil law are not treated as married for the purposes of determining the appropriate tax unit to be allowed to the couple.[160] The approach taken to married individuals who are separated but not divorced varies. For example, in the United States, such persons are treated as married individuals,[161] whereas in Germany the election for joint filing applies only to married individuals living together. In Kenya and Zambia, the aggregation of a

[156] *See* FRA CGI § 156.

[157] *See* FRA CGI § 194.

[158] *See* FRA CGI § 197(2).

[159] *See generally* Toni Robinson & Mary Moers Wenig, *Marry in Haste, Repent at Tax Time*, 8 Va. Tax. Rev. 773 (1989).

[160] For some purposes, some income tax laws also treat persons living in a partnership without being married in the same way that they treat a married couple. *See* AUT EStG § 33(4)(1); NLD NLD WIB § 56. Rules based on whether two people live together can, however, be criticized on grounds of invasion of privacy.

[161] There is an exception to this for a married individual who has primary responsibility for the maintenance of a child (USA IRC §§ 2(c), 7703 (b)). This exception applies only when the individual elects to file separately and ensures that the rates of tax for unmarried individuals apply rather than those for married individuals electing to file separately.

wife's income with that of her husband does not apply when the spouses are separated and the separation is likely to be permanent.[162]

Marriage, separation, and divorce occurring during the taxable year must also be dealt with (e.g., the status of a person could be determined as of the end of the year[163] or prorated for changes in status during the year). The complexity and confusion that can result from situations such as these argue against designating the married couple as the tax unit. A further consideration may be constitutional restrictions on discrimination on the basis of marital status.[164]

Even when the individual is the tax unit, it may be necessary to know the marital status of the individual. Marital status may be relevant to personal reliefs (see below) or to the definition of "associate" (which may apply, e.g., to prevent income shifting).

As indicated above, many countries have adopted separate taxation of persons, regardless of marital status—an approach that developed largely in response to the recognition of equal legal status for married and unmarried individuals. A secondary consideration that has proved of key importance in many jurisdictions is the disincentive effect of aggregate or joint filing on nonworking spouses seeking to enter the workforce. If spouses' incomes are aggregated, the tax rate imposed on the income derived by a spouse entering the workforce is based on the highest marginal rate of the principal earner. It has been argued that this effect discourages women in particular from entering or reentering the workforce following a period of child-rearing, and this concern has been a prime factor behind the move from aggregated or joint filing to individual units in many jurisdictions. Finally, administrative considerations are an important factor in favor of an individual tax unit. It is much easier, for example, to design a system of final withholding for employment income if the spouse's income does not need to be taken into account.

C. Divorced and Separated Persons

The family law of many jurisdictions may require a higher-income spouse who formerly supported a lower-income spouse to provide support to the lower-income person for a period following separation or marriage dissolution. In many jurisdictions that use the individual as the tax unit, the payments are ignored for tax purposes—that is, the payer is not allowed to deduct the payment and the recipient is not taxed on it.[165] In effect, the payments are treated in the same manner as payments made within a marriage. Among other things, this rule ensures that there is

[162] KEN ITA § 45(2) and (3); ZMB ITA § 3(1)(b).

[163] *See* USA IRC § 7703 (applies only to certain sections of the Code).

[164] *See* vol. 1, at 28.

[165] Ordinarily, support payments are not a deductible expense of the payer because they are not incurred in deriving income subject to tax. Consequently, it is usually not necessary to expressly provide for the denial of a deduction for such payments. In some jurisdictions, though, the receipt of support payments may constitute the derivation of income because of the periodic nature of the payments. It may be necessary, therefore, to expressly exempt such amounts from tax. *E.g.,* AUS ITAA (1997) § 51–50.

no tax advantage to be gained from separation or divorce. Moreover, it is a simple rule to administer.

The treatment of support differs in jurisdictions that use spousal units and those that rely on joint filing. Systems that allow some splitting of income during marriage may continue to allow splitting following separation by allowing the payer a deduction for payments and including the amounts in the recipient's taxable income. In some cases, income shifting in this manner is allowed after divorce even though it is not permitted during marriage.[166] This approach is most often seen as a way of subsidizing support obligations with the object of providing a higher income for dependent spouses, particularly those with children. In recent years, this rule has been subject to strong criticism and many judicial challenges in jurisdictions that allow shifting of tax liability on support payments.

[166] *E.g.,* USA IRC §§ 71, 215; ZMB ITA §§ 17 (h), 40. Full or partial deductions for alimony are allowed in Belgium, Canada, France, Germany, the Netherlands, and Sweden, and a limited tax offset is provided in the United Kingdom on the same basis as that for married couples. *See* Ault et al., *supra* note 78, at 276–80; Sommerhalder, *supra* note 153.

D. Recognition of Support for Dependents

Many tax theorists argue that, in the context of an income tax levied on the basis of ability to pay, expenses incurred to support dependents should be disregarded for tax purposes. Rather, it is argued that relief for the cost of supporting dependents is best provided through direct government assistance to families and not through the tax system.[167] Despite these arguments, most income tax systems provide some relief for the cost of supporting dependents. While the various tax relief systems adopted have been criticized as inefficient, inequitable, and administratively complicated, few jurisdictions have moved to replace income-tax-based relief systems entirely with direct grants or expenditure programs.[168] However, in most industrial countries, it is now common for tax support programs to be combined with direct expenditure programs (sometimes means-tested, sometimes universal) to ameliorate some of the drawbacks of tax-based support systems.[169] Relief for dependents through the income tax should be structured to take into account the existence of such programs and the level of benefits they provide.

Tax relief may be provided through income splitting with dependents, deductions for the support of dependents, or refundable or nonrefundable tax offsets for the support of dependents.[170]

To some extent, income tax systems recognizing spousal units (other than systems that simply combine the income of the spouses and tax it as if it were derived by one individual)[171] in effect use income shifting as a means of providing tax support for dependents. Only France extends this system of relief to the support of children through its *quotient familial* system.[172] This system provides upside-down relief as the tax saving from shifting income through the *quotient familial* system increases with the principal earner's income. That is, the greater the

[167] A contrary argument is that relief for dependents is a way of implementing a policy whereby income is split among family members: "each family member should be taxed on items he actually consumes or accumulates, regardless of source." Michael McIntyre & Oliver Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax,* 90 Harv. L. Rev. 1573, 1576 (1977). Under this argument, deductions for dependents should not be considered subsidies, and therefore do not suffer from the upside-down relief problem described in this section.

[168] Sweden now provides all support for families through direct expenditure programs. Austria has an extensive system of family subsidies and very little tax relief for dependent children. *See* Familienlastenausgleichsgesetz 1967; AUT EStG § 33(4), (8).

[169] Examples include Australia, Belgium, Canada, France, Germany, Ireland, Italy, the Netherlands, Spain, the United Kingdom, and the United States.

[170] Tax offsets can be provided directly or indirectly by providing an extension of the lowest or tax-free threshold to taxpayers supporting dependents.

[171] As was the case under the earlier U.K. income tax regimes. *See* Brooks, *supra* note 148. This system has been largely abandoned, at least for earned income (i.e., income from employment, business, or the provision of services).

[172] *See supra* note 157.

ability of the principal earner to support dependents, the greater the tax relief provided. Also, in the case of high-income earners, the relief provided by this method applies to discretionary income used for personal consumption or savings, but not for the support of dependents.

A common method of tax relief has been to allow individual taxpayers to deduct a specific amount as compensation for the support of dependents. The amount of the deduction may vary with the number of dependents. Because a tax deduction is a subtraction from income, under a progressive tax system, the higher the individual's income, the greater the value of the relief. In other words, relief through tax deduction suffers the same upside-down effect as relief through income splitting, in that relief is provided inversely with the taxpayer's need. Moreover, a deduction system fails to provide any relief for individuals with incomes below the lowest tax threshold. For these reasons, some countries have moved away from deduction-based relief systems for dependents or have phased out the deduction for higher-income taxpayers.[173]

Some jurisdictions have replaced tax deductions with tax offsets as the method of relief for the support of dependents.[174] As with deductions, the amount of the offset may vary with the number of dependents. A tax offset is a subtraction from the tax payable by the individual (i.e., it is an amount taken into account after the rates of tax have been applied to the taxable income of the individual). A tax offset that can be applied against tax otherwise due is of the same value to all taxpayers who can use it and, therefore, avoids the upside-down effect of deductions.[175] However, like the deduction, it provides no support for taxpayers whose incomes are so low that they incur no tax liability under the ordinary income tax rate scale. This problem could be solved by making the offset refundable, but this solution has not generally been adopted.[176] Instead, reliance is placed on direct expenditure programs to assist these persons.

Tax policy in this area is likely to be influenced by administrative considerations. Particularly where relief is given outside the tax system, tax administration considerations argue in favor of relying on such relief and providing no deductions or offsets through the tax system. If it is decided to provide tax relief for the support of dependents, then the design of the relief should be kept as simple as possible. In some developing countries, the amount of the relief may

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[173] *E.g.,* USA IRC § 151(d)(3) (deduction phased out by 2 percentage points for each $2,500 by which the taxpayer's adjusted gross income exceeds the threshold amount ($150,000 for a married couple)).

[174] *See* CAN ITA § 118.

[175] It is possible to design tax offsets that increase in value with income. For example, taxpayers in the Democratic Republic of the Congo are given a 5 percent reduction in tax otherwise payable (which is effectively a credit equal to 5 percent of the tax otherwise due) for each eligible dependent. The reduction is subject to two limitations—it is available for up to only nine dependents and a total monetary cap is imposed on the reduction: ZAR CDC § 89. Because the reduction is a percentage of total tax, which rises with total income, the benefits provided by the system increase with income.

[176] Exceptions include Canada and the United States. The Canadian goods and services tax credit, designed to provide relief particularly to lower-income persons for indirect taxes, is refundable: *see* CAN ITA § 122.5. In the United States, the Earned Income Tax Credit, which is partially designed to provide relief for the support of dependents, is also refundable; *see* USA IRC § 32.

vary with the number of dependents. Indeed, there may be separate reliefs depending on the nature of the dependent children, or if the dependents are handicapped or elderly persons. Administrators in some jurisdictions are concerned that taxpayers will simply claim the greatest relief possible regardless of the actual circumstances. For example, if the amount of the relief increases with the number of children up to, say, a maximum of three children, taxpayers may simply claim relief for three children regardless of the actual number of children they have to support, provided they believe the administration does not have the resources to check these claims. This issue is particularly important where it is decided to make PAYE withholding a final tax.[177]

Those who argue for direct expenditure programs to provide financial assistance for persons supporting dependents cite a number of difficulties that apply to all tax-based relief systems. The first, and most important, is that of targeting. Whether a deduction or an offset-based relief system is used, the benefit will accrue to some taxpayers who require no assistance with support of dependents and will fail to reach some taxpayers very much in need of such assistance. Moreover, the tax system cannot provide controls to ensure that the relief is used to subsidize support. The taxpayer enjoying the relief may not be the taxpayer responsible on a day-to-day basis for supporting the dependent, for example, when tax relief is provided to a high-income taxpayer who fails to pass on the benefit of the relief to a lower-income spouse who is responsible for acquiring the necessities used to support the dependent. Depending on how it is structured, direct financial assistance may overcome this problem.[178] Finally, it may be more difficult from an administrative perspective to define dependents in an income tax system than in a social welfare system, because the concept of collective needs is different from the concept of ability to pay and social support authorities may have more expertise, and social support laws more flexibility, in identifying dependency. This is particularly the case in respect of unrelated persons living with a supporter or where support is provided through extended families and family support networks.

If a tax-based system to provide relief for persons supporting dependents is chosen, it should be designed to minimize the upside-down, targeting, and administrative difficulties noted above. Proposals to provide tax relief for taxpayers supporting dependents should also be considered in light of decisions concerning the design of the rate scale. Adjustment of the tax-free threshold or lower brackets can be used to provide across-the-board "basic living expenses" tax relief to all taxpayers that is sufficiently generous to those supporting dependents.

A number of difficult definitional issues must be dealt with in any scheme for dependency relief through the tax system. Particular care needs to be taken with these because they can involve difficult factual and legal issues, and they will affect the majority of taxpayers who must apply the tests, usually without professional advice. The following issues are involved:

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[177] *See infra* sec. XII; ch. 15.

[178] For example, the Australian home child-care allowance is paid to the parent actually caring for the child. The Swedish child subsidy is paid to the mother, if she is in charge.

(1) Relationship. A basic issue is whether the right to claim relief for a dependent should be limited to relatives. If so, the relation must be specified, that is, just children, or also parents, or also a broader group of relatives. The argument for restricting relief to support of relatives is that otherwise too much may rest on the other possible test for dependency, namely, the amount of support provided. The level of support, particularly support in kind, may be rather complicated to determine, while relation is usually easier to determine. Some countries extend tax relief to persons living in the household of the taxpayer, even when they are not related to the taxpayer.[179] In countries with extended families and extensive family[180] support networks, this could result in serious administrative problems.

(2) Allocation of relief. Particularly in a system based on an individual filing unit, two taxpayers may often satisfy the entitlement rules with respect to a particular dependent. Only one should be allowed to claim the relief. Rules need to be provided to assign the right to the relief to one or the other spouse or for apportioning the relief between the spouses.[181]

(3) Support requirement. A decision must be made as to whether to extend entitlement to dependency relief automatically to, say, taxpayers with children or to limit automatic entitlement to cases where the taxpayer supplies the requisite amount of support. Support is a notoriously difficult concept to define and it would be best from an administrative point of view not to include it among the qualifications for dependency relief. It could be presumed, for example, that a person residing in the same household is receiving support.

(4) Income test. Dependency is often determined by reference to a dependent's personal taxable income (i.e., no recognition for dependency is allowed if the dependent's income exceeds a specific threshold). This rule is important if dependency is not restricted to those with a close family relationship, but is less critical if the relationship test is fairly narrowly defined. It raises a practical problem of administration, because it requires determining the income of one taxpayer in order to tax another. Where the test is specified, it is necessary to provide the time period for which it will apply. It is easier to apply if the dependent's income is tested for a period prior to that for which the deduction is allowed, but this may not adequately deal with changed circumstances.

(5) Period for relief. Another issue for the tax-free threshold as well as for the dependency deduction is whether they are applied annually or monthly. Some systems restrict the deduction to taxpayers who earn income in a given month. This facilitates the use of final withholding taxes. The entitlement to the deduction can be determined on a month-to-month basis, so that no need arises to adjust withholding for events taking place in prior months.

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[179] *E.g.,* DEU EStG § 32; WIB art. 46. These provisions include relief for foster children.

[180] The support networks might also be based on a clan, village, or tribe, or on other groups. In some cases, support responsibilities may be allocated by law or custom to persons other than the parents. Application of a relationship test might be inconsistent with such support networks.

[181] For example, in Belgium and the Netherlands, the deductions for dependents are automatically allocated to the higher-income spouse. *See* Sommerhalder, *supra* note 153.

X. Income Tax Rate Scale

A. Progressive and Flat-Rate Scales

A key issue in the design of the income tax rate structure is the progressivity, if any, to be incorporated into the tax rate scale. A progressive rate structure is one under which the effective rate of tax—the fraction of income paid in tax—increases as the level of income increases. A progressive tax can take the form of a graduated rate scale or a flat-rate scale combined with a tax-free threshold.

While setting the rate structure is a matter of economic and budgetary policy, as well as tax policy, and will often be influenced by political considerations, there are also technical considerations. First, the flatter the rate structure applicable to individuals, the fewer the incentives for such persons to engage in income shifting.[182] Second, if the rate of tax applicable to legal persons is not aligned with the maximum marginal rate for individuals, taxpayers may enter into income-diversion arrangements. For example, if the rate for legal persons is less than the maximum marginal rate for individuals, high-income earners may enter into arrangements to divert their income to entities that they own. This is discussed further below. Third, there may be administrative advantages to establishing a broad standard marginal rate into which most taxpayers with income tax liability will fall. This suggests that, apart from the zero bracket, there may be a need for no more than three or four positive rates: a standard rate, a rate below the standard rate, and one or two rates above it.[183] Even two positive rates might be adequate.

As noted in section II(A), above, some jurisdictions are moving toward imposing flatter rates of final withholding taxes on particular types of income, especially income from capital. Contrary to prima facie appearances, this trend does not necessarily undermine overall progressivity. While final withholding tax rates are usually lower than the highest personal marginal income tax rate, the effective rate of these taxes may be equal to or greater than the highest marginal tax rate, and, depending on the income bracket of taxpayers deriving income subject to flat-rate withholding, progressivity may even be enhanced by such taxes.

The effective rate of withholding taxes may exceed the highest personal marginal income tax for a number of reasons. The most important is that withholding taxes are levied on a gross basis, while the ordinary progressive rate scale is applied to net income. In the case of dividend income, in the absence of an imputation system, the effective tax rate imposed on dividends may include a substantial underlying company tax. In the case of interest income, not adjusting for inflation may mean that nominal interest far exceeds the real income a lender enjoys.

[182] *See infra* sec. X(C).

[183] A rate schedule with a larger number of brackets may appear to be more progressive, but in fact a schedule with three or four rates can be designed to offer a similar progression in the effective rate of tax.

A further tax rate issue to be resolved is that of a basic tax-free threshold, below which income is not taxed. Almost all tax systems provide such a tax-free threshold, either through a zero rate bracket or through tax offsets or universal deductions. The size of the tax-free zone will depend on revenue needs—including the impact of other taxes, particularly on low-income taxpayers—and on administrative considerations. Significant administrative savings can be realized if a large number of low-income persons can be excluded from the tax net by way of a generous tax-free threshold.

B. Income Averaging and Antibunching Rules

The interaction of a progressive rate structure and a system of annual assessment can lead to tax rate anomalies in four respects. The first, noted earlier in section VIII(B), arises when taxpayers enter or exit the tax system during a tax year and possibly derive an inappropriate advantage by treating partial-year income as if it were full-year income for the purposes of the progressive rate scale. The three other anomalies apply to taxpayers who have been in the tax system for several years.

The second problem is a general one that follows from taxpayers' income derivation patterns. Taxpayers' actual annual earnings over the period in which they are in the tax system may be far different from their *average* annual earnings over the same period. Typically, taxpayers' earnings vary as they change employment, as they achieve seniority, and so forth. Application of the progressive rate structure to each year separately will yield a very different, and probably higher, result than would the application of the progressive tax rate structure to the average earnings over the period.

The third problem is similar to the second, but focuses on particular classes of taxpayers who are more likely than other taxpayers to derive income unevenly from year to year over the same period. Common examples of such taxpayers are farmers, artists, authors, and inventors. A taxpayer who derives widely fluctuating amounts of income from year to year may be subject, over a number of years, to a tax burden substantially higher than that faced by a taxpayer who derives the same overall income evenly.

The fourth problem is faced by taxpayers deriving lump-sum gains, such as capital gains or lump-sum retirement payments. These taxpayers may face a higher tax burden when the whole gain is taxed in the year of realization rather than annually as the gain accrues, pushing the taxpayer into a higher tax bracket. This is referred to as a "bunching" of the gain.

The problem of unequal lifetime income patterns and unequal derivation patterns by particular classes of taxpayers may be addressed through measures to average income. However, as explained below, it is common to direct these measures only at the third type of problem. The problem of income bunching can be addressed through antibunching provisions. These are also explained below.

1. Income Averaging

General income averaging may be used to address the problem of changing income-earning patterns. In simplified terms, general income averaging typically involves ascertaining the taxpayer's average income over a specific number of years, including the current year, and applying to the current year the marginal rates applicable to the average income. This procedure results in lower rates of tax for a year in which the taxpayer's income is abnormally high. A system of general averaging may impose considerable administrative burdens on revenue authorities. It would make it very difficult to treat PAYE withholding as a final tax on employment income. It can also provide unintended benefits for taxpayers who do not deserve relief.[184] Quite clearly, the case for general averaging is strongest when the income tax rate scale is sharply progressive. As the rate scale is flattened, the case for averaging diminishes, particularly when the potential benefits are weighed against the resulting administrative burden. For these reasons, jurisdictions that have used general averaging systems have moved to abolish those systems as the progressivity of the rate scales has been reduced.[185]

An alternative to general averaging is to confine income averaging to particular classes of taxpayers, notably primary producers, artists, inventors, and authors.[186] Averaging rules for specific types of income can be far less complicated for the tax system as a whole than general averaging rules, although they are complex for the taxpayers involved. Depending on how the rules are designed,[187] they may provide unintended benefits and distort taxpayer behavior as taxpayers seek to recharacterize transactions or income types to take advantage of income averaging. Unless the rate schedule is very progressive, it is best from the point of view of simplicity to eliminate any averaging rules.

2. Antibunching Rules

Similar concerns with distorted tax liability in the context of a progressive rate structure apply to lump-sum payments, particularly those that are attributable to gains, such as capital gains or lump-sum retirement payments, that have accrued over several tax years but that are assessable only in the year in which they are realized. In these circumstances, any increase in taxation resulting from the imposition of higher marginal tax rates on the lump sum may be seen as an appropriate, if somewhat crude, claw-back of the deferral advantage enjoyed by the taxpayer prior to realization. Nevertheless, for political reasons, some jurisdictions do provide

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[184] For example, a young professional whose average income is depressed because he or she earned little or no income while in school.

[185] *See* CAN ITA § 118 (repealed 1980); USA IRC §§ 1301–1305 (repealed 1986).

[186] See AUS ITAA (1936) §§ 149–158L (farmers, artists, and authors) and §§ 159GA–159GDA (special "income equalization deposit" rules to provide further averaging for farmers); CAN ITA § 119 (farmers and fishermen).

[187] The design issues are similar to those for antibunching rules discussed in sec. XI(B), below, except that they involve taking into account the income of prior years.

special averaging rules for particular types of income, such as capital gains[188] or lump-sum retirement payments.[189]

Again, it is best to avoid such rules, but if they are provided they should be designed so as to minimize windfalls to taxpayers. The best way to do this, known as "top-slice" averaging, is for relief to be triggered only if, in the absence of any averaging rule, the derivation of a lump sum would be subject to tax rates that would not otherwise apply to the taxpayer. Thus, if a taxpayer's taxable income, apart from extraordinary gains, was high enough to ensure that the last units were taxed at the highest marginal rate, the averaging system would not be invoked because it would make no difference to the tax rate whether the gain were derived in one year or over a number of years. Typically, a top-slice averaging system slices a lump-sum payment into fractions (by dividing the payment by a number of years, which might be based on a notional determination of the period over which the payment has accrued) and determines the tax payable on the fraction, which is then multiplied by the denominator of the fraction to determine the tax payable on the entire lump sum. The system is best illustrated with an example. If the averaging system presumed that a lump sum should be averaged over, say, five years, the rules would determine the taxpayer's tax liability on taxable income without considering the lump sum and then considering the other income plus one-fifth of the lump sum. The difference between the tax payable on the taxable income without the lump sum and taxable income including one-fifth of the lump sum is the tax actually imposed on the one-fifth of the lump sum. This figure is then multiplied by five to determine the tax to be imposed on the entire lump sum.

If the taxpayer's taxable income without the lump sum is low enough that the addition of one-fifth of the lump sum still leaves the last units of taxable income subject to lower tax rates, those lower rates will be applied to the entire lump sum. If, however, the last unit of the taxpayer's taxable income, excluding the lump sum, is subject to the highest marginal tax rates, it will make no difference whether one-fifth of the payment or the entire payment is added to the taxpayer's taxable income when derived because the same rate will apply before and after the averaging system is invoked. Even this method can result in unintended benefits, for example, when a taxpayer derives, on a steady basis, capital gains eligible for averaging.

C. Income Shifting

Under a progressive rate schedule, there is an incentive to shift income to related parties unless the type of income in question is taxed at a flat rate on a schedular basis. As a result of income shifting, income that would otherwise be derived by a single taxpayer can be derived by two or more taxpayers who are then able to use more than once the tax-free thresholds and low rates applicable to lower levels of income. The income will be subject to much lower total taxation than if it had been derived by a single person.

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[188] *E.g.,* AUS ITRA sched. 7.

[189] *E.g.,* Belgium, Germany, and Netherlands.

A company tax rate that is lower than an individual's marginal tax rate may stimulate a related type of income diversion, from the individual to a company controlled by the individual or persons related to the individual.[190]

A number of countries have adopted measures to restrict income shifting. Experience has shown that, because a variety of income-shifting techniques are available to taxpayers, multiple responses are needed. Attempts to invoke universal responses, such as reliance on general anti-avoidance provisions or tax authorities' discretions, have had limited success because they can be applied only on an ad hoc basis, following an audit. Moreover, general responses are administratively costly to apply and can often be defeated by apparent "business purpose" explanations for income-shifting arrangements.

At the heart of some countries' antishifting rules, of which the United States provides the leading example, are judicial doctrines that decline to recognize income-shifting arrangements as effective for income tax purposes, notwithstanding their validity under property law.[191] Judicial doctrines alone have proved insufficient to address the problem of income shifting, and a range of legislative approaches have been used. Separate rules are used for shifting investment income and income from services.

The most sophisticated and, unfortunately, complex antishifting regimes are those that use attribution rules for non-arm's-length transfers of property or underlying income-generating property. Generally, these attribute to the transferor for income tax purposes income subsequently derived by the beneficiary of the transfer, whether income or property is transferred directly or through a trust.[192] A broader approach to preventing shifting of investment income is to attribute all investment income derived by married persons to the higher-income spouse.[193] Several jurisdictions have global antishifting systems, which impose either the highest personal marginal tax rate or the marginal rate of the parents on investment income derived by minors

[190] Whether there is such an incentive to divert income depends on a number of features of the corporate and individual income tax systems. *See infra* ch. 19.

[191] *See* Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Clifford, 309 U.S. 331 (1940); and Commissioner v. Harmon, 323 U.S. 44 (1944).

[192] CAN ITA §§ 74.1, 74.2 contain comprehensive attribution rules applicable to transfers to spouses and children whereby the income from property so transferred is taxed to the transferor. AUS ITAA (1936) §§ 102, 102A–102CA contain less comprehensive attribution rules when income is alienated through a trust or for less than seven years. In some cases, income is attributed directly to the transferor; in other cases, it is taxed in the hands of a trustee at the transferor's marginal rate. In addition, AUS ITAA (1936), pt. IIIA imposes a tax liability on the transferor in respect of income-producing property that has appreciated in value as well as in respect of most transfers of income streams. GBR ICTA § 660 contains a rule disregarding dispositions over short periods; § 663 provides that any income from settlements for the benefit of minor children will be taxed as income of the settlor; and § 683 provides for a tax liability of the settlor when income is payable to any person but the settlor.

[193] This approach was followed in the United Kingdom, where before 1990–91 spouses were taxed on aggregate income, but could elect to be taxed separately on earned income. *See* GBR ICTA §§ 279(1), 283 (repealed by Finance Act, 1988); *see also* John Tiley, Butterworths U.K. Tax Guide 1990–91 ¶ 3.01 (1991). It still is the case in Belgium and the Netherlands. *See* BEL CIR § 126; WIB § 5(1).

and, in some cases, on earned income in excess of the fair market remuneration that would be paid to these persons for services they provide.[194] At the price of some complexity, some systems provide exceptions for investment income that was clearly not derived as the result of an income-shifting arrangement. Examples of exceptions include income from property left in a bequest and income derived from property provided as settlement of a personal injury damages claim. An alternative approach for dealing with children's income used in some jurisdictions is to aggregate children's investment income with the income of the parent who claims the child as a dependent or with both parents' income in the case of joint taxation.[195] Constitutional or other restrictions may prevent the application of this approach in some jurisdictions.[196]

More sophisticated antishifting measures may be needed to deal with the various techniques used to shift business income. Excessive payments to spouses or children for "services" provided to the taxpayer may be countered with restrictions on deductions for payments to such persons.[197] Attribution rules can be used to counter income shifting through the use of partnerships involving related parties when one partner provides the bulk of the services from which the partnership derives its income and the other party has not provided any equivalent value.[198] Jurisdictions have had less success combating income shifting through service trusts or companies. These are trusts or companies that provide tax-deductible services to a taxpayer in a business context for a price much higher than the taxpayer would pay if the services were acquired directly. The beneficiaries or shareholders of the trust or company are persons related to the taxpayer. Income shifting through this device could be combated by denying taxpayers deductions to related service companies or trusts in excess of the amounts those entities pay the unrelated parties who actually provide the services acquired.

Separate measures are needed to deal with the shifting of employment income by means of interposed companies or trusts. When the highest marginal tax rate imposed on individuals is higher than the rate imposed on companies, individuals may establish a company to provide services that they would otherwise provide as an employee. Income is derived by the company and is subject to a lower rate of tax. Experience shows that these arrangements cannot be

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[194] *E.g.,* AUS ITAA (1936) §§ 102AA–102AJ (unearned income of minor child taxed to the child at the maximum marginal rate); BEL CIR § 126 (income of children taxed together with parents' income); NLD WIB (unearned income of child, other than certain capital gains, taxed to parent with highest earned income); USA IRC § 1(g) (certain unearned income of minor child taxed at parents' rate).

[195] *See, e.g.,* ESP IRPF § 89(3) (when parents opt for joint taxation, all income (earned and unearned) is aggregated); FRA CGI § 6 (same).

[196] For example, in Germany, owing to the constitutional clause in defense of the family (GG art. 6(1)), unearned income of the children is taxed separately rather than aggregated with their parents' income. *See* Tipke & Lang, *supra* note 111, at 54.

[197] *See, e.g.,* AUS ITAA (1997) § 26–35.

[198] *See, e.g.*, AUS ITAA (1936) § 94. This provision has proved of limited efficacy because attribution follows only if it can be shown that the person to whom income would be attributed "controlled" the partnership. Tax authorities have had more success in arguing that there was no actual partnership in these cases.

combated through the use of judicial doctrines or general antiavoidance provisions alone and that specific antishifting measures are needed instead.[199] One approach is to impose a higher company tax rate on "personal service corporations," that is, on companies whose incomes are primarily attributable to services provided by an employee or employees who own the company or who are related to persons who own the company.[200] An alternative approach is to attribute income derived by personal service companies to the individuals providing the services for which the company is paid.

A related problem arises from individuals using interposed private companies to derive investment income that they would otherwise derive directly and that would be subject to higher individual marginal tax rates. Once again, a number of different measures may be needed to address this problem. One technique is to deny private companies concessions, such as exemptions or tax offsets for intercorporate dividends, that are available to other companies.[201] Alternatively, or additionally, taxes may be imposed on undistributed investment income retained by private companies to encourage distributions of this income to the company owners.[202] And, finally, measures may be introduced to prevent companies from distributing to shareholders in a nontaxable way income that was taxed only at the lower company tax rate. For example, loans from a private company to a shareholder or related party may be deemed to be taxable distributions by the company.[203]

XI. Tax Offsets

It was explained earlier that two types of subtractions are relevant to the calculation of the actual tax payable by a taxpayer. First, an amount may be subtracted from gross income in the calculation of the taxable income of the taxpayer. Second, an amount may be subtracted from the tax payable. It is common for a subtraction from gross income to be referred to as an

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[199] The Australian and U.S. experiences illustrate this point. Australian authorities first tried to combat shifting of this sort by imposing an undistributed earnings tax on private companies. (The tax was also adopted to protect the "classical" company and shareholder tax system—*see infra* ch. 19.) The undistributed profits tax was abandoned on introduction of the imputation system in 1986. At that time, company and highest individual rates were aligned. When a significant rate differential was reintroduced in 1988, authorities tried to use a general antiavoidance provision to combat shifting by means of interposed companies. That approach proved of limited efficacy, and in 1995 the government announced that new, comprehensive antishifting rules would be enacted. However, following a change in government, reform legislation was deferred indefinitely. U.S. authorities found it virtually impossible to combat income shifting by means of interposed companies. The problem was solved in that country when the company tax rate was roughly aligned with the highest personal income tax rate.

[200] *See* CAN ITA §§ 123(1), 125.

[201] This approach is used in Australia for "unfranked" dividends (dividends paid out of profits that have not been fully taxed in the hands of the distributing company) derived by private companies. *See* AUS ITAA (1936) § 46F.

[202] *See* USA IRC § 541.

[203] *See* AUS ITAA (1936) § 108.

"allowable deduction," and a subtraction from the tax payable, as a "tax credit." However, the term tax credit sometimes does not translate well into other languages, perhaps because credit can also mean loan.[204] As explained in section II(C), above, the term "tax offset" has been used in this chapter to avoid these difficulties. Whatever terminology is used, it is important that the legislation clearly and consistently distinguish between these two types of subtractions because of the different tax consequences.

Four broad categories of tax offset may be allowed: (1) in recognition of tax already paid by the taxpayer (e.g., under a current payment system) or by another person on behalf of the taxpayer (e.g., by an employer through PAYE withholding, another person paying income subject to withholding, or a trustee deriving income on behalf of a beneficiary); (2) in recognition of tax paid by the taxpayer or by another person on behalf of the taxpayer (through withholding tax) to foreign tax authorities;[205] (3) in an imputation system in recognition of tax previously paid by a company on dividends (or deemed dividends) distributed to the taxpayer;[206] and (4) for concessional purposes to support certain activities or responsibilities of the taxpayer, such as medical expenses,[207] child care,[208] charitable or political contributions,[209] support for dependents,[210] and retirement savings,[211] or to provide general relief to taxpayers with low earned income.[212] As was explained earlier, tax offsets may be used for these purposes in preference to deductions from gross income to avoid the upside-down effect of deductions, which provide greater tax savings to higher-income persons.[213]

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[204] *Cf.* vol. 1, at 218 note 146 (tax credit vs deduction for VAT input tax). In France, the term *avoir fiscal* is used synonymously with *crédit d'impôt*. See FRA CGI § 158 *bis*. The draft tax code of Russia (art 135) uses the term *nalogovi credit* (literally tax credit) to describe a postponement of the time for payment of tax, that is, in the sense of extension of a loan rather than in the sense of tax credit as it is used here. In referring to the crediting of foreign taxes, the draft tax code uses the verb *zaschitivat'* (counting toward, crediting), and uses the term "creditable amount" rather than "tax credit" (art 560). The term used in Germany (*anrechnen* or *Anrechnung*, *see* EStG § 36) similarly has the sense of counting toward or charging. When a translation problem exists, the solution may lie in using a verb rather than using "tax credit" as a noun. However, when the verb used is equivalent to "deduct," then the problem discussed in the text—namely, the need to distinguish between deductions from income and deductions from tax—must be addressed.

[205] Such a tax offset is commonly referred to as a "foreign tax credit." *See infra* ch. 18.

[206] Such a tax offset is commonly referred to as an "imputation credit." *See infra* ch. 19.

[207] *See* AUS ITAA (1936) § 159P.

[208] *See* USA IRC § 21.

[209] *See, e.g.,* CAN ITA § 118.1(3) (charitable gifts); USA IRC § 24 (political contributions—repealed).

[210] *See* AUS ITAA (1936) § 159J. *See supra* sec. IX(D).

[211] *See* AUS ITAA (1936) § 159SM.

[212] *See* USA IRC § 32 (earned income credit).

[213] *See supra* sec. VII.

Different rules apply to the recognition of tax offsets for taxes actually paid (the first three categories of tax offset noted above) and to tax offsets provided for concessional purposes. The latter have no nexus with income taxes actually paid and can be set by reference to independent criteria on the basis of the taxpayer's need for concessional support. One technique sometimes used to improve the targeting of concessional support tax offsets is to use "disappearing" tax offsets that decrease in value as a taxpayer's income increases.[214] Tax offsets that are intended to act as substitutes for direct social assistance payments may also be made refundable when they exceed the tax payable by a person entitled to the offsets.[215]

The extent to which offsets for taxes actually paid are recognized will vary. Offsets for advance payments of tax by the taxpayer are usually recognized completely; any amount that exceeds the final tax levied on the taxpayer is refundable in full. In contrast, taxes paid to foreign governments are usually recognized only to the extent of local taxes imposed on the foreign income with no refund of any excess offset.[216] Tax offsets for company taxes allowed under an imputation system may or may not be refundable depending on the design of the imputation system.[217]

In some cases, taxpayers may be allowed to carry forward to future years nonrefundable offsets that have not been recognized previously. Restrictions may be placed on the recognition of offsets for foreign tax and company tax paid that are carried forward, so that they may be used only to offset taxes on particular types of income. When different rules concerning refundability and carryover apply to different kinds of offsets, rules are needed to specify in which order offsets are taken.[218] These may require taxpayers to first recognize nonrefundable offsets and offsets that cannot be carried forward or transferred, so as to preserve the value of refundable offsets and offsets that can be carried forward or transferred.

[214] *E.g.*, USA IRC § 21(1)(2) (child-care credit).

[215] *See* text at note 177 *supra*.

[216] Further restrictions with respect to foreign income may divide that income into different income "baskets" on the basis of income type, the jurisdiction in which it was derived, or both these criteria, and may limit recognition of offsets for taxes paid on foreign-source income in a particular basket to local tax payable on that particular basket, with no carryover to other baskets of foreign-source income. *See infra* ch. 18.

[217] *See infra* ch. 19.

[218] *See, e.g.*, USA IRC § 38(d).

XII. Administrative Aspects of Taxing Employment Income

Almost all countries collect the income tax payable on employment income (PAYE) on a current basis by withholding at source by the employer.[219] Employers collect the PAYE withholding tax, although the employees bear the liability because, under the PAYE provisions, employees whose salaries have been subject to PAYE withholding are deemed to have received the gross (pretax) amounts of pay they are due. Administrative and collection provisions impose on employers the obligations to withhold and to remit, and parallel penalty and interest provisions will apply to nonwithholding or nonremittance.

If the employer has withheld tax but has failed to remit it to the tax authorities, it is appropriate to relieve the employee of any further tax liability (because the employee has already effectively borne the tax).[220] In contrast, the provisions related to nonwithholding are usually drafted as parallel alternatives, allowing revenue authorities to collect the tax from either the employer or the employee, provided that it is collected only once.

If tax has been withheld, but the employer enters into bankruptcy or insolvency proceedings before the tax is remitted to the tax authorities, it is customary to give the government a priority interest in this fund, regardless of the general position that may be taken as to the priority given to tax debts owed by bankrupt or insolvent taxpayers. In effect, the fund is treated as being the property of the government rather than that of the employer.[221]

To be effective, PAYE collection and remittance obligations should be imposed on as broad a range of employers as possible. The objective, particularly if PAYE is to be used as a final tax on employment income, is to apply the system to every situation where payment is made substantially for the labor of the recipient of the payment—that is, where the person receiving payment will not be entitled to substantial deductions in respect of materials, equipment, and so forth. The definition of persons subject to PAYE withholding is generally coextensive with the general definition of employee for income tax purposes, which is often broader than the labor law notion of employment.[222]

While the costs to an employer of administering PAYE collections are generally a small part of administering employee payrolls generally, PAYE obligations do impose a cost on

[219] This section elaborates on a few issues in PAYE taxation; for a full discussion, *see infra* ch. 15.

[220] *E.g.,* USA IRC § 31(a) (credit allowed for the "amount withheld").

[221] The New Zealand position is not atypical: revenue authorities are given priority for PAYE and withholding taxes not remitted by an employer, but stand with other creditors for the employer's basic income tax liability (*see* NZL ITA § 365). A contrasting position was taken recently in Australia, where the priority for PAYE and withholding taxes was abolished. On the same theory, the failure to pay over the tax withheld can be made a crime, as was done in Sweden, on the basis that it is analogous to embezzlement. *See* Leif Mutén, *Sweden Enacts Tax Account System*, 15 Tax Notes Int'l 905 (Sept. 22, 1997).

[222] *See supra* sec. IV(A).

employers, which is higher for small employers. In recognition of this fact and of the desirability of spreading the PAYE net as widely as possible, different remittance schedules can be applied to large and small employers, with the frequency of remittance falling with the size of employers' payrolls. Because employees are paid more often than the taxes are remitted to tax authorities, employers will obtain the benefit of the tax funds during the period between collection and remittance. This benefit can offset to some extent the costs of administering PAYE taxes, and the longer delay in remittance for smaller employers offsets in part the relatively greater costs faced by these employers. It must be recognized, however, that differential remittance dates do impose an additional administrative burden on tax authorities. When there is little or no computerization of the administration, a system of uniform remittance dates for all businesses may be easier to manage.[223] In Russia and certain other countries of the former Soviet Union, it is typical for remittance to be required simultaneously with the payment of wages. This is a holdover from the previous system of clearance accounts. It may still be justified under current circumstances because businesses are in extremely tight cash situations and temptations not to remit should not be offered. However, this should be changed when these circumstances no longer prevail.

Notwithstanding the desirability of extending the PAYE coverage as broadly as possible, most PAYE systems contain exceptions for particular types of employment. A common exception is for employment in respect of personal services for an employer that are not part of the employer's business or occupation. This exemption would apply, for example, to a housekeeper or a home gardener.

It was suggested earlier in this chapter that there has been a trend toward designing the PAYE withholding system so as to make such withholding the taxpayer's final liability. This has the administrative advantage of excluding a large number of salary and wage earners from having to file a return, thereby freeing up scarce enforcement resources for other purposes. For PAYE withholding to be the final liability on employment income, the amount withheld must be accurate, which means the employer must be made aware of the employee's *taxable* income. This is usually done through an employment declaration, in which the taxpayer enumerates deductions, reliefs, or tax offsets that should be taken into account when determining taxable income. In some cases, the employment declaration may also provide the employer with information about other income derived by the taxpayer.

The use of employment declarations and withholding taxes as final taxes on employment income raises a number of technical and policy issues, which are discussed below.

A. Deductible Expenses

One of the main difficulties in making PAYE a final tax is the treatment of deductions. The tax is withheld from gross employment income, while in theory income tax is imposed on

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[223] There is, however, a compensating factor, namely, that the total number of transactions to be processed is smaller if small employers are required to pay less frequently. In developing countries, it is not uncommon for 75–90 percent of employers to fall into the "small employer" category, and a system that requires less frequent remittances from these employers may on balance require a smaller staff.

net gains, after recognizing deductible expenses incurred by an employee to derive the gross employment income.

It is impossible to take into account actual employment expenses when calculating PAYE withholding, because these will generally not be known at the start of the year. One possibility is to require employees to advise the employer of the incurrence of employment expenses so that they may be taken into account in subsequent withholdings. This approach has several problems. First, it may encourage employees to make inflated claims. This could be avoided by requiring the employee to produce documentary evidence to substantiate the claim to the employer. However, this requirement may impose an unreasonable and expensive compliance burden on employers. Also, the system imposes some obligation on the employer to assess whether or not the claim for a deduction is valid. Again, this may be an unreasonable and expensive burden to impose on employers.

Accordingly, if employee withholding is to be a final tax liability on employment income, a surrogate for recognition of actual expenses must be used. The alternatives of allowing a standard deduction or eliminating the deduction for employee expenses are discussed in section IV(B), above. Another option is to take no employment-related deductions into account in determining PAYE withholding, but to give employees an option to file a return if they wish to claim such deductions (in excess of any applicable threshold). The choice between these alternatives will be based on a balancing of equity objectives and administrative resources in the jurisdiction.

B. Personal Reliefs

Where it is decided to make PAYE withholding a final tax, it is necessary to keep the design of personal reliefs as simple as possible.[224] If dependent spouse support is to be offered through the tax system, from an administrative point of view, the best option is to have a single relief that is intended to compensate notionally for the support of a spouse, children, and other dependents. It is then available to all resident individual taxpayers. While this relief may represent a windfall advantage to those taxpayers with no dependents, many such taxpayers are likely to claim relief in any case if the administration does not have the resources to check such claims. For taxpayers with dependents, it avoids arguments as to who is a dependent (particularly where there is an extended notion of the family) as well as the problems that arise with a change of tax status during the tax period (see below).

If tax relief is to be provided for dependents through deductions or tax offsets related to the actual number of dependents, relevant information on an employee's dependents must be provided on the employment declaration form. The declaration forms should be filed annually if a taxpayer is claiming such relief and should contain enough information (full name, birth date, and so forth) to enable auditors to detect fraud by comparing declarations for different years. Allowing a taxpayer to claim a deduction for a dependent only if the dependent has obtained a taxpayer identification number has proved effective in combating fraud because this makes it

[224] *See supra* sec. IX(D).

possible to confirm both the existence of the dependents and their dependent status.[225] Also, the form should provide the taxpayer's spouse's taxpayer identification number if the spouse is not a dependent to enable auditors to determine when two persons are claiming the same dependents (if individuals are used as the tax unit).

One technical and policy problem raised by recognition of relief for dependents is a change of status during a year—a taxpayer may marry or separate, have a child or lose a child (or the child may cross an age threshold during the year), or a dependent may enter (or reenter) or depart from the household. The simplest approach for handling additions to dependency relief is to place the onus on the employee to provide information on increased support obligations by submitting an amended employee declaration at the time the increase occurs. Additional relief can then be taken into account for future tax withholding. This incentive does not apply to employees who lose a support obligation or an entitlement to relief during the year. Nevertheless, an employee could be obliged to provide information on changes in personal relief entitlement, and the information could be checked against the following year's initial employment declaration form. This process may be administratively onerous. The simplest alternative is to allow taxpayers to enjoy dependency relief for the entire year, even if their entitlement changes during the year (concomitantly, a taxpayer would not become entitled to dependency relief until the new year).

C. Multiple Employment and Changes in Employee Status

An employee's status may change during a year in a variety of ways relevant to her or his tax liability. For example, an employee may become a resident or cease to be a resident during an income year. Similarly, an employee may enter full-time employment or retire from full-time employment during this period. The employee may also change employment or accept positions with more than one employer. The PAYE system must be designed to cope easily with these types of events.

Changes in residency or entering or leaving the workforce are relevant only if benefits are prorated for persons changing status in these ways. Proration is sometimes used to prevent exploitation of benefits or the tax-free thresholds that are intended for persons enjoying a particular status for the entire tax year.[226] Only some types of proration can be handled in the context of a PAYE withholding system. It is in theory possible to take into account changes when a person commences employment (e.g., when a person leaves full-time education or becomes a resident), but impossible to take account retrospectively of changes when a person ceases employment (e.g., upon retirement or emigration). Recognizing changes of status poses a number of practical problems, of which the most significant is calculating withholding amounts. One key attribute of a PAYE system is the use of withholding liability charts that enable the employer to determine easily the exact amount of tax to be withheld from each salary payment.

[225] USA IRC § 151(c)(3)(D)(I).

[226] For example, Australia prorates the tax-free threshold for persons becoming or ceasing to be a resident and for persons ceasing full-time education. See AUS ITRA §§ 16–20.

The charts are based on different levels of taxable income and are designed so that employers can take into account with relative ease such entitlements as personal allowances for dependent support. However, they cannot deal easily with a range of individual circumstances, such as variable tax-free thresholds. As a result, jurisdictions using these systems do not treat PAYE withholding as the final tax liability for employment income.

Problems also arise when an employee has more than one source of employment income. In this case, the total amount withheld will be accurate only if at least one employer knows the details of the employment income paid by others. While in some cases this may be possible, an employee may not wish to disclose the existence of other employment to his or her primary employer. In light of these problems, the system for final PAYE withholding for employees with more than one job is not likely to be fully satisfactory.[227] One option is to require persons with more than one job to file a return so that their final tax liability can be determined.

A related problem area is that of taxpayers changing employment during the year. If the taxpayer's salary level is relatively unchanged following a change of employment, unobtrusive administrative procedures can ensure a continuity of appropriate PAYE withholding. If the former employer is required to provide the employee with a statement of his or her PAYE position at the date of leaving, the information can be provided to the new employer, who can use it as the basis for withholding to ensure accuracy for the year. This system will not work when the salary level changes following a change of employment. While the new employer will know the taxpayer's total expected employment income for the year, the PAYE withholding charts will not show how withholding should be adjusted to compensate for the relative under- or overwithholding at the first place of employment (in terms of the changed total expected employment income). As a result, PAYE withholding cannot accurately be used as a final tax liability in this situation, and it may be necessary to require employees who change employment to file returns unless their salary level has not changed or income rate bands are so broad (or so flat) that a taxpayer's proportionate liability would not change with the change in income.[228]

D. Fringe Benefits

The taxation of fringe benefits in the hands of employees poses particular problems if employee taxation is to be based on a PAYE withholding tax that is intended to represent the taxpayer's final employment tax liability. From an administrative perspective, there is relatively little difference to an employer between the alternative fringe benefits tax systems—whether fringe benefits are taxed in the hands of employers or employees, it is common to require the employer to monitor and value all fringe benefits, although valuation is clearly much simpler when the employer can report total benefits and does not have to allocate those benefits to individual employees.[229] The principal difference is the impact of the tax on employee liquidity.

[227] *See infra* ch. 15, sec. III(C).

[228] This problem could be taken care of if withholding were computerized instead of being based on charts, or if withholding were in any event done on a cumulative basis (*see infra* ch. 15), but this will be beyond administrative capacity in most developing and transition countries.

[229] *See supra* sec. IV(C)(3).

Because withholding cannot be extracted from a benefit in kind, the tax on fringe benefits must be withheld from an employee's wages or salary, in addition to the tax payable on the wages or salary. As mentioned earlier, in the context of fringe benefits taxation, this process may have a significant effect on the employee's cash flow when the value of taxable benefits is quite high relative to the value of cash remuneration. Thus, one effect of imposing a final PAYE withholding tax on employee fringe benefits in such a situation may be to cause employees to "cash out" the benefits and restructure their remuneration packages to receive wages or salaries in preference to benefits in kind, even those that are most efficiently provided through employers because of the availability of group discounts, such as medical and dental insurance.[230] This possibility must be balanced against the obvious administrative advantages of using PAYE withholding tax as a final tax on all employment income and benefits derived by taxpayers.

If the cash-flow problems resulting from the introduction of PAYE withholding on fringe benefits are seen as transitional and the value of fringe benefits is not high compared with cash salaries, employers may be able to meet the initial cost of the PAYE deductions, recovering the funds over time from salaries as selected benefits are cashed out. The effect of this process is to transfer the cash-flow problem from employees to employers temporarily and to impose a real cost on employers. Whether this would occur depends on the relative bargaining powers of employers and employees.

A different problem arises with respect to the application of PAYE withholding to benefits that the employer may pay for once a year but that have the effect of providing a benefit to the employee continuously throughout the year. For example, an employer may provide employees with a health plan for which the employer accounts only once a year for the costs of operating the plan. Similarly, the valuation formula for a car fringe benefit will yield a single value for the year or perhaps a few values at the end of each mileage recording period if the formula takes mileage into account. In cases like these, it will be necessary to allocate part of the cost or benefit to each pay period of the employee. Rules of thumb will have to be devised to do this from the beginning of the year when the exact cost for the year will not be known until later.

One advantage of the fringe benefits tax discussed earlier is that taxation at the employer level facilitates the use of PAYE as a final tax and avoids the cash-flow problem noted above.

E. Other Income Sources

Unless the income tax rate scale is completely flat, PAYE withholding tax can operate as a final tax liability only for taxpayers deriving income solely from employment. In many developing and transition countries, this may be the case for a majority of employees. To the extent that employees do derive business or investment income, it is likely to be a *de minimis* amount for most employees relative to their employment income. Failure to reconcile the PAYE tax liability and the tax liability employees should incur if their complete employment and other income is taken into account will accordingly not seriously undermine the progressive tax system in most cases. The most likely scenario for an individual is that she or he will have a single job

[230] *See* text at note 91 *supra*.

with her or his only other income being interest on a bank account. In this situation, it is possible to make PAYE withholding a final tax by taking steps to ensure the accuracy of PAYE withholding (as discussed above) and imposing a final withholding tax on interest income. Alternatively, PAYE can be used as a final tax on incomes up to a nominated threshold, on the assumption that persons above the threshold are likely to have income other than bank interest.

In some cases, failure to combine employment income and other income when determining final tax liability can prima facie violate the objectives of the progressive income tax. The extent to which treatment of the PAYE withholding tax as a final tax liability on employment income defeats overall progressivity depends on both the structure of the income tax rate scale (and in particular the degree of graduation) and the treatment of other income. In theory, the imposition of separate tax liabilities on business and investment income reduces the overall progressivity of the tax system, although in practice this may not prove to be true. In many cases, global taxation has in fact reduced progressivity because taxpayers have exploited shortcomings in the provisions by which income from capital is taxed to defer recognition of gains and to use deductions for investment income expenses to reduce their taxable income from employment. Unless the provisions for measuring business and investment income are well drafted and contain special rules for quarantining expenses incurred to derive those types of incomes (for further detail, see ch. 16), overall progressivity may be threatened.

The choice between using the PAYE withholding tax as a final tax liability in all cases or only when taxpayers do not also derive business or investment income will thus depend on a variety of factors, in particular the type of taxes imposed on business and investment income and the sophistication of the rules protecting the integrity of the business and investment tax systems.

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Taxation of Income from Business and Investment

Lee Burns and Richard Krever

Lobbyists know that a 0 percent tax rate on capital income is not, in fact, the lowest possible rate.
—Joel Achenbach

I. Introduction

This chapter addresses the design and drafting of the income tax law as it applies to business and investment income.

While employment is an activity exclusively engaged in by individuals, business and investment activities may be engaged in by individuals or legal persons. Consequently, the rules for taxing income from business and investment cut across the taxation of individuals and legal persons. Countries with separate tax laws for individuals and legal persons need to coordinate the rules for taxing business and investment income, even though these may not always be uniform.

Regardless of the overall design of the income tax,[1] it is common to provide special rules for taxing business or investment income. These rules primarily relate to the tax base, timing of the recognition of income and deductions, and collection of tax. By far the most important are the timing rules. Particularly in the business context, these rules must negotiate the difficult terrain that bridges financial accounting and taxation. While uniformity between tax and financial accounting may seem desirable, countries have adopted quite different approaches: some countries have achieved substantial uniformity; in others, tax and financial accounting are substantially independent.

Note: Contributions to this chapter were made by Frans Vanistendael. The appendix is by Victor Thuronyi, with contributions by David Williams.

[1]Global, schedular, or composite; and single or separate tax laws for individuals and legal persons. *See supra* ch.14, sec. II.

II. Business Income

The characterization of an amount as business income is important in both schedular and global income tax systems.[2] Under a schedular system, it is common for separate taxes to be imposed on employment, business, and investment income. Consequently, the characterization of an item of income determines which tax regime applies to it. Under a global system, there is often a notional schedular breakdown of income types under which business income is specifically mentioned as a type of income that is included in gross income. Even if the notion of income is completely global, special rules, particularly tax accounting rules, may apply to business income. Other types of income derived by individuals may be calculated using different rules.

The starting point in determining whether an item of income is business income is to determine whether the activity giving rise to the income is properly characterized as a business. This issue is considered first below, followed by a discussion of inclusion rules related to business income. The third topic covered in this section is deductions for business expenses.

A. Definition of Business

In the absence of a definition in the income tax law, the term "business" will have its ordinary meaning.[3] In broad terms, a business is a commercial or industrial activity of an independent nature undertaken for profit.[4] The concept of a business may overlap with the notion of employment for tax purposes.[5] Whether this is the case will depend on the definition of employment that is included in the law. For administrative reasons, employment should be defined for income tax purposes to include all continuing service relationships where most or a significant part of the service provider's income is derived from one customer and that income essentially represents remuneration for the service provider's labor.[6] This will include some independent contractor relationships (i.e., relationships that are within the ordinary meaning of business). Where employment is defined in these broad terms, the definition must be coordinated with the definition of business so that the same economic activity is not characterized as both a

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[2]*See also supra* ch. 14, sec V.

[3]While the word business is commonly used in income tax laws, some countries use other expressions, such as "entrepreneurship", to identify independent economic activity. *See, e.g.,* EST IT § 9(1) (income derived from entrepreneurship).

[4]Some systems have distinguished a trade from a profession or vocation. *See, e.g.,* GBR ICTA § 18 (sched. D, case I (trade) and case II (profession or vocation)). *See also supra* ch. 14, sec V. As discussed in ch. 14, it is preferable not to draw such a distinction. Therefore, business should be defined to include both trade and professional activities. *E.g.,* AUS ITAA (1997) § 995-1; CAN ITA § 248; IND ITA § 2(13); KEN ITA § 2; ZMB ITA § 2.

[5]In the United States, employment is considered to be a business, but other systems generally do not follow this approach. This is in any case largely a semantic point in the United States, which distinguishes the business of employment from other businesses.

[6]*See supra* ch. 14, sec. IV(A).

business and an employment for income tax purposes. This could be achieved by providing that a business does not include an employment.[7]

B. Definition of Business Income

The definition of business income may serve a number of purposes in a global or schedular income tax system, for example, to identify a category of income for which special deduction or timing rules apply. It may also be used to characterize a particular item of income as business income where the income may otherwise be characterized as investment income. An important purpose of the definition in jurisdictions with a less than comprehensive judicial concept of income (e.g., those that rely on U.K. jurisprudence) is to broaden the tax base.

The relationship between income characterization and timing rules is an important factor in the design of the income tax rules applicable to business income. In turn, the timing rules depend on the relationship between tax and financial accounting rules. Because of the importance of this latter relationship in determining business income for tax purposes, this relationship is discussed first below. There then follows a discussion of specific inclusion rules relating to business income.

1. Financial Accounting and Business Income Taxation

Two basic models are used to determine the taxable income arising from business activities (referred to as "taxable business income") of a taxpayer[8] for a tax period: the receipts-and-outgoings system and the balance-sheet system. Under the receipts-and- outgoings system, generally used in common law countries, the determination of taxable business income is based on the calculation of all recognized income amounts derived by a taxpayer in the tax period and all deductible expenses incurred by the taxpayer in the tax period. Under the balance-sheet method, common in many European civil law jurisdictions, taxable business income is calculated by comparing the value of the net assets in the balance sheet of the taxpayer at the end of the year plus dividends distributed by the taxpayer during the year with the value of the net assets in the balance sheet of the taxpayer at the end of the previous year.[9] A positive difference constitutes taxable business income, while a negative difference is a business loss.

While the two models may sound quite different, in practice, they are similar in many respects. In theory, the starting point for the balance-sheet method is the taxpayer's financial accounts, while the receipts-and-outgoings system starts with gains and expenses that are recognized for tax purposes. In practice, however, most taxpayers in receipts-and-outgoings regimes use accounting records of commercial profits and losses as a starting point to show gross

[7] *E.g.,* AUS ITAA (1997) § 995-1; CAN ITA § 248; KEN ITA § 2.

[8] In this discussion, the reference to "taxpayer" is intended to include a partnership, although, generally, a partnership is not a separate taxpaying entity. However, it is usual to calculate the taxable income (or the gross income and deductions) arising from the partnership's activities as if the partnership were a separate taxpayer in respect of that income for the purpose of determining the tax liability of the partners. *See generally infra* ch. 21.

[9] *See infra* appendix.

income and expenses. The recorded income and outgoings are then adjusted as necessary to reflect the differences between tax and commercial accounting rules. Similarly, while the balance-sheet method explicitly commences with commercial accounting records, these must be adjusted to reflect differences between tax law and commercial accounting practice. In some circumstances, the two systems may yield the same determination of taxable business income.

Not all business taxpayers are required to compile comprehensive accounting records that include balance sheets. Accordingly, in jurisdictions that use the balance-sheet method to calculate taxable business income, smaller businesses operated by sole traders and self-employed persons (particularly those that account on a cash basis)[10] may be allowed to calculate income as the difference between taxable receipts and deductible expenses.[11]

The relationship between the determination of business income for tax purposes and financial accounting rules is analyzed in detail in the appendix to this chapter. Those materials note that the principal purpose of financial accounting is to provide an accurate analysis of the profitability of an entity to the managers and owners of an entity, as well as to creditors and potential outside investors. Income tax, in contrast, is concerned with the measurement of the net economic gain of a taxpayer in a fixed period for the purpose of collecting a portion of the gain as tax. These differences explain why classifications used in one system may not be relevant to the other. For example, because financial accounting is concerned with presenting owners, creditors, and investors with an accurate reflection of the ongoing profitability of an entity, it places some emphasis on classifying gains by reference to their regularity.[12] Distinctions of this sort that are drawn for accounting purposes are generally not carried over for tax purposes in jurisdictions that use the balance-sheet method of calculating taxable income.[13] The accounting distinctions are, however, relevant in some jurisdictions that use the receipts-and-outgoings method of determining taxable income.[14]

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[10]*See infra* sec. IV(B)(1) for a discussion of cash-basis accounting.

[11]*See, e.g.,* DEU EStG § 4(3) (taxpayers who are not required under commercial law to keep double-entry books and do not keep such books).

[12]For example, financial accounting may distinguish between ordinary gains and extraordinary gains (which often equate to "capital gains" in income tax concepts) to ensure that readers of the accounts are not misled into thinking that extraordinary gains will be regularly received by the business. Often, extraordinary gains realized upon disposal of an asset have accrued over many years. *See* Financial Accounting Standards Board (USA), General Standards I17.106 and I17.107 for an example of the criteria used in financial accounting to identify extraordinary gains. The key criteria in U.S. financial accounting standards are the "unusual nature" of the transaction yielding the gain (I17.108) and the "infrequency of occurrence" of the transaction (I17.109).

[13]However, several countries draw a distinction between capital gains and other business income. *See infra* ch. 20, sec. III(A).

[14]For example, in common law countries, gains that are characterized as extraordinary gains for accounting purposes are commonly treated as capital gains for tax purposes, where the tax system provides different treatment for capital gains and ordinary income gains.

A second area in which financial and tax accounting rules differ is the treatment of income to which a future liability may attach or income that is related to goods or services to be provided in future years. This difference is relevant to both methods of determining taxable business income. Financial accounting uses a variety of means to ensure that the calculation of income does not present a distorted view of true long-term profitability when a taxpayer's right to retain income is contingent on the provision of goods or services in the future or is otherwise associated with potential future liabilities.[15] Income tax rules, by way of contrast, are not as concerned with qualifying or deferring recognition of income for the purpose of noting the taxpayer's future obligations. Instead, they tend to recognize income when the taxpayer has command over the gain, while deferring recognition of the consequent obligation until it is actually satisfied.[16]

The relationship between tax and financial accounting is important in the design of income tax rules in developing and transition countries. These two types of jurisdictions differ from each other in key respects in terms of their financial accounting systems, and both types of jurisdictions differ again from industrial countries.

Most developing countries have relatively comprehensive financial accounting rules, usually based on the systems of one or more of the member countries of the Organization for Economic Cooperation and Development (OECD). In many cases, however, local accounting rules have not evolved in line with changes in industrial countries that were adopted to reflect changes in commercial practice. A different situation exists in most transition countries, where financial accounting rules were designed for application in a centrally planned economy and are now undergoing or have undergone reform. The adoption or reform of accounting laws has ameliorated the problem, but the accounting laws alone are not sufficient for income tax purposes. In many cases, statutory regimes are not supported by developed commercial accounting practice or judicial precedents that can be used to fill in the gaps in accounting statutes. Accordingly, it may be necessary for income tax laws of developing and transition countries to include characterization and timing rules, instead of relying on financial accounting. Tax accounting issues that should be addressed in income tax laws are reviewed below in section IV(B).

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[15]In some cases, this is done by recognizing receipts as income but then appropriating part of the amount received to a "reserve" to indicate that it is not actually available for use or distribution, but is being held for eventual application to satisfy a contingent or potential liability. Alternatively, an amount received may be treated as unfettered profits but be subject to a notation to the accounts indicating that it is subject to a contingent or potential liability and may not, therefore, reflect actual gain. This might be done, for example, where goods are sold subject to the purchaser's right to rescind the contract within a fixed period. A receipt related to the provision of future goods or services is likely not to be treated as income at all for financial accounting purposes. Instead, it will probably be credited to a "prepaid revenue account," which is a liability of the company (offset by an increase in cash). As the goods or services are provided, the liability will be diminished and amounts will move from the prepaid revenue account to the income account. Income tax treatment of advance payments may accord with the accounting treatment or may require inclusion of the payment in income. *See infra* sec. IV(C)(1).

[16]*See infra* sec. IV.

2. Specific Inclusions

It was stated above that a key purpose of the definition of business income is to broaden the income tax base, particularly in jurisdictions that rely on U.K. law or precedents. Jurisdictions that use U.K. concepts[17] measure taxable business income using the profit-and- loss method, based on taxable receipts and allowable deductions. In these jurisdictions, only receipts recognized as business income under judicial precedents or specific rules in the statute are included in gross income from business.[18] The judicial concept of business income in U.K. law characterizes gains as income from business if the receipt is a product or an ordinary incident of the carrying on of a business. Judicial precedents for determining whether gains satisfy this test emphasize the characteristics of the receipt, such as periodicity, and the subjective intention of the taxpayer with respect to the derivation of the gain.

A gain may thus be income from business if it arose from a transaction that was entered into by the taxpayer with a business or profit-making intention.[19] Such a gain is said to arise from an adventure or concern in the nature of trade.[20] Under this approach, gains from "one-off" or isolated transactions such as immovable property sales and speculative financial transactions are particularly difficult to imbue with an income character, and the disputes concerning the characterization of gains from such transactions account for a high percentage of taxation cases in jurisdictions relying on U.K. judicial concepts. In these jurisdictions, gains from transactions that fall outside the business income concept are likely to be considered capital gains and hence outside the judicial concept of income. Rather than define business income expansively to overcome this problem, many common law jurisdictions have simply accepted the judicial characterization and grafted capital gains tax regimes on to the basic income tax system[21] or adopted a separate capital gains tax.[22]

In jurisdictions that use the balance-sheet method to calculate taxable income, the business income concept is typically formulated to encompass both gains from ongoing

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[17]The U.S. courts have taken a broadly similar approach to the issues discussed in this paragraph, although there are some differences in the approach of the case law--hardly surprising given the extensive amount of litigation on these issues.

[18]Also sometimes called “assessable income.” *See supra* ch. 14 note 25.

[19]*See* Rutledge v. Commissioner, 14 T.C. 490 (1929); Martin v. Lowry [1927] A.C. 312.

[20]Some income tax systems derivative of U.K. principles include an “adventure or concern in the nature of trade” in the definition of business. *E.g.,* KEN ITA § 2; CAN ITA § 248; IND ITA § 2(13); ZMB ITA § 2. This has its source in U.K. tax law in which trade is defined to include “every trade, manufacture, adventure or concern in the nature of trade” (GBR ICTA § 832).

[21]For example, the inclusion of capital gains in AUS ITAA (1936) §§ 160AX–160ZZU and CAN ITA §§ 38–55.

[22]*E.g.,* GBR TCGA.

commercial activities and gains on the disposal of business assets, including immovable property and machinery.[23]

A broad definition of business income can also be helpful in transition jurisdictions that use evolving accounting standards and accounting codes as the basis for calculating taxable income. It can achieve certainty and simplicity in the income tax base and avoid the application of significant administrative and judicial resources to issues arising from the uncertain boundaries of business income. Choice of an appropriate drafting technique to accomplish this objective will depend upon the drafting norms followed in the jurisdiction.

A wide inclusion provision should treat as business income any gains arising on the disposal of business assets.[24] It should be made clear that the inclusion rule applies to all assets of a business and not just those used in the normal operations of the business. Thus, the concept of business asset should include not only assets physically used in, or held by, the business, but also investment assets related to a business activity. For example, a person carrying on a construction business may make short-term investments with advance payments received, and these investments should be considered business assets and not investment property. For companies and partnerships this effect can be achieve by a rule that treats all assets of such entities as business assets. For individuals conducting business activities, that may be achieved through a broad definition of business asset that includes all assets used, ready for use, or held for the purposes of a business. As a practical matter, it may be difficult to draw the line between the business and investment activities of an individual. Nevertheless, making the distinction will be necessary if gains on the disposal of investment assets may be either untaxed or subject to some form of tax concession.[25]

The inclusion in business income of gains arising on the disposal of business assets needs to be coordinated with any special regimes applying to specific types of assets, particularly inventory and depreciable or amortizable assets, as such regimes may have their own inclusion rules. Even if these regimes do have their own inclusion rules, it still should be made clear that the amount included under those rules is characterized as business income. This should also be the case for amounts included in gross income as recapture of excess depreciation or amortization.[26]

The business income inclusion rule should also cover any gain arising in relation to a business debt.[27] Ordinarily, if a person receives money with an obligation to repay, the receipt of

[23]The following definitions of business income for commercial and industrial enterprises are based on a net-increment-of-assets theory (*théorie du bilan*) and include all gains on assets used for business purposes: AUT EStG § 4 ; BEL CIR § 24; FRA CGI §§ 34, 36, and 38/1 and 2; DEU EStG §§ 4 and 5; CHE LIFD § 16; ESP IRPF § 41. NLD WIB § 7 taxes any advantage, whatever the name or the form, derived from an undertaking.

[24]*See infra* sec. V for a discussion of the timing and calculation rules relating to gains on the disposal of assets.

[25]*See infra* sec. VI(B).

[26]These amounts may also be referred to as balancing charges or as claw-back. *See infra* ch. 17, notes 170–71.

[27]*See generally supra* ch. 14 sec. VI(F).

the money is not regarded as income because of the offsetting liability to repay the amount received. However, if a debtor is able to discharge a business liability for less than the face value of the liability,[28] there needs to be some adjustment to the debtor's tax position to reflect the increase in the debtor's net worth. The simplest way of making this adjustment is to include the difference between the face value of the liability and the discharged amount in the business income of the debtor in the tax year in which the debt is discharged.[29] If the discharge has come about because the debtor is in financial difficulties, it may be appropriate to defer recognition of the gain by applying it to reduce the debtor's loss carryovers or asset costs, rather than including it in income.[30] Applying the gain in this way will reduce the debtor's deductions or cost recognitions in later tax years, thereby increasing the debtor's taxable income in those years.

Other items that can be explicitly enumerated in a definition of business income include the following:

- amounts received as consideration for accepting a restriction on the capacity to carry on business;
- amounts received as an inducement payment to enter into a contract or business arrangement (e.g., a lease "inducement" payment received for entering into a lease of business premises);
- gifts received by a person in the context of a business relationship;
- recovery of amounts previously deducted as business expenses, including bad debt claims; and
- amounts received in respect of lost business profits under a policy of insurance or a contract for indemnity or as a result of a legal action.[31]

As stated above, a specific inclusion rule may also be used to give priority to the characterization of a particular item of income as business income where the income may also be characterized as investment income. For example, investment income will usually be defined to include interest income. However, where interest income is derived by a person in carrying on a business of banking or money lending, it is appropriate to treat the income as business income and not investment income. It is also appropriate to treat interest income as business income when its derivation is incidental to business operations. This would be the case, for example, with interest derived on a business's normal bank accounts or short-term investments. The same

[28]Where the debt is a fixed-interest security, this may come about because a general rise in interest rates has resulted in a reduction in the value of the debt, so that the debtor is able to repurchase the debt for less than its face value. It may also come about under a debt- defeasance arrangement whereby a borrower liable to repay a loan at some future date pays a third party an amount approximating the present value of the loan in consideration of the third party's agreeing to pay the amount owed by the borrower when it becomes due. Finally, it may come about because the value of the debt has decreased because the debtor is in financial difficulties.

[29]*E.g.,* LSO ITA § 19(2); UGA ITA § 19(1)(a); USA IRC § 61(a)(12).

[30]*E.g.,* UGA ITA §§ 19(3), 39(3) (insolvency); USA IRC § 108 (insolvency or in formal bankruptcy proceedings). Some countries apply this rule in all cases and not just to debtors in financial difficulties. *See e.g.,* AUS ITAA (1936) sched. 2C; CAN ITA § 80 *et seq*.

[31]It may be preferable to deal with the last two of these specific inclusions with general inclusion rules applying to all types of income (and not just business income). If general rules are used, it will be necessary to provide rules concerning the category of income into which these items fall.

can apply to rental income where the business of the person deriving the income is the holding or letting of property.

The proper characterization in these circumstances may be relevant to the application of rules that quarantine deductions against particular classes of income.[32] Where income is derived from foreign sources, the characterization of the income may also be relevant to the calculation of the foreign tax credit limit.[33] It should be provided that the treatment of such income as business and not investment income for inclusion purposes does not preclude the income from retaining its characterization as interest or rental income for other purposes of the legislation. This ensures that any specific provision applying to such classes of income (such as nonresident withholding tax) is not avoided by an argument that the income is not interest income but business income.

C. Deduction of Business Expenses

In theory, all costs incurred to derive business income should be recognized for the purpose of determining net income, although the timing of recognition may vary for different types of expenses.[34] Early income tax laws often used restrictive language such as "ordinary and necessary" when defining deductible expenses.[35] Phrases such as this invite a subjective ex post facto analysis as to the desirability or effectiveness of business expenses. Other early income tax laws referred to expenses that were "wholly and exclusively" incurred to derive income subject to tax.[36] Terminology of this sort opens the door to a complete denial of a deduction for dual-purpose expenses, such as those incurred to derive both exempt income and income subject to tax, or those incurred for both personal purposes and to derive income subject to tax.

Generally, courts in jurisdictions that employ restrictive language of the sort described have read the provisions creatively and refrained from applying them to deny taxpayers deductions for genuine business expenses. The courts have adopted flexible interpretations of terms such as “ordinary and necessary” to discourage tax officials from second-guessing business decisions and denying a deduction for what subsequently proved to be ineffective or inappropriate outgoings.[37] Similarly, courts have applied language such as “wholly and

[32]For example, it may be provided that expenses incurred in deriving investment income may be deductible only against investment income. *See infra* sec. VI(A)(3).

[33]In some countries, the limit must be calculated separately for different types of income. *E.g.,* USA IRC § 904.

[34]*See infra* sec. IV(D). The issues raised here are similar to those that arise under the value-added tax (VAT) for input credit, and the reader might usefully compare the discussion in vol. 1, at 219–20.

[35]USA IRC § 162, for example, has retained the phrase "ordinary and necessary expenses."

[36]This was the rule in early Australian and Canadian income tax laws. GBR ICTA § 74(a) has retained this phrase. It is still also found in many income tax laws derivative of U.K. principles. *E.g.,* KEN ITA § 15; SGP ITA § 14; ZMB ITA § 29.

[37]This has been the experience in the United States. *See* Welch v. Helvering, 290 U.S. 111 (1933) and Commissioner v. Tellier, 383 U.S. 687 (1966).

exclusively" in a pragmatic fashion. Under such an approach, an expense that can be apportioned may, in relation to a part of the expense, be seen as incurred wholly and exclusively for the purpose of deriving income subject to tax.[38]

An alternative model for the design of a deduction provision commences with broad, nonrestrictive language and then supplements the general rule to allow deductions (the "positive" limb or limbs of the deduction provisions) with specific restrictions on deductions (the "negative" limb or limbs).[39] To accommodate dual-purpose expenses, the positive limbs should contain apportioning language: for example, "expenses are deductible *to the extent* that they are incurred in the production of income subject to tax." To ensure that the broad objectives of the positive limbs are achieved, it may be useful to refer to alternative bases for deductions—for example, deductions may be allowed for expenses incurred in the production of income subject to tax *or* incurred in the operation of a business carried on for the purpose of producing income subject to tax. Many outgoings incurred by a business are necessary or appropriate to the operation of the business but not consumed directly in the income-earning process of the business. A specific reference to expenses of a business will ensure that all legitimate business expenses are deductible.

Negative limbs, prohibiting deductions for particular types of expenses, fall into three broad categories: restrictions on deductions for personal expenses, restrictions on immediate deductions for capital outgoings (incurred to derive long-term or long-life benefits), and restrictions on deductions motivated by policy considerations. It is important in drafting to state clearly the relationship between provisions denying deductions and any specific rules allowing deductions (such as depreciation provisions).[40] Ordinarily, the prohibition rules override general rules for the allowance of a deduction, but are in turn subject to specific rules allowing deductions. For example, the prohibition on immediate deductions for capital outgoings overrides the positive limb allowing a deduction for business expenses, but, as explained below, the prohibition may in turn be overridden by measures that allow the outlay to be deducted under a depreciation or amortization regime.

[38]In the case of GBR ICTA § 74(a), *see* Ransom v. Higgs [1974] 1 WLR 1594.

[39]*E.g.,* LSO ITA § 33.

[40]*See* Commissioner v. Idaho Power Co., 418 U.S. 1 (1974) discussed in ch. 17 *infra* at note 57.

There are two advantages to a general deduction provision designed with broad positive limbs followed by specific negative provisions that specify the types of nondeductible outgoings. First, this technique avoids the impossible task of enumerating the endless list of expenses that may be incurred by a business.[41] It is impossible for legislative drafters to anticipate every type of expense that will be incurred, and, as a result, a system that allowed deductions only for enumerated expenses would inevitably prejudice some businesses. Second, and more important, the drafting approach that commences with a broad general deduction measure followed by specific deduction-denial measures provides a logical and sound framework for taxpayers, tax administrators, and tax adjudicators and makes the task of characterizing unusual expenses simpler for all parties.

1. Personal Expenses

The first category of deduction-denial measures applies to personal expenses and is relevant only to unincorporated businesses, because companies are inherently incapable of incurring personal expenses.[42] In the context of individuals deriving business income, it may be redundant to restrict the deductibility of personal expenses, since by definition a personal expense will not satisfy the criteria for deduction as a business expense. Nevertheless, as indicated in chapter 14 in the context of employment expenses,[43] statutes often prohibit deductions for personal expenses. Courts in particular find negative provisions of this sort useful for reinforcing decisions to deny deductions for personal outgoings. Further specific restrictions are sometimes used, for example, restrictions on deductions for "luxuries" where the value of the outgoings will not be taxed to the beneficiaries of the expenditures.[44]

Another type of personal expense to which specific restrictions are often applied is a "hobby" expense. A hobby is a personal activity that in other circumstances might constitute a business. For example, a holiday or weekend property could be nominally operated as a farm. Similarly, a taxpayer might pursue a recreational hobby, such as photography, sculpture, racing, or gambling, that constitutes a business for other taxpayers. Restrictions are needed to prevent taxpayers from deducting the expenses associated with such properties or activities.

Restrictions on the deductibility of hobby expenses may be achieved in two ways. First, reliance may be placed on a suitable definition of "business," drafted to exclude investments or activities that are not primarily intended as income-earning ventures. This approach has proved

[41]The exhaustive-list approach seems to be favored by jurisdictions with a history of central planning. *See, e.g.,* MNG BEIT § 5(1); CHN EIT § 6.

[42]There is, however, a line of U.K. judicial authority that suggests that some business expenses, such as damages or fines, may be incurred by traders (including legal persons) in a personal capacity. *See* Strong & Co. Ltd. v. Woodifield [1906] AC 448 (brewery company held to incur damages in its capacity as householder rather than innkeeper). This authority now has little impact, particularly outside the United Kingdom, as later courts have distinguished the decision and largely confined it to the particular facts of the early cases.

[43]*See infra* ch.14, sec. IV(B).

[44]*See* BEL CIR § 53/10; DEU EStG § 4 V 7; Klaus Tipke & Joachim Lang, Steurrecht 261–63 (13th ed. 1991).

to be of little utility because courts in jurisdictions using this approach have found it almost impossible to map a clear line between genuine businesses and hobbies that are conducted with businesslike features.[45] A second approach is to allow expenses of any activity to be deducted only against income generated by the activity unless the taxpayer can demonstrate, by reference to objective criteria set out in the legislation or in regulations, that the activity constitutes a business.[46] Further, under such an approach, a rule based on profitability can be applied to determine that an activity is a business. For example, it can be provided that where the activity is the taxpayer's principal source of livelihood, it will not be considered a hobby and expenses will be deductible in future years, subject to loss-carryover rules.[47] Alternatively, an activity can be presumed to be a business based on profitability over several years—for example, three years out of five.[48] Care must be taken that such rules do not prevent a genuine business activity from being treated as such during an extended period of recession or of adverse seasonal factors.[49] Given this caveat, this approach prevents abuse of the deduction measures while recognizing the start-up costs and profit fluctuations that legitimate businesses may encounter.

2. Capital Expenses

The second category of deduction-denial measures applies to capital expenditures, which are incurred to acquire assets or benefits[50] with a life extending beyond the tax period. In principle, measures preventing deductions for capital expenditures are not intended to impose absolute prohibitions on their recognition. Rather, they are supposed to prevent immediate deduction for outgoings relating to long-term benefits, and other provisions in the law should allow for their recognition on a more appropriate timing basis. However, in some countries, the effect of rules preventing immediate deductions for capital expenditures is to prevent any deduction for these expenses.

A properly designed system will provide for the recognition of all types of capital expenditures. Under such a system, the method of recognition depends on the nature of the asset

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[45]This approach is used in Australia. The limited efficacy of this approach prompted the government to adopt specific hobby expense restrictions in 1985, but political and technical difficulties led to their withdrawal, and tax authorities continue to rely on the business definition as the sole means of restricting deductions for hobby expenses.

[46]*E.g.,* USA IRC § 183. The regulations under § 183 list nine factors to consider in characterizing a taxpayer's activities. It is made clear in the regulations that the list is not exhaustive and that no one factor or even a majority of factors is decisive.

[47]*See infra* sec. IV(A)(2).

[48]*See* USA IRC § 183(d).

[49]For example, a farmer may be forced to take a job in town during a period of adverse seasonal conditions or a period of depressed commodity prices. During this period, the farming activity may not be the farmer's principal source of livelihood nor may the farming activity be profitable, but this should not prevent the farming activity from being treated as a business.

[50]A benefit is a business advantage that does not involve the acquisition of any asset, such as, for example, the reduction of competition. *See* Graeme Cooper et al., Cooper, Krever & Vann's Income Taxation 10-34 to 10-54 (1993).

or benefit acquired by the expenditure and, in particular, on whether the asset or benefit "wastes" over time. An asset or benefit wastes if it declines in value through usage or over time. Examples are buildings, plant, machinery, patents, and contractual rights of a limited life (such as an agency dealership for a fixed term). For such assets or benefits, the cost should be recognized by way of depreciation or amortization deductions allowed over the life of the assets or benefits.__epreciation and amortization rules are discussed in detail in chapter 17.

An asset does not waste if its value does not decline through usage or over time, although it may vary in response to market conditions. Examples are land and shares. For such assets, the cost of acquisition should be recognized upon disposal of the asset, through provisions that allow the cost base of the asset to be deducted in computing gain or loss on the disposal. Rules for cost inclusion and gain calculation are discussed in section V, below.

The design of a comprehensive regime for the recognition of capital expenditures must adequately provide for expenditures yielding benefits with uncertain lives. For example, a person may incur substantial expenditures in fighting the license application of a potential competitor or defending title to an asset already owned. Given that such expenditures may result in long-term benefits, they may be characterized as a capital expenditure; because the life of the benefit is uncertain, however, they may not fit within the ordinary amortization rules. To deal with such expenditures, it is suggested that a residual amortization rule be included to allow recognition over an arbitrary period of any capital expenditure for wasting or uncertain life benefits not covered by specific depreciation or amortization rules, or that it be included in the cost base of identifiable assets.[51]

An alternative approach that can be used in jurisdictions that have separate capital gains provisions for business taxpayers is to recognize the expenditure as a capital loss when the benefit acquired by the expense has expired.[52] However, this approach suffers from several major flaws. First, recognition of the expenditure is deferred until the asset or benefit expires, so that there is not a proper matching of expenses to revenue. Second, the expenditure is then recognized as a capital loss that, under the capital gains rules, may be applied only against capital gains. Third, even under a comprehensive regime for the taxation of capital gains, some capital expenditures will not be covered—namely, expenses that are not related to the acquisition of an identifiable tangible or intangible asset.[53]

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[51]For example, Canada uses a residual amortization rule that allows a taxpayer to recognize expenditures for wasting benefits not covered by other depreciation provisions on a 7 percent declining-balance basis. Not all the cost is recognized; *see* CAN ITA § 14.

[52]Australia, for example, has adopted this approach.

[53]Such expenditures never recognized for tax purposes are sometimes known colloquially as "nothings"(as in Canada prior to the adoption of the residual amortization rule in that jurisdiction), or "black holes," the term gaining currency in Australia.

The cost of inventory is not considered a capital expense in the ordinary sense because inventory is related to on-going business operations. Nevertheless, inventory does not waste, and, therefore, the cost of acquiring inventory should not be recognized until it is sold.[54]

3. Policy-Motivated Restrictions

The third category of deduction-denial measures applies to expenses that satisfy the positive nexus test for deductibility but that the legislature chooses, for various reasons, to disallow as a deduction. One reason the legislature may choose to do this is to discourage or penalize a particular activity for public policy reasons. Examples include prohibitions on the deductibility of fines and similar penalties[55] and bribes and similar illegal payments.[56]

A deduction-denial rule may also apply to income tax paid to other domestic or foreign jurisdictions, as well as to the domestic tax itself.[57] The treatment of foreign taxes will depend on the international tax regime.[58] The problem of other domestic income taxes arises most commonly in federal jurisdictions. The treatment by the federal or subordinate governments of taxes paid to the other level of government will depend on the fiscal support arrangements in place in the jurisdiction. In some jurisdictions, the two or more income taxes operate in parallel; in others, one level of government provides a deduction or credit for income taxes paid to the other.[59]

Other policy-motivated deduction restrictions may be designed to reinforce tax administration. A common example is the denial of a deduction for payments made by the taxpayer that are subject to withholding tax if the taxpayer has failed to withhold tax as required.[60] Another example is payments that are not properly substantiated by documentary evidence.[61]

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[54]*See infra* sec. IV(D)(4).

[55]*See, e.g.*, AUS ITAA (1997) § 26-5; EST IT § 16(4); LSO ITA § 33(3)(e); UGA ITA § 23(2)(h).

[56]*See, e.g.*, GBR ICTA § 577A (expenditure incurred in making a payment where the making of the payment constitutes the commission of a criminal offense); USA IRC § 162(c); OECD, Implementation of the Recommendation on Bribery in International Business Transactions, 4 OECD Working Papers, No. 34 (1996).

[57]*E.g.,* EST IT § 16(3); LSO ITA § 33(3)(b); SGP ITA § 15(1)(g); UGA ITA § 23(2)(d).

[58]*See infra* ch. 18.

[59]*See* vol. 1, at 68. It may be concluded that no explicit deduction prohibition is needed where deductions are not to be given for income taxes paid to another level of government as the payment may not satisfy the positive nexus tests in the deduction provisions (because the tax is not considered an expense of earning income). This means that if recognition is to be provided for another domestic income tax by way of deduction (*e.g.*, USA § IRC 164), a specific allowable deduction or tax offset provision will be needed.

[60]*E.g.,* AUS ITAA (1936) § 221YRA(1A) (no deduction for royalties paid to a person outside Australia until withholding tax paid to the Commissioner).

[61]*E.g.,* AUS ITAA (1997) § 900-70 (car expenses) and § 900-80 (business travel). These rules apply only to individuals and partnerships in which an individual is a partner.

The legislature may also choose deduction denial to deal with borderline expenses that have elements of both business expenses and personal consumption. Such expenses are discussed in chapter 14 in relation to employment,[62] but the issues are equally relevant where the expenses are incurred by a business for the benefit of a customer, client, or other business associate. The main examples are entertainment, meal, and refreshment expenditures. For these expenditures, a deduction may be disallowed to the extent that the amount is not included in the income of the beneficiary of the expenditure (subject to exceptions where, for example, the benefits are provided to paying customers or given to a broad cross section of the public as samples).[63] Alternatively, some countries limit the deductible portion of expenses to a fixed amount specified in the statute.[64] Similar limitations apply in relation to costs incurred in providing leisure facilities maintained for the benefit of employees and business associates, and the payment of social club membership fees for the benefit of employees.[65] A limitation may also be included on the deductibility of the cost of a gift made directly or indirectly to an individual if the gift is not included in the individual's income.[66]

Other examples of policy-based deduction-denial rules are some interest expenses;[67] contributions to nonapproved pension, superannuation, or private social security schemes (to encourage contributions only to schemes with rules that achieve the government's retirement income policies);[68] and contributions to political lobbying organizations or to political parties.[69]

III. Investment Income

[62]*See infra* sec. IV(B).

[63]*E.g.,* AUS ITAA (1997) § 32-5 (entertainment expenses deductible only if the value of the benefit is included in the recipient's income, is subject to fringe benefits taxation, or in other limited cases); UGA ITA § 24 (entertainment expenses only deductible if the value of the benefit is included in the recipient's income or the entertainment is supplied to the public as part of the taxpayer's business).

[64]*E.g.,* CAN ITA § 67.1 (deductible amount is 80 percent of the expenses incurred); IND ITA § 37(2) (first 10,000 rupees is deductible plus 50 percent of the excess); LSO ITA § 33 (deductible amount limited to 50 percent of the expenses incurred); NZL ITA § 106G (deductible amount is 50 percent of the expenses incurred); USA IRC § 274(n) (only 50 percent of expense is deductible).

[65]*E.g.,* AUS ITAA (1997) §§ 26-45 (recreational club facilities) and 26-50 (leisure facility or boat); CAN ITA § 18(1)(l); NZL ITA § 106G.

[66]*E.g.,* UGA ITA § 23(2)(f).

[67]*See infra* sec VI(A).

[68]*E.g.,* LSO ITA §§ 95, 96.

[69]*E.g.,* CAN ITA § 18(1)(n) (political contributions).

As with employment and business income, the characterization of an amount as investment income[70] (or as a particular type of investment income) is important in both schedular and global income tax systems.[71] Under a schedular system, characterization determines which tax regime applies to the income. Under a global system, there may be a specific inclusion rule for investment income or special timing or administrative rules.

There are two broad approaches to the inclusion of investment income in gross income. First, the inclusion rule could refer to investment income, which is then separately defined by reference to specific categories of income, such as annuities, dividends, interest, rent, and royalties.[72] Where capital gains on the disposal of investment assets are included in the income tax base, investment income may also be defined to include such gains.[73] Alternatively, the inclusion rule may refer to specific categories of investment income rather than to a collective notion of investment income.[74] Even under this design, it may still be necessary to define investment income for particular purposes under the income tax law.[75]

Under either method of inclusion, the specific categories of investment income may be the subject of supplementary definitions. While these supplementary definitions will be relevant to the income inclusion rules, they may in fact be more relevant to other aspects of the income tax, particularly withholding on payments such as interest and royalties paid to nonresidents. Given the flexibility of modern commercial law contracts, a nonresident may derive income that is functionally equivalent to interest, royalties, or rent, but is not within the ordinary meaning of those terms. In the absence of broad definitions of interest, royalties, and rent, this income may not be subject to tax.[76] In these cases, there may be no doubt that what is derived is income, but it may not be covered by the definition of interest or royalties for the purposes of the relevant nonresident withholding tax.

In light of this, the drafting of supplementary definitions of specific categories of investment income, such as royalties, may be influenced by international practice, particularly that reflected in the OECD Model Tax Convention on Income and Capital [77] (OECD Model Treaty).

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[70]In some jurisdictions, the term "property income" or "capital income" may be used.

[71]*See also supra* ch. 14, sec. IV.

[72]*E.g.,* LSO ITA §§ 17(1)(c), 20; UGA ITA §§ 18(1)(c), 21.

[73]*E.g.,* LSO ITA § 20.

[74]*E.g.,* EST IT § 9; IDN LCIT § 4; SGP ITA § 10.

[75]*See supra* text at notes 24 and 25.

[76]If the nonresident withholding tax rules do not apply, then it is often fairly easy to structure the transaction so that the income derived by the nonresident has a foreign source.

[77]*See supra* ch. 18, note 9.

Supplementary definitional rules for annuities, interest, rent, and royalties are discussed below. The definition of dividends is discussed in chapter 19, section VI.

A. Annuities

In common law jurisdictions, annuities were originally developed in the context of trust law, where they were used to impose a support obligation on an estate. The obligation required the estate to pay a fixed stipend to a beneficiary, using both income derived by the estate and capital, if income was insufficient to satisfy the payment obligation. Commercial or purchased annuities are a more recent development. A taxpayer purchasing a commercial annuity provides an "annuity provider" with a capital sum that is returned with compensation conceptually similar to interest in fixed payments over a specified term or, in the case of a life annuity, over the taxpayer's life.

A taxpayer must be allowed to recover the cost of purchasing an annuity, so that only the profit portion of the gain is taxed. The usual procedure is to recognize the cost of the annuity on a pro rata basis over the life of the annuity. The cost recognized as a portion of each annuity payment is determined by dividing the cost by the total number of payments for a fixed annuity and by the total number of estimated payments for a life annuity. This can be done by first prorating the payments and recognizing only a part of each payment as income or by recognizing the entire annuity payment as income and allowing an offsetting deduction for the cost component attributed to the payment.[78]

This method of cost recovery results in a deferred taxation of annuity income. This deferral makes annuities an attractive investment vehicle for both individuals and businesses. In particular, it is possible to structure an ordinary commercial loan so that it takes the legal form of an annuity, and thereby take advantage of deferred taxation. From an economic perspective, fixed-term annuities are in many respects the functional equivalent of a “blended” loan in which the borrower repays the loan principal over the period of the loan. In a blended loan, each payment contains a return of principal and an interest component, but the interest component of the initial payments is high compared with the repayment of principal, while the interest component of the last payments is small, since most of the principal on which interest is calculated has been repaid by the time of those payments. Given the functional similarity between blended loans and annuities, commercial lenders may try to characterize an ordinary commercial blended loan as an annuity in order to defer recognition of interest income by recognizing interest income in equal installments over the life of the transaction rather than predominately in the initial payments.

Under normal circumstances, a borrower would prefer to enter into an ordinary loan arrangement than an annuity arrangement, because the former entitles the borrower to larger deductions in the early period of the loan. However, if the borrower is a tax-exempt person (or is in a net operating loss position), a loan offers no advantages over an annuity because there will be no tax advantage from recognizing the higher interest component at the beginning of the loan.

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[78] *E.g.,* AUS ITAA (1936) § 27H; ZAF ITA § 10A. *See infra* sec. VI(A)(4).

If the borrower is indifferent between a loan and an annuity, the lender may suggest the annuity option and offer a reduced rate of interest in return for the deferral opportunity.

Many common law jurisdictions vulnerable to this practice have enacted antiavoidance provisions to prevent exploitation of the annuity rules in this manner. The simplest solution is to restrict the annuity treatment described in section III(A), above, to limited categories of annuities such as retirement annuities and to define other annuities as ordinary compound interest blended payment loans for tax purposes, whatever the legal designation given to them by the parties. This will allow tax authorities to notionally dissect annuity payments into interest and principal components, as if the payments were made pursuant to an ordinary commercial loan contract.

B. Interest

Interest is the compensation earned by a creditor for the use of his or her money during the period of the loan. Fundamental to the ordinary notion of interest is that there is a debt obligation. To make this clear, interest may be defined by reference to a debt obligation with a separate definition of debt obligation in the law that includes accounts payable and obligations arising under promissory notes, bills of exchange, debentures, and bonds.[79]

As indicated above, modern commercial law contracts make it possible to convert interest on debt or quasi-debt obligations into a variety of other forms, including discounts and premiums in respect of loan principal. Thus, interest is often defined for tax purposes to include commonly used interest substitutes such as discounts and premiums. However, even terms such as these have a recognized legal meaning, and, like the notion of interest itself, characterization as discount or premium may be avoided. Consequently, it is suggested that the definition of interest include a general formula to more effectively cope with the flexibility available to taxpayers in the way they structure their financial transactions. For example, interest could be defined to include "any other amount that is functionally equivalent to interest."[80]

C. Royalties

The definition of "royalties" for tax purposes is complicated by the fact that the term has diverse meanings across jurisdictions, and, even within a jurisdiction, may be applied to fundamentally different types of payments. One meaning is a payment for the use of a person's intellectual property. Thus, an author may be paid royalties for the right to print and sell books containing the author's copyrighted material, a musician may be paid royalties for the right to produce and sell tapes or compact discs containing the musician's work, or an inventor may be paid royalties for the right to produce and sell the inventor's patented system. Royalties may also be payable for the right to sell products bearing a trademark or copyrighted identification marks, or for the right to use know-how. In each of these cases, royalty payments are normally based on output (so much for each unit sold or produced).[81]

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[79]*E.g.,* UGA ITA § 3 (definitions of interest and debt obligations).

[80]*E.g.,* UGA ITA § 3 (definition of interest).

[81]*See generally* Murray v. ICI Imperial Chemical Industries Ltd. [1967] 2 All E.R. 980, at 982–83.

A related type of royalty is a payment for the sale of intellectual property. Rather than licensing a publisher to print a book with an author's work, the author may sell the copyright to a publisher, with the proceeds from the sale being paid as royalties based on sales. In essence, the copyright is sold for an unknown price, to be determined and paid as the books are sold. This sort of royalty is fundamentally different from the first one in that it is consideration for a sale, not payment for the use of the recipient's property. However, despite the legal difference, there may not be much of an economic difference in some cases. For example, the sale may cover only a limited geographic area or a limited period of time and may therefore have essentially the same effect as a license covering this area and period of time.

A third type of royalty is paid for the exploitation of natural resources connected with land, most commonly mineral resources (including petroleum), gravel, or timber. Calculation of the amount of royalties payable is normally based on the quantity or value of the resources taken, for which these royalties are effectively a purchase price.

Because royalties encompass so many different types of payments, the characterization of amounts as royalties for tax purposes varies from jurisdiction to jurisdiction. In particular, not all countries classify royalties as a category of income in its own right. Some countries classify some kinds of royalties as rental income[82] or, for royalties received by individuals for intellectual property created by personal exertion, as income from independent labor.[83] Other countries classify royalties as investment income subject to the same basic rules as interest income.[84]

The definition of royalties for tax purposes may also be influenced by international practice. There is a definition of royalties in article 12 of the OECD Model Treaty, which applies to transactions between the Contracting States. This definition has been included in the domestic tax law of many countries either generally or in relation to the taxation of nonresidents.[85] The article 12 definition includes payments for the use of, or right to use, intellectual property rights or know-how. It also includes payments for the provision of technical assistance ancillary to the use of intellectual property rights or know-how.[86] The definition does not include natural resource royalties. This is because such royalties are treated as income from immovable property under the OECD Model Treaty and, therefore, are dealt with under article 6 rather than under article 12. This reflects a distinction between royalties related to property that has its origin

[82]AUT EStG § 28 (1)3; DEU EStG § 21(1).

[83]NLD WIB § 22/1 (b).

[84]BEL CIR § 17 par.1/4.

[85]*See generally infra* ch. 18, sec. IV(E).

[86]Prior to 1992, the definition of royalty in the OECD Model Treaty also included amounts received for the use of, or right to use, any industrial, commercial, or scientific equipment (i.e., amounts received under a lease of movable property). The OECD Model Treaty was amended in 1992 to exclude such amounts from the definition of royalties with the intention of bringing them within the business profits article. Notwithstanding this, the definition of royalties in the domestic tax law of some countries still includes such amounts. *See, e.g.,* AUS ITAA (1936) § 6; KEN ITA § 2; LSO ITA § 3; UGA ITA § 3; ZMB ITA § 2.

outside the jurisdiction (such as technology rights), for which there may be limited source-country taxing rights, and royalties related to immovable property located in the jurisdiction (such as the taking of natural resources), for which there are full source-country taxing rights. If natural resource royalties are excluded from the domestic law definition of royalties, they may be included in the definition of rent (which is not usually subject to nonresident withholding tax) or treated as a separate category of income.

A definition of royalty based on the use of, or right to use, certain rights can be avoided by structuring the transaction as a disposal of the right. For this reason, some countries also define royalties to include the gain arising on the disposal of rights or property covered by the royalty definition.[87]

D. Rent

Under ordinary principles, rent is an amount received as consideration for the use or occupation of, or right to use or occupy, immovable property or tangible movable property. As indicated above, the scope of the definition of rent for the purposes of the income tax may depend on the definition of royalties. If rent from the lease of movable property is included as a royalty, then the definition of rent may be confined to consideration for the lease of immovable property. Similarly, for the reasons given above, natural resource royalties may be treated as rent rather than as royalties.

As with transactions involving the payment of interest, it may be possible to structure a leasing transaction so as to convert rent into other forms, such as premiums on leased premises. Thus, a definition of rent for income tax purposes should include commonly used rent substitutes, such as premiums.[88]

IV. Issues of Tax Accounting

A. The Tax Period

1. Annual Measurement of Taxable Income

Given that the income tax is imposed on an annual basis, it is necessary to specify the income tax year. The tax year will normally be specified as the calendar year, or as a fiscal year set to complement the government's fiscal year. In the discussion below, this is referred to as the "normal tax year."

In many jurisdictions, taxpayers may be permitted to substitute a different 12-month period as their tax year.[89] However, allowing taxpayers to choose a tax year that differs from that

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[87]JPN Corp TL § 138(7); KEN ITA § 2; UGA ITA § 3. *See further infra* ch. 18, sec. IV(E).

[88]*E.g.,* UGA ITA § 2 (definition of rent).

[89]*E.g.,* AUS ITAA (1936) § 18; EST IT § 6; IDN LCIT § 12; LSO ITA § 49; UGA ITA § 40.

of other taxpayers may result in some revenue loss if taxpayers are able to exploit the inconsistency.[90] It is suggested, therefore, that a taxpayer should be allowed to use a substitute tax year only with the permission of the tax administration, and, for this purpose, a procedure for applying for permission should be provided in the law or regulations. Permission should be granted only when the taxpayer demonstrates a legitimate need to use a substitute tax year.[91] To ensure that there is no loss or unacceptable deferral of tax resulting from the move to or from a substitute tax year, the tax administration should be allowed to prescribe conditions for the use of the substitute tax year. The right to apply for permission to use a substitute tax year may be restricted to corporate taxpayers or may extend to other business taxpayers (although cases where a sole trader can demonstrate a need to use a substitute tax year are likely to be rare).

A taxpayer using a substitute tax year may wish to cease to do so or to change to another substitute period (perhaps as a result of takeover). A procedure for making such changes may be provided, and, ordinarily, the rules outlined above should also apply to such applications.

Special rules are needed for "transitional" years when a taxpayer changes its tax year. The transitional period should be specified as the period commencing at the end of the taxpayer's last complete tax year to the beginning of the changed tax year. This ensures that the different years mesh with the rest of the legislation and prevents transitional problems, such as an extended tax year (greater than 12 months) when a taxpayer changes from one tax period to another.

The tax law is typically enacted (and amended) for application to the normal tax year. For example, changes to the income tax law may be stated to apply to the calculation of tax liability for a particular year and all subsequent years. Where taxpayers may use a substitute or transitional tax year, it is necessary to specify the law that is to apply to that tax year. For example, it may be provided that the law applicable to a normal tax year applies also to a substitute or transitional tax year that commences during the normal tax period.

2. Loss Carryovers

The annual measurement of income from economic activity that extends over a number of years is likely to lead to fluctuating measurements over the years, and this, combined with fluctuations in economic performance, may result in tax years in which allowable deductions exceed gross income (i.e., a taxpayer suffers a net loss for the year).

The tax law may provide for a net loss to be carried forward and allowed as a deduction in a subsequent tax year or carried back and allowed as an additional deduction in a previous tax year. The carryback of a net loss requires reopening the taxpayer's assessment for the prior tax year. From a theoretical perspective, taxpayers may be allowed virtually unlimited carryback and

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[90]An example is the use by a partnership of a substitute tax year to defer tax. *See infra* ch. 21, sec. II(B)(4). Another example involves taxpayer *A* paying at the end of its tax year a deductible expense to taxpayer *B*. If *B* is on a different tax year, *B* may not be taxed on the payment until later.

[91]For example, a case for using a substitute tax year may be established by a corporate taxpayer where the taxpayer belongs to a group of taxpayers (including foreign entities) with a group balance date for business accounting purposes that differs from the normal tax year.

carryover of net losses for recognition in years other than the years in which they are suffered,[92] but this theoretical case is tempered by two practical considerations.

First, there are significant divergences between the actual tax system adopted in any jurisdiction and the theoretical ideal. So long as it is impossible to guarantee the integrity of a comprehensive income tax base, safeguards against "bottomless holes" must be adopted; limitations on loss carryback or carryover are important elements in the safeguard armory.[93]

Second, unlimited carryback or carryover of net losses is possible only with sophisticated administrative resources, resources much greater than those available to taxpayers and administrators in most jurisdictions. For this reason, it is suggested that only loss carryovers be allowed. There may be some advantage in setting the loss-carryover period to coincide with the period in which the tax administration can amend an assessment (this period will also usually coincide with the period for which a taxpayer is required to keep records), but a longer period may also be specified. In countries where loss carryover is limited, examples of periods allowed are 5,[94] 7,[95] 8,[96] and 20[97] years.

Under a schedular income tax, carryover of losses will be provided for by reference to classes of income separately dealt with in the schedules. Even under a global income tax, carryover of losses may be to some extent schedularized.[98] Further, the carryover of losses by

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[92]*See generally* Dale Chua, *Loss Carryforward and Loss Carryback*, *in* Tax Policy Handbook 141 (P. Shome ed. 1995). Examples of unlimited loss-carryforward rules are AUS ITAA (1997) § 36-15; GBR ICTA § 393 (there is also a three-year loss-carryback rule in ICTA § 393A); NZL ITA § 188; ZAF ITA § 20; SGP ITA § 37; ZMB ITA § 30. Other countries with unlimited carryovers include Belgium, Germany, Ireland, Luxembourg, and Sweden. *See* Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation 242 (1992).

[93]For example, a large backlog of loss carryovers, which resulted from a combination of factors, such as inadequate definition of inflation adjustment and abuse of tax holiday provisions, threatened to undermine the corporate income tax in Argentina in the late 1980s and early 1990s. *See* vol. 1, at 464–65.

[94]*See, e.g.*, EST IT § 21; FRA CGI §§ 156(I) and 209(I); HUN CTDT § 17(1); IDN LCIT § 6 (the Minister of Finance may decree that an eight-year period applies to specific types of businesses). Five-year periods are also allowed in Denmark, Greece, Italy, Japan, Portugal, and Spain. *See* Commission of the European Communities, *supra* note 92, at 242.

[95]*See* CAN ITA § 111 (a three-year carryback rule also applies); CHE LIFD § 67(I); Commission of the European Communities, *supra* note 92, at 242.

[96]*See* IND ITA § 72.

[97]*See* USA IRC § 172.

[98]*See infra* sec. IV(B)(5) (foreign currency losses); VI(B) (capital losses); USA IRC § 469 (passive activity losses).

companies (and other entities as appropriate) whose ownership changes may be restricted to prevent trafficking in "loss" entities.[99]

B. General Timing Issues in the Recognition of Income and Deductions

1. Method of Accounting

The use of a tax year to measure, on a year-by-year basis, income from economic activity that extends over more than one tax year requires rules to allocate income and expenses to particular tax years. Under both the balance-sheet method and the receipts-and- outgoings method, the allocation of income and expenses is made by reference to cash- or accrual-basis accounting systems. Both systems measure income when it is derived and recognize expenses when they are incurred, but the time at which a taxpayer is considered to have derived an amount or incurred an expense can differ significantly under the two systems.

Under the cash-basis system, income is derived when it is actually received by, or made available to, or applied to the benefit of, the taxpayer, and expenses are incurred when they are paid. Under the accrual-basis system, income is derived when the right to receive the income arises, and expenses are incurred when the obligation to pay arises.

Practices for determining the appropriate method of tax accounting to be applied by a taxpayer vary. In some countries, the law leaves the matter to be determined according to financial accounting principles[100] or by the courts.[101] In other countries, the tax law may, within limits, give taxpayers a choice in the method of accounting to be applied.[102] Whatever practice is adopted, salary and wage earners would normally account for income and deductions on a cash basis, and legal persons conducting businesses account for income and deductions on an accrual basis. Individuals conducting business typically enjoy some flexibility. In particular, it may be appropriate and simpler for smaller businesses to use cash-basis accounting. However, if small businesses are allowed to use cash-basis accounting, the threshold between cash-basis and accrual-basis taxpayers must be set out.[103]

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[99]*See infra* ch. 20.

[100] *See infra* appendix (France, Germany).

[101]In Australia, the courts have made it clear that a taxpayer's method of accounting is to be determined according to legal principles and not according to generally accepted accounting principles. Nonetheless, the courts have developed legal principles that, in most cases, bear a close relationship to accounting principles.

[102]*E.g.,* EST IT § 37 (an individual may use either the cash or the accrual basis of accounting for business income, but other taxpayers must use the accrual method); LSO ITA § 50 (a taxpayer may account on a cash or an accrual basis except when gross income for a tax year exceeds a monetary threshold, in which case the taxpayer must account for business income on an accrual basis in all subsequent years); UGA ITA § 41 (a taxpayer may account on a cash or an accrual basis, provided that the tax method chosen conforms to generally accepted accounting principles and subject to the tax commissioner's power to prescribe otherwise in particular cases).

[103]*E.g.,* LSO ITA § 50. *See supra* note 102.

When taxpayers are allowed a choice of accounting method, they may change their basis of accounting, particularly if a threshold is set above which accrual-basis accounting must be applied. Changes in accounting methods can also arise from changes in the law, which may require all taxpayers to change the way they treat particular types of transactions.[104] When a taxpayer changes its method of accounting, transitional measures are needed to prevent lacunae or overlaps. A lacuna can arise, for example, when a taxpayer changes from a cash to an accrual basis because amounts billed but not received in the tax year prior to the change may escape taxation. This is because no amount has been received in the tax year in which the cash method applied, and no entitlement to receive has accrued in the tax year to which the accrual method applies.

It is suggested that transitional rules relating to a change in accounting method be drafted in broad terms because it may not be possible to anticipate every area needing such rules. In particular, the rules should not be confined to income and deductions because issues may arise in relation to tax offsets or other aspects of the income tax. A broad rule should permit adjustments to be made to the income, deductions, offsets, or other items as necessary to ensure that no item is omitted or taken into account more than once. It is also necessary to specify the tax year in which the adjustment is to be made. Ordinarily, this would be the first tax year under the changed method.[105] To properly monitor a change in tax accounting method, it may be provided that the change can be made only with the permission of the tax commissioner.

To minimize problems of administration, it may be decided to stipulate that once a taxpayer has been required to use the accrual method, the taxpayer must continue to use that method even if his or her gross income is less than the applicable threshold in a subsequent year. Some jurisdictions allow taxpayers to change back and forth between systems provided their income rises above or falls below the threshold for a number of consecutive years.[106]

The timing of recognition of income and expenses is crucial to the calculation of taxable income under both the receipts-and-outgoings system and the balance-sheet system. Under both systems, the choice between cash-basis accounting and accrual-basis accounting will have a significant effect on the measurement of taxable income. So, too, will the rules that govern exactly when receipts and expenses are recognized under cash- and accrual-basis accounting.

In Anglo-American jurisdictions, the financial accounting rules are typically established by generally accepted accounting principles devised by the accounting profession through self-

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[104]For example, suppose the law is changed to require capitalization of certain costs of producing inventory that could be deducted under prior law as current expenses. An effect of this rule would be to increase the value of opening inventory for the tax year in which the changed method is first applied. This would lead to a gap because the opening inventory would exceed the prior year's closing inventory (valued under the old method).

[105]*But see* USA IRC § 481 (three-year spread).

[106]For example, Hungary requires taxpayers who are above the threshold for two consecutive years to change from cash-basis accounting to accrual-basis accounting and allows, at the taxpayer's option, unincorporated taxpayers to switch from accrual-basis accounting to cash-basis accounting if their taxable incomes fall below the threshold for two years. *See* Act XVIII of 1991, Accounting Act § 13.

governing autonomous professional bodies. In civil law jurisdictions, the rules may be established by an accounting act or by the commercial code, supplemented by generally followed accounting practices or by regulations. In both cases, it may be necessary or appropriate for the income tax law to specifically address particular types of transactions whose accounting treatment may be vulnerable to manipulation intended to distort the measurement of taxable income (usually by accelerating recognition of deductions or deferring recognition of income). It may, therefore, be desirable both to reinforce fundamental tax accounting rules with clarifying statements of principle and to adopt more detailed tax accounting rules for particular types of transactions. The extent to which specific rules need to be articulated for tax purposes, therefore, will differ from case to case and will depend on the clarity and specificity of the financial accounting rules. This qualification applies to much of the discussion below. Thus, while it is suggested that a number of rules be specified for tax purposes, in many jurisdictions it may not be necessary to provide an explicit tax rule because the matter is already taken care of appropriately by the accounting rules.

Specific tax accounting issues that may be addressed in the income tax statute are reviewed below.

2. Currency Translation Rules

A taxpayer's income, deductions, and offsets[107] must be measured in the national currency. With the greater integration of the world's economies, it is increasingly likely that a taxpayer will derive income or incur expenses in a foreign currency. The income tax law should therefore include rules for translating amounts denominated in a foreign currency into the national currency.

The basic rule should provide for currency translation on a transaction-by-transaction basis. Under such a rule, each receipt of income denominated in a foreign currency should be translated into the national currency at the time the income is derived. Similarly, each deductible expenditure denominated in a foreign currency should be translated into the national currency at the time the expenditure is incurred. The basic rule should be broadly stated so that it can apply to other amounts taken into account for tax purposes. For example, the translation rule should apply to foreign tax when a foreign tax credit applies.

If multiple exchange rates apply at the time the foreign currency is to be translated into the national currency, it is necessary to specify which rate is to apply. For example, when a buying and selling rate is specified for the relevant day (as is usually the case), it could be provided that the exchange rate midway between the two for that day is to apply.[108] In other cases, there may an official exchange rate and a market rate, in which case a discretion may be provided to the administration to require the taxpayer to use the exchange rate that most accurately reflects the taxpayer's income.

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[107]For an explanation of tax offsets *see* ch. 14, sec. XI.

[108]*E.g.*, UGA ITA § 58.

A requirement to translate amounts denominated in a foreign currency on a transaction basis may be too onerous for a taxpayer who enters into multiple transactions in a foreign currency. For example, a taxpayer may have a foreign branch that engages in many transactions daily in the foreign country in which the branch is located. The branch's financial accounts are most likely to be maintained in the currency of that jurisdiction, and the tax law may allow the taxpayer to keeps its tax accounts in that currency as well. In this case, the taxpayer will be permitted to calculate the taxable income of the branch in the foreign currency (referred to as the "functional currency" of the branch). The taxable income of the branch will be translated into the national currency at a specific exchange rate. Ordinarily, the rate specified would be the average exchange rate for the tax year. It may be desirable to permit tax authorities to substitute alternative translation formulas in special circumstances, such as when dealings are in a particularly volatile currency.[109] Alternative formulas may include the use of weighted averages (taking into account when most transactions take place) or even requiring translation by reference to shorter averaging periods, such as a month, a week, or even a day. Because the functional currency is the currency of the country in which the branch is located, when the foreign branch derives amounts denominated in a currency other than that currency, the ordinary transaction-based rules should apply to translate that other currency into the functional currency.

The currency translation rules apply only for the purpose of reporting in national currency any foreign currency amounts derived, incurred, or otherwise taken into account for tax purposes. Foreign currency transactions themselves may generate gains or losses for a taxpayer. These are discussed in section IV(B)(5), below.

3. Claim of Right

Taxpayers often receive or pay amounts that are disputed or potentially subject to dispute because, for example, the amount is received by mistake, is erroneously computed, or is the subject of a controversy about, say, performance or quality. The question is when these amounts should be recognized as income or deductions.

In the broadest sense, all amounts received and payments made are contingent in that they may later be subject to dispute. The income tax would not be workable if there were no recognition of receipts and expenses until the payments were settled (in some cases, this could involve waiting until the expiration of lengthy statutory limitation periods). To solve the problem, it is usual to require taxpayers to recognize amounts for which they make an initial claim of right and expenses that they are initially obligated to satisfy. This rule eliminates arguments by taxpayers that the recognition of an amount for tax purposes is unclear because its legal status is uncertain.

A claim-of-right rule may arise under general principles[110] or through specific legislative provision.[111] Under a claim-of-right rule, the normal tax accounting rules as to when income is

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[109]*See* vol. 1 at 460–62.

[110]This is the case in the United States. *See* North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932).

[111]*E.g.,* UGA ITA § 45(1).

derived or expenditures are incurred[112] apply to an amount even if there is a dispute or potential dispute as to entitlement or obligation.

When a claim-of-right rule applies, an issue arises as to the treatment of repayments made or received should it ultimately be found that the taxpayer is not entitled to receive, or obliged to pay, the amount. Two broad approaches may be identified for dealing with such cases. First, the assessment for the tax year in which the income or expenditure is recognized can be reopened and adjusted, so that the original inclusion or deduction and the repayment are treated as a single transaction; or, second, the adjustment can be made in the tax year in which the claim of right or obligation to pay is withdrawn.

While the first approach may be theoretically correct and is used in some industrial countries, it may not be administratively feasible for developing and transition countries to adopt such a rule . Consequently, the second approach is considered preferable.[113] Again, the basis of the timing of the adjustment will depend on the tax accounting rules applicable to the taxpayer. In the case of a cash-basis taxpayer, an adjustment is made to eliminate income and expenses when payments are refunded to the appropriate party. In the case of an accrual-basis taxpayer, the adjustment is made when the claim of right is given up. It will be necessary to coordinate the claim-of-right rules applicable to deducted expenditure with the general rules on recoupment of deductions.[114]

4. Price Uncertainty

It is not uncommon in commercial transactions for the determination of the price to be subject to some contingency. In this case, the uncertainty relates not to the existence of a right to receive or obligation to pay, but to the amount that is ultimately receivable or payable.[115] Contingent prices may be based on either "positive" contingency conditions or "negative" ones.

Positive contingency conditions usually establish a fixed base price and a further payment obligation in line with criteria such as productivity and profitability. For example, mining rights may be sold for a lump sum or installment payments plus an amount for each ton in excess of a floor amount mined. Similarly, a business may be sold for a lump sum or installment payments plus a percentage of profits for a given period following the sale.

A negative contingent price establishes a fixed base price that is subject to downward variation if a condition is not met. For example, mining rights may be sold for a lump sum or a

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[112]*See supra* sec. IV(B)(1).

[113]This approach was adopted by the courts in the United States (U.S. v. Lewis, 340 U.S. 590 (1951). In certain circumstances, under IRC § 1341, an adjustment is made to the current year based on the tax reduction that would have resulted by excluding an amount from income in the prior year.

[114]*See* ch. 14, sec. III(D)(2).

[115]*See supra* sec. IV(B)(3), and *infra* sec. IV(C)(1) and (D)(1) for the treatment of amounts due or payable that are subject to uncertainty as to legal rights or obligations.

series of installment payments that presume a certain tonnage will be available. In the event that the property produces less than the amount expected, the price will be adjusted downward by a particular amount for each ton.

A simple way of dealing with positive contingent prices is to dissect the sale price into two components—a right to receive or an obligation to pay a fixed amount (either as a lump sum or in installments) and a right to receive or an obligation to pay additional amounts contingent upon the occurrence of a specific event—and to recognize the two elements separately. The fixed amounts are recognized according to normal tax accounting rules (including those relating to installments, if relevant). The later contingent amounts are treated as though they attach to contingent rights or obligations that crystallize when the condition precedent to further payments is satisfied.

Negative contingency obligations are treated similarly in respect of the initial fixed payment or payments, but offsetting deductions or adjustments are made available when it becomes clear that the original payment was not correct.

While the approach suggested above for ignoring contingencies until the time they are resolved may result in some use of contingent terms to defer accrual of income, it is suggested that, from an administrative point of view, this is the most appropriate way for most developing and transition countries to deal with contingent amounts.

5. Foreign Currency Exchange Gains and Losses

While the translation of foreign-currency-denominated amounts is dealt with above, this section deals with gains and losses on foreign currency exchange transactions (and similar transactions described below). The primary issue in relation to such gains and losses is timing; although, for those income tax systems derivative of U.K. principles there may also be characterization issues (i.e., whether the gain or loss is recognized under general principles or whether specific statutory recognition rules are needed).

The simplest type of foreign currency gain or loss is that realized in respect of foreign currency holdings. A taxpayer may have foreign currency holdings as a consequence of engaging in international transactions. For example, a taxpayer may receive foreign currency as payment for services rendered or goods supplied or may acquire foreign currency to meet a business expenditure.[116] Alternatively, a taxpayer may keep foreign currency holdings as a hedge against inflation or as an investment. In each case, the foreign currency is an asset of the taxpayer so that a gain or a loss will accrue as the value of the foreign currency fluctuates relative to the local currency during the period in which the foreign currency is held.

From the perspective of a comprehensive income tax base, the ideal tax treatment of foreign currency holdings is an annual valuation and recognition of gains and losses on an

[116]While the foreign currency translation rules discussed in section IV(B)(2), above, apply in determining the amount in national currency of the income derived or the expenditure incurred in these cases, the taxpayer may actually hold the foreign currency for longer than the exchange day.

accrual basis. Many industrial countries are moving toward recognizing gains and losses related to financial instruments through an annual valuation commonly known as "mark to market."[117] If accrual-basis taxation is adopted for financial instruments, it may be important to recognize foreign exchange gains and losses on both the asset and the debt side on an accrual-basis as well, so as to avoid serious distortions in the treatment of financial instruments generally. This is particularly important in highly inflationary economies.[118] However, unless the remainder of the income tax system measures gains consistently on an annual accrual basis, accrual-basis taxation of foreign currency holding gains and losses may be out of step with the remainder of the income tax system and may impose a considerable administrative burden on revenue authorities with limited experience in relatively sophisticated accrual measurement systems.

For these reasons, foreign currency holding gains and losses are often taken into account on a realization basis. Provided that foreign currency is treated as an asset, all dealings in foreign currencies (acquisitions, disposals, and conversions into other foreign currencies) can be dealt with by the provisions for recognizing income and losses that apply to ordinary property transactions.

A second source of foreign currency gains and losses arises from foreign currency loans and debt claims. Under a realization-based system, no special rules are needed for interest payments or interest receipts. If these are made in foreign currency, they are translated into local currency under the general translation rules. With respect to repayment of principal, provision should be made for lenders and borrowers to recognize as a gain or a loss (as appropriate) the difference between the value in local currency of a loan principal at the time the loan is made and its value in local currency at the time it is repaid. Once again, however, if accrual-basis taxation is used for financial instruments, it may be more appropriate to recognize foreign exchange gains and losses on an accrual basis as well, by incorporating these changes into the annual valuation rules for obligations and debt claims denominated in foreign currency.

Special rules may be needed for rollovers or refinancing of foreign debt, which arises when a foreign debt owed by a taxpayer is rolled over or refinanced by a new loan in the same foreign currency from the same lender. In theory, there is no reason to treat this arrangement any differently from one in which a borrower repays a foreign currency loan by borrowing from a completely different borrower. However, in some jurisdictions, this type of arrangement may be treated for tax purposes as an extension of the original loan and may thus not be recognized for the purpose of measuring foreign currency gains or losses.

A third type of foreign currency gain or loss arises as a by-product of the separation of income and expense recognition and actual receipt or payment in accrual-basis accounting. Accrual-basis taxpayers will initially record the amount of income derived in a foreign currency or expenses incurred in a foreign currency by translating those values into their national currency

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[117]For example, Canada, New Zealand, and the United States have adopted accrual-basis taxation for some financial instruments, and Australia proposes to do so.

[118]*See* vol. 1, ch. 13.

at the time the income is derived or the expense incurred.[119] If there has been movement in the national currency against the foreign currency between those times and the times at which income is actually received or expenses paid, the amounts recorded in the taxpayer's accounts and the amounts actually received or paid will differ, and an adjustment must be made to "correct" the original amount recorded.

There are, in theory, three ways this can be done. First, the taxpayer's accounts can be reopened and recalculated, with the actual income received or expenses paid (as translated to the national currency) substituted for the amount originally recorded by the accrual-basis taxpayer. However, in many cases this correction requires reopening a previous year's accounts. As has been explained earlier, it is very rare for tax systems to adopt procedures involving reopening accounts of previous years because of the administrative burden this imposes on both taxpayers and tax officials.

A second solution is to correct the taxpayer's accounts by attributing the difference between the income or expense originally recorded and the amount actually received or paid to the specific account to which the amount relates. Thus, if an income amount turns out to be more or less than originally recorded, it is corrected by adding an amount to income or subtracting (as an allowable deduction) an amount, depending on which way the currency moved. Similarly, if an ordinary deduction turns out to be more or less than originally recorded, the correction takes the form of an addition to income or an additional deduction, as the case may be. If the amount refers to the acquisition of property—either inventory, depreciable property, or nondepreciable property—the correction is made to the relevant property account. That is, if the expenditure is on inventory, an adjustment is made to the closing value of inventory in the year in which the expense is paid and the currency difference crystallized. Similarly, if the expenditure is on depreciable property, the tax value of the asset is adjusted in that year, and if the expenditure is on non-depreciable property, the cost base is adjusted in that year.

The second solution is the preferable option from a theoretical perspective, because it achieves the correct timing recognition of currency rate differences attributable to the purchase of property. Because the difference is attributed to the actual property acquired, it will be recognized in line with the recognition of the expense generally—for example, if the expense is for depreciable property, the cost of the property is adjusted and correctly recognized over the life of the property. Similarly, if the expense is for nondepreciable property, the corrected cost is recognized when there is a disposal of the property.

Whatever its theoretical merits, the second solution is not commonly used, probably because of the administrative costs it involves. The third solution, adopted in most jurisdictions, is by far the simplest from an administrative perspective. Under the third approach, when a foreign currency difference crystallizes because previously recorded foreign currency income is received or a previously recorded foreign currency expense is paid, the difference is simply recognized as a foreign currency gain or loss without any attempt to change underlying accounts by attributing the amount to the underlying transaction.

[119] *See supra* sec. IV(B)(2).

A realization system of recognizing foreign currency gains and losses should be accompanied by a quarantining system. This can be accomplished by treating foreign currency gains and losses as capital gains and losses, so that foreign currency losses are subject to the same limitation as capital losses.[120] Such a quarantining system is necessary to prevent taxpayers from entering into "wash" transactions intended to generate paper foreign exchange losses without any real change in the taxpayer's economic position. Without a quarantining system, if the local currency falls in value against a foreign currency in which a taxpayer has borrowed, the taxpayer with the foreign debt can trigger a recognition of a paper loss simply by refinancing the loan. By borrowing an additional amount in the foreign currency sufficient to repay the loan principal, the taxpayer is able to extinguish the original debt and claim a deduction for the difference between the value of the principal in local currency when the loan is made and the value at the time the loan is "repaid."

Quarantining rules will not be needed if foreign exchange gains and losses are taken into account on an accrual basis. In this event, depending on the rules for interest income and expense and any inflation-adjustment rules, it may be appropriate to provide that foreign exchange gains and losses are treated as interest income and expenses, respectively. The rationale for this is that the exchange difference plus the actual interest paid on a foreign currency debt will be roughly equivalent (on an ex ante basis) to interest paid in domestic currency on a domestic currency debt. If foreign currency losses are not treated as interest expenses, then transactions can easily be structured to circumvent limitations on the deductibility of interest expense.

6. Bad Debts

For tax purposes, debts fall into two broad categories. The first comprises amounts recognized by an accrual-basis taxpayer as income on an account yet to be satisfied.[121] The second consists of amounts due on a loan provided by the taxpayer. Both types of debts represent a liability to the debtor and an asset to the creditor. In the ordinary course of events, if the debt proves unrecoverable, the creditor should be able to recognize a deduction or loss when the debt or loan is written off as unrecoverable. However, it is usual for special rules to be adopted to deal with both types of debt.

In some jurisdictions, losses on assets such as debts owing to the taxpayer will not be addressed by the general rules for measuring business income. In other jurisdictions, the loss may otherwise be recognized, but a specific rule is adopted to control the timing of loss recognition or to impose conditions on the recognition. The primary purpose of the special rule applying to loans that subsequently become uncollectible is to control the timing of the loss recognition. In some jurisdictions, only taxpayers in the business of money lending are allowed to recognize bad debts related to loans.[122]

[120] *See infra* sec. VI(B).

[121] A cash-basis taxpayer who has provided a customer with goods or services may find it impossible to collect payment. Usually, tax systems provide no special rules for debts in this situation, although the taxpayer may be able to recognize the loss under general provisions or, in some cases, under capital gain and loss rules.

[122] *E.g.,* AUS ITAA (1997) § 25-35; CAN ITA § 20(1)(p) (moneylenders and insurers); IND ITA § 36(1)(a), (2) .

There are two approaches to the calculation of bad debt deductions: the charge-off method and the reserve method.[123] Under the charge-off method, taxpayers are able to recognize bad debts only on previously recognized income amounts or on nonrecoverable loans when the debt owing to the taxpayer is determined to be worthless. The reserve method, by way of contrast, allows a taxpayer to partially recognize debts when they become doubtful and before they are fully written off for financial purposes. In other words, under the reserve method, taxpayers will be allowed a bad debt deduction for an outstanding loan before the debt is formally treated as nonrecoverable.

It is suggested that the charge-off method should be used by all taxpayers other than financial institutions to recognize losses on loans. The difficulty in applying the reserve method is that it requires an accurate estimation of debts that are most likely to prove worthless. Because of the nature of their business and the standards imposed by external regulatory bodies requiring continuous monitoring and maintenance of accurate information on outstanding loans owed to them, financial institutions should be able to determine with a reasonable degree of accuracy the percentage of loan debts owed to them in the tax year that will ultimately prove bad. Further, the determination of the bad debt reserve can be based on the classification of the institution's loans made according to the rules of the central bank or other regulatory agency. It should be possible to ensure, therefore, that the bad debt reserve claimed by the financial institution accurately reflects potential bad debts. For other taxpayers, under the reserve method, the bad debt reserve is likely to be an arbitrary percentage of outstanding debts at the end of the tax year.[124] For many taxpayers, such a rule simply results in an unwarranted deferral of recognition of a portion of the taxpayer's income to the following tax year.

The key issue in applying the charge-off method for recognizing a deduction for a bad debt is when a debt has become worthless (as discussed below, this is also relevant for the reserve method). Determining whether a debt is bad usually involves considering all the circumstances, including continual nonperformance, adequacy of security, and the financial state of the debtor. To prevent abuse, the law could provide that a taxpayer must have reasonably pursued without success certain avenues for recovery before the debt is written off for income tax purposes.

Where a bad debt deduction has been allowed under the charge-off method and the taxpayer subsequently recovers or part of the debt, the amount recovered should be reincluded in gross income. Reinclusion in gross income may be pursuant to a specific rule to that effect or a rule applicable to the recoupment of deductions generally.

The reserve method contrasts with the charge-off method in that it allows recognition of some losses on debts before they are written off as nonrecoverable. Under this method, a reserve

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[123] *See generally* Julio Escolano, *Loan Loss Provisioning, in* Tax Policy Handbook 145 (P. Shome ed. 1995).

[124] In countries that use the reserve method, the law may stipulate that the bad debt reserve is such amount as the administration considers reasonable given the taxpayer's circumstances. With such a rule, though, the practice often develops that the administration allows all taxpayers to claim an arbitrary amount as the bad debt reserve. Taxpayers who want to claim a reserve in excess of that amount then have to make a case to the tax commissioner.

is established as an allowance against the eventuality that some outstanding (nonperforming) loans may prove to be uncollectible. The bad debt deduction in the reserve method thus includes recognition of doubtful debts that have not turned Abad in the sense of being written off. The method uses a formula that takes into account debts that are sufficiently doubtful at the end of a year to be recognized for commercial financial accounting purposes under relevant financial institution rules, doubtful debts that are finally recognized as nonrecoverable and written off during the year, and recoveries of debts previously written off.

Under a normal reserve method, regardless of how the actual reserve is calculated, the tax deduction for bad debts is computed as follows

(i) Closing reserve (amount of doubtful debts at end of year), less

(ii) opening reserve (amount of doubtful debts at end of prior year), plus

(iii) debts written off during the tax year, less

(iv) recoveries of previously written off debts, equals

(v) bad debt deduction for the tax year.

The closing reserve for one year becomes the opening reserve for the following year. Determining the tax deduction for loan losses based on a reserve method may appear, at first, to provide a double deduction for loan losses. Each loss, however, is deducted for tax purposes only once. There is no double deduction because, once loans are written off, there is no end-of-year reserve with respect to those loans. The end-of-year reserve relates only to loans outstanding on the books at the end of the year. When a previously written-off amount is subsequently recovered, the deduction otherwise allowed must be reduced by the recovered amount. Thus, the previous deduction is reversed.

For example, suppose a taxpayer has at the end of its first year of doing business $1,000 of doubtful debts. No debts have been written off during this year. The taxpayer's bad debt deduction for the year would be calculated as follows:

Closing reserve = $1,000
Opening reserve = 0
Bad debt deduction = $1,000

Further debts that become doubtful during year 2 will be taken into account in determining the amount of the reserve, as will debts that were recognized as doubtful in year 1 and actually written off as nonrecoverable in year 2 and formerly doubtful debts that subsequently proved recoverable. If the taxpayer had another $1,000 of debts that became doubtful in the second year and wrote off half of the previous year's doubtful debts ($500) while collecting one-fourth of the previous year's debts that had been classified as doubtful, the second-year reserve deduction would be calculated as follows:

(i) closing reserve ($1,250), less

(ii) reserve at the beginning of the tax year ($1,000), plus

(iii) debts written off during the tax year ($500), equals

(iv) bad debt deduction for the tax year ($750).

The closing reserve for year 2 is the amount of doubtful debts remaining at the end of the tax year. This would comprise $250 from the previous tax year ($500 of the previous year's doubtful debts are no longer doubtful, because they have been written off, and $250 are no longer doubtful because they were subsequently collected) plus $1,000 arising in year 2).

Some of the previous year's reserve amount representing doubtful debts ($500 worth) has actually been written off. The reserve is reduced by that amount, and the same amount is included directly in the bad debt deduction by adding it to the formula for deduction of bad debts.

Where a previously written-off amount is subsequently recovered, the deduction otherwise allowed must be reduced by the recovered amount. Thus, if we assume in year 3 that the taxpayer encounters another $1,000 of doubtful debts as of the end of the year, writes off no further debts, and recovers $200 of a previously written-off debt, the taxpayer's doubtful debt deduction for year 3 would be

(i) closing reserve (amount of doubtful debts remaining, $2,250), less

(ii) reserve at the beginning of the tax year ($1,500), plus

(iii) debts written off during the tax year (0), less

(iv) recoveries of previously written-off debts ($200), equals

(v) bad debt deduction for the tax year ($550).

Note the closing reserve for year 3 (and thus the opening reserve for year 4) takes into account doubtful debts, but is not affected by recoveries, while it was affected by debts written off. Debts written off will no longer be included in the reserve, while recoveries have no effect on the amount of doubtful debts held by a taxpayer. All that has happened is that part of a previous deduction has been reversed.

C. Timing Issues in the Recognition of Income

1. Income Subject to Potential Claims or Charges

Financial accounting attempts to measure the income of a continuing business over an extended period. Tax accounting, by contrast, measures *annual* net gains to determine a net amount that should bear a tax liability. The different objectives of the two accounting systems explain why they often diverge significantly with respect to their treatment of income when there is some doubt about the taxpayer's right to retain the income or when the receipt of income is tied to possible future outgoings.

Cases for which there may be some doubt about the taxpayer's right to retain the income fall into two categories. The first is attributable to the attendant risk in business that once a service or product has been delivered, the customer may demand a refund because of dissatisfaction with the service or product. This category is addressed through the claim-of-right rule discussed in section IV(B)(3).

The second type of doubt arises in respect of income that relates to the future provision of services or goods. An example of doubt about a taxpayer's right to retain income is the receipt of an up-front payment for a service or product that will be delivered over a period of years—for example, under a contract to provide continuing lessons or a contract for a multiyear magazine subscription. Similarly, a taxpayer may accept a refundable deposit for delivery of a product or service in a future year. An example of a case where the receipt of income is tied to possible future outgoings is the sale of a product, such as a car, subject to a multiyear warranty. Financial accounting rules often treat both types of situation similarly, while it is not unusual for tax accounting rules to prescribe greatly different treatment of the two situations.

Financial accounting rules tend to spread recognition of income over the periods during which the retention right is uncertain or the possibility of related expenses remains. This is normally done through reserves. Where a business derives income in either of these situations, it will establish a notional reserve in its financial accounts to indicate that part of the income received is not available for use or distribution, but rather is being held to satisfy a possible repayment obligation or to cover anticipated future costs associated with the income. The net income reported for financial accounting purposes will not include amounts in reserves.

Tax accounting rules often distinguish between the two situations and sometimes allow taxpayers to defer recognition of income that is subject to possible repayment while denying deferral of income merely because its receipt may give rise to future expenses.

The rule allowing taxpayers to defer recognition of income that is subject to possible repayment may reside as a general tax accounting principle established by the courts or may be incorporated into the tax legislation if it is not normal for the courts in a jurisdiction to adopt tax accounting rules outside the statute. Where the rule is based on judicial doctrines, it is usually established by interpreting the term "derived" with respect to income as meaning a right to retain income without the risk of return. Thus, in the case of a prepayment for the provision of future services, a taxpayer will be treated as deriving the income not when it is received but rather on a year-by-year basis, as services are provided and customers lose their rights to refunds.[125] If the rule is established through legislation, it is important that the onus be placed on the taxpayer to demonstrate, on the basis of previous experience or statistical evidence, that there is a genuine

[125]For example, the rule is established by judicial doctrine in Australia.

risk that the taxpayer's customers will cancel the contract for future services or products and upon cancellation will be entitled to a refund of amounts previously paid.[126]

This approach is not universal. In some countries, tax authorities have interpreted tax accounting principles to require immediate recognition of prepaid amounts. This approach may be modified in particular instances.[127] However, taxpayers are usually not required to recognize refundable deposits or security deposits (such as those paid to utility companies to guarantee payment of accounts or to landlords to cover possible damage to the premises). Rather, these are treated as akin to loans or receipts over which the taxpayer has no claim of right.[128]

The focus on annual measurement explains why tax accounting rules make no similar provision for potential future expenses, such as warranty expenses connected with current derivation of income. Once again, the lack of recognition for possible future obligations can be the result of judicial doctrines or specific statutory prohibitions.[129] This approach is consistent with the concept of economic performance discussed in section IV(D)(1), below.

2. Installment Sales

Where a taxpayer sells property on an "installment" basis, payment may be made over a number of tax periods. Some jurisdictions have allowed both cash-basis and accrual-basis taxpayers to recognize income from the sale over the period of payments, under the so-called installment method.[130] Where this system is used, taxpayers recognize gain on a pro rata basis over the payment period, assuming that each payment contains an equal return of cost and each payment therefore also contains an equal percentage of the total profit realized.[131]

The installment method involves a number of serious tax policy problems. Some problems are relevant to all disposals of property, while others are relevant only to disposals that

[126]*E.g.*, CAN ITA § 20(1)(m), which requires that payment be for goods or services that it is "reasonably anticipated" will have to be delivered or rendered after the end of the year. *See also* USA IRC § 455 (deferral of prepaid subscription income).

[127]*E.g.*, in the United States, tax authorities have interpreted tax accounting rules to deny deferral of income related to goods and services to be provided in future years, but have adopted some exceptions, such as a ruling that allows taxpayers to recognize income for services over two years in some cases (Rev. Proc. 71-21, 1971-2 CB 349) and to defer recognition of payment for the sale of some types of inventory and other specified assets (Treas. Reg. § 1.451-5).

[128]*See supra* sec. IV(B)(3).

[129]*See, e.g.*, CAN ITA § 20(7).

[130]*E.g.,* USA IRC § 453.

[131]It has been observed that the U.S. rule results in a reduction of tax liability compared with a vendor who receives the whole price at the time of disposal. This is because no account is taken of the effect of time on the value of money in determining the amount of each taxable installment. *See* Marvin A. Chirelstein, Federal Income Taxation 284–85 (1994).

give rise to capital gains, particularly if capital gains are treated preferentially relative to other gains.

If capital gains are treated more preferentially than to interest income, vendors may seek to disguise all or part of the interest component of installment payments as a capital gain by raising the total price and reducing the interest charged. To combat this, special measures may be needed to "carve out" the implicit interest component of each payment so it can be taxed as interest.[132]

Even if capital gains receive no tax preference compared with interest income and appropriate interest is charged on installment payments, or if gains on the disposal of property are treated as business income, the installment basis of income recognition can lead to serious inequity and inefficiency. This is because it effectively subsidizes vendors providing vendor finance relative to vendors who sell for cash, leaving the purchasers to finance the acquisition from third-party lenders. The taxpayer selling on an installment basis (and thus providing vendor finance) can defer recognition of gain and payment of tax until payments are made, while the vendor selling for up-front consideration enjoys no tax deferral. If the tax savings from deferral are passed on in part to the purchaser (through a lower sale price or interest rate), installment sale vendors will also enjoy a market advantage compared with those unable to finance the sale of their own property.

The solution to this problem that some jurisdictions have adopted is to recognize the entire sale price at the time an installment sale contract commences.[133] This has the effect of treating the installment sale as a sale for full value to the purchaser, supplemented by a loan from the vendor to the purchaser.

3. Long-Term Contracts

It is not uncommon for businesses to enter into contracts that extend beyond the tax period and that require both performance and payment to be made over the life of the contract. These contracts are referred to as long-term contracts.

In a long-term contract, the total payment to be received by the taxpayer is often set out in the contract.[134] In a sense, the taxpayer is therefore "entitled" to receive the money upon entering into the contract, although the taxpayer is not entitled to actual payment at that time. However, unlike with an installment sale, the taxpayer has not performed all that is required under the contract. The various rationales set out earlier for up-front recognition of gain on an installment sale do not apply to long-term contract arrangements, because the arrangement is not a substitute for the up-front payment that would otherwise take place, as with an installment sale.

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[132]*E.g.* AUS ITAA (1936) § 256; CAN ITA § 16(1); USA IRC § 63(b).

[133]*E.g.,* AUS ITAA (1936) § 160ZD(1)(a); USA IRC § 453(b)(2), (e), (g), (k) (providing circumstances under which installment method does not apply).

[134]This will not always be the case. For example, a contract may be of the cost-plus type or may involve an incentive fee.

In economic terms, it may be appropriate to recognize a certain amount of income upon signing the contract based on the present value of the profit that the taxpayer is expected to make. However, this amount will often be impossible to measure.

The adoption of specific rules for long-term contracts can avoid confusion, particularly for accrual-basis taxpayers, about the recognition time for income and deductions arising under a long-term contract. Two accounting methods commonly used for long-term contracts are the percentage-of-completion method and the completed-contract method. Under the percentage-of-completion method, profit is recognized in proportion to the progress made on the contract during the relevant accounting period. In other words, the profit is recognized as it "emerges" over the life of the contract. Under the completed-contract method, profit is not recognized until the contract is substantially performed. Accounting standards now clearly favor the percentage-of-completion method as a better measure of "periodic accomplishment" over the life of the contract. From a tax perspective, the completed-contract method gives rise to an unwarranted deferral of tax.

The principal issue under the percentage-of-completion method is, not surprisingly, how to measure the percentage of the contract completed during the taxable year. A relatively administrable, although somewhat arbitrary, rule is to assume that the percentage of completion equals the percentage of total contract costs incurred during the year.[135]

Example

Contractor enters into a construction contract to be completed over three years. Under the contract, Contractor expects to incur expenses of $50,000 and to derive gross income of $1,500,000, for a taxable net profit of $1,000,000. In the first year of the contract, the contractor incurs expenses of $200,000. Contractor's expected taxable net profit is allocated to each tax year in a pro rata fashion, using the ratio of actual expenditure to expected total expenditure as the key. Thus, in this example, the recognized taxable profit in the first year would be $1,000,000 x $200,000/$500,000 = $400,000. If expenses of $200,000 were also incurred in the second year, recognized taxable profit in that year would also be $200,000.

Long-term contracts that envisage performance and payment made over a number of tax years fall into the broad categories of fixed-price and cost-plus contracts. Under the former, the total consideration for the contract is agreed on before work begins; under the latter, the customer agrees to pay the taxpayer a consideration based on costs incurred plus a profit margin.[136] The formula used to determine annual recognition of profits under the percentage-of-completion method will initially use estimates of total profit in fixed-price contracts or total profit and total costs in cost-plus contracts. As the contract proceeds, the calculation must be

[135] *E.g.,* UGA ITA § 46.

[136] A variant is the cost-plus-incentive-fee contract, where the contractor's profit margin may vary depending on the extent of cost overruns, timeliness of completion, or other factors. The various kinds of contracts are described here for information; they should not be defined as separate categories for tax purposes.

revised to reflect the changed base figures and an adjustment made for what turned out to be the incorrect amounts previously recognized. An adjustment may also need to be made where profits change because, for example, the contractor is paid an "incentive fee" for early completion.

The correction for changed expenses or profit can be done two ways. Some jurisdictions use a sophisticated "look back" method to reallocate contract profits over the years of the contract at the time it is completed.[137] While this method is useful for minimizing tax avoidance, it is probably too complicated to be advisable for most developing and transition countries. A simpler alternative is to revise the calculation and make adjustments when the change becomes known. The revision approach can lead to a loss in one year even though the total project yields a profit. The phenomenon can be illustrated using the example provided above and assuming costs in the final year run to $300,000 instead of the expected $100,000.

Example

If there were no cost overrun in the final year, the contractor's taxable income for the third year would be $1,000,000 x $100,000/$500,000 = $200,000. However, if the costs were $300,000, the total profit on the project would be only $750,000 ($1,500,000 gross payment less $750,000 total expenses). The taxpayer has already recognized $800,000 in profits in previous years. Thus, in the third year of the contract, the taxpayer would recognize a loss of $50,000.

The loss recognized in the final year can be dealt with under the normal rules for loss carryovers. One problem that may emerge for developing and transition countries is that the contract may be the taxpayer’s only income-producing activity in the country, so that there is no benefit in a loss-carryover rule. To overcome this problem, a special loss- carryback rule for long-term contracts can be formulated.[138]

The definition of a long-term contract subject to the long-term contract income-recognition rule should include any contract for the manufacture, installation, or construction of property (including a contract for the performance of services related to such manufacture, construction, or installation), provided the expected term of the contract extends over more than six months and the contract is not completed in the tax year. This would ensure the rule applies to, for example, the construction of buildings, bridges, dams, pipelines, tunnels, and other civil engineering projects; construction management contracts in relation to such projects; the construction of major items of plant; and contracts for the refurbishing of hotels and other business premises. The long-term contract rules would not apply to most service contracts, however.

D. Timing Issues in the Recognition of Expenses

[137] *E.g.,* U.S.A. IRC § 460.

[138] *E.g.,* UGA ITA § 46 (loss carryback allowed only with the permission of the tax commissioner).

1. Economic Performance and Recognition of Expenses

A fundamental principle that merits reinforcement is the nexus between legal and economic liability for accrual-basis taxpayers and between payment and economic liability for cash-basis taxpayers. It was noted earlier that an accrual-basis taxpayer is normally understood to have incurred an expense when the obligation to pay arises, and a cash-basis taxpayer is treated as having incurred an expense when it is paid. It is important that the "obligation to pay" for accrual-basis taxpayers and "amount paid" for cash-basis taxpayers be interpreted in an economic sense, not a strict legal contractual sense.

This means that the act of legally entering into a contract that will obligate a taxpayer to make future payments should not in itself cause an accrual-basis taxpayer to be treated as if it had incurred the payments. In an economic sense, an obligation to make payment in the future is not actually "incurred" until there has been an economic performance that gives rise to the obligation to pay. While a taxpayer may commit to make a payment in the future for services to be provided in the future, the obligation is not actually incurred until the services are provided, as the obligation is only contingent prior to the provision of services. For example, a taxpayer can enter into a long-term contract to rent premises for a number of years. The rental obligation with respect to each of the future years is not actually incurred until those years. Similar principles apply to cash-basis taxpayers who actually make payments for services or goods that will be received over several years. Insofar as the payment relates to future years, it does not represent an expense incurred at the time of payment. Rather, it is akin to a security deposit to the recipient to guarantee the price for the goods or services to be delivered in the future. If, for some reason, the contract is terminated before delivery, the taxpayer should be entitled to a refund, either under the contract itself or under contract law principles in most jurisdictions.

The basic deduction provisions in many income tax systems may not be interpreted to operate in this strict way. In particular, immediate deductibility under the general deduction provision is normally not restricted to expenditures that are consumed in a tax period.[139] Consequently, in the absence of a specific rule to the contrary, an accrual-basis taxpayer that enters into a long-term commitment for the purchase of goods or services may be allowed to deduct the entire amount payable under the contract. Similarly, a cash-basis taxpayer who makes a prepayment for the future delivery of goods or services may be able to deduct the entire amount paid. To prevent this result, some countries have added to their income tax laws a supplementary rule, sometimes known as an economic performance rule, to reinforce the principles that accrual-basis taxpayers should recognize expenses as incurred when the obligation to pay has crystallized and not when the agreement creating the obligation is entered into, and that cash-basis taxpayers should recognize expenses as paid when the contracted good or service is provided and not when initial consideration is given to the supplier. The economic performance rule provides that an expense will not be treated as incurred before economic performance with respect to the expense occurs.

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[139]An exception is Indonesia, where it is provided that costs of earning income that have a useful life of more than one year may not be deducted at once, but rather are to be deducted under the amortization rules. The position under the Indonesian income tax conforms closely to the theoretical model outlined in the text. *See* IDN IT §§ 6(1)b, 9(2), and 11(10).

If it is thought that a general economic performance rule applicable to all taxpayers is not needed because under general principles accrual-basis taxpayers are considered to have incurred expenses only in the years in which goods or services are provided, then a prepayment rule applicable to cash-basis taxpayers should be provided.[140]

2. Accruing Liabilities

A taxpayer's ongoing business will normally give rise to accruing liabilities that will not have to be satisfied until a future tax year. Common examples include the liability of borrowers to pay compounding interest when a debt matures, the liability of insurance companies to pay insurance claims related to the current year when the claim is settled in a future year, the growing liability of extractive industries to restore property when mining is completed, and the obligation of employers to pay future benefits to employees on the basis of current work.

No consistent approach is universally adopted to address these issues. It is generally the case that accruing liabilities that give rise to actual debts can be recognized as they accrue. This is true, for example, with a compounding interest obligation, where compounded interest is treated as a new deposit by the lender. While there are exceptions to the rule, discussed below, taxpayers generally are not permitted to recognize accruing liabilities where no actual debt is created by the accruing liability. In some cases, however, tax legislation may allow recognition for specific types of accruing liabilities, such as to fund environmental restoration or to provide pension or retirement benefits to employees where the funds are notionally allocated to a reserve by the taxpayer.

The simplest statutory approach to the problem is to enact a general rule that, subject to specific exceptions,[141] denies taxpayers deductions for an accruing liability until the liability has crystallized into an actual obligation to pay or created an actual debt of the taxpayer. Possible exceptions can then be considered on a case-by-case basis where the interests of the taxpayers can be balanced against the revenue costs of the exceptions. Appropriate conditions can be attached to each exception allowed. For example, to qualify for recognition of an accruing liability, a taxpayer may be required to establish an actual reserve in its accounts and insulate those funds from encroachment to satisfy other liabilities of the taxpayer.

3. Repairs and Improvements

An area that gives rise to disputes in a number of jurisdictions is that of expenditures for repairs and improvements. It is common for income tax systems to distinguish between expenses for these two purposes and to allow deductions for the former, while the latter are capitalized into the cost base of the assets to which they relate and recognized over time through the

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[140]*E.g.,* AUS ITAA (1936) §§ 82KZL–82KZO.This applies to all types of prepayments, but does not apply where the benefit is provided within 13 months of the date the expenditure was incurred, where the prepayment is required by legislation or court order, or where the prepayment is less than A$1,000.

[141]Such as for bad debts of financial institutions. *See* secs. IV(B)(6) and VI(D).

depreciation system or as part of the cost base when calculating a gain or loss on final disposal is calculated.

From an income tax perspective, the distinction between repairs and improvements is quite artificial. The complicated and contradictory case law in many jurisdictions illustrates well how impossible it is in practice to establish mutually exclusive camps and to classify categorically work on assets as either repairs, improvements, or acquisitions of new subassets that are incorporated into larger assets.[142] Even if a satisfactory method of distinguishing repairs, improvements, or acquisition of replacement parts can be devised, the distinction is unlikely to yield appropriate tax treatment; as often as not, the classification has no relevance to the life of the benefit acquired, which is the principal criterion determining recognition and timing for business expenses.

The application of the expense recognition principle—recognition over the life of the benefit—is almost impossible to apply to many repairs, alterations, or improvements, because there is often no way in which the effective life of these benefits can be estimated. Accordingly, a surrogate formula is needed to determine the tax treatment of such outgoings.

The simplest rule is one that eliminates the need to distinguish between repairs, improvements, or the installation of replacement parts through the use of a simple mathematical formula (sometimes known as a repair allowance).[143] The formula system presumes that, on average, the amount of repairs needed will bear a relatively fixed relation to the total value of depreciable property. Any excess over this amount can be presumed to be an improvement. Thus, it is logical to presume that high expenditures relative to the value of the relevant property are likely to give rise to benefits that enjoy a life approximating that of the underlying property, while low expenditures relative to the value of that property are likely to enjoy briefer lives. For example, expenditures on repairs or improvements that exceed, say, 5 percent of the value of an asset can be considered to be the purchase price of a long-term benefit and added to the cost base of the asset, while expenses less than that threshold can be considered to be costs incurred to derive short-term benefits and deducted immediately.[144]

If the traditional approach of immediate write-offs for repairs and capitalization of improvements is adopted in preference to a repair allowance, a special rule for initial repair expenses should be considered. Where a taxpayer acquires a used asset and incurs initial repair expenses to prepare the property for use in the taxpayer's business, it is arguable that the initial expenses should be wholly capitalized and treated as part of the acquisition price for the asset. If the vendor incurs the repair expenses and sells the property in a ready-to-use form, the costs would be directly incorporated into the cost of the asset. A purchaser should not be able to accelerate deductions by purchasing property not ready for use and then repairing the property to bring it to usable form.

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[142]*See infra* ch. 17, sec. II(B).

[143]*See infra* ch. 17, note 50.

[144]Where a pooling depreciation system is used (*see infra* ch. 17, sec. III(G)), the 5 percent threshold can be applied by considering expenditures on all assets in a pool relative to the value of the pool.

There are three ways in which a rule of this kind can be formulated. First, one could establish a bright-line rule under which all repairs within, say, six months of an asset's placement in service are treated as capital costs, regardless of the facts of the individual case. Alternatively, one could establish a presumption that repairs undertaken within a certain period are capital in nature, which the taxpayer can rebut by showing that the repair is genuinely a repair rather than a set-up cost. A third approach is to adopt a cost formula similar to the repair allowance described above. For example, the rule can apply only to repair costs incurred within one year of the acquisition of an asset and allow a deduction for repair costs of up to 5 percent of the original acquisition cost while requiring taxpayers to capitalize repair costs in excess of that amount incurred within that year.

4. Inventory

Income tax systems commonly measure gains and losses from the acquisition and disposal of inventory separately from gains and losses arising from the disposal of other property.[145] The essential purpose of tax accounting rules relating to inventory is to ensure that a deduction is not allowed for the cost of acquiring inventory until the inventory is sold.[146] This policy objective is consistent with the general rules regarding gains and losses from the disposal of nonwasting assets, but separate rules are adopted for inventory in recognition of the continual turnover of this type of property.

As with other tax accounting rules, the rules relating to inventory may be based on commercial accounting standards or may be specified in the tax law or in regulations. An initial issue that should be addressed in the inventory rules is what is encompassed in inventory and thus subject to those rules.[147] In some jurisdictions, inventory is not defined and, therefore, takes its normal commercial meaning.[148] In other jurisdictions, it is defined, but in terms largely declaratory of its normal commercial meaning.[149] Essentially, inventory is anything that is turned over in the ordinary course of business (i.e., it is the things in which a business trades). Inventory may be bred or grown (such as livestock and agricultural produce), manufactured, purchased, or otherwise acquired (such as through a barter transaction). Inventory is not confined to finished goods. It includes goods in the process of production (i.e., work in process), and raw materials and supplies that are to be consumed directly or indirectly in the production of goods.

Inventory is not limited to tangible movable property. In particular circumstances, immovable or intangible property can be inventory. Generally, there is nothing in the intrinsic nature of any particular item that gives it the character of inventory. The same item may be

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[145]*See generally* Dale Chua, *Inventory Valuation, in* Tax Policy Handbook 139 (P. Shome ed. 1995).

[146]*See supra* sec. II(C)(2).

[147] In jurisdictions that rely on British legal concepts, inventory is commonly referred to as "trading stock."

[148]Singapore is an example of such a jurisdiction.

[149]*E.g.,* AUS ITAA (1997) § 70-10.

inventory in the hands of one person but not in the hands of another. For example, a motor vehicle may be inventory in the hands of a motor vehicle dealer but not in the hands of a person who purchases it from the dealer. In fact, a person may hold the same type of item in different capacities. For example, the private motor vehicle of a motor vehicle dealer will not be part of the inventory of the dealer, nor will a vehicle acquired to deliver parts or pick up customers.[150]

The system used to defer recognition of the cost of inventory will depend on whether the income tax system generally uses the receipts-and-outgoings method or the balance-sheet method to determine business income. There are two equivalent systems for measuring the cost of inventory in jurisdictions in which the receipts-and-outgoings method is used to calculate taxable business income. The simpler of the two systems is based on financial accounting principles.[151] In this case, a deduction is allowed for the cost of goods sold during the tax year calculated according to the following formula:

(Opening inventory + cost of purchases) - closing inventory.

An equivalent system used in some jurisdictions is to allow a deduction for the cost of inventory acquired during the tax year, followed by a re-inclusion in gross income of the value of closing inventory.[152] The re-included amount is the excess for the tax year of closing over opening inventory. Where opening inventory exceeds closing inventory, a deduction should be allowed for the excess to ensure that expenses incurred in prior years are recognized when stock is eventually sold.[153]

It should be provided that the value of closing inventory for a tax year becomes the value of opening inventory for the next tax year. Items included in inventory should follow the accounting rules for purchases and sales. Thus, if the taxpayer has recognized the cost of inventory that is not yet physically received, it should nevertheless be included in inventory, and, if the taxpayer has recognized income from the sale of inventory, it should not be included in inventory, even if physically on hand at the close of the year.

In many jurisdictions, taxpayers are able to value closing inventory at the lower of cost or market value. Thus, if the market value of inventory falls below its cost,[154] a taxpayer can recognize the loss in the tax year in which it occurs without actually disposing of the inventory. In some jurisdictions, taxpayers can also use the higher of market value and cost to value closing

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[150]It is possible that an asset may change status. For example, a motor vehicle dealer may take his or her private motor vehicle into inventory, or vice versa. The tax consequences of a change in status of an asset are discussed in sec. V(E)(1), below.

[151]*E.g.,* UGA ITA § 47.

[152]*E.g.,* AUS ITAA (1997) § 70-35.

[153]A variation on this approach applies in New Zealand where taxpayers are allowed a deduction for the cost of inventory and a deduction for the value of opening inventory, while the value of closing inventory is included in gross income. *See* NZL ITA §§ 85, 104.

[154]This may arise, for example, because of damage, deterioration, or obsolescence.

inventory, to bring forward recognition of gain prior to disposal.[155] There is no persuasive policy reason in favor of the latter concession, and it may be used for tax minimization or avoidance purposes by generating gains to offset losses that might not otherwise be recognized for tax purposes. Accordingly, while the choice between the lower of cost or market value may be incorporated into the inventory rules, a choice of higher cost or market value is not recommended.

In the ordinary case, closing inventory will be valued at cost. Two particular issues arise when valuation is based on cost: first, the identification of amounts included in the cost of inventory that is manufactured or constructed by the taxpayer; and second, the valuation of closing inventory where the cost of inventory has varied and it is not possible to trace individual items of stock.

The first issue with cost concerns the extent to which ancillary costs such as labor costs or factory overhead costs should be included in the cost of manufactured or constructed inventory. If such costs are included in the cost of manufactured or constructed inventory, they will not be recognized until the inventory is sold. Two basic models are used to determine the cost of manufactured or constructed inventory. Terminology differs from jurisdiction to jurisdiction, but the fundamental features of the two models are similar across tax systems. Under the simplest method—commonly known as the prime-cost method—the cost of inventory is the sum of direct material costs, direct labor costs, and variable factory overhead costs. Direct material costs are the cost of materials that become an integral part of the inventory produced. Direct labor costs are the costs of labor directly involved in the production of inventory. Variable factory overhead costs are those factory overhead costs that vary directly with the volume of production. Under the more complex method–the absorption-cost method–a percentage of fixed factory overhead costs (such as rent) is included in the cost of inventory. Where absorption costing is used, rules must be adopted to distinguish costs that are attributable to the inventory and costs that should be considered general overhead expenses (and are thus deductible without reference to the inventory provisions).[156]

Different rules may be adopted for cash-basis and accrual-basis taxpayers with respect to the amounts included in the cost of inventory. A cash-basis taxpayer may be allowed to determine the cost base of inventory using either the prime-cost or the absorption-cost method, while accrual-basis taxpayers are usually required to use the absorption-cost method.[157]

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[155]*E.g.,* AUS ITAA (1997) § 70-45; NZL ITA § 85(4).

[156]Ordinarily, general, administrative, and selling expenses are not included in the cost of inventory. *See, e.g.,* USA IRC 263A and the regulations thereunder (in 1986, the types of expenses required to be included in the cost of producing inventory were substantially broadened). As an economic matter, however, all costs incurred by a firm should ultimately be recovered as part of the cost of production, so that arguably all expenses of a firm should be allocated to costs of production. Such a rule would also be simpler to administer, because it would minimize the requirement to draw distinctions among different types of costs. *See* Victor Thuronyi, *Tax Reform for 1989 and Beyond,* 42 Tax Notes 981–96 (Feb. 20, 1989).

[157]*E.g.,* UGA ITA § 47(5).

The second issue that arises when valuation is based on cost relates to the identification of items of inventory that are on hand at the end of the tax year. This is necessary where the cost of acquiring, constructing, or manufacturing different units of inventory has varied. For unique products, businesses can trace the actual movement of stock and thus ascertain the exact cost of closing inventory. More commonly, businesses buy and sell generic stock, and there is no record of the movements of individual items. Thus, for inventory other than unique traceable stock, a presumptive tracing rule must be applied. While a number of variations are used in different jurisdictions, most fall into one of three inventory tracing methods, the first-in-first-out (FIFO), average-cost, or last-in-first-out (LIFO) system. Under the FIFO method, the cost of inventory on hand at the end of the tax year is determined on the assumption that items purchased or produced first are sold first, so that the items on hand at the end of the year are those last purchased or produced. Under the average-cost method, the cost of inventory on hand at the end of the tax year is determined by reference to the weighted-average cost of all items on hand at the beginning of the tax year and purchases during the year. Under the LIFO method, the cost of inventory on hand at the end of the tax year is determined on the assumption that items purchased last are sold first, so that items on hand at the end of the year are the earliest items purchased or produced. In a period of moderate inflation, the use of the LIFO method for valuing trading stock will provide taxpayers with a simple compensation for the effects of inflation on measuring profits.[158] However, the LIFO method is complex and results in undervaluation of inventory.[159]

5. Research and Development

The longevity of benefits derived as a result of expenditure on research and development is incapable of measurement at the time the expense is incurred. It may be presumed, however, that some long-term benefit is realized as a consequence of any research and development expense. For example, even if a research and development outlay yields no direct, relevant results, the expenditure may provide long-term benefits by narrowing down options and suggesting possible paths for other research initiatives.

Because it is not possible to estimate accurately the useful life of benefits resulting from research and development expenses, a hypothetical life must be adopted. In many jurisdictions, doubts about the longevity of benefits from research and development expenses are resolved in the taxpayer's favor through the use of relatively short amortization periods, or immediate deductions, for these outgoings.[160] Such treatment is also seen as a tax expenditure (i.e., tax concession) that encourages research and development.[161] An additional argument in favor of

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[158]Special rules for valuing closing inventory apply under comprehensive inflation adjustment systems. *See* vol. 1, ch. 13.

[159]*See* McLure et al., The Taxation of Income from Business and Capital in Colombia 239–40 (1990).

[160]*E.g.,* AUS ITAA (1936) § 73B (immediate deductions range from 100 percent to 125 percent of the relevant expenditure incurred); LSO ITA § 40 (immediate deduction); UGA ITA § 33 (immediate deduction); USA IRC § 174 (at the taxpayer’s election, research and experimental expenditures may be immediately deductible or amortized over five years).

[161]*See generally* Stanley S. Surrey & Paul R. McDaniel, Tax Expenditures 211–12 (1985).

allowing an immediate deduction for research and development costs is that it may be difficult to distinguish them from other general business expenses. There are, however, disadvantages to the use of an amortization period for research and development outgoings that is significantly shorter than the period applicable to other capital expenses. Most important, generous treatment of research and development expenses will lead to taxpayers recharacterizing expenses as research and development outlays to accelerate the deduction of these expenses. This may happen, for example, with equipment that is used both in manufacturing products and in developing new products. To limit the scope for recharacterization, it may be provided that research and development expenditure does not include the cost of acquiring a depreciable or intangible asset, the cost of acquiring land or buildings, or the expenditure incurred for the purpose of ascertaining the existence, location, extent, or quality of a natural deposit.

A possible hybrid approach is to prescribe a limited amortization period for research and development expenses and to allow an immediate deduction of that part of the expense that is attributable to any project or line of inquiry pursued by research if the project is abandoned without generating results.

V. Issues Relating to the Taxation of Assets

A number of issues arise in the design of the income tax as it applies to assets.[162] Some issues may be specific to particular classes of assets,[163] while others may be relevant to all assets. It is suggested that the asset rules be structured so that the rules common to all assets are included in a single regime of general application. These rules include those for determining the cost base of assets, realization and recognition rules, and rules for determining gain or loss on disposal. In systems based on the balance sheet, they will include rules for determining the balance-sheet value of assets. Specific rules for particular classes of assets can then build on these basic rules. This approach not only ensures that rules are provided for all assets, but also means that there is a fundamental consistency in the basic treatment of different classes of assets. An alternative approach in some countries is to provide detailed rules for a particular class of asset (such as investment assets), with much briefer rules provided for other assets. It is recommended that this approach be avoided.

A separate asset regime of general application is supplementary to the operation of the inclusion and deduction provisions in the law. It is not the purpose of the regime to bring amounts to tax or allow amounts as a deduction. Rather, its purpose is to elaborate the meaning of concepts used in the inclusion and deduction provisions. The main areas that can be dealt with in a separate asset regime are timing and calculation matters. The timing rules identify the tax year in which the inclusion and deduction provisions apply to an asset, and the calculation rules provide for the determination of the taxable or deductible amount. Depending on the asset, the taxable amount may be a gain calculated by subtracting the cost base of the asset from the consideration received for the asset, and the deductible amount may be a loss calculated by subtracting the consideration received for the asset from the cost base of the asset. In other cases, such as inventory, the taxable amount may be the consideration received, and the deductible amount may be the cost of the asset. In either case, the asset regime should provide for the determination of the cost base of, and consideration received for, assets.

The main matters that may be dealt with in a separate asset regime are discussed below.

A. Timing Rules for Realization of Gain or Loss

Ordinarily, gains or losses arising in relation to assets are taxed not as they accrue, but rather in the tax year in which the taxpayer realizes the gain or loss. In most cases, a gain or loss is realized at the time the taxpayer ceases to own the asset. While a taxpayer will normally cease to own an asset as a result of the sale of the asset, there are other ways in which this can occur

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[162]The concept of an asset is used in this discussion in preference to the concept of property that is used in some tax laws (*e.g.,* IDN IT § 4(1)d ("gains arising from the sale or transfer of property")). In its ordinary meaning, an asset is any thing that may be turned to account. Depending on general law meanings, the notion of property may not be interpreted this broadly. For example, legally enforceable rights that are purely personal in nature may not be regarded as property.

[163]For example, specific rules may apply to inventory, depreciated or amortized assets, and assets subject to capital gains taxation.

(e.g., as a result of an in-kind exchange, a gift, or a distribution of the asset). Thus, it is suggested that the concept of disposal, rather than a narrower concept like sale, be used to state the basic realization rule. In its ordinary meaning, disposal covers all situations in which the ownership of the asset changes. Even so, an extended definition of disposal will be necessary to cover all intended realization events in relation to assets, particularly those relating to intangible assets. The definition of disposal should include the redemption, expiry, cancellation, surrender, loss, or destruction of an asset. It should also be provided that the disposal of an asset includes a partial disposal. An example of a partial disposal is the sale of a lot that has been part of a single block of land that has been subdivided.

The disposal rules may also provide for gain or loss recognition where an asset that is outside the tax system is brought within the tax system, or vice versa. This can occur because a change in the taxpayer's circumstances changes the tax status of assets held by the taxpayer. For example, a nonresident taxpayer may become a resident taxpayer. If the new country of tax residence taxes worldwide income, then the change in residence may bring assets held by the taxpayer at the time of the change within the tax system of the new country residence (these assets previously being foreign assets of a nonresident). Alternatively, a resident taxpayer may become a nonresident taxpayer. The effect of the change may be to take some assets held by the taxpayer at the time of the change outside the tax system of the taxpayer's former country of tax residence (these assets now being foreign assets of a nonresident). A similar situation can arise where an exempt person becomes a taxpayer, or vice versa. This can happen as a result of a change either in the taxpayer's circumstances or in the law.

In these situations, there is no change in the ownership of the asset, and so there is no disposal in the ordinary meaning of the word. If an entry or exit from the tax system is to be treated as a realization event, then it will be necessary to include deemed-disposal rules to cover this situation.[164] Comprehensive deemed-disposal rules can be difficult to enforce and may not be necessary for developing or transition countries.[165] However, it will be necessary to include some such rules, particularly to prevent taxpayers from obtaining a tax deduction for what is essentially consumption expenditure (e.g., if a personal-use asset becomes a business asset, there should be a deemed disposal and reacquisition to ensure the decline in value due to personal use is not recognized for tax purposes). The effect of a deemed-disposal rule is to treat a particular event as giving rise to the disposal of an asset for a consideration equal to either the market value or the cost base of the asset at that time depending on the circumstances.[166] If relevant, the taxpayer will also be treated as having immediately reacquired the asset for the same consideration. This then becomes the new cost base of the asset for tax purposes.

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[164]Rather than artificially "deem" that a disposal has occurred when one has not, an alternative approach is to define the situations in which gains and losses are brought to account as taxation "events"—*see*, *e.g.*, AUS ITAA (1997), proposed Div. 104.

[165]It is suggested that this is the case for residence change situations. *See* ch. 18, sec. VI(E).

[166]Market value consideration will be recognized when an asset moves in or out of the tax system (*see supra* sec. V(A)), while consideration equal to cost will be recognized in most cases when an asset changes tax status (*see infra* sec. V(E)(1)).

B. Cost Base

The basic rule is that the cost base of an asset is the consideration given for the acquisition of the asset.[167] This should include any borrowed funds used to acquire the asset. Where the taxpayer has given consideration in kind for the asset, the market value of the in-kind consideration at the time of the acquisition should be included in the cost base of the asset. The cost base of an asset should include any ancillary costs incurred in the acquisition of the asset, such as legal and registration fees relating to transfer of the ownership of the asset, transfer taxes, agent's fees, installation costs, and start-up expenses to make the asset operational. The cost base of an asset should also include any capital expenditures incurred to improve the asset and expenses incurred in respect of initial repairs.[168]

When there is a partial disposal of an asset, it is necessary to provide rules to apportion part of the cost of the original asset to the part of the asset sold. For this purpose, the cost of the original asset should be apportioned by reference to the market values of the respective parts of the asset at the time the asset was originally acquired.[169] It may be difficult to apply this rule when an asset was acquired without contemplation of part disposal. The information may thus not be available at the time of disposal to apportion cost on the basis of market values of the respective parts of the asset at the time of acquisition. In this case, the original cost can be assumed to be allocated on a pro rata basis by reference to relative market values of the part sold and the part retained at the time of disposal.[170]

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[167]While much tax terminology is similar in different countries, this is not the case for "cost base" and its equivalents. It is in fact more than a difference in terminology, and has to do with differences in the structure of income tax laws. The United States has an underlying concept of "basis" (and adjusted basis) which is used throughout the income tax law for such purposes as computing capital gains or depreciation deductions (for example, the term adjusted basis is used more than 300 times in the Internal Revenue Code). The concept is defined in USA IRC §§ 1011–1016. Similarly, Australia has the concept of cost base of assets, which is defined in AUS ITAA (1936) § 160ZH, but this concept is not as pervasive in the tax law as is the American concept; it does not govern depreciation deductions, for example, which are determined according to the cost of plant. *See* ITAA (1997) §§ 42-60 to 42-90. The Canadian approach is similar. *See* CAN ITA § 54 (adjusted cost base). Most countries do not have a formal underlying concept of basis. They might refer to the cost or acquisition cost of assets in rules for determining capital gains. For example, the Spanish law refers to the acquisition value in its capital gains rules. *See* ESP IRPF § 46. France similarly refers to the acquisition price. *See* FRA CGI § 150 H. The United Kingdom uses the concept of cost both for capital gains purposes and for purposes of determining qualifying expenditure for depreciation purposes. On the other hand, Germany, like the United States, has an underlying concept for the valuation of assets, namely *Buchwert* (book value). The concept of *Buchwert* is used both for purposes of computing capital gains and for purposes of the balance-sheet method of determining taxable income (for which see Appendix *infra*). *See* DEU EStG §§ 6, 6b(2). In most cases, the *Buchwert* of an asset for purposes of German tax law will correspond to the concept of adjusted basis as used in U.S. tax law.

[168]*See infra* sec. IV(D)(3).

[169]*E.g.*, UGA ITA § 53(5).

[170]*E.g.*, AUS ITAA (1936) § 160ZI. Another approach, not recommended, is to allocate cost on a pro rata basis using features of the property sold, such as the size of a part of immovable property sold compared with the size of the part retained. Given that it is only by chance that there would have been a consistent movement in the market value of the respective parts of the asset since the original asset was acquired, this approach is likely to lead to inappropriate allocations of original cost.

A taxpayer may hold a number of assets of the same type. When the assets have been acquired for different costs, and the taxpayer disposes of only a part of his or her holdings of the asset, it will be necessary to know which asset or assets have been disposed of for the purposes of determining the cost of those assets. Ordinarily, outside of inventory, it should be possible to identify the particular asset or assets disposed of so that the actual cost of those assets is used. However, there may be some types of asset for which actual identification is not possible. Examples include shares of a company that is not obliged to use registration numbers and holdings of precious metals. For these assets, a presumptive tracing rule needs to be provided. While several possible tracing rules may apply when the asset is inventory,[171] an identification rule based on first-in-first-out is suggested for noninventory assets.

Cost-base rules should cover two special cases. The first case is where a taxpayer acquires an asset in circumstances in which the acquisition constitutes the derivation of an amount included in the taxpayer's gross income. For example, a taxpayer may be remunerated with an asset rather than with cash. In this case, the cost base of the asset should be the amount included in gross income plus any consideration given by the taxpayer for the asset. The purpose of this rule is to prevent double taxation.

The second case is where a taxpayer acquires an asset in circumstances where the acquisition of the asset is the derivation of exempt income. In this case, the cost of the asset should be the exempt amount plus any consideration given by the taxpayer for the asset. The purpose of this rule is to ensure that the exemption is not clawed back on a subsequent disposal of the asset.

C. Consideration Received

The basic rule is that the consideration received for the disposal of an asset is the price received for the asset, including the market value of any in-kind consideration. Where borrowed funds are included in the cost base of the asset, any relief from the debt by the transferee must be treated as part of the consideration received on disposal of the asset.

Where a taxpayer disposes of two or more assets for a single undissected consideration, it is necessary to provide for the apportionment of the consideration among the assets. For this purpose, the consideration received should be apportioned by reference to the market values of the assets disposed of as of the time of the disposal.

In some situations, the consideration for a disposal of an asset may be nominal or zero. For example, a taxpayer may give an asset (such as inventory) to a customer or a client as a sample or as part of a promotion. Where the parties are genuinely unrelated and the purpose of the dealing is not to shift value to some related, but tax-preferred transaction between the parties, the actual consideration received (if any) should be treated as the consideration for the disposal of the asset. The treatment of non-arm's-length transactions is discussed in section V(D), below.

[171] *See supra* sec. IV(C)(5).

The consideration rules must correspond to the notion of disposal that applies for the purposes of the law. For example, it was stated above that the notion of a disposal should extend to situations where an asset has been lost or destroyed. For these disposals, there may be no consideration received for the disposed asset, or the taxpayer may have received insurance proceeds or damages (see below).There are a number of different rules in different jurisdictions that apply in these circumstances. Often, however, these are explicable by reference to particular historical factors and are of little precedential value. In the absence of special circumstances, the simplest and fairest rule is to measure losses arising from such involuntary disposals by reference to the actual consideration received, if any. If no consideration is received, then the taxpayer will have incurred a loss on the disposal equal to the cost of the asset.

Where a taxpayer is subject to a deemed disposal in respect of assets moving in or out of the tax system, a market value rule should apply to the disposal. This means that the taxpayer is treated as having disposed of the assets for their market value at the time of the deemed disposal and to have immediately reacquired them for the same amount. This ensures that only the gain or loss arising while the asset is within the tax system is recognized.

Special rules may be needed for compensation (such as insurance proceeds or damage awards) received in relation to assets. Where compensation is received in respect of the loss or destruction of an asset, the amount should be treated as the consideration received for the disposal constituted by the loss or destruction of the asset. For this purpose, it is necessary to ensure that the definition of consideration received is drafted broadly so as to cover such amounts.

Compensation may also be received for damage to an asset where the asset has not been lost or destroyed. If the amount of the compensation equals the cost of repairs (e.g., fixing the car after an accident), then no gain should be recognized in relation to the compensation amount. Where the compensation offsets damage that cannot be repaired, it should be recognized through a reduction in the cost base of the asset.

D. Non-Arm's-Length Transfers

In the absence of prophylactic measures to control the amount of cost and consideration for tax purposes, related parties may choose transfer prices in the hope of achieving a variety of tax objectives—minimizing recognition of gain to defer taxes, inflating gains to absorb losses that were carried forward, value shifting to transfer gains to a lower bracket or exempt taxpayer, and so forth. Objectives unrelated to taxation, too, may also influence transfer values. For example, taxpayers may wish to shift value to improve their balance sheet for the purpose of obtaining debt finance.

To prevent manipulation of transfer prices, rules for determining the deemed market value consideration are needed for non-arm's-length transactions. In broad terms, an arm’s-length transaction is a transaction in which the parties act completely independently of each other and seek to put their own interest first. A transaction between related parties would be presumed to be a non-arm’s-length transaction because one or both parties may be willing to subordinate their own interest to that of the other party or a related third person for the purpose of achieving an overall tax saving. However, this is only a presumption because related parties can enter into a transaction on arm's-length terms. The nature of the transaction is usually tested by reference to the price that would be expected if unrelated parties entered into the transaction.

Non-arm's-length transactions require complementary deeming rules. The person disposing of an asset in a non-arm's-length transaction should be treated as having received consideration for the disposal equal to the market value of the asset at the time of the disposal. The same amount should then be treated as the cost base of the asset for the person acquiring the asset.

While gifts are usually non-arm's-length transfers, they raise special conceptual issues. Genuine gifts occur most commonly within families; most "gifts" outside the family involve some sort of quid pro quo. The case for treating gifts in the same manner as other non-arm's-length transactions (i.e., as a disposal for a deemed market value consideration) is strong. Any other treatment introduces inefficiencies and inequities by distinguishing between persons who dispose of property or services for arm's-length consideration and make a gift of the proceeds and those who provide the property or services directly.

The argument commonly raised against deemed market value consideration in respect of gifts is the alleged liquidity problem faced by the donor. Often, the lack of liquidity is at the choice of the donor, given that the donor could have disposed of the property at market value. A secondary argument focuses on the alleged valuation difficulties encountered in a transfer for no consideration. The problem is no greater than that encountered in any non-arm's-length transfer, however, and tax administrators can apply to gift transactions the expertise developed to value all other non-arm's-length transactions.

Similar issues apply to testamentary gifts. While it seems intuitively inappropriate to treat the taxpayer who makes a gift of property differently from the taxpayer whose property transfers on death, a distinction between inter vivos and testamentary gifts is not unusual. Often, jurisdictions that provide a deferral in respect of testamentary transfers impose death duties or similar taxes, and it may be thought that liquidity problems could be exacerbated as a result of the two tax liabilities. Similar treatment of inter vivos and testamentary gifts is desirable, however, in light of the inequities that would follow from a complete exemption from recognition of accrued gains on death (by means of a cost-base step-up for recipients of property) and the economic lock-in inefficiencies that would follow from a deferral of recognition (by means of a cost-base rollover for the recipient). Liquidity problems, if any, can be addressed through, for example, installment payments of tax subject to ordinary finance charges.

E. Nonrecognition Rules

There may be situations in which a taxpayer has realized a gain or a loss on disposal of an asset, but recognition of the gain is deferred until a later event occurs. Similar deferral may apply when property changes its tax status. In some jurisdictions, these nonrecognition rules are referred to as providing rollover treatment. The tax position of a taxpayer or asset is rolled over into another taxpayer or asset, as the case may be. This is done by deeming the taxpayer to have disposed of relevant property for consideration equal to its cost and to have reacquired the property (if there has been no actual disposal of assets) or to have acquired replacement property for consideration equal to the original cost.

Tax laws commonly provide for rollover treatment in four types of situations, described below.

1. Changes in the Tax Status of Assets

An asset can change its tax status in a number of ways. For example, a trader may take some stock from inventory for personal use or consumption (or vice versa, although this is much less common). An item of inventory can also become a business asset of another type, such as depreciable or amortizable property, or vice versa. Similarly, property acquired as business assets or inventory may subsequently be held as an investment asset, or vice versa,[172] and in some cases may thus be subject to different tax rules.

Rollover treatment, which can be applied to most changes of tax status, is the equivalent of saying that the asset was originally acquired for its ultimate use, and so the interim period in which the asset was held for some other use is thus ignored. A deemed disposal for cost will normally lead to no gain or loss recognition. For example, if an item of inventory is removed for personal consumption by the taxpayer, the taxpayer will be treated as having disposed of the stock at the time it was taken out of inventory for cost,[173] which will offset the deduction obtained for the cost of inventory. Some systems (e.g., Germany), however, treat a withdrawal of assets from business use as a disposal for market value.[174]

A special rule is needed when a personal-use asset that would be depreciable property if it were a business asset is converted to a business asset. If rollover treatment were applied in this case, the taxpayer would be able to recognize some personal consumption costs for tax purposes. For example, if a taxpayer converted a machine from personal-use property to inventory, the decline in value due to personal use could be recognized as a loss if the property were rolled over at cost. Such conversions should be treated as disposals for market value.

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[172]This possibility can be confined to individuals carrying on a business, because all assets of a company or partnership should be deemed to be business assets. *See supra* sec. II(B)(2).

[173]*E.g.,* AUS ITAA (1997) § 70-110.

[174]This approach corresponds to the deemed disposal on conversion of assets to business assets–*see supra* sec. IV (A).

2. Disposals Intended to Trigger a Loss

While the income tax system tends to recognize gains and losses only when there is a disposal of an asset or a prescribed tax event giving rise to a deemed disposal, the value of assets changes continuously. The realization event aspect of the income tax system can provide taxpayers with opportunities to reduce tax liability by accelerating recognition of losses on assets that have declined in value while deferring recognition of gains on assets that have appreciated over the same period. If the disposals are genuine market transactions to unrelated parties, the losses will normally be recognized for tax purposes. In some cases, loss recognition will be denied, however, and rollover treatment will be imposed.

The first loss situation in which rollover treatment is prescribed is for below-cost transfers to related persons, even if the price reflects market value. Losses are generated even though the asset continues to be owned by the same group of companies or the same family. To prevent such artificial generation of a loss, the transferor should be treated as having disposed of the property at cost, and the transferee should be treated as having acquired the asset for the same amount. This preserves the accrued loss, which will be realized when the transferee eventually sells the asset outside the group or family.

The second loss situation in which rollover treatment is prescribed is for "wash sale" situations. A wash sale is when a taxpayer disposes of an asset that has declined in value and immediately thereafter acquires the same or a similar asset. The transaction costs may be minimal compared with the tax savings resulting from the realized loss. The effectiveness of such transactions can be avoided by prescribing rollover treatment to wash sales that involve the taxpayer’s reacquisition of the asset within a designated period.

3. Involuntary Disposals

A nonrecognition rule may apply to an involuntary disposal of an asset when a replacement asset has been acquired. Examples of involuntary disposals to which this rule may apply are the loss or destruction of an asset (e.g., through fire or theft) and the compulsory acquisition of an asset by a government authority. There are usually two conditions to the application of the nonrecognition rule. The first condition is that the proceeds of the disposal (such as insurance proceeds) must be used to acquire a replacement asset of a kind similar to the disposed asset. The second condition is that the replacement asset is acquired within a specified time of the involuntary disposal, say, one year. The nonrecognition rule should apply only to the extent that the proceeds of the involuntary disposal are used to acquire the replacement asset. If the proceeds of the involuntary disposal exceed the cost of the replacement asset, then the excess of the proceeds over the cost of the replacement asset should be recognized as a taxable gain arising from the involuntary disposal. Where the nonrecognition rule applies, the cost of the replacement asset is the cost of the involuntarily disposed of asset plus the amount (if any) by which the consideration given for the replacement asset exceeds the consideration received on the involuntary disposal. The nonrecognition rule that applies to involuntary disposals is illustrated by the following example:

Example

A taxpayer owns an office building that cost $1,000,000. The building is destroyed by fire. The taxpayer receives $1,500,000 under an insurance policy, which is wholly used to acquire a replacement office building. Under the nonrecognition rule, no gain or loss is taken into account on disposal of the building to the extent that the insurance proceeds of the disposal are used to acquire the replacement building. The tax cost of the replacement building is $1,000,000—that is, the cost of the destroyed building at the date of its destruction. This means that recognition of a $500,000 gain made by the taxpayer on disposal of the destroyed building is deferred until the taxpayer disposes of the replacement building.

If the actual cost of the replacement building was $1,600,000, then the tax cost of the replacement building would be $1,100,000 (the cost of the destroyed building plus $100,000 paid by the taxpayer for the replacement building in addition to the insurance proceeds). Recognition of a $500,000 gain made by the taxpayer on disposal of the destroyed building is still deferred until the taxpayer disposes of the replacement building.

If the replacement building had actually cost $1,400,000, then the cost of the replacement building would still be $1,000,000, but the difference between the insurance proceeds and the cost of the replacement building ($100,000) would be included in the taxpayers's business income. This is because this part of the insurance proceeds has not been used to acquire the replacement building. Recognition of the other $400,000 of gain in relation to the involuntary disposal is deferred until the taxpayer disposes of the replacement building.

4. Spousal Transfers

A nonrecognition rollover may be provided to facilitate the transfer of assets between spouses (or former spouses) on the breakdown of a marriage. The transferee spouse takes over the original cost of the asset so that recognition of any gain or loss that has accrued prior to the transfer is deferred until a subsequent disposal of the asset by the transferee spouse.

F. Transitional Basis for Assets Previously Outside the Tax Base

The reform of income tax legislation often brings into the tax base gains on assets that were not previously subject to income taxation. To avoid the retrospective application of the tax law, transitional measures should prevent or at least minimize the taxation of gains that have accrued prior to the introduction of the new tax. From a theoretical perspective, the ideal rule is one that sets the cost of assets previously outside the tax base as their market value at the time the new tax reform comes into effect. To prevent market confusion and potential disruption between the unveiling of the new tax rules and their effective date, some jurisdictions that have expanded the tax base in this manner have used the market value as of the time the new measures were unveiled or shortly before.

A rule based on market value when the tax base is broadened is feasible only if market value information is readily available at that time and accessible, when there is an eventual disposal of the property. Experience in industrial countries that have adopted this approach shows that few difficulties emerge when this rule is applied to "publicly listed assets," such as publicly traded shares or precious metals, or to assets included in data bases that can be used to estimate closely the value of an asset at the time of tax reform. An example of the latter is real estate where property records will show the sale price of neighboring properties sold around the time of the tax reform. However, valuation is a prime source of dispute and litigation in the case of assets involving intangible elements such as goodwill (e.g., businesses or shares in private companies). In industrial countries, these values are normally determined by financial indicators, such as comparable rates of return in similar businesses. In developing and transition countries, it is more appropriate to use a surrogate measure of value when the tax base is broadened. The simplest rule for assets acquired prior to tax reform is to deem cost to be the original cost adjusted by a factor such as inflation adjustment. Even this surrogate measurement may be difficult to apply in some cases, for example, when assets have been acquired long before tax reform or through inheritance.

One country attempted to broaden its tax base by introducing measures on a prospective basis so that they applied only to assets acquired after a certain date.[175] This approach is not recommended because it creates arbitrary differences in the treatment of assets depending on when they are acquired. These differences encourage taxpayers to enter into transactions to shift value from taxed to untaxed assets. Further, this approach creates a lock-in effect in that persons holding assets acquired before the relevant date are encouraged to hold onto them.

VI. Special Regimes

A. Interest Income and Expenses

It is common for tax legislation to contain special rules for interest income and expenses. As discussed in section III(B), it is usual to define interest broadly to ensure that amounts functionally equivalent to interest (such as discounts and premiums) are treated as interest for tax purposes.

It is necessary to include special timing rules in relation to interest. These rules serve two purposes. First, they ensure that the different amounts within the broad definition of interest (such as discounts and premiums) are subject to the same recognition rules. In the absence of special accounting rules, it might be possible for a taxpayer to recognize a gain relating to a discount or premium when the gain is realized—that is, upon redemption or repayment of the loan. Thus, even if the discount or premium is taxed as interest, the recipient may still enjoy a significant deferral advantage over ordinary interest. Special accounting rules are needed to

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[175]AUS ITAA (1936) § 160L.

deem the recipient to derive the gain represented by a discount or premium as if it were compound interest derived over the life of the loan.[176]

Second, special rules are necessary to prevent taxpayers from taking advantage of timing mismatches that can arise in accounting for the various forms of interest. For example, a mismatch can arise when a financial institution issues a security to an individual under which the payment of interest is deferred for, say, five years. In the absence of special rules, the financial institution may be permitted to deduct the interest expense as it accrues, while the individual accounts for the interest income when it is paid (under cash-basis accounting). To avoid such mismatches, it may be provided that both the lender and the borrower must account for interest income on an accrual basis, regardless of the taxpayer's general method of accounting. An exception may be provided if the interest is subject to withholding tax. Both the lender and borrower may be required in this case to account for the interest on a cash basis.[177]

Limitations on the deduction of interest expenses may be desirable for a number of reasons. In principle, like other expenses incurred to derive business income, interest expenses should be deductible in full. However, restrictions on interest expenses may be used

- to prevent taxpayers from exploiting the full deductibility of interest in periods of high inflation;
- to prevent taxpayers, particularly foreign taxpayers, from exploiting different tax rates on interest and dividends; and
- to prevent taxpayers from exploiting differences in the treatment of interest and capital gains.

Finally, in common law jurisdictions in particular, special rules may be needed to prevent taxpayers from exploiting the different treatment of "blended" payment loans and annuities.[178]

1. Inflation Benefits

In the absence of special rules on interest deductibility, taxpayers who borrow in a high-inflation environment may derive a significant tax advantage from debt financing. Most of what is nominally interest expense may in fact be repayment of a portion of the loan.[179] A system of

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[176]AUS ITAA (1936) §§ 159GP–159GZ; CAN ITA § 12(3), (4), and (9); ESP § 37 Uno 2(A) (rendimientos implicitos); but see, to the contrary, FRA CGI § 125-0 A (capitalized interest taxed only at the time of the expiration (*dénouement*) of the contract, so that the taxpayer has a timing advantage in capitalizing the interest).

[177]Some countries do attempt to apply accrual tax rules although the payment of interest is subject to withholding tax. When payment of interest is deferred by capitalizing it into discounts, premiums, or other forms of capital gains, the rules on withholding tax should provide that the tax becomes due by the payor on any portion of the gain, premium, or discount that has accrued during the taxable period. In such cases, withholding tax is to be paid on an annual basis before effective payment of the income. *See further* BEL CIR § § 19 (3), 267.

[178]*See supra* sec. III(A).

[179]*See* vol. 1, ch. 13, sec. IV(A).

global inflation adjustment can be used to address this problem.[180] However, because most countries will not adopt such a system, partial adjustment for interest could be considered, although the case for inflation adjustment of interest expense is not appreciably stronger than the case for inflation adjustment of the cost of inventory, depreciable assets, and other property. Nor is there a reason why inflation adjustment rules (or surrogate rules) imposed on borrowers paying interest expenses should not apply equally to lenders deriving interest income. Selective recognition of the effects of inflation on only one element of the business income equation will introduce new and potentially more significant distortions into the income tax system. This fact should be kept in mind when proposals for adjusting allowable deductions for interest expenses are evaluated.

2. Thin Capitalization

If the domestic company and shareholder income tax regime is based on a classical tax system, comprising separate taxation of company income and distributions to shareholders, there will be an incentive for taxpayers to invest by way of debt instead of equity. Distributions are thus deductible to the company and are taxed only once in the hands of investors. Extensive reliance on debt financing is known as thin capitalization.

Adoption of a partial imputation system reduces the incentive to recharacterize equity as debt and dividends as interest payments. Adoption of full imputation almost eliminates the distortion in respect of domestic shareholders, provided both dividends and interest are subject to similar tax treatment. If interest is subject to a different regime, such as low domestic withholding tax, shareholders in companies deriving income that will not carry imputation credits are likely to structure their investment as debt in order to convert their returns to interest.

Unless imputation is extended fully to all foreign shareholders, an incentive to engage in thin capitalization will remain for these taxpayers. Even then, a bias toward debt investment will exist if the final tax imposed on interest income is different from that imposed on dividends, as is often the case.[181] Alternative solutions to the problem of thin capitalization as applied to foreign shareholders are discussed in chapter 18.[182]

If rules designed to counter thin capitalization arrangements are to apply to all shareholders, they are best located in the statutory provisions applicable to companies. If the rules are to apply only to foreign shareholders, they can be included with other international tax measures. Thin capitalization rules can also be used in lieu of explicit inflation adjustment of interest expense, which may be considered too complicated to apply. In this case, the rules should apply to the deduction of all interest expenses.

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[180]*See* vol. 1, ch. 13, sec. IV(D).

[181]For example, lower rates of tax on interest, including zero rates, may be prescribed by treaty.

[182]*See infra* ch. 18, sec. (V)(G)(2).

3. Interest Quarantining

A problem confronted in many tax systems is the difficulty of matching interest expenses to corresponding income attributable to those interest expenses. Interest is generally deductible as incurred, while income is recognized as derived. Taxpayers may enjoy considerable tax benefits if they may deduct interest outgoings in the period before the years in which the resultant gains are taxed. The benefits are increased if the income qualifies for a preference—such as partial exemption, special rates, or inflation adjustment—while nominal interest is deductible in full against nonpreference income subject to ordinary rates of tax.

In some cases, it is relatively easy to identify the period of deferral of income. For example, an investment asset may yield no current income, its entire return taking the form of capital gains that will be taxed when they are realized. Another case is when interest expense is incurred to finance the construction of property, such as heavy equipment, a public utility plant, or a building. In this case, because of the passage of time, the taxpayer expects the finished project to be worth at least as much as the incurred costs plus interest on those costs up to the time the property is placed in service or sold.

Other cases of deferral may be more difficult to identify. For example, a taxpayer may acquire immovable property for the dual purposes of using it as business premises and deriving business income during the period of occupancy and of realizing a further gain upon disposal. Alternatively, a taxpayer may acquire property for the dual purposes of deriving rental income during the lease period and deriving a further gain when the property is sold at the expiration of the lease term. In these cases, the property is generating income that is currently taxed, but there is also an element of appreciation in value that will not be taxed until the gain is realized.

Two measures can be used to minimize the mismatch of interest deductions and consequent income. First, interest incurred in respect of the acquisition or construction of property before the property generates income can be capitalized into the cost base of the property. Second, quarantine rules can be applied to interest incurred to derive dual- element income, such as rent or business income and capital gain. Because investment income is most likely to involve dual elements, it is common to restrict quarantining rules to this type of income. Normally, quarantining will limit interest deductions that are incurred to derive investment income to the amount of investment income derived during the taxable year, with an indefinite carryover of undeducted interest. When taxpayers carry on business in a personal (not incorporated) capacity, it will be necessary to separate business credit from personal credit[183] Some countries, in principle, still permit unlimited deductions of interest even on personal loans,[184] which result in a considerable loss of revenue.

B. Finance Leases

[183]BEL CIR art. 14; CAN ITA § 20(1)(c); FRA CGI art. 31/1 (d); USA IRC § 25. The United States provision is considered by some commentators to be excessively complicated.

[184]*See* NLD WIB § 45/1 f, with some limitations in arts. 45/3 and 5; CHE: LIFD § 33(1)(a).

A lease is an agreement under which the owner of an asset (the lessor) grants another person (the lessee) the right to use the asset for a stated period. As consideration for the right, the lessee agrees to make rental payments to the lessor. At all times, the legal ownership of the asset remains with the lessor. The commercial accounting treatment of a lease and its tax treatment will depend on whether the lease is a "finance lease" or an "operating lease."

A finance lease[185] is an arrangement that is legally structured as a lease, but has the same economic effect as a sale on credit and purchase of the leased asset. Thus, under a finance lease, the lessor effectively transfers the benefits and risks of ownership of the leased asset to the lessee while retaining legal title in the asset. An operating lease is one in which the legal and economic ownership of the leased asset remains with the lessor so that the lease payments are genuinely for the use of the leased asset.

Under tax law, three broad approaches to the use of finance leases are adopted. One approach is to give effect to legal form, so that all leases are effectively treated as operating leases for tax purposes. This means that the lessor would be treated as the owner of the leased asset and thus the person entitled to claim depreciation and other deductions relating to ownership. The rental payments are treated as income of the lessor and a deductible expense of the lessee.[186]

The other two methods broadly accord with commercial accounting treatment of finance leases. In contrast to the strict legal approach, commercial accounting rules recognize the economic reality of a finance lease by treating it as a sale and purchase of the leased asset. Thus, the lessee (not the lessor) is treated as the owner of the asset, which is entered into the lessee's books as an asset of that taxpayer. The lessor is shown for accounting purposes as having made a loan to the lessee, the rental payments being treated as payments of principal and interest on the loan.

Treating a finance lease for tax purposes in the same way as other leases gave rise to arrangements under which such a lease could be used to transfer tax benefits from a person who could not use them to a taxpayer who could. Consider, for example, a person who wishes to acquire an item of substantial plant. The person does not have sufficient funds to self-finance the acquisition and will thus need to borrow. In the ordinary case, the person will be able to deduct the interest expense and claim depreciation deductions in relation to the cost of the asset. Suppose, however, that the person is not in a position to use these deductions, or at least not immediately. The person may not expect to earn enough income for several years to take advantage of the deductions, so that the benefit of the deductions is deferred. Alternatively, the person may be a tax-exempt entity, such as a government instrumentality, which cannot utilize the deductions at all. Another possibility, particularly in developing and transition countries, is that the person may be entitled to a tax holiday, and so, again, cannot use the deductions. In these cases, arrangements can be entered into whereby a financier acquires the asset and leases it to the

[185]The term finance lease is commonly used in tax literature. Commercial accounting rules use the term capital lease.

[186]*See* Gustav Lindencrona & Stephan Tolstoy, International Fiscal Association General Report, *Taxation of Cross Border Leasing* 21, 30 (75a Cahiers de droit fiscal *international*) (1990).

person under a finance lease. Because the financier is the legal owner of the asset, it is entitled to claim deductions related to ownership. The effect of the finance lease is to transfer the tax benefits associated with ownership to the financier, although, through the terms of the lease, the economic benefits and obligations are with the lessee. The availability of the tax benefits means that the financier is able to provide the lessee with a lower cost of funds. The arrangement, however, is detrimental to the revenue because it results in the full utilization of what would otherwise be unused tax benefits.

Tax law treatment of finance leases in a manner similar to accounting treatment can be accomplished in two ways. In some jurisdictions, courts will use general interpretation principles to read the tax law as giving effect to the underlying economic form of a lease, not its apparent legal form. In others, the tax law has been drafted to achieve this result explicitly.[187] It is recommended that this approach be adopted in developing and transition countries.

Tax laws drafted to achieve a result similar to commercial accounting practice should make it clear that for tax purposes, the arrangement is treated as a sale on credit from the lessor to the lessee, and so the lessee is treated as the owner of the property and the lessor as a financier. The deemed purchase price is the present value of the rental payments to be made under the lease, and the price is treated as financed through a loan from the lessor to the lessee. Each payment the lessee makes under the lease is treated as a repayment of principal and interest under the loan. The interest component is calculated according to actuarial methods on the principal outstanding at the commencement of each payment period, with the balance of the payment treated as repayment of the principal.[188] The interest component of each payment is treated as an interest expense of the lessee and interest income of the lessor.

The central issue is the determination of whether a lease is a finance lease. It is suggested that several alternative tests based on commercial accounting rules be prescribed. The essence of these tests is to identify cases where economic ownership of an asset effectively passes to the lessee. Under these tests, a lease will be treated as a finance lease if any of the following circumstances is present:

- The term of the lease (including any period under an option to renew) is equal to or greater than 75 percent of the estimated economic life of the leased asset.

- The lease contains an option to purchase the leased asset at end of the lease for a fixed or determinable price.
- The estimated residual value of the property to the lessor at the end of the lease term is less than 20 percent of its fair market value at the commencement of the lease.

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[187]*E.g.*, CAN Income Tax Regulation 1100(1.1); LSO ITA § 68; UGA ITA § 60.

[188]*See supra* sec. III(A).

- The present value of minimum[189] lease payments equals or exceeds 90 percent of the fair market value of the asset at the commencement of the lease term.
- The leased property is custom-made for the lessee and, at the end of the lease term, will have little or no value to anyone other than the lessee.

C. Capital Gains

While the concepts of capital gains, their historical basis, and the terminology used vary from jurisdiction to jurisdiction, distinctions between capital gains and other gains are common. In many countries, capital gains (or certain categories of gains) are treated preferentially for tax purposes. Preferences may include lower rates, partial or even complete exemptions, averaging, and inflation adjustment that are not available for other gains.[190]

Even when capital gains are fully taxable in the same manner as other income, the distinction is often retained for the purpose of quarantining capital losses against capital gains. Quarantining is necessary because capital gains are taxed on a realization basis. In the absence of quarantining, taxpayers can defer the recognition of gains and accelerate the recognition of losses to reduce taxes payable on other income.

In some jurisdictions, the concept of a capital gain is legislatively defined, while in others (for the most part the United Kingdom and former U.K. colonies), it is largely a judicial concept defined by tests set out in case law. In former U.K. colonies, in particular, great care must be taken when drafting the definition of capital gains. One problem almost unique to these jurisdictions arises from the fact that the flexibility of property and contract law enables taxpayers to engineer many transactions to give rise to gains that would be characterized by the courts in some of the jurisdictions as capital gains under the governing judicial concepts and thereby excluded from the ordinary income tax base. Because these gains are not generated by disposals of property as those are normally understood, they can be brought into capital gains provisions only with terribly complex deeming provisions. A far simpler approach is to modify the definition of income to ensure that these gains are included in the tax base.[191]

In many jurisdictions, all gains derived from the disposal of assets by legal persons and from the disposal of business assets are treated as ordinary business income.[192] Under this

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[189]The term “minimum lease payments” is intended to include regular “rental” payments plus any supplemental mandatory payments (e.g., the amount of a lessee guarantee of residual value).

[190]*See* generally John King, *Taxation of Capital Gains*, *in* Tax Policy Handbook 155 (P. Shome ed. 1995).

[191]Australia provides an excellent example of the problems that can be encountered if capital gains provisions are used to catch gains that fall outside the judicial income tax base, such as payments for entering into negative covenant (noncompetition) agreements and payments for agreeing not to pursue contractual rights. In Australia, this was first attempted by resort to complex and highly artificial deeming provisions. The courts rejected them as virtually meaningless. A second, and more complex, redraft was needed. Rather than simply adding these gains to the ordinary income tax base, the government now proposes to replace the artificial deeming provisions with legislation defining capital gains "events."

[192]Examples include many European jurisdictions.

approach, capital gains derived in the context of a business are not subject to any preferences that may be available to individuals deriving capital gains on investment portfolios. Exceptions may be made for disposals involving the liquidation of the business, which may be taxed preferentially.

There is a large body of literature debating whether capital gains should be given preferred treatment or taxed at all, and it does not seem useful to repeat the arguments here. Any distinction between capital gains and other gains will of course involve definition problems. Long experience in OECD countries suggests that a completely satisfactory definition cannot be found. Inevitably, taxpayers alter their behaviour to exploit tax concessions in ways not originally intended by the legislation. Transactions are altered to recharacterize income not subject to the concession as gains that do qualify for special treatment. This, in turn, leads to calls for complex antiavoidance provisions, to considerable litigation, and to significant dead-weight losses from energies diverted to tax planning.

At the same time, in the context of limited administrative capacity in developing countries, there are persuasive arguments for excluding from the tax base many types of capital gains and losses derived by individuals. Because capital gains and losses may accrue over many years and are generally recognized on a realization basis, taxpayers may not have maintained adequate records for calculating the amount of the gain or loss. For this reason, and coupled with notorious difficulties of enforcement, it may be appropriate to exclude from the tax base most capital gains realized and losses suffered by individuals, apart from gains and losses attributable to assets, such as shares and other financial investments and immovable property. Other exclusions are desirable for tax policy reasons. Thus, for example, losses on personal-use assets such as cars and appliances whose value declines as a result of use should be excluded to ensure that taxpayers are not able to recognize capital losses on what is essentially personal consumption.[193]

The drafting approach adopted to achieve exclusion of these gains or losses will depend on the general drafting structure; whether a jurisdiction is based on a schedular or a global model; whether the background or judicial concept of income would otherwise include these gains or losses; and, if the jurisdiction uses a global income tax system, whether global taxation is achieved by means of separate inclusions for employment, business, and investment income. If the exclusions are to be legislated through a specific exclusion measure, that provision can refer to all nonbusiness assets owned by physical persons apart from listed assets (which would then include intangible property and immovable property). An alternative approach is to exclude personal-use property other than immovable property, with personal-use property defined as property acquired primarily for the personal use and enjoyment of a physical person or his or her family.

[193]Examples of jurisdictions with exemptions for these assets include Australia and Canada.

D. Farming Income

It is not unusual for jurisdictions to provide special rules for determining farming income, because of, in addition to political considerations

- the possibility that farmers will not retain business records in the same format as other businesses;
- the practical difficulties in auditing farmers;
- the difficulties of valuing farm produce and livestock inventory; and
- the fact that farmers are more likely than other business persons to take items out of inventory for family consumption.

An important consideration in the design of the farming tax regime will be the administrative capabilities of tax authorities. In developing countries in particular, surrogate measures of income using presumptive criteria may be the most efficient method of determining tax liability,[194] at the potential cost of some equity.

Special rules will also be needed to deal with consumption of a farmer's own produce. Several competing policies must be considered in this situation. It is arguable on equity and efficiency grounds that consumption of self-produced inventory should be treated as a disposal at market value. This policy would achieve equity between taxpayers who sell their produce to purchase other types of food in the market and those who consume their own produce. It would also eliminate a distortion in favor of consuming one's own goods as opposed to participating in the market. At the same time, however, it is true that persons other than farmers are able to produce foodstuffs for themselves without tax consequences. If the same treatment were accorded to farmers, it would be necessary to distinguish inventory from production intended for personal use. Also, it could be argued that farmers, by virtue of their knowledge of the industry, could purchase produce for a value much lower than the market price faced by other taxpayers.

These problems are most easily resolved by treating consumption of inventory as a disposal at cost instead of at market value or, equivalently, by disallowing a deduction for the cost of self-consumed produce.

E Non–Life Insurance Companies

Under a short-term[195] insurance contract, the insured person will pay a premium to the insurer as consideration for the insurer, upon the happening of a specified event within a given time, paying to the insured or a nominated person either an agreed sum or the amount of the loss caused by the event. The period of cover under the insurance contract is usually one year, after which the insurance contract is simply renewed. Depending on the sophistication of the local

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[194]*See* vol. 1, ch. 12.

[195]Short-term insurance as used here includes property and casualty insurance and term life insurance, provided the term of insurance is not beyond one year or so. Life insurance with longer terms raises other issues that are beyond the scope of this book.

non–life insurance market, insurable risks may be limited to loss of property or may extend to virtually any risk other than loss of life.

The taxable income arising from short-term insurance activities is generally calculated in the same way as the taxable income arising from other business activities, with premiums derived included in gross income and claims incurred allowed as a deduction. However, three features of short-term insurance activities may justify special tax treatment. These are discussed below.

1. Income-Recognition Rules

Income-recognition rules must take into account that some part of the premiums received during a tax period will cover risks for a period after the end of that year (referred to as “unexpired risks”). This is because, in many cases, the period of the insurance policy will not coincide with the insurance company’s tax year. The accounting practice is for insurance companies to treat a portion of their short-term insurance premium income received during a year as relating to unexpired risks as of the end of the year. This amount is not regarded as having been earned until the following year and, therefore, is excluded from their income for that year and included in income in the following year. A similar approach may apply for tax purposes. This may be an aspect of the accrual tax accounting rules,[196] or a specific deductible allowance may be provided for premiums in respect of unexpired risks (with a re-inclusion rule for the following year).[197]

2. Deduction-Recognition Rules

On the expense side, deduction-recognition rules must take into account the three types of claims that may arise during a tax year for a company carrying on a short-term insurance business. The first type of claim is one that arises and is paid out during the tax year. This is allowed as a deductible expenditure of the company. The second type of claim is one that arises during the year, but that has not been paid out as of the end of the tax year. This type of claim is also allowed as a deduction under accrual tax accounting on the basis that the obligation to pay has arisen during the tax year. The amount of deduction is based on established insurance practice for assessing the likely amount payable on a claim. The third type of claim is one that is unreported as of the end of the tax year; it relates to an event that has occurred during the tax year but that has not been reported to the insurance company, either because a third party has not made a claim against the insured or because the insured has not reported the claim or the happening of the event. This type of claim may also be allowed as a deduction under accrual tax accounting on the basis that the happening of the event crystallizes the liability of the insurance company to pay, even though the claim has not yet been reported to the company.

3. Contingency Reserves

[196]Premiums paid in respect of unexpired risks may be treated as unearned income.

[197]E.g., UGA ITA § 17 and fourth sched.; ZAF ITA § 28(2); ZMB ITA §25 and third schedule.

For financial accounting purposes, companies carrying on short-term insurance retain a contingency reserve to meet the exceptional level of claims that may arise from a catastrophe. It is not recommended that a deduction for tax purposes be allowed on the basis of the creation of a contingency reserve for financial accounts purposes. As noted in section II(B)(1), reserves are used in financial accounting to provide an accurate picture of the long-term profitability of a business. Tax accounting, on the other hand, is concerned with the accurate measurement of net gains on an annual basis. The establishment of a contingency reserve does not represent a sufficiently certain liability to be recognized for income tax purposes.

VII. Administrative Aspects of Taxing Business and Investment Income

Taxes imposed on income from business are normally self-assessed,[198] which imposes on the taxpayer, in the first instance, responsibility for calculating taxable income and the tax due on that income and for making installment payments at designated times. The taxpayer's calculations are reviewed by revenue officials when returns are filed and may be subject to further audit. The self-assessment system may be supplemented by a withholding system applicable to certain business payments. The withholding system is discussed further below.

A. Advance Payments of Tax

The most crucial element of the system for collecting business tax is the formula for determining installment payments. The object of the system is to require businesses to pay tax on a regular basis throughout the year as income is derived, not when final liability is determined after the end of the tax year. This formula ensures revenue flow to tax authorities, prevents deferral of tax payment, and minimizes the risk of disbursement of income before the appropriate proportion is remitted as payment of a tax liability. Related issues are mechanisms for adjusting payments if the taxpayer's business income changes during the year and reconciliation of installment payments with the final tax liability.

The frequency with which installments of business income tax must be made varies significantly among countries. In many jurisdictions, different frequencies are used for different types of businesses (unincorporated or incorporated) or different sizes of businesses (based on taxable income or turnover). The use of variable installment payment frequencies has two objectives: (1) to minimize administrative costs for smaller businesses; and (2) to reduce financing charges for smaller businesses that face a number of biases in the capital market and, accordingly, tend to place greater reliance on cash flow to fund ongoing operations. In light of these objectives, a frequency distinction based on the size of a business is more logical than one based on legal form. However, rules based on size may be manipulated by taxpayers establishing multiple companies. This practice may be combatted through consolidation rules, but this tends to add complexity to the system. An alternative approach is to base payment schedules on a combination of business size *and* form. The simplest approach is to use the same

[198]In other words, the taxpayer determines (assesses) the amount of tax due and files (lodges) the tax return.

rule as that used to determine when businesses are required to use accrual accounting, or to use the same form of rule with a different threshold.

There are four basic models for the formula used to determine business tax installments. Two systems rely on the previous year's taxable income as the basis for estimating the taxable income of the current year, and two use data from the current year to estimate total taxable income for the year.

The simplest system is based on the previous year's taxable income, divided by the number of installments. (Alternatively, the formula can be based on the previous year's tax liability, adjusted, if necessary, by any change in tax rates.) A slightly more sophisticated system is one based on the previous year's taxable income (or tax liability), adjusted by an "uplift" factor that is based on the actual or projected inflation rate or on a measurement of expected growth in nominal incomes generally.[199]

The simplest system relying on current-year data is based on records of turnover for the installment period. The turnover for the period is multiplied by the ratio of the previous year's taxable income to turnover for that year to estimate the probable taxable income that will ensue from the known turnover for the current year. A more sophisticated system draws on an estimate of actual taxable income for the year based on income derived and expenses incurred in the year until the end of the installment period.

Systems for determining installments on the basis of the current year's income provide a more accurate calculation of a taxpayer's probable total liability for the year and the appropriate installment payments to be made. However, the potential administrative burden they impose on taxpayers is considerably greater than for systems based on the previous year's income. Also, these systems, particularly ones based on a running determination of taxable income for the year, are possible only if taxpayers have access to relatively sophisticated accounting and tax expertise. Accordingly, a system based on actual income for the year is more easily applied in industrial countries than in developing or transition economies. Nevertheless, a number of transition countries require payment of tax according to results for the current period.[200]

Systems based on income of the current year are self-adjusting in terms of changes in business fortunes. If the taxpayer uses prior-year information to calculate liability for current-year installments, some adjustment mechanism is needed if the taxpayer's taxable income for the year is likely to differ significantly from the estimated income on which installments are based. To protect taxpayers from undue hardship in the event of falling business income, the taxpayer should have the option of nominating an expected taxable income that is lower than that yielded by the presumptive formula or of altering the estimate downward if circumstances make this appropriate during the year. Rigorous interest and penalty measures will discourage taxpayers from deliberately nominating lower-than-expected incomes to reduce installment payments and thereby deferring payment of some tax until a final reconciliation payment at the end of the year.

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[199]The uplift system is used, for example, in Australia for individuals deriving business and investment income.

[200]*See* KAZ TC § 51.

These measures should impose a charge significantly higher than the prevailing interest rate to ensure that taxpayers do not use underestimation as a means of securing finance (in effect "borrowing" tax due until the close of the year). Countries with serious tax collection problems may not want to provide any option for taxpayers to reduce required installments, if there is a concern that any reasonable penalty would be ineffective in deterring abuse of such an option.

While most installment systems that are based on taxable income of the previous year provide taxpayers with the option of substituting a lower estimate of expected income, it is not usual to require taxpayers to uplift their estimates if financial information during the year indicates that income will be greater than that yielded by the presumptive formula.[201] Not requiring taxpayers to uplift provides taxpayers with a deferral advantage in times of increasing income. To avoid the problem, taxpayers can be required to use an installment calculation system based on current-year information, such as turnover.

One particular problem with both systems is that of taxpayers commencing business. In the absence of any special provisions, these systems allow such taxpayers to defer tax on the income derived in the first year until the end of that year. Because it is common to allow taxpayers to substitute lower estimates when they believe income is falling, taxpayers leaving business suffer no corresponding overpayment of taxes when closing business operations. Although the deferral by taxpayers commencing business undermines the installment system, most jurisdictions that rely on a formula of installment payments that is based on statistics from previous years do not make any effort to address the problem. Because taxpayers commencing businesses are not likely to earn substantial profits in the first year, the approach of not providing a special rule for these taxpayers is justifiable. However, the absence of a special rule may provide significant windfall benefits to some categories of taxpayers, such as lawyers or accountants, who are invited to join the firm as full partners (and hence become business proprietors). It also opens a potential door to abuse if business owners move the business operations to a new company on a regular basis (or even annually) to defer payment of tax. However, this is not likely to emerge as a serious problem until an economy is fairly advanced.

B. Withholding

A domestic withholding system can be applied to payments made to some self-employed persons, although it is not administratively possible to apply such withholding taxes to all payments made to those persons. For example, given that the tax is withheld by the payer of the income, it is not feasible to apply the tax to all payments to a self-employed person with a large number of small-value customers, particularly nonbusiness (i.e., final-consumer) customers. Even if such customers complied with their obligations to withhold the tax and remit it to revenue authorities, matching the large number of small withholdings to particular taxpayers would be an extremely onerous task for the administration. Withholding tax on self-employed persons, therefore, is usually confined to those industries with a small number of business customers. Even then, there is generally a value threshold before withholding applies and,

[201]Provisions for uplift estimates need not be explicit. The United States imposes an implicit requirement by levying additional tax on large corporate taxpayers whose estimated tax payments are less than actual tax. *See* USA IRC § 6655(d)(2).

possibly, an exclusion for contracts with nonbusiness consumers. The most common industries to which withholding tax applies are construction and transportation.[202] An exception may be provided for taxpayers with a satisfactory compliance record. Consolidation measures may be needed to prevent taxpayers from splitting contracts into multiple contracts, each generating payments below the withholding threshold.[203]

Withholding on payments to self-employed persons is generally at a flat rate applied against the gross amount of the payment. Because the rate is applied against gross income, some amount of deductions is notionally taken into account in determining the rate. This is important because taxpayers in the industries to which such withholding applies are likely to claim substantial deductions for the cost of inputs. If the rate of withholding on gross receipts is set too high, then the withholding tax may ultimately exceed the taxpayer's chargeable income for the year of assessment, causing serious cash- flow problems for the taxpayer.

Withholding on income derived by self-employed persons who are resident taxpayers will generally not be a final tax. A taxpayer will be required to file a return showing taxable income for the tax year and tax payable thereon, and a tax offset will be given for the withholding tax.

C. Withholding on Income from Capital

Final withholding taxes on gross income are the usual method for assessing nonresidents on income from capital. A final withholding tax means the recipient is not required to file a return or face additional assessment in the source jurisdiction with respect to income subject to the tax. The recipient may be subject to additional tax in the recipient's country of residence. In most countries, final withholding taxes are imposed on interest and dividends paid to nonresidents. They are often extended to royalties and less commonly to rental income paid to nonresidents[204] and to distributions from trusts.[205]

The use of final withholding taxes on income from capital paid to resident taxpayers is a growing phenomenon, but the practice is far less common than for nonresidents. Reluctance to use final withholding taxes for resident taxpayers primarily stems from equity concerns. The use of any flat rate will prejudice taxpayers whose incomes would be subject to lower rates if the ordinary rate structure were applied and will provide a windfall to taxpayers whose incomes would otherwise be subject to higher rates.

The widespread use of final withholding taxes on different categories of income effectively creates a schedular system with what are, in effect, separate taxes on different

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[202]*E.g.*, AUS ITAA (1936) §§ 221YHA–221YHZ.

[203]*See, e.g.,* Regulations for the Implementation of the Individual Income Tax Law § 21 (State Council, People’s Republic of China, Jan. 28, 1994) (consolidation of payments).

[204]*See*, *e.g.*, CAN ITA §§ 212(1)(d), 215(1).

[205]*See*, *e.g.*, CAN ITA § 212(1)(c).

categories of income. The system may, in fact, become a hybrid system with flat-rate taxes on some categories of income and progressive rates on others. In theory, the system may be designed so as to minimize the loss of progressivity by applying withholding taxes as a final tax only if the taxpayer's income is primarily of the category subject to progressive rates (and therefore not subject to final withholding taxes)[206] In practice, however, such a system would be difficult to implement.

There is no doubt that final withholding taxes on income from capital are preferable from the perspective of administrative simplicity. As was noted in chapter 14,[207] flat-rate withholding taxes on income from capital may not undermine progressivity as much as feared. The important point is that, if income from capital is segregated in this manner, taxpayers are unable to minimize tax by mismatching gains and losses and exploiting inconsistencies in timing or treatment of different types of expenses and gains. In fact, some studies from Scandinavia hold that the movement toward "dual income taxes" (i.e., flat-rate taxes on some types of income from capital and progressive rates on other income) may actually increase progressivity by precluding taxpayers from exploiting arrangements to minimize their tax in these ways.

The choice between separate withholding taxes or ordinary assessment for income from capital will depend on a range of political and administrative considerations. Essential to the effective functioning of either system is a high-integrity taxpayer identification number (TIN) system. This is important for an ordinary assessment system for auditing purposes. The TIN system serves several different functions if withholding taxes are used. One purpose is to facilitate auditing. While tax authorities may no longer be concerned with attributing income from capital to the correct taxpayer if final withholding taxes are used, they will be interested in comparing income from capital with other income sources to ascertain whether the taxpayer declared enough income to explain the investments now generating investment income.

A second purpose of TINs in a system that uses withholding taxes is to give taxpayers the option of filing in appropriate cases. While optional filing complicates the administration of the withholding tax, it can be used to protect the interests of lower-income taxpayers who are subject to ordinary assessment tax rates that are less than the withholding tax rates. It can also be used to protect taxpayers who incur significant expenses to derive their income from capital. This may be the case with, for example, taxpayers deriving rental income.

An alternative to optional filing sometimes mooted to protect lower-income taxpayers from the impact of withholding taxes that are higher than their marginal tax rate is a limited exemption from withholding. The exemption is usually suggested for interest on accounts in financial institutions up to a designated amount. However, because it is impossible for financial institutions to know of other accounts that depositors may hold, higher-income taxpayers are likely to exploit the exemptions by opening multiple accounts. A high-integrity system of

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[206] *See*, *e.g.*, Charles McLure & Santiago Pardo, *Improving the Administration of the Colombian Income Tax, 1986-88, in* Improving Tax Administration in Developing Countries 124, 126–27 (Richard Bird & Milka Casanegra eds. 1992).

[207] *See* footnote 28 and accompanying text in that chapter.

taxpayer identification numbers will enable tax authorities to identify these cases, but a very sophisticated system for cross-referencing data is required. Also, additional tax can be collected only by means of an assessment levied on appropriate taxpayers. The use of mandatory withholding tax coupled with optional filing by lower-income persons is administratively simpler, because it transfers the onus for further action to the taxpayer. Such a system would not be desirable, however, if a large number of additional returns had to be filed. Either system can be used to identify taxpayers who may be involved in shifting arrangements. Appropriate targets for antishifting audits can be identified by comparing claims for lower or zero tax rates with returns of spouses and other family members.

Optional filing for income from capital raises a number of issues. First, it must be decided whether optional filers can elect to have a lower or zero withholding tax imposed or whether they are subject to the withholding tax, with the two being reconciled after the tax year when a return is filed. In that case, a refund of excess withholding tax may be made. Allowing taxpayers to seek a lower or zero withholding tax rate by submitting an appropriate form to income payers ensures that there is no overpayment of tax during the year. However, such taxpayers would have to be required to file returns at the end of the year to ensure that they are entitled to the lower rates or exemptions they claim. This further filing imposes some burden on taxpayers and an additional administrative burden on income payers, who must provide revenue authorities with details of all cases in which taxpayers seek lower withholding rates or exemptions. It also imposes further administrative burdens on tax authorities, who must cross-check with individual returns those cases of lower or zero withholding rates in order to ensure that taxpayers are entitled to the benefits they claim. Measures are needed to discourage taxpayers from deliberately or inadvertently claiming entitlement to lower or zero withholding tax rates. These include interest payable on the deferred payment of tax and penalties depending on the culpability of the taxpayer. Finally, if the choice is between an exemption from withholding and full withholding, taxpayers subject to tax rates even only slightly below the withholding rate would enjoy a significant deferral on their tax liability.

If taxpayers are not given the option of seeking lower or zero withholding rates subject to reconciliation when a return is filed, it must be decided whether refunds of withholding tax should be accompanied by compensation for the use of the taxpayer's funds prior to the refund. Compensation in the form of interest imposes additional administrative burdens on tax authorities, but promotes equity. Only a limited number of persons are likely to file returns to obtain refunds.

If the system of mandatory withholding tax subject to reconciliation when a return is filed is adopted, an exception should be made for exempt taxpayers, who should be able to claim an exemption in any case. Also, the final withholding tax should not be used for interest paid to financial institutions, because these taxpayers will incur significant expenses to derive interest income and their net margin on interest payments will be much smaller than the gross payment.

It is not necessary to choose between a final withholding tax and a withholding tax subject to reconciliation for all classes of income from capital. For example, a final withholding tax can be imposed on interest income and dividends, while taxpayers subject to a withholding tax on rent can be allowed to file a return and seek reconciliation if withholding tax rates are higher than the taxpayers' personal rates.

The taxation of income from royalties is complicated because royalties encompasses several conceptually different types of payments, which are classified differently by different countries.[208] The categorization is important, not so much for the definition of income as for the deduction of losses and expenses. The extent to which taxpayers incur expenses to derive royalty income will vary significantly depending on the type of royalty. Depending on the structure of the tax system and the characterization of royalty income, taxpayers may be entitled to deductions for itemized expenses, a standard deduction, or no deduction at all. This treatment will in turn determine whether a withholding tax can be applied to some or all types of royalties.

If royalties are assessed under a schedular tax system or are subject to a final withholding tax, there is a good case for an effective tax burden in line with the maximum tax rate in the personal income tax and the normal rate of corporate income tax. Any substantial discrepancy between the tax rate for royalties and the rates for other income will cause taxpayers to recharacterize payments as royalties, or as something other than royalties, depending on which alternative leads to the lowest tax burden. Also, any preferential treatment or rates for royalties will encourage multinational businesses to withdraw profits in the form of royalties rather than as dividends or interest.

[208]*See supra* sec. III(C).

Appendix.Relation Between Tax and Financial Accounting Rules

A. Introduction

Commercial companies keep accounts for the information of their owners and creditors. These reflect the assets and liabilities of the company on a balance sheet as well as the profits for the preceding year. The relevance of a company's profits for commercial accounting purposes and for tax purposes is broadly similar. For purposes of the income tax, profits are considered to constitute taxable capacity. Profit is, of course, an imprecise concept. It is a temporal concept, requiring measurement against a defined period of time. Although the basic purpose of measuring profit is shared by commercial accounting practices and by the tax rules, the purposes of tax and financial accounting are not exactly the same. Because of these differences in purpose, and in the light of different legal and commercial traditions, different countries have developed different systems for relating the tax rules and the commercial accounting rules.[209] How they do this is a critical issue for the drafting of the rules for determining business income. At one extreme, business income can be measured according to an entirely self-contained set of rules that are included in the income tax law and regulations. At the other extreme, the income tax law can state simply that income for tax purposes is the same as income as determined under the rules for commercial accounting. As we shall see, in practice most countries adopt a combination of rules.

B. Evolution of Commercial Accounting Rules

In the two centuries since joint-stock companies came to be widely used, pressures have been applied to define how business profits are identified. Membership of businesses has been drawn more widely, and members now require formal checks on the accounts of their businesses. External controls have been imposed, usually by legislation, and include independent audits. Further, many members of a business are portfolio investors, requiring—as do the markets—greater transparency of performance of a business. These accounting regulations have not been applied universally: smaller corporate businesses and noncorporate businesses are often exempted wholly or partly from these obligations.

The original lack of a required form of accounting has been replaced in all OECD countries by a combination of law and accounting practice designed to produce some consistency and objectivity in the presentation of company accounts. There are, however, distinct national differences both in the rules and principles adopted and in the legal or professional forms that those rules and principles have taken. The tendency in civil law countries has been to adopt rules within the commercial code or a law on accounting. By contrast, in common law countries, much of the content of accounting rules has been left for professional bodies or expert committees to produce.

[209]*See generally* Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation 50–51, 195 (1992); Guido de Bont et al., Fiscal Versus Commercial Profit Accounting in the Netherlands, France, and Germany (1996).

Accounting laws and practices are being coordinated at regional and international levels, as well as being imposed more strictly at the national level. A comparative discussion of the effectiveness of accounting standards for tax purposes may start with an examination of the International Accounting Standards (IAS), produced since 1973 by the International Accounting Standards Committee, an autonomous body, but associated with the International Federation of Accountants (IFAC), a nongovernment body of professional accountants. Some thirty standards have been issued—a mixture of general principles (e.g., prudence, substance over form, and materiality)[210] and specific rules (such as the information to be disclosed in financial statements).[211]

Within Europe, the countries of the European Union apply a series of company directives that require set principles and formats for company accounts.[212] Some officials of the European Commission attempted to adapt some of these rules into a format to provide a common definition of the tax base for income tax, but the attempt failed even to secure support within the Commission and was never officially published.

Progress has been made in recent years, but accounting norms are inconsistent, incomplete, and evolving. It is too early to expect a common definition of profit at the international level, although one is starting to emerge. But for public companies in states with developed capital markets, there are standard formats, principles, and rules for presenting accounts. The growing internationalization of business reinforces this trend.

C. Current Practice

1. Overview

Some states base their determination of the taxable capacity of companies on the commercial accounts of those companies. In these states, the precise form of company accounts is typically laid down in the commercial code. Subject to some specific exceptions in both tax legislation and jurisprudence, compliance with the commercial law also amounts to compliance with the tax laws, and tax is levied accordingly. The profit that the company declares to the market is closely related to the profit on which it is taxed (although, in practice, the extent of the profit declared to the market may be driven by tax considerations).

Other countries have a tax definition of profits that may be markedly different from the company's own view of its profitability for the purposes of payments of dividends and publication to the market. Historically, these countries have taken a more relaxed view to the detailed form of company accounts for general legal purposes, but have imposed rules requiring specific accounting treatment of both additions and diminutions to wealth for tax purposes only. With limited exceptions, what a company does for accounting purposes is totally irrelevant to its income tax position. As a consequence, the income tax law and regulations must govern in detail

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[210]IAS 1.

[211]IAS 5.

[212]*See* particularly the Fourth Company Directive—78/660/EEC, and the Seventh —83/319/EEC.

the methods of accounting for all the elements that enter into the determination of taxable income.

To clarify the matter, we will review the rules applicable in Canada, France, Germany, the United States, and several transition countries. The topic is a complex one, and the reader should be warned that the discussion below does not capture all the subtleties of each system, which would require a much more in-depth examination.

2. Germany

In Germany, the Commercial Code provides that companies of a specific size are required to keep double-entry books.[213] Fairly detailed rules are provided for how these accounts are to be kept. If an issue is not specifically governed by a written rule, it is to be resolved according to principles of orderly bookkeeping.[214] For tax purposes, determination of taxable income starts with the accounting balance sheet. Specifically, taxable income is determined under the net worth comparison method.[215] The net worth method uses the net worth (assets minus liabilities) in the opening and closing balance sheets for the taxable year.

The basic idea of the net worth method is that taxable income is the difference between closing net worth and opening net worth. It is also, however, necessary to subtract those items that increase closing net worth but that should not be included in taxable income (e.g., tax-exempt receipts and contributions to capital) and to add items that decrease closing net worth but that should not be deductible in determining taxable income (e.g., dividends).

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[213]The discussion in this section is based on Brigitte Knobbe-Keuk, Bilanz- und Unternehmenssteuerrecht (9th ed. 1993).

[214]Handelsrechtliche Grundsätze ordnungsmäßiger Buchführung (GoB).

[215]*See* vol. 1, ch. 13, for further discussion of the net worth method. The net worth method is set forth clearly in the income tax laws of France and Germany. *See* FRA CGI § 38; DEU EStG § 4. Under certain circumstances, certain types of income are determined as the difference between income and expenses, instead of being determined by the net worth method. Those familiar with the Haig-Simons concept of income, which also uses a net worth concept, may misunderstand what the net worth method involves. Unlike the Haig-Simons concept, the net worth method generally does not involve mark-to-market taxation, because it uses the book value, rather than the fair market value, of assets on the balance sheet in determining net worth (except in cases where book value is determined according to fair market value).

Accordingly, taxable profit for the year is

(i) the amount of net worth reflected in the closing balance sheet, less

(ii) the amount of net worth reflected in the opening balance sheet, less

(iii) contributions to capital and other receipts that are not taxable, plus

(iv) withdrawals made in favor of the owners and expenses that are not deductible.

There are two questions for each item of the balance sheet: (1) should the item be included as an asset (or liability) and (2) if so, how should it be valued? As to both issues, the general rule is that for tax purposes the treatment in the accounting balance sheet applies unless there is a specific rule to the contrary in the tax law. In some cases, the taxpayer has a choice under the accounting rules as to how to treat an item. In these cases, having made an election for accounting purposes, the taxpayer is bound to follow the same treatment for tax purposes. Once the return has been filed, changes to the accounting treatment are permitted only under limited circumstances. If the treatment of an item on the balance sheet is contrary to the accounting rules, then the taxpayer may make the correction. If the treatment results from an option under the accounting rules, the taxpayer may change the treatment for tax and accounting purposes only with the consent of the tax authorities. Even if the tax law specifically authorizes a favourable treatment of an item, it has been provided that the treatment is not available unless the same treatment is applied for commercial accounting purposes.

In a number of specific cases, however, the tax law specifies that the treatment of an item for tax purposes differs from that applicable for accounting purposes. These concern particularly the allowance of deductions. The tax law also contains relatively extensive rules for valuation of property, which apply instead of the accounting norms.

The consequence of this legal structure is that, in the absence of a specific rule in the tax law, the treatment of an item for income tax purposes is governed by the rules in the commercial code. If this does not contain a specific rule, then the "principles of orderly bookkeeping" apply. It is the principles of accounting practice, rather than specific tax principles, that are consulted in disputes about determining taxable income.

3. France

France also uses the net worth comparison method of determining taxable business income for companies keeping double-entry books.[216] Although tax accounting follows commercial accounting, the application of this principle has been somewhat different from that in Germany. This results from the fact that in France the commercial accounting rules were not codified in the commercial code until relatively recently (1983). Thus, while there was a doctrine that tax and commercial accounting should be the same, absent express provision to the contrary

[216]The discussion in this section is based on Mémento Pratique Francis Lefebvre Comptable 1991, at 28–30 (1990).

in the tax laws, in practice it was left to the tax laws and to courts interpreting the tax laws to develop accounting principles. Thus, for example, the principle of *créances acquises et dettes certaines* (accrued receivables and fixed liabilities)[217] was developed as an interpretation of the tax law to govern the timing of accrual.

Now that fairly detailed accounting rules have been codified in the commercial code, France is in approximately the same position as Germany. Future questions about tax accounting will presumably be handled with reference to the rules of commercial accounting. Of course, if the legislature does not like court decisions applying those rules for tax purposes, it is always free to provide specific contrary rules that will apply for tax purposes.

4. United States

The United States represents an example of the opposite extreme from France and Germany. The tax laws of the United States contain no general principle relating commercial accounting and tax accounting. This means that all of the principles of tax accounting must be contained in the Internal Revenue Code and regulations (or must be derived by courts from interpretation of this legislation). There is a separate concept of tax accounting, which is similar to commercial accounting in that it follows the principle of continuity: the taxpayer cannot generally change the method of accounting without the permission of the Internal Revenue Service. In a few special instances, tax provisions have been made applicable on condition that the taxpayer follow the same method of accounting for commercial accounting purposes (e.g., LIFO).[218] And the minimum tax has been based on income as determined for financial accounting.[219] But apart from these special provisions, tax rules are independent.

5. Canada

In Canada, the definition of taxable income by reference to generally accepted accounting principles was proposed but rejected in 1947.[220] Despite the failure to enact this language, the concept of generally accepted accounting principles has been important in the interpretation of

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[217]This is approximately equivalent to the "all events" test for accrual accounting in the United States. *See* Treas. Reg. § 1.446-1(c)(1)(ii) ("Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability").

[218]*See* USA IRC § 472(c).

[219]*See* Tax Reform Act of 1986, P.L. 99-514, 100 Stat. 2085, 2326, sec. 701 (1986). The relevant provisions, codified at IRC § 56(f), were subsequently repealed.

[220]*See* Brian Arnold et al., Canadian Income Tax 290 (19th ed. 1993).

the income tax law.[221] This means that while there is not strict conformity between commercial and tax accounting, there should in practice be a fairly close correlation between the two.

6. Transition Countries

Countries in transition have had to address the relation between tax and commercial accounting rules at a time when both are at an early stage of development. A number of countries have followed the French/German approach. For example, in the Czech Republic, Latvia, the Slovak Republic, and Slovenia, the law explicitly refers to commercial accounting as the basis for tax accounting absent specific provisions to the contrary in the tax law.[222] In Estonia, the statute says nothing about conformity between financial and tax accounting and delegates to the Minister of Finance the specification of the accounting rules.[223] However, the regulations issued under this authority call for income measurement according to the accounting norms, unless otherwise specified by the tax law.[224]

The techniques for linking the definition of taxable income to accounting differ depending on the form of the definition. If taxable income is defined on the basis of net worth comparison, there is a reference to the balance sheet in the definition of taxable income, which can be interpreted without further specification as referring to the accounting balance. In countries where taxable income is defined as the difference between receipts subject to tax and deductible expenses, the usual practice is to state that taxable income is the same as commercial accounting income, with the modifications stated in the tax law.

In Russia, Kazakhstan, and other countries whose tax legislation is influenced by the Russian legislation, the traditional approach has been for the same set of accounting rules to apply for all purposes, including taxation. Thus, under the system that applied in the former Soviet Union, the question of the relation between tax accounting and financial accounting could not even be raised, because there was simply one accounting system. The system was spelled out in detail, leaving little or no room for independent judgment by accountants. When new tax laws were adopted at the time of the splitup of the Soviet Union—and because these were modified thereafter—the tax laws often did contain accounting rules (referring to income being determined as the difference between taxable receipts and deductible expenses), which on their face appeared to make the tax laws independent of the financial accounting norms. However, the new tax rules were by and large interpreted in the light of prior practice, that is, as requiring the accounting norms to be applied for tax purposes. At the same time, financial accounting was undergoing often radical reform to bring it into line with international practice. This reform has proceeded at quite different paces in different countries that were formerly part of the Soviet Union. At the time of writing, there is accordingly some uncertainty as to the current or

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[221]*See* Brian Arnold, *Canada*, 10 Tax Notes Int'l 1533 (May 1, 1995); Brian Arnold, *Supreme Court of Canada Discusses Financial, Tax Accounting*, 16 Tax Notes Int'l 730 (March 9, 1998).

[222]*See* CZE ITA § 23(2); SVK ITA § 23(2); LVA EIT § 14; SVN PT § 9.

[223]*See* EST IT § 37(1).

[224]Instructions on the Payment to the Budget of Income Tax on Enterprises, § 5.1.

prospective relationship between tax and financial accounting in these countries. The situation is quite difficult during the transition; in some cases, tax laws have been reformed in advance of accounting reform, so that it is difficult for tax law to refer to accounting practice, which is not fully developed or appropriate for the new tax legislation.[225] Some advisors would in any event prefer to separate tax from accounting. Once accounting reform has been undertaken and accountants have been trained in the new methods, it will be easier to specify a more permanent relationship between tax and financial accounting.

D. Choice Among Different Approaches

As the above review suggests, the relationship between tax and accounting norms differs substantially from one country to the next. It cannot be said that there is one right or best practice for a particular country. The general approach to be pursued in a particular country will be heavily influenced by tradition, and it is usually best to respect the practice with which tax officials and accountants are familiar rather than trying to impose something different because it follows the personal preference of a foreign advisor. Moreover, the state of development of accounting practice is relevant in deciding the extent to which it makes sense to rely on commercial accounting rather than on autonomous tax rules. Within each country's paradigm, however, it is possible to make a number of adjustments so as to assure a solid revenue base. For example, in countries that will be starting with accounting profit, it is important to limit the reserves that are deductible for tax purposes. A number of transition countries have adopted the effective approach of not allowing deductions for reserves unless they are specifically enumerated in the tax law.[226] The reserves allowed can then be limited to those for bad debts (perhaps only for banks) and those for insurance companies. Even these reserves should be carefully circumscribed, but the issues required to do so are beyond the scope of this book.

In addition, in a system that relies generally on the accounting norms, it is possible to provide for any number of deviations from those norms when considered appropriate for tax purposes, although administrative convenience should be taken into account. For example, different rules can be provided for depreciation. To the extent possible, tax and accounting calculations should be on the same basis so as to reduce unnecessary paperwork. In the case of depreciation, accounting norms may provide a number of options to the taxpayer. However, from the point of view of tax policy, it is generally considered preferable to have a single set of rules that apply to all taxpayers. Therefore, it may in any event be impossible to achieve total conformity between tax and accounting norms in this regard.

[225]This is why the tax codes of Georgia and Kazakhstan, and the enterprise profit tax law of Ukraine, do not refer to accounting norms (unlike the Latvian law, accounting reform in that country having proceeded at a much more rapid pace).

[226]*See* ROM PT § 4(3); LVA EIT § 6(3); GEO TC § 52(2); KAZ TC § 18(2).

17

Depreciation, Amortization, and Depletion

Richard K. Gordon

> Strictly speaking, the calculation of income demands complete revaluation of all assets and obligations at the end of every period. Practically, the question is: How shall the requisite value estimates be obtained?
> —Henry Simons

I. Introduction

Henry Simons correctly noted that a comprehensive income tax requires the revaluation of all assets and obligations to take into account accumulated gains and losses at the end of every tax period. As a general matter, all income tax systems have accepted that, in many instances at least, the practical question of valuing property for each relevant period can be very difficult to answer. Changes in the value of property will often not be taken into account until some particular moment, such as when ownership of the property is transferred or the property becomes worthless. However, such deferral of accounting for accrued gains and losses may result in either undertaxation, if the value of the property has increased, or overtaxation, if it has decreased. Most tax accounting systems allow or require the periodic estimation of gain or loss on certain types of property.[1] Depreciation (often called amortization when involving nonphysical property) is one of the most important instances where the taxpayer is allowed to deduct estimations of loss over time.[2] The decision to accrue estimated declines in value through depreciation is largely predicated on three points: that the

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Note: Victor Thuronyi, Leif Mutén, Alvin Warren, Victoria Summers, Philip Dawicki, and Melinda Milenkovich made numerous helpful comments on earlier drafts. I would like to give special thanks to Emil Sunley, who took considerable time to disabuse me of many a theoretical error and who provided particularly close commentary on earlier drafts.[1]There are other techniques for taking account of the time value of money when gains or losses are not accrued currently. *See* the discussion *infra* at text accompanying note 12 regarding the application of estimated interest charges on deferral values, and at text accompanying note 13 regarding first year capital recovery.

[2]*See generally* Dale Chua, *Depreciation Schedules, in* Tax Policy Handbook 136 (P. Shome ed. 1995).

If property has a useful life shorter than the taxable year, its full cost could be completely deducted before the next taxable year, obviating the problem of unaccounted losses.[3] For this reason, most jurisdictions deny a full deduction for the cost of any property with a useful life of greater than one year, while at the same time restricting depreciation allowances to such cost.

Because gain in the value of property is not typically recognized until the property is transferred (or until it is scrapped or otherwise becomes worthless), most tax jurisdictions include a counterbalancing or compensating rule not to recognize accrued but unrealized losses.[4] Also, many jurisdictions do not tax either the gains or the losses on certain property held by individuals. Finally, many tax systems exempt from tax the income generated by some types of property. However, depreciable property usually generates currently taxable income. If deductions were not allowed for losses in the value of such property, there would be a mismatching of income and loss, and therefore overtaxation.[5] For this reason, depreciation deductions are typically limited to property that generates currently taxable income.

Many types of physical property used to produce income are subject to wear and tear, which reduces the property's value.[6] In addition, technological changes may make the property relatively obsolete and therefore also less valuable. Nonphysical property may also lose value, either because the right to possession or use is limited in time (such as with the case of a lease or patent) or because of technological obsolescence. These factors—wear and tear, obsolescence, and in the case of nonphysical property, a limited term—all tend to cause the value of certain types of property to decrease over time. Although the rules of different jurisdictions vary, as a general matter it is to the costs of such property that depreciation deductions are normally restricted. The most common, and perhaps most important, method of fixing such a restriction is by limiting deductions to types of property that have predictable useful lives.

Of course, the knowledge that property is losing its value as a result of wear and tear or obsolescence over its useful life does not permit the fixing of the value of each intervening yearly reduction.[7] In addition to yearly fluctuations in the effects of wear and tear and

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[3]If the property has a life greater than the current tax year, a full deduction would result, interest and tax rates remaining equal, in an exemption from tax of any net income, except for economic rents. *See* Institute for Fiscal Studies, The Structure and Reform of Direct Taxation (Report of Committee chaired by J. E. Meade) 231–32 (1978). However, it would be possible to take only a partial deduction. *See infra* note 13 and accompanying text.

[4]*See generally* the discussion of the role of compensating distortions in a comprehensive income tax in Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 Harv. L. Rev. 925, 983–84 (1967).

[5]*See* Jeff Strnad, *Taxation of Income from Capital: A Theoretical Reappraisal*, 37 Stan. L. Rev. 1023, 1027–28 (1985). *See* also Example 1 *infra* sec. III(A).

[6]The value of the property may decrease for various reasons. One common way is for it to lose efficiency and therefore its productivity. As output drops, so does income; as a result, its value necessarily declines.

[7]Nominal errors in useful lives can be corrected by "recapturing" excess depreciation deductions, or by allowing additional deductions when the property is transferred or becomes worthless. *See infra* sec. III(E). However, even with such corrections, if each yearly allowed depreciation amount varies from the actual, there can be a considerable tax effect owing to the time value of money. *See* Paul Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. Pol. Econ. 604 (1964); Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implications*, 99 Yale L. J. 1817, 1822, 1865–79 (1990).

obsolescence, other factors may cause variation in the value of the property. Various market forces, such as changes in supply or demand for the product produced by the property or in the cost of production or availability of replacement property because of technological innovation or other reasons, will likely result in a corresponding increase or decrease in its value. Generally speaking, these effects are less predictable and may result in increases as well as decreases in value. As a result, there is probably no jurisdiction that generally includes such effects when determining allowable depreciation.[8] However, repairs or improvements made to property, or an increase in the term of nonphysical property, may increase its productivity or its productive life and therefore its value. Because these effects are often easier to estimate, they are frequently included in determining depreciation allowances.

There are techniques other than depreciation for compensating for accrued decreases (or increases) in the value of property held for the production of income. One technique would, instead of allowing current deductions for depreciation, allow a deduction only when the property is transferred (or scrapped), but also give the taxpayer an additional allowance for the time value of the postponement of the deduction.[9] There are a number of problems with this approach. First, whenever interyear tax payments or refunds are involved, circumstances may change, with regard to both the tax system and the taxpayer. Rates may go up or down, taxpayers may go out of business, and, in either case, cash flow is invariably affected. However, as noted, most jurisdictions restrict depreciation in some fashion to property whose decline in value can be predicted through the fixing of a useful life. Nevertheless, property without a known useful life may also depreciate in value. At least in these cases, it might be preferable to allow the taxpayer some allowance for the delay in realizing a tax benefit for incremental reductions in asset value.[10]

It is also possible to go the other way around, and deduct a portion of the full cost of property in the first year in an amount equal to the discounted value of all future deductions, after which no more deductions would be allowed. This technique, proposed by the economists Alan Auerbach and Dale Jorgenson,[11] has a number of advantages, the principal one being that future changes in the inflation rate will not change investment incentives and, therefore, will not create distortions. Again, however, changes in effective tax rates are not automatically compensated

[8]An estimate for depreciation is not necessary if the actual decline in fair market value of the property is known. There may be other instances where actual declines in value can be ascertained without a property transfer. In the majority of instances, jurisdictions do not allow such evaluations outside of the system of depreciation. There are two important exceptions. The first is property held as inventory or trading goods. The other involves the use by certain jurisdictions of "extraordinary provisions." *See infra* notes 140, 142.

[9]In fact, such a system could be used to compensate for all accrued but unrealized changes in the value of property. *See* Mary L. Fellows, *A Comprehensive Attack on Tax Deferral*, 88 Mich. L. Rev. 722, 728–31 (1990).

[10]The tax administration could construct tables for taxpayers to use in estimating the value of the lost depreciation deductions. *See* David J. Shakow, *Taxation without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111, 1118–23 (1986). Of course, this does not solve the problem of unpredictable annual variations in the value of the property.

[11]Alan Auerbach and Dale Jorgenson, *The First Year Capital Recovery System*, 10 Tax Notes 515 (April 14, 1980).

for, and it would be necessary to estimate real rates of return and asset lives to determine the discount rate. While the latter is also necessary in other systems of depreciation, errors can be adjusted during the lifetime of the asset.[12] This means that if tax or interest rates change, or if the life of the property is miscalculated, while there may be no distortion, there may still may be windfalls, either for the taxpayer or the government.

The author is not aware of any tax system which employs either of these systems.

II. Definition of Depreciable Property

A. Categories of Property

Although all techniques for accounting for the accrued decrease in the value of business property are related, many jurisdictions have different rules for different types of property. Although methods vary, property may be divided into a number of different categories. For physical property,[13] categories include (1) buildings other than industrial plant, (2) industrial plant and equipment, (3) depletable property (e.g., minerals), (4) land, and (5) inventory. For nonphysical property, they include (1) term-limited rights (e.g., leases, copyrights), and (2) property without specific time limits on use, such as goodwill. In addition, there are sometimes special provisions regarding the self-creation of otherwise depreciable property and incidental expenses, such as repair relating to depreciable physical property. Depending on the jurisdiction, some systems, for example, the accounting-based rules of the French, Germans, and Japanese, tend to rely relatively more on general rules that apply to many categories, while others, particularly those of the Commonwealth, tend to have specific (and sometimes not entirely congruent) rules for each category, or even subcategory, of property.

B. Property the Cost of which Cannot Be Deducted in One Year

Income tax laws generally allow deductions for the costs of earning or securing current taxable income.[14] Income tax laws should, however, prohibit the taking of a current deduction for the purchase of any property that has a useful lifetime longer than a year.[15] As a corollary, any of the costs of self-creating such property should be treated in the same fashion as the costs of purchasing it.[16] The treatment of the costs of repairing or otherwise extending the life of such

[12] *See infra* note 140 and accompanying text.

[13] Although frequently used, the distinction between physical and nonphysical (also referred to as tangible and intangible, or material and nonmaterial) is not always obvious. For example, is computer software physical or nonphysical?

[14] *See supra* ch. 16.

[15] Except for *de minimis* rules, which would allow an immediate deduction for relatively small costs. *See* the discussion at the text accompanying notes 44–48 *infra*.

[16] *See generally* Fellows, *supra* note 11, at 768–70 (1990).

property should depend on the effect of the cost. If the effect lasts beyond a taxable year, that cost should also not be deductible. However, if the effect lasts for less than the taxable year, a current deduction is appropriate.[17]

Depreciation deductions should be permitted only for costs relating to a subcategory of such property. Depreciation deductions should be allowed for all of the related costs that had been disallowed as deductions.

Certain systems, typically those found in civil law countries, base their income tax systems directly on financial accounting.[18] The French, German, and Japanese, for example,[19] follow the rules noted above fairly clearly and directly. They have a general provision disallowing a current deduction for expenditures for property, both physical and nonphysical, with a useful life longer than a year.[20] Contained within this accounting rule is the principle that only such property, including any related costs, may be depreciated, provided that other criteria are also satisfied.[21] Indonesia, which adopted a major tax reform in 1984, has a similar rule, although not expressed in terms of financial accounting.[22]

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[17]However, it may be difficult to make distinctions among such different costs. When the costs are distinguished, the effect is to divide the property into different pieces, each of which is viewed separately. In theory, this could also be done for the different costs involved in the creation of an asset. Considerations of administrative ease may play the most important role in determining how such costs are treated. *See* the discussion *infra* at note 54. *See* also the discussion concerning *de minimis* rules below.

[18]*See supra* ch. 16, Appendix A. There are a number of benefits when financial and tax accounting treatment are equal; these benefits are pointed out throughout the chapter. However, in addition to the obvious benefit of simplicity, the most important benefit may be this: the tax incentive to overstate depreciation so as to minimize tax due can be significantly lessened by the disincentive not to understate income in financial reports. This effect will perhaps be greatest for listed companies, where pressure to report profits, and therefore boost share prices, may be greatest.

[19]This chapter refers to the tax laws of major industrial economies, primarily Australia, France, Germany, Japan, the United Kingdom, and the United States. The chapter also makes frequent reference to the tax laws of a sample of developing and transition economies that have recently undergone major tax reforms (primarily Indonesia, Kazakhstan, and Lesotho). The sample reflects the involvement of either the author or the IMF Legal Department in reforms in these countries and is intended to highlight techniques of adopting rules to developing and transition country circumstances. Finally the chapter occasionally makes reference to other countries that have may have an unusual rule in a particular instance.

[20]Property that has been manufactured by the taxpayer is included in this rule, as in general are any repairs that extend the life or term of the property. *See* FRA CGI art. 39-1-2°, FRA CGI Ann. III art. 38 *quinquies*, FRA Council of State Decision of July 18, 1941; JPN IT art. 31, JPN IT Reg. 21-7 I, II; DEU EStG § 7. The German rule explicitly allows a deduction of costs for maintaining property if the effect of the maintenance lasts for less than one year. DEU Einkommensteuer-Richtlinien (EStR) § 157.

[21]The French statute provides for "write-offs for depreciation actually taken...to the extent that such write-offs are generally justified according to the usage of each industry, commerce, or business . . . ." FRA CGI art. 39-1. 2°. This rule applies generally to all property both physical and nonphysical with a "predicted life" of more than a year. The cost of property with a life of more than one year cannot be deducted currently, and only assets with a life of more than one year may be depreciated. *See, e.g.,* Decision of the Conseil d'Etat of Feb. 24, 1936 (FRA). The Japanese statute is similar to the French, as is a Japanese regulation. *See* JPN IT arts. 22(3), 31; JPN Rule 7. The

(continued)

Typically, Commonwealth countries do not have financial accounting-based systems. They often do not have express statutory provisions disallowing current deductions for property with a useful life of more than one year or specifically limiting depreciable property to this category. The result is often a confusing set of rules. For example, the British statute denies deductions for costs of "capital."[23] The definition of capital is found not in the statute, but almost entirely in court cases. Unfortunately, the often rather lengthy court definitions are perhaps less clear than the rather succinct accounting system rules. For example, no major British court decision appears to have directly noted that for property to be capital, it must have a useful life of more than a year. Nevertheless, that does seem to be the general implication of existing case law.[24]

Unlike the accounting-based systems, British law does not have a stated statutory rule restricting depreciation to property that is defined as capital in nature. Instead, further statutory language provides allowances for depreciation only for certain limited classes of both physical and nonphysical property. While each class of physical property has its own separate requirement that the expense be capital in nature, there is no general principle that applies to all property or even to all physical property. While the rules for nonphysical property are more general, only listed types of nonphysical property may be depreciated.[25]

German statute more specifically denies a current deduction, and limits depreciation, to property with a use "which extends by experience to a period of more than one year." DEU EStG § 7 (1).

[22]The Indonesia statute states that "the cost of earning, collecting, and securing income paid over more than one year may only be deducted through amortization . . . ." *Id.* art. 9(II). "The acquisition price or value . . . shall be adjusted for . . . improvements, alterations, or additions" IDN IT art. 10(II).

[23]The original Income Tax Act 1842, Act 5 & 6 Vict. c. 35(1), S. 100, schedules A, B, C & D, denied deductions for "capital withdrawn from or any sum employed...as capital in [a] trade." The current U.K. statutory provision denying a deduction for capital is found in GBR ICTA § 74(f), (g).

[24]In 1879, a taxpayer coal company attempted to take deductions for depletion. The House of Lords upheld the disallowance of the deduction. "[T]he capital involved in making it, would gradually be exhausted and lost; but the *decaying character of the property* would not make it the less subject to be taxed...so long as the mineral lasted." Coltness Iron Company v. Black, [1881] 6 A.C. 315, 327 (Lord Penzance) (emphasis added). Effectively, this would include as capital any property that lasts for more than a year, in that other property would become "exhausted" in less than a year, and the loss could be realized accordingly. Future cases further defined capital as something that was "not once and for all" but of "enduring benefit." Atherton v. British Insulated and Helsby Cables Ltd [1926] A.C. 205, 213–14 (Viscount Cave). *Coltness* and its progeny are still relied upon. *See also* Butterworths U.K. Tax Guide 1990–91 § 7:103. The idea of permitting a partial deduction to allow for depreciation was not considered.

[25]The British system did not, in fact, develop to permit deductions for depreciation. Instead, provisions were added to give "allowances" for "capital expenditure" for physical property. These "allowances," in effect, were viewed not as rules essential to determine an accurate picture of actual income, but as a kind of concession. In other words, there was no importation of the rules, or for that matter, the theory, of financial accounting. The current rules providing capital allowances are found in GBR CAA §§ 1(1)(a); 22(1)(a); 35(1); 37(1)(a); 52(1)(a); 60(1)(b); 61(1)(a); 67A(1), (2); 68(1)(b); 159(1)(a). For depletion, *see id.* § 105(1). For certain nonphysical property *see* GBR ICTA § 520(1).

As under the accounting system jurisdictions, the cost of property that has been manufactured by the taxpayer is a capital cost. However, in the United Kingdom, the treatment of costs of repairs done to maintain property is neither simple nor particularly logical. The statute specifically disallows as a deductible expense costs to improve structures, unless the structures constitute manufacturing plant.[26] There is no such statutory provision for improvement of equipment. However, court cases suggest that an improvement would be "part of the cost of the income-earning machine" and therefore not deductible.[27]

Using different logic, court cases have allowed deductions for repairs, with no apparent reference as to how long the repair might last or even to whether the property repaired is itself otherwise eligible for depreciation.[28] Courts have disallowed deductions for renewals of structures, apparently meaning something that transcends mere repairs and comes closer to a replacement.[29] Naturally, this has required the courts to make nice distinctions among repairs, improvements, and renewals,[30] distinctions that are not based on the length of effect of the activity and that therefore do not appear necessary or justified by any theory of depreciation. To add to the confused nature of the system, notwithstanding these cases a deduction will apparently be allowed for renewals if they are of equipment, and apparently even for some plant.[31]

The confusing and patchwork nature of the U.K. rules appears due, at least in part, to the lack of a coherent theory expressed in statutory form, itself the result, most likely, of the incremental fashion in which the system for allowing for depreciation was created.[32] Other Commonwealth countries often rely on British case law, frequently along with their own, often unclear, statutory provisions. The mix may not always be much more systematic than the scheme found in the United Kingdom.[33]

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[26]The United Kingdom's Income and Corporation Taxes Act disallows the deduction of "capital employed in improvements of *premises* . . . ." GBR ICTA § 74(g) (emphasis added). Improvements to manufacturing plant would be nondeductible but would be depreciable, given that plant is itself depreciable. GBR CAA § 12.

[27]*See, e.g.,* Commissioner v. Nchanga Consolidated Copper Mines, Ltd. [1964] A.C. 948, 959 (citing New State Areas Ltd. v. Commissioner for Inland Revenue, S.A.L.R. [1946] A.D. 610, 620, 621 (Watermeyer, C.J.)).

[28]*See*, *e.g.,* Phillips v. Whieldon Sanitary Properties Ltd. (1952) 33 T.C. 213, 219 (Donovan, J.).

[29]*See id.*

[30]They are discussed in Butterworths U.K. Tax Guide 1990–91 (John Tiley ed., 9th ed. 1990) §§ 7:115–7:119.

[31]This confusing distinction is discussed in *id.* at § 7:119.

[32]*See* Walter W. Brudno & Frank Bower, Taxation in the United Kingdom 192 (Harvard World Tax Series 1957).

[33]For example, the Australian statute denies a deduction for "losses and outgoings of capital, or of a capital . . . nature," AUS ITAA § 51(1) and has case law defining capital predicated on U.K. case law. *See e.g.,* Sun Newspapers Ltd. v. Fed. Comm'r of Taxation (1938) 61 C.L.R. 337, 380 (citing Atherton [1926] A.C. 205). *See also* 1994 Australian Master Tax Guide ¶ 14-060. Unlike the British statute, the Australian statute does not specifically limit depreciation for physical property to capital items. However, for nonphysical property, the statute expressly limits allowances to expenditures of a capital nature. AUS ITAA §§ 124L(1)(a), (b). Somewhat akin to the British case law, improvement of capital property is generally capital and not deductible, while maintenance and upkeep are

(continued)

The U.S. system has two separate, although related, principles. The statute, under a confusingly worded provision entitled "Capital expenditures," denies a current deduction for "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."[34] A regulation further states that this means physical property with a life of "substantially" longer than the "tax year," although no such specific rule is applicable to nonphysical property.[35] Another section applies this rule to costs of self-constructed property and includes related and "indirect" costs.[36] While the capital expenditures rule covers improvements, there is no specific rule concerning costs of repair.[37]

In a manner analogous to that of the British experience, therefore, an enormous amount of administrative and judicial attention has been devoted to the distinction between nondeductible improvements and deductible repairs.[38] As with the U.K. cases, the U.S. courts have paid little or no attention to whether the effect of the improvement or repair was to last for longer than a year. There is no specific rule that limits depreciation to that property that cannot be deducted because of its longevity, although this is implied in another regulation.[39] There is also a section that disallows a deduction for costs of property for which a deduction has

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not capital and may be deducted. 1994 Australian Master Tax Guide ¶ 14-060. The Lesotho statute is also somewhat unclear on this point. It first denies a deduction for expenses "chargeable to capital account." LSO ITA § 33(3)(c). However, the statute does not explicitly tie depreciation to costs that are so chargeable to "capital account." Instead, it defines "depreciable asset" as "tangible movable property or an industrial building which is wholly or partly used in the production of income subject to tax and which is likely to lose value because of wear and tear, or obsolescence." *Id.* § 3(1). Although implicitly this must refer to property whose usefulness extends beyond the taxable year, this is not stated outright. An "intangible asset," for which depreciation may be allowed, is also not defined with reference to capital. The statute also allows for a deduction for "expenditure (other than expenditure of a capital nature) incurred on repairs to assets used in the production of income . . . ." *Id.* § 42(1).

[34]USA IRC § 263(a)(1).

[35]The regulation reads that the statutory language refers to "a capital expenditure that is taken into account through . . . a charge to capital accounts . . . ." USA Treas. Reg. § 1.263(a)-1(b). Examples of such capital expenditures include "buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life *substantially beyond the taxable year* . . . . a copyright . . . [t]he cost of goodwill . . . ." *Id.* § 1.263(a)-2(a), (b), (h) (emphasis added). *See also id.* § 1.446-1(a)(4) (the regulations to the accounting rules under USA IRC § 446).

[36]*See* USA IRC §§ 263A (a), (b).

[37]There used to be a repair allowance as part of the Class Life Asset Depreciation Range System. *See infra* note 50.

[38]*See*, *e.g.*, USA Treas. Reg. § 1.162-3; Fidelity Storage Corp. v. Burnet, 58 F.2d 526 (1932), *rev'd* 18 BTA 517 (1929) (roof repairs with new material are deductible), Georgia Car & Locomotive Co. v. Helvering, 2 BTA 986 (1925) (new roof not deductible); *see generally* 4 RIA United States Tax Reporter ¶¶ 1625.172 through 1625.185.

[39]This is buried in a completely different section concerning "methods of accounting." "[A]s a further example . . . a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization . . . and may later affect the computation of taxable income through depreciation . . . ." USA Treas. Reg. § 1.446-1(c)(1)(ii)(A).

otherwise been allowed.[40] Kazakhstan, which adopted a major reform in 1995, uses phrasing that is clearer than the American.[41]

Many jurisdictions have *de minimis* rules, allowing a deduction for costs of acquiring a limited amount of property with a life of longer than a year. The simplification benefits of such a rule depend on the entire system for depreciation. Where a pooling system is used, it is not difficult to depreciate low-cost items: their cost is simply added to the pool in the year they are acquired and there is therefore no need to keep track of the individual assets. In contrast, under a single-asset system, there would be a stronger case for a *de minimis* rule on simplification grounds. The purpose of such rules is to aid administration, but also sometimes to provide relief to small taxpayers. There are various ways in which such rules can be implemented. For example, the German rule permits an immediate deduction for the costs of a unit of movable property with a value of less than DM 800.[42] However, a problem immediately arises as to what constitutes a single unit of property; much property can itself be broken up into smaller pieces. The German solution is to require that the property be "capable of individual use,"[43] which effectively limits costs for creation and for repair. A slightly different tack is taken in the Japanese law, although it uses a test similar to that of the Germans to determine what constitutes a separate piece of property.[44] With a few minor exceptions, physical property that costs less than ¥10,000 is deductible. The U.S. statute takes a rather different approach, allowing small taxpayers a deduction of up to a total yearly limit on the sum of all costs associated with depreciable physical property of $17,500.[45] Larger taxpayers are not affected by this rule.[46]

Some jurisdictions have rules of thumb regarding deductibility of repair or maintenance expenses. The Japanese, for example, give the taxpayer a choice of capitalizing such costs or of taking an immediate deduction up to limits set by two rules of thumb. The limits for deductibility are set at either 30 percent of an asset's total maintenance expense, or 10 percent of the asset's

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[40]*Id.* § 1.161-1.

[41]One article denies deductions to expenses for "fixed assets and other expenses of a capital character...." KAZ TC art. 14(1). Another article defines fixed assets as "assets with a value over 40 minimum wages and a service life of more than one year which are subject to depreciation in accordance with art. 20." *Id.* art. 5(18). Art. 20 states that assets subject to depreciation do not include "property the value of which is fully deducted in the current year in the determination of taxable income." *Id.* art. 20(2), (3). Two additional articles involve "intangible assets," for which depreciation is allowed under the provisions of art. 20. *See id.* arts. 23, 24. The Kazakhstan statute also includes a general provision denying more than one deduction to expenses "included in several expenditure categories . . . ." *Id.* art. 14(2). There is a clear-cut rule with regard to costs of repairs: they are deductible, up to a fixed limit. This is discussed *infra* at the text accompanying notes 50–52.

[42]DEU EStG § 6(2).

[43]*Id.*

[44]JPN IT Rule 7; JPN IT Basic Circular Notice (195).

[45]USA IRC §§ 179(a), (b), (d)(1).

[46]*Id.*

total acquisition cost, whichever is lower.[47] The United States used to have a *de minimis* rule based on fixed percentages of acquisition costs, but repealed it when accelerated depreciation was introduced in 1981.[48] Kazakhstan defines deductible expenses to include repairs on physical property up to 10 percent of the written-down value of the sum of all depreciable property within a particular category of property.[49] All other repairs must be depreciated.[50]

By and large, the accounting-based jurisdictions appear to have the most transparent and coherent rules concerning what costs for acquiring, creating, and sustaining property cannot be deducted because the effective life of such property extends beyond a year, and limiting depreciation to a subclass of such property. The British and other Commonwealth rules are frequently confusing and inconsistent. Nor are the U.S. rules a model of statutory clarity. Whether or not rules based on accounting are used, the statute should be as clear as possible as to the relationship between asset life, deductibility, and depreciability. First, the statute should deny a current deduction for the costs of any property with a useful life of greater than the current tax year. The German rule provides some guidance.[51]

Another way to do this might be to deny a current deduction for any costs of a capital nature. This could be separately defined to include all property that has a life longer than the current tax year. All costs of self-creation, preparation, repair, or extension that increase the life of the property beyond a single year should be included in "cost."[52] Depreciation allowances should then be limited to those costs for which a deduction was denied. While this can be easily included in accounting-type rules,[53] a separate statement could also be added that restricts depreciation allowances for capital costs.

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[47]A number of other methods are also permissible. JPN IT Rule 7. *See generally* Yuji Gomi, Guide to Japanese Taxes 1994–95 ¶ 6-308.

[48]Under that rule, all expenditures for repair and improvement of "repair allowance property" that were not clearly capital expenditures could be treated as deductible to the extent that they did not exceed the repair allowance. The repair allowance was obtained by multiplying the repair allowance percentage by the average basis of the repair allowance property in the ADR (asset depreciation range) class. The repair allowance percentages for the various ADR classes were listed in a number of Revenue Procedures. USA Treas. Reg. §§ 1.167(a)-11(d)(2)(iii), 1.167(a)-11(d)(2)(iii); Rev. Procs. 72-10, 77-10.

[49]The phrasing of this rule to apply to cumulative written-down values of classes of property is due to the use of pooling in the Kazak statute. Pooling is discussed *infra* at sec. III(G).

[50]*See* KAZ TC art. 21.

[51]"In the case of business assets, if the use or exploitation thereof by the taxpayer in the obtaining of income extends by experience to more than one year [the rule describes how much is to be deducted each year]" DEU EStG § 7(1).

[52]*See* the German rule, *supra* note 22. However, an argument could be made that the effective life of each separate repair should be tracked separately, so that each can be depreciated separately. Although theoretically appealing, this would add to administrative inconvenience and would be a highly unusual provision; the author is not aware of any jurisdiction that does so.

[53]*See supra* note 23.

The German *de minimis* rule makes administrative sense to the extent that it allows taxpayers to avoid keeping separate track of assets with relatively trivial costs. However, if pooling is used to keep track of assets, the argument in favor of such a rule is greatly reduced.[54] Also, as noted, once such *de minimis* rules are adopted, it is necessary to have careful rules regarding what constitutes a single asset. Another possibility would be to adopt the U.S. cumulative *de minimis* rule, which is restricted to small taxpayers and which obviates the need to determine what is a separate piece of property and allows smaller taxpayers to avoid the trouble of depreciating such property. Some combination of these rules, such as allowing deductibility of costs for assets under a certain amount, but with a total limit on costs so deducted, and perhaps limited to small taxpayers, would also be possible.

Rules of thumb regarding the deduction or capitalization of maintenance costs, while not being true to theory, are probably worth the deviations from theory for purposes of improving ease of administration. Variations on the Japanese, old U.S., and new Kazak rules may all be reasonable guides.

C. Property Held to Generate Current Taxable Income

No deduction should be allowed that represents personal consumption. Therefore, any decrease in the value of any property resulting from personal consumption should not be deductible through depreciation. While perhaps this rule could be subsumed under the general requirement that deductions be limited to the costs of earning current taxable income, the denial of deductions for capital costs found in many laws sometimes appears to require a separate statement of this condition with regard to depreciation.[55] Also, because one of the purposes of depreciation is to prevent mismatching of income and expenses, it should apply only to property that generates *currently* taxable income.[56] As noted above, the French, German, and Japanese rules are closely related to the financial accounting treatment given assets, which means that only

[54]*See infra* sec. III(G).

[55]A related issue was raised in Commissioner v. Idaho Power Co., 418 U.S. 1 (1974). That case involved the interrelation between IRC § 263 (which disallows deductions "paid out for new buildings or for permanent improvements or betterments") and IRC § 167(a)(1) (which allows a deduction for depreciation of "property used in a trade or business")(*see also* notes 36 and 64 and accompanying text). The taxpayer contended that § 167 existed independently of § 263, while the Commissioner contended that § 263 took precedence over § 167. The court found for the Commissioner. This is a good example of the need to spell out the interaction between provisions denying deductions and those allowing deductions, particularly the deduction for depreciation. *See supra* ch. 16, sec. -----. *See also* KAZ TC § 15(3).

[56]This means that even if property is subject to a capital gains tax on sale or transfer, if it is not also held for the generation of taxable income currently, depreciation deductions should not be allowed.

property used to generate business income may qualify for depreciation.[57] Indonesia similarly provides through a general statutory rule.[58]

Reminiscent of the capital requirement discussed above, the British statute does not include a general rule restricting depreciation to property held to generate currently taxable income. Instead, a separate limit is included for each class of depreciable physical property, while another statutory provision relates to nonphysical property.[59] Other Commonwealth countries, however, may use a smaller number of more general rules, although typically they have separate sections for physical and for nonphysical assets.[60] Kazakhstan does so as well.[61] The U.S. statute, however, includes a general rule that restricts depreciation for both physical and nonphysical property to that "used in the trade or business" or "held for the production of income."[62]

Some jurisdictions with accounting-based systems, such as France and Japan,[63] and the Commonwealth jurisdictions of Australia and Lesotho[64] as well as the United States[65] explicitly allow for apportionment of costs of property used partly for the generation of taxable income and partly not, and allow depreciation attributable to the costs of the former. Other jurisdictions, such

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[57]The German rule specifically restricts depreciation to "business" property used "in the obtaining of income" DEU EStG § 7(1). *But see infra* the discussion concerning apportionment at text accompanying notes 65–70.

[58]The Indonesian statute first generally restricts deductions for depreciation or depletion, allowing them only when they are a "cost of earning, collecting, and securing income," and then more specifically restricts depreciation to property "owned and used in a business or owned for the production, recovery, or securing of income." IDN IT § 11(1), (12).

[59]Capital allowances for each separate class are limited to property held "for the purposes of [a] trade." GBR CAA §§ 1(1)(a); 22(1)(a); 35(1); 37(1)(a); 52(1)(a); 60(1)(b); 61(1)(a); 67A(1), (2)(b); 68(1)(b); 159(1)(a). For depletion, the rule is found in *id.* § 98(1), and for certain nonphysical property in GBR ICTA § 520(1).

[60]For example, the Australian statute includes a general rule limiting depreciation of physical assets to "plant or articles . . . used for the purpose of producing assessable income." AUS ITAA § 54(1). There is also a general rule that applies to depreciable nonphysical property. *Id.* §§ 124L(1), 124M. Other rules concerning depletion Other rules concerning depletion allowances for minerals carry similar restrictions. *See, e.g., id.* § 122DG(2). Lesotho has similar separate restrictions for physical property and nonphysical property, LSO ITA §§ 3(1), 44(1), and a specific rule for depletion. *Id.* § 43.

[61]Physical asset depreciation is limited to "capital goods used in production," and intangible asset depreciation to "those utilized over a long period in economic activity." KAZ TC §§ 20(1), 24(1).

[62]USA IRC § 167(a). However, a separate rule exists for depletion, which is restricted as well to a deduction against gross income. *Id.* § 613.

[63]*See* Direction général des impôts, Précis de fiscalité ¶ 517 (1994) [hereinafter Précis]; JPN IT § 31.

[64]AUS ITAA § 61; LSO ITA § 41(4).

[65]Treas. Reg. §1.167(a)-5.

as the United Kingdom, do not do so explicitly, but have so allowed through case law.[66] The German rule is quite different. If more than 50 percent of movable depreciable property is used for business purposes, the entire asset is depreciable. If more than 10 percent is not, none of it is. If the business use lies between those two percentages, the taxpayer may choose.[67] Understandably, according to at least one commentary, this rule makes little sense.[68]

It is an essential requirement that to qualify for depreciation, the property, regardless of its type, must be held or used for the production of currently taxable income. While apportionment in the case of "dual use" property seems to make theoretical sense, it may make tax administration that much more difficult. However, the German rule seems unnecessarily favorable to the taxpayer as far as depreciation is concerned.[69]

D. Wear, Tear, Obsolescence, and Useful Life

Depreciation is an estimate of a decline in the value of property. Therefore, property that does not decline in value, or whose decline cannot be reasonably estimated, should not be eligible for depreciation. Generally speaking, it would be possible to allow depreciation for the costs of any property that declines in value. As noted earlier, property can be expected to decline in value for many reasons, including wear and tear, obsolescence, or time-limited rights of use. A number of jurisdictions predicate depreciation first on the existence of these attributes. However, while reductions in value resulting solely from limited terms of use are simple to estimate, it may be quite difficult to do so for those reductions that result from wear and tear and obsolescence. Most jurisdictions therefore greatly restrict how depreciation may be computed. For example, land may be subject to wear and tear, but because it has no fixed useful life, the decrease in value owing to such wear and tear might be difficult to estimate, and a deduction for depreciation of land as such is not generally allowed.

Most jurisdictions rely to some extent, either explicitly or implicitly, on the concept of "useful life," to determine whether the costs of a property are eligible for depreciation treatment at all (i.e., it must have a determinable useful life), as well as what amount of depreciation will be permitted (i.e., annual rate of depreciation is fixed by reference to that determinable useful life). In essence, a useful life analysis extends the concept of limited term of use (so often applicable for analysis of the decline in value of nonphysical property) to physical property. A variation of the useful life analysis is to assign useful life rules of thumb to property by type. These assume that a particular kind of property always has an ascertainable useful life and fixes that life. The necessary result of the first function of useful life is that certain types of property

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[66]GBR CAA §§ 1, 24(1)(a); G.H. Chambers (Northiam Farms) Ltd. v. Watmouth [1956] 3 All E.R. 485.

[67]DEU EStR § 14.

[68]*See* Klaus Tipke & Joachim Lang, Steuerrecht 295–97 (13th ed. 1991).

[69]The German rule should be seen in the light of capital gains tax being levied on property labeled business property (and hence depreciable) but not on private (nonbusiness) property.—L.M.

are excluded entirely from depreciation. The second function, using useful lives to fix annual depreciation deductions, will be discussed below.[70]

Some systems do not base their analysis for some, or even all, property either on wear and tear or obsolescence or on a useful life analysis. Instead, they simply provide specific rules for the depreciation of particular properties or classes of properties. Still other systems may provide apparent rules of thumb that are so arbitrary as to suggest that they are not based on any useful life analysis or on any readily available theory of depreciation. However, two major problems can arise if neither the "subject to wear and tear and obsolescence" or "determinable useful life" rules exist. First, if the rules refer only to specific properties or classes of property, certain types of property, which according to theory should be subject to depreciation allowances, may be excluded, perhaps even unintentionally. Second, if the rules are too general, some property, which according to theory should not be subject to depreciation allowances, may slip through the cracks and be included.

The French accounting-type rule makes no reference to physical wear and tear or to obsolescence. However, only physical and nonphysical property, with reasonably ascertainable useful lives may be depreciated.[71] However, if the useful life of property cannot be fixed beforehand, and then "extraordinary depreciation" occurs, a deductible provision, similar in effect to depreciation, is allowed.[72] The German rule specifically limits depreciation to property that suffers from wear and tear and depletion, as well as extraordinary technical or financial depreciation.[73] The German regulations also state that only property with a determinable "limited" life may qualify.[74] The Japanese rule is somewhat different, although the effect is largely the same.[75] Under the French rule, depreciation of goodwill is not generally allowed because it has no ascertainable useful life.[76] However, the Germans and Japanese have special

[70]It should be noted that it may be possible to estimate reductions in a property's value attributable to wear and obsolescence on a current basis without knowing its useful life. However, knowing an asset's useful life allows the mechanical application of a number of techniques for computing depreciation allowances.

[71]The French statutory provision does not expressly state this. *See* FRA CGI § 39-1-2º. However, decisions of the Council of State make clear that no property can be depreciated unless its useful life can be determined when acquired. *See* Decision of the Conseil d'Etat of Feb. 24, 1936, Recueil des décisions du Conseil d'Etat [Lebon] 236.

[72]FRA CGI Ann. III, art. 38 *sexies*.

[73]DEU EStG § 7(1), (6).

[74]DEU EStDV §§ 9a-11d, EStR §§ 42-59c.

[75]The Japanese statute is similar to the French. *See* JPN IT art. 31. While regulations do not specify that a useful life be determinable, this is implied by the fact that depreciation is based on the determined service life. JPN IT Reg. 21-3. *See also* JPN IT Basic Circular Notice 191-(3), which states that "since depreciable assets means assets the utility of which decreases gradually, objects of art and curios *the value of which does not decrease despite the lapse of time* are not included (emphasis added)."

[76]However, a provision may be made for extraordinary loss.

rules for the amortization of goodwill.[77] The Indonesian statute has recently switched to an accounting-type model for depreciation. Although the wording is different, the treatment of the costs of physical assets is broadly similar in effect.[78] While the costs of nonphysical property are depreciated, broadly speaking, on the basis of expected useful life, there is no specific restriction requiring that a useful life be ascertainable.[79]

The U.K. statute has no general rule restricting the depreciation of property to wear and tear or obsolescence or to property with determinable useful lives. For certain types of both physical and nonphysical property, there are, however, individual provisions allowing a fixed yearly amount of depreciation for each of a number of different classes. These categories are fixed by type of property and have only two different rates of depreciation; at least in cases other than certain buildings, these categories and rates appear not to be based on useful lives, even as a rule of thumb.[80] A major exception exists in that there is no provision for the depreciation of structures other than industrial buildings or plant and hotels, even if the structure (such as an office building) is used to generate current income.[81] Goodwill is not included as depreciable property.

The Australian statute is in some ways quite similar to the U.K. law, while in others it departs radically. Although it does not specify that a useful life must be determinable, depreciation for the costs of physical property is based on the effective life of the unit.[82] As with the United Kingdom, no depreciation is allowed for the cost of buildings other than plant. Goodwill is also not included. The Lesotho statute starts out by limiting depreciation for physical property to that which "is likely to lose value because of wear and tear or obsolescence."[83]

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[77]*See infra* sec. II(E)(2).

[78]The previous system (in effect 1984–94) included no general restriction for physical property based on determinable useful lives. However, similar to the U.S. statute, all categories of such property (other than buildings) were assigned to classes based on property life. IDN IT art. 11(III). However, the Minister of Finance was empowered to issue a decree determining what types of property had what useful lives, making the system similar to the Kazak one. *Id.* art. 11(XIV). The new law switches to a financial-accounts-based system, predicated on expected useful lives; however, the Minister is to issue a decree fixing the useful lives of (at least some) types of property. IDN IT (1994) arts. 11(10), (11).

[79]IDN IT art. 11(X).

[80]Costs for industrial buildings, hotels, and dredging are all depreciated at 4 percent a year, GBR CAA §§ 3, 7, 134, and costs for machinery and plant, motor vehicles, mining, patents, and copyrights are all depreciated at 25 percent a year. *Id.* §§ 24, 67, 69, 70–72, 34, 98, 105; GBR ICTA § 520.

[81]*See* Butterworths U.K. Tax Guide 1990–91 §§ 8:12–8:14 (John Tiley ed., 9th ed. 1990).

[82]Depreciation is allowed only for costs of "plant or articles" and a "unit of industrial property," which includes "rights" such as patents, copyrights, or designs. *See* AUS ITAA §§ 54(1) 124K(1), 124L. Depreciation is based on the "effective" life of the property, with six different spans of effective lives from fewer than 3 years to 30 or more. *Id.* §§ 55(1)–(5), 124M(1).

[83]LSO ITA § 3(1).

However, the statute makes no reference to useful lives for physical property; there, depreciation is allowed by type of property, although a catchall category allows the depreciation of any depreciable physical property (other than nonindustrial buildings, which are specifically excluded).[84] Intangible assets are depreciated on the basis of useful life.[85]

The U.S. statute begins with a general rule that restricts depreciation for the costs of property, both physical and nonphysical, that is due to "exhaustion, wear, and tear (including a reasonable allowance for obsolescence)."[86] As with the Australian statute, in the case of physical property there is no explicit reference to useful lives.[87] However, also as with the Australian statute, the standard method of determining annual depreciation allowances for the costs of physical property is based on the estimated useful life of that property; there are also a number of rules of thumb that appear to assume consistent useful lives for a few additional classes of property.[88] Regulations permit depreciation for nonphysical property only when its useful life is limited and its length “can be estimated with reasonable accuracy."[89] Explicitly excluded in this rule is goodwill, presumably because it has no accurately determinable useful life.[90] However, a separate statutory provision permits depreciation of purchased goodwill and certain other nonphysical property.[91]

In a manner somewhat similar to the U.S. and Lesotho statutes, the Kazak statute first limits depreciation to physical property that is liable to wear and tear.[92] It then assigns physical property to a small number of classes, the apparent assumption being that the property in each category has roughly comparable useful lives.[93] However, there is a residual class covering all physical property liable to wear and tear (other than land) that is not listed in the other classes. This means that it is possible for different types of physical property that might have radically different useful lives to be depreciated at the same rate. There is no requirement that

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[84]*Id.* § 43; LSO ITA sixth sched.

[85]*See* LSO ITA § 44(2).

[86]USA IRC § 167(a).

[87]USA Treas. Reg. § 1.167(a)-2.

[88]There are essentially nine property classifications, of which six are based on useful lives, and three—residential rental property, nonresidential real property, and railroad grading or tunnel bores—are based on type; these last three appear to be rules of thumb. USA IRC § 168(c)(1), (e)(1).

[89]USA Treas. Reg. § 1.167(a)-3.

[90]*Id. See also* X-Pando Corp. v. Commissioner, 7 T.C. 48, 53–54 (1946).

[91]USA IRC § 197.

[92]KAZ TC art. 20(1).

[93]*Id.* art. 20(3).

nonphysical property be subject to obsolescence, but it must have an ascertainable useful life. Nevertheless, a single depreciation rate is fixed for all nonphysical property.[94]

As noted, a large number of different techniques exist for restricting depreciation to property whose decline in value can be reasonably estimated. For both physical and nonphysical property, either a "subject to wear and tear and obsolescence" or a "determinable useful life" rule would be necessary. In part because a determinable useful life can provide a basis for determining reasonable depreciation allowances, this rule should probably be included.[95] If for administrative reasons it is preferred that various types of property be listed with their assumed useful lives, such lists can be seen as guidance in specific applications of the general rule. However, in such cases, rather than have catchall rules, it might be better to require the taxpayer to declare a fixed useful life. This would avoid any ambiguity regarding such assets as financial securities.

A French-type rule that allows for a special after-the-fact allowance when a useful life cannot be determined—provided that a reasonable estimate of a reduction in value can be found— makes theoretical sense, although it could prove difficult to administer. One possibility would be to permit such an allowance only if there was clear evidence, such as a recent price for identical property. Another would be to follow the French rule that any additional allowances be reflected in financial statements; however, this would probably be a less effective tool with unquoted companies or in jurisdictions where financial reporting is relatively unimportant. A third possibility would be not to permit deductions or allowances for property without determinable useful lives, but instead, when the property is transferred or is rendered worthless, to impute the time value of the lost deductions. This, however, might be too much of an administrative burden for developing and transition countries.

[94]*Id.* arts. 20(3)(3), 24.

[95]*See supra* sec. II(D).

E. Exclusions of Particular Property

1. Land

As a general matter, costs for acquiring land would be excluded from depreciation either through the operation of the wear and tear or determinable life rules. However, land can be prepared or developed in a way that increases its value, but that preparation or development may itself have a limited useful life. If the value of the preparation or development can be separated from the rest of the land, a reduction in value of this separate amount can be estimated. If the development or preparation is itself part of otherwise depreciable property, those costs can be included and depreciated together.[96] However, if there is a specific statutory exclusion of land, it should be drafted so as not to cover the preparation or development of land that itself may have a determinable useful life. Depletion, an issue related to but different from other matters concerning land, is discussed below.[97]

The French statute does not explicitly exclude the cost of land from depreciation; it only excludes property with no determinable useful life. Therefore, preparations of land that are part of the costs of another depreciable property should not be excluded, nor would other land workings that themselves have a determinable useful life.[98] The German rule is similar,[99] as is the Japanese.[100] Indonesia specifically excludes land and makes no specific reference to whether the workings of land can be depreciated as part of the cost of other property.[101] The same is true of Kazakhstan[102] and the United States.[103] The U.K. law has no specific rule allowing land to be depreciated. As noted earlier, the costs of nonindustrial buildings are generally not subject to depreciation. However, a provision allowing depreciation of certain buildings includes the cost of land preparation.[104] Australia has a more restrictive rule.[105]

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[96]*See* the discussion *supra* concerning costs regarding self-creation or improvement of property. However, if they are related to depletion, they may not fall in value at the same rate as the mineral property and should have a separate depreciation provision.

[97]*See infra* sec. III(D).

[98]*See* Précis, *supra* note 65, ¶ 1082.

[99]DEU EStDV §§ 9a–11d.

[100]*See* JPN IT Reg. 21 (I).

[101]IDN IT art. 11(I).

[102]KAZ TC art. 20(2)(1).

[103]USA Treas. Reg. § 1.167(a)-2.

[104]GBR CAA § 13.

[105]AUS ITAA § 54(2)(b) limits depreciation for “structural improvements on land” to “(i) fences, dams, and other structural improvements on land which is used for the purposes of agricultural and pastoral pursuits; (ii) structural

(continued)

If a statute includes a general rule limiting depreciation to property with a fixed useful life, there would appear to be no specific reason to exclude land, nor would there then be a reason to provide a special rule for the workings of land. However, an additional rule, perhaps more appropriate for a regulation than a statute, could spell out that the costs of working land that are related to construction of otherwise depreciable assets must be included as costs and that other workings are depreciable provided that they have a determinable life.

2. Goodwill

What exactly constitutes goodwill may not be entirely self-evident. It is generally thought to include the value, based on reputation, that the relevant public attaches to a particular product or service and the undertaking that provides it. It can be created through the provision of a good product or service and can be enhanced through such things as advertising. It can often be transferred through the sale of a trademark, and can constitute part of the value of the transfer of a copyright, a patent, or an entire business.

As noted earlier, some jurisdictions disallow depreciation for goodwill because it has no ascertainable useful life, making it difficult to estimate a decline in its value.[106] Also as noted, it might be possible to impute the value of lost deductions at the point when goodwill is transferred or becomes worthless. However, there are other justifications for disallowing any deductions for a decline in the value of goodwill in certain circumstances. These circumstances exist when costs that relate to the creation or maintenance of goodwill are not disallowed, but are deductible; as a compensating distortion, losses in goodwill itself should not be deducted. As noted, goodwill can be a valuable component of an enterprise, reflected in such things as company trademarks. It derives from many things, perhaps the most important of which are the quality of the enterprise's product and advertising. If the costs of carrying on the business, and of advertising, are generally deductible, losses in the value of goodwill itself should not be.[107] Obviously, a separate and more accurate solution would be to deny a current deduction for at least certain costs, like advertising and promotion, and to either depreciate them independently if a useful life can be estimated or treat them as part of the cost of creating or maintaining goodwill.[108]

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improvements (not including an improvement that is an access road...)...on land that is used for the purposes of forest operations."

[106]This is true of both French and U.S. rules, while British and Australian rules do not include goodwill as depreciable property. *Supra* sec. II(D).

[107]At least some evidence would suggest that advertising and promotional expenses have the effect of creating goodwill that lasts longer than a single year. *See* George Mundstock, *Taxation of Business Intangible Capital*, 135 U. Penn. L. Rev. 1179, 1186–89 (1987). Nevertheless, it is common for jurisdictions to permit the deduction of advertising and promotional expenses. *See supra* ch. 16.

[108]*See id*.

This argument works with regard to goodwill that is self-created. However, if goodwill is purchased, rather than created, and deductions for a decline in the value of goodwill are disallowed entirely, there may be a tax incentive for self-created, rather than purchased, goodwill.[109] For example, the German statute permits the amortization of goodwill, but only if it is acquired rather than created; the statute fixes a specific period that is not based on any determinable useful life.[110] The United States also allows depreciation of goodwill over a fixed period and limits such amortization in the case of self-created goodwill to licenses, permits, covenants not to compete, franchises, trademarks, and trade names.[111] Other jurisdictions also allow depreciation or amortization of goodwill over fixed periods, although the provisions themselves are typically not limited to goodwill, but to categories of nonphysical property.[112] The actual periods involved do not appear to be justified by any theory.[113] However, the rules presumably assume that an arbitrary period may better match income and expense than assuming an infinite life and allowing recovery only on sale.

As can be seen, there is little consistency among different jurisdictions concerning how the costs of goodwill should be treated. However, particularly if advertising and promotional costs are deductible, there may be an argument for allowing depreciation of acquired goodwill. As noted earlier, the difficulty in determining useful life might require a special exception to the general rule, as well as a specific rate of depreciation. It may also be possible to deny any depreciation deductions until the goodwill is sold or disposed of and a fair market value of the goodwill is obtained. At the time of the realization, the time value of money of the disallowed depreciation can be imputed.

3. Inventory

Any change in the value of property that is stock or inventory is typically accounted for separately from the depreciation provisions.[114] Thus, inventory should be expressly excluded from the operation of depreciation.[115]

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[109]Frequently, self-created goodwill is not designated as separate property until an enterprise is sold. Because of this, it is less likely that the issue of depreciating the costs of self-created goodwill would arise.

[110]DEU EStDV §§ 9a–11d; EStR §§ 42–59c. (Note that the seller of goodwill will normally have been taxed.—L.M.)

[111]USA IRC § 197 (a), (c)(2), (d)(1)(D), (E), (F).

[112]For a summary of treatment in the EU, *see* Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation 254 (1992). In Kazakhstan, a single, arbitrary depreciation rate is fixed for all nonphysical property. KAZ TC § 24(2).

[113]*Id*. The Japanese generally allow the depreciation of goodwill, either as a fixed percentage or over a fixed period. Both, however, are determined by the taxpayer. JPN IT Reg. 21-3.

[114]Accounting for inventory is discussed *supra* ch. 16.

[115]*See, e.g.,* KAZ TC art. 20(2)(2); USA Treas. Reg. § 1.167(a)-2(a).

4. Property the Costs of Which Have Already Been Accounted For

If the decline in the value of an asset is already accounted for in some way, no deduction for depreciation is needed. Jurisdictions such as France, Germany, and Japan, which generally rely on accounting-type rules, disallow double deductions through their general accounting rules.[116] Some jurisdictions, such as Kazakhstan, have a general provision denying multiple deductions for the same item of expense, while others, such as the United States, have a rule specifically denying depreciation for property whose cost has been otherwise deducted. Still others, such as Australia, deny deductions for property that has been depreciated.[117] A general rule like that in Kazakhstan could, for the sake of clarity, be supplemented with a more specific statement applying the rule to depreciation.[118]

III. Depreciation Rates and Methods

A. Economic Depreciation

Ideally, allowed depreciation deductions should reflect the actual decrease in the market value of the property. However, absent a yearly sale or exchange of an identical asset, the actual decrease in fair market value will be difficult to determine.

Example
Depreciation based on discounted cash-flow analysis

Assume that Taxpayer *A* purchases the right to use an industrial formula for a period of five years. Assume in this example that there is no inflation and that the formula will produce a cash flow of $1,000 every year until the right to use the formula expires. The market value of the five-year know-how would be equal to the sum of its cash flow. However, $1,000 paid two years from now is worth less than $1,000 paid one year from now. To determine the net present value of $1,000 paid each year for five consecutive years, each $1,000 would have to be appropriately discounted.[119]

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[116] *See* Précis, *supra* note 65, ¶ 517; JPN IT art. 31; JPN IT Rule 3; DEU EStG § 6.

[117] AUS ITAA § 56(3).

[118] There have been instances where double deductions have been allowed. For example, in the United States, an investment credit was allowed for certain property. Originally, the amount of the credit had to be subtracted from the cost of the property for purposes of computing depreciation, but this rule was repealed in 1964. (Strictly speaking, a double deduction was not involved, but the effect of allowing a 100 percent deduction plus a credit is equivalent.) In 1982, Congress required the basis of property to be reduced by one-half the investment tax credit. *See* Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, JCS-38-82, at 35–37 (1983). Lest the reader consider this an esoteric point, note that the revenue increase from this provision was estimated at $14 billion over the period 1983–87.

[119] "[T]he invested capital represents the ability to generate future earnings, and as an asset with a limited life ages, its value will decline by an amount representing a netting of (a) the loss of the portion of the investment that

(continued)

Table 1. Depreciation of Asset Yielding Constant Income

Year	Cash Return	Present Value	Fair Market Value	Depreciation	Taxable Income
	--	$952	$4330	--	--
1	$1,000	$907	$3546	$784	$216
2	$1,000	$864	$2723	$823	$177
3	$1,000	$823	$1859	$864	$136
4	$1,000	$784	$952	$907	$93
5	$1,000	--	--	$952	$48

Cash Return: total cash return from investment during the year (as indicated in column 1). Present Value: the present value at the beginning of year 1 of $1,000 realized during the year (as indicated in column 1). Fair Market Value: the value of the investment at the beginning of the year (as indicated in column 1). Depreciation: the accrued capital loss during the previous year (as indicated in column 1) or the change in fair market value during the year. Taxable Income: income under a Haig-Simons tax base, or the difference between the cash income of $1,000 and the accrued capital loss listed in the Depreciation column.

In this example, the decline in the value of the formula accelerates very slightly over the years. The example assumes that no changes in supply or demand or of obsolescence in the formula will affect its rate of return. Also, at the end of the term during which the taxpayer may exploit the formula, the formula has no residual value.

Now assume that, instead of a formula of limited term, the investment in the example is an item of physical property. The example would then assume that the property produces the same amount of income every year for five years and then abruptly stops producing any. In the real world, it is unlikely that many physical assets would perform in such a manner over the period of their useful life. A number of studies of individual physical properties have been undertaken over the years to estimate how quickly they lose value over their useful lives. On average, it seems that most physical property tends to lose a greater amount of value earlier than the property in the example.[120] Also, at the end of a physical property's useful life, the property often has a residual or scrap value.

generated last year's earnings and (b) the increase in value of the remaining investment (i.e., of the future years' earnings that are now nearer on the time horizon)." David S. Davenport, *Depreciation Methods and the Importance of Expectations: Implications for Human Capital*, 54 Tax Notes 1399, 1400 (1992).

[120]*See, e.g.*, Charles R. Hulten & Frank C. Wykoff, *The Measurement of Economic Depreciation, in* Depreciation, Inflation, and the Taxation of Income from Capital 81–125 (Charles R. Hulten ed. 1981).

B. Straight Line and Accelerated Depreciation

Financial accounting techniques typically use a different method of estimating depreciation deductions.[121] Straight-line depreciation, which is perhaps the most basic type, assumes that the property will lose an equal amount each year during its useful life. In the above example, this would be one-fifth of the cost of $4,330 in each of the five years, or $886 a year. This yearly amount in deductions would be more than that allowed in the example for the first three years and less for the last two. Because of the time value of money, the straight-line deductions are more generous.

Other methods of financial accounting, usually reserved for physical property, allow for greater depreciation deductions in the early years than is found in the straight-line method. Empirical evidence suggests that most physical property declines more rapidly than assumed either in the example or in the slightly faster straight-line depreciation. For this reason, faster depreciation may be provided for such property. There may be another, even faster rate to account for physical property that is subject to unusually rapid technological obsolescence, such as computers, or to other property like cars and trucks, that can continue to operate even when partially broken down.

Even faster depreciation may be allowed to offset the erosion of nominal property value attributable to inflation. This chapter does not specifically address the effects of inflation, which is treated more generally in chapter 13 (see vol. 1). However, it is worth noting here that if there were no other method in place for adjusting for the effects of inflation, increasing the rapidity of depreciation deductions could reflect the faster decrease in nominal value of property attributable to an overall increase in prices.

Another reason for allowing for faster depreciation is that tax rules often seek to provide taxpayers with a schedule of deductions that is more beneficial to them than actual economic depreciation. As a result, effective tax rates are reduced below the apparent or statutory tax rate. This is often justified by the argument that increasing depreciation deductions for an asset in the early years will create an incentive to invest in that asset. This is often known as "accelerated" depreciation, although that term can sometimes be used to refer to any method of depreciation faster than straight-line. Using accelerated depreciation to reduce the rate of taxation on income from a particular asset below that of income from other assets creates an incentive for the taxpayer to invest in that asset, which would distort choices otherwise dictated by the market. Economists would also argue that the incentive effects are heavily biased toward less risky assets.[122]

C. Declining-Balance Depreciation

[121]It should be remembered that an important goal of financial accounting is to let the owners know what their income actually is. However, to protect potential investors and creditors in a business, most financial accounting standards have rules built into them to ensure that income estimates are under- rather than over-stated. *See* Financial Accounting Standards Board, Statements of Financial Accounting Concepts 60–62 (1994).

[122]I am indebted to Peter Goss for pointing this out to me.

One technique of increasing the proportion of total allowable deductions taken in the early years is called the "declining-balance" method, which is often expressed as a factor of how much more depreciation is to be taken relative to straight line. If a factor of 2 in a declining-balance method were used in Example 1, in the first year twice the amount of straight-line depreciation would be allowed. Because straight line allowed one-fifth, or 20 percent, double-declining depreciation would allow 40 percent, or $1,772. However, if depreciation is to reflect a reduction in market value of an asset, 40 percent of cost cannot be allowed each year for five years; the total would add up to more than the cost of the asset, and an asset cannot be worth less than zero. The declining-balance method requires that, for each consecutive year after the first, the percentage allowed as depreciation be taken not of original cost, but of the amount of cost remaining after the previous year's deduction. In this example, the "balance" left for depreciation would be $4,330 minus $1,772, or $2,558. Forty percent of that amount would be $1,023.

Under a pure declining-balance system, not all the depreciation is taken over the predicted useful life of the asset. Instead, the amount of depreciation is extended indefinitely, with ever smaller amounts allowed in each successive year. Indefinite depreciation for each asset would not, however, be practicable. This issue can be resolved in several ways. First, a declining-balance system can be used until the last year of the useful life, at which point the remaining amount can be deducted in the final year. A variation on this rule is to either require or allow the taxpayer to switch over to a straight-line system sometime before the end of the useful life.[123] Second, the depreciation account for the asset could simply be kept open past the end of the asset's useful life. Such depreciation accounts are referred to as "open ended" because they include assets placed in service in more than one year.

Under the open-ended accounting system, a declining balance can be expressed simply as a yearly percentage deduction of the remaining cost. An estimate of the useful life of an asset can be used to determine which percentage should be allowed; in the above example, one can determine that 200 percent declining balance system is equal to a 40 percent annual deduction for those assets with five-year useful lives. But once the 40 percent annual deduction is selected for a particular asset, the useful life is no longer relevant to determining the allowable deductions.[124]

While in the real world some physical property such as computers or cars might actually lose value as rapidly as is estimated in a 200 percent declining balance system, in the majority of cases it is likely that such a system would vastly overstate economic depreciation.[125] However, a

[123]For example, in the United States a declining-balance depreciation by a factor of 2 for an asset with a ten-year useful life requires a switch to straight line at the fifth year. In this way, the amount of cost left to be depreciated (41.2 percent) is deducted in equal portions (6.86 percent) during the final, straight-line period. *See* USA IRC § 168(b)(1).

[124]Because such a system of open-ended accounts does not depend on a fixed date at which the asset's useful life ends, it is more commonly used to determine allowances not for single assets, but for all similar assets. This allows asset accounting on the basis of "pools," an issue that is discussed at greater length in sec. G *infra*.

[125]*See* Hulten & Wykoff, *supra* note 122.

declining-balance system need not "accelerate" depreciation over actual economic depreciation; the net present value to the taxpayer of a declining-balance system depends on the percentage of annual balance allowed. For many physical assets, a declining balance rule probably more accurately reflects economic depreciation than does straight line.[126] A system seeking to increase the value of depreciation over straight line can do so also by reducing the estimated useful life of the asset by a certain percentage. Either a straight-line or a declining-balance system can then be used.

Using a rule of thumb percentage (such as 125 percent) of straight line over useful lives as a rough estimate of economic depreciation still depends on determining the useful lives of assets, an activity that is hardly an exact science. And, obviously, trying to fix depreciation not on some rule of thumb, but on even more accurate empirical data, is more difficult. There are an enormous number of different assets, and, as noted earlier, technology and markets constantly change. Giving the authority to the taxpayer on her or his own to determine depreciation allowances is clearly an invitation to overestimation; giving the government such authority could easily overburden the tax administration.

Whenever there is great mismeasurement of the depreciation of an asset for tax purposes and the amounts invested in such assets are significant, the effect on tax revenues (and investment incentives) can be substantial. For example, in Indonesia, such sectors as cement, steel, and mineral processing are very important to the economy, employ long-lived assets, and, under their system of depreciation, had been entitled to what empirically appears to have been massively accelerated allowances. As a result, the effective tax rate on income from such assets has been very low. In such circumstances at least, special classes with special depreciation schedules should be fixed.

Certain assets clearly depreciate very rapidly. For example, cars, trucks, and especially computers (as well as other office equipment) may depreciate very rapidly even though their useful lives are rather long. While cars or computers may be used for years, their fair market values may drop precipitously in a short time. For these assets, a rapid declining-balance system would be appropriate. To require slower depreciation would increase the effective tax rate on returns from such equipment, and would create a disincentive to invest in them.

Countries often also provide special depreciation incentives for certain types of preferred property. These choices are not based on any attempt to match economic with tax depreciation. Instead, they are designed to create incentives for the taxpayer to invest in such property by reducing the effective tax rate on the income it produces. Special tax incentives designed to distort market investment choices are not generally the subject of this chapter. However, when such incentives are adopted, policymakers should make public both the intended effects of such incentives and the justification for adopting them.

As noted earlier, jurisdictions have vastly different basic statutory structures for determining amounts of depreciation deductions. Apart from special incentive provisions, they can be divided into (1) those that base deductions primarily on useful life, (2) those that use

[126] *See id.* at 94.

somewhat broader rules of thumb, but that are also based primarily on useful life, and (3) those that use rules that appear to be largely arbitrary. Those systems that use (1) may also provide guidance, either mandatory or suggestive, as to what the useful lives of a range of properties are. Those that use (1) and (2) often provide acceleration for properties that appear to decline in value more quickly than straight line suggests. There is also a difference with regard to which jurisdictions include in their estimation the likely scrap value of the property, if any, once it has reached the end of its useful life.

The French and German rules, although somewhat different, provide some of the purest examples of system (1). They are primarily based on the useful life of the property, with special provisions for unexpected or exceptional falls in value, though never for increases in value. In France, the useful life of the property is determined by financial accounting principles, although a 20 percent variance is permitted.[127] Straight-line depreciation is then generally required for the property, including all nonphysical property, unless declining balance is specifically allowed.[128] Declining-balance depreciation is allowed, although not required, for certain physical property, including most machinery used in manufacturing and transport, office machines, and buildings used for light industry with a useful life of less than 15 years.[129] The degree of declining balance depends on useful lives: 1.5 for useful lives of 2–4 years, 2.0 for 5–6 years, and 2.5 for 6 years or more.[130] However, because the French system is based on an actual attempt to duplicate real decreases in value of the asset, extra depreciation can be taken on any property to reflect special wear, changes in technology, or even the market for the good.[131] However, the depreciation deductions that are taken for tax purposes also have to be taken for financial reporting purposes.[132] Depletion allowances are uncharacteristically based largely on special provisions that have no apparent relationship to actual depletion. In addition, there are many special rules for accelerated depreciation for specially favored property.

The German rule also bases depreciation primarily on the useful life of the property.[133] However, most useful lives are not determined strictly by financial accounting principles, in that the Ministry of Finance has listed recommended rates by category (machinery, office equipment, office furniture) and then more specifically by individual type.[134] In addition, the statute provides

[127]FRA CGI art. 39-1-2°; Précis, *supra* note 65, ¶ 1083.

[128]*See id.*; FRA CGI Ann. II, art. 24.

[129]FRA CGI art. 39A; FRA CGI Ann. II, art. 22.

[130]FRA CGI Ann. II, art. 24-2.

[131]Although reasonable proof would have to be provided. *See* Précis, *supra* note 65, ¶ 1083. Special deductions can also be taken for property not normally depreciable. *See supra* note 74.

[132]*See* Précis, *supra* note 65, ¶ 1083.

[133]DEU EStG § 7.

[134]The tables, with useful lives and rates, are found in Afa-Tabellen, vom Aug. 15, 1957, in der Fassung der ersten bis dreizehnten Ergänzung.

specific rates for certain buildings.[135] However, as in France, a declining-balance system is permitted in some instances for physical property; but in Germany, all movable fixed property is eligible, and up to a factor of 3 over straight line may be used, but with a limit of 30 percent total deduction a year.[136] Unlike in France, there is also a provision that, for all movable fixed property, allows the taxpayer to fix depreciation as a percentage of output, although the taxpayer must provide "proof."[137] There is also, as in France, a general provision allowing for "extraordinary technical or financial depreciation."[138] There are many special rules for accelerated depreciation for specially favored property.

The Japanese rules have a similar mix of straight-line and declining-balance methods, also based on useful lives for which the Ministry of Finance provides guidance;[139] special deductions can also be taken for most physical property for extra wear or obsolescence.[140] The depletion rules are nearly identical to those in Germany.[141] Accelerated depreciation is also provided for favored property. In both Germany and France, scrap value is not normally taken into account in determining depreciation; however, any value realized from the sale of a depreciated asset would be included in income.[142]

The British rules, not surprisingly, are a fairly good example of system (3) above, where the rules appear to be largely arbitrary. As noted earlier, British depreciation rules are based on neither useful lives nor on any other apparent estimation of actual declines in value. With only two rates available for all depreciable physical and nonphysical assets (including depletion), it can be guaranteed that allowances do not approximate reality.[143]

At least with regard to the limited categories of property that the statute includes as depreciable, Australia is a fairly good example of system (2) above, or those that use somewhat broader rules of thumb, but that are also based primarily on useful lives. Most physical property

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[135]DEU EStG § 7(4).

[136]*Id.* § 7(2).

[137]*Id.* § 7(1).

[138]*Id*.

[139]JPN IT art. 31; Ministry of Finance Ordinance No. 50 (1951).

[140]JPN IT Reg. 21-(2) II, Rule 7-(2).

[141]JPN IT Reg. 21-3.

[142]*See* discussion *infra* at sec. III(E) regarding transfer of property. However, as a matter of accounting conformity, in Germany estimates of scrap value can be included in determining depreciation for depreciable property (e.g., a ship) that normally has a substantial scrap value at the end of its useful life. *See* International Bureau of Fiscal Documentation, Taxation of Companies in Europe, German Federal Republic 53 (1995).

[143]*See supra* note 82.

is put into one of seven categories, based on useful life.[144] A declining-balance system is then used, unless the taxpayer opts for a straight-line system at rates published in the statute.[145] Taxpayers generally determine the useful lives of property, although the Commissioner of Inland Revenue publishes recommended lives, which the taxpayer can use.[146] For most nonphysical property, a straight-line system based on useful life is used.[147]

Lesotho seems to lie somewhere between the British and Australian systems. Its law relies on a broad and rather crude rule of thumb for three different categories of physical property, including depletion, selected by type and not by useful life; these categories allow a 5 percent, 20 percent, or 25 percent annual deduction.[148] However, there is also a catchall category for physical property not otherwise listed (except buildings other than industrial, which may not be depreciated), at the annual rate of 10 percent.[149] However, intangible assets are depreciated over their useful lives in accordance with the straight-line system.[150]

The Kazak statute is similar to both the British and Lesotho rules.[151] As with Lesotho, there is a residual class covering all property (other than land) not listed in the other classes.[152] Like the U.K. system, a single, arbitrary depreciation rate is fixed for all nonphysical property.[153] These systems do not consider scrap value.

The U.S. statute is similar to the Australian, with most physical property put into one of nine categories based on the property's useful life; three categories are based on rules of thumb without any direct reference to useful lives: residential rental property, nonresidential real property, and railroad grading or tunnel bores.[154] Of course, such reference to useful lives is indirect in that property with similar useful lives was chosen for each class, and the allowable

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[144]*See* AUS ITAA § 55.

[145]*Id*. §§ 55, 56(1); but *see id*. § 56(1A). There are special rules for certain other properties, such as certain motor vehicles, works of art, and Australian trading ships.

[146]*Id.* § 54(A).

[147]*Id.* §§ 124S, 124M.

[148]*Id.* sixth sched.

[149]*Id*. The relatively slow rate of 10 percent is intended to prevent taxpayers from arguing that property is not listed in one of the other classes and therefore falls into the catchall.

[150]*Id.* § 44(2).

[151]*See* KAZ TC art. 23(1).

[152]*Id.* art. 20(3)(3).

[153]*Id.*

[154]USA IRC § 168(c)(1), (e)(1).

depreciation was based on estimates of those useful lives. Depreciation is allowed using a 200 percent declining balance, switching to straight line when more beneficial to the taxpayer, except for 15- or 20-year property, for which only 150 percent declining balance is allowed, and for immovable property or railroad property, for which straight line is required.[155] Nonphysical property is depreciated at a straight line,[156] and depletion is based either on a "reasonable allowance" or on a fixed annual percentage based on a large number of different categories of mineral.[157]

There is an obvious advantage to trying to match tax depreciation to real decreases in value. The accounting-type rules do at least set this as a principal goal. However, there are a number of objections to these systems: they are too complicated, and they give the taxpayer too much of an opportunity either to understate lives or to take unjustified additional depreciation. Therefore, justification can be found for the somewhat simpler rules followed in the United States and in Australia and for the much simplified rules followed in Lesotho and Kazakhstan. However, if administrative considerations permit a somewhat more sophisticated system, compromises can be made to keep the best of the accounting-based systems, without allowing too much latitude to the taxpayer. A compromise might include the following: along the lines of the French, German, and Japanese systems, a general rule could set annual depreciation rates as equal to straight line over the useful life unless an exception is provided.

The first exception would allow a 150 percent declining balance for all physical property, to take account of the apparently greater speed with which such property actually declines in value. The taxation authority could then publish properties by type, as amended from time to time, along with their useful lives and the yearly depreciation rates. The second exception could allow, where specifically provided in regulations, 200 percent declining balance for physical property that tends to experience more rapid declines in value, as provided by regulation. The taxation authority could then publish properties by type, as amended from time to time, along with their useful lives and the yearly depreciation rates. In addition, any policy to accelerate depreciation for purposes other than ease of administration should be clearly stated and reflected not simply in changes in allowable yearly deductions.

The question of whether scrap value should be taken into account is really one of ease of administration. Certainly, as a matter of theory, scrap values should be included where appropriate, because the existence of a scrap value would mean that the asset does not decline to worthlessness over its useful life. A rule could require that if scrap values are assumed in financial accounts, they should be included in tax depreciation accounts as well. Another possibility would be for the tax administration to provide estimates of scrap values for those items of physical property for which it publishes useful lives, at least those for which scrap value is high. Another would be to use the Japanese rule of thumb method.

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[155] *Id.* § 168(b).

[156] *See* USA Treas. Reg. § 1.167(a)-3.

[157] USA IRC §§ 611(a), 613(a). There are seven different groups of minerals with different allowances. *Id.* § 613(b).

D. Depletion

Minerals that are extracted from the land will result in a reduction in the land's value; if the value of the minerals can be separated from the value of the rest of the land, a reduction in value of this separate amount can then be estimated. For a number of reasons, allowances for decreases in the value of mineral or similar property are often conceived of as separate from the accounting for depreciation of other property. One of the most important is that natural resources are often exploited at varying rates over the years. The rate of exploitation directly affects the decline in the value of the natural resource. This is in contrast to the assumption that underlies depreciation allowances for most other property, both physical and nonphysical: the rate of decrease is relatively constant throughout the property's useful life.

To account for the possibility that exploitation may vary over time, depreciation can be fixed on the basis of a reasonable estimate as to how much of each unit extracted reflects a decrease in the amount of total remaining mineral. This is known as "unit-of-production depletion."[158] Of course, this could be expressed as a given useful life, but only assuming a fixed rate of extraction. The second problem is that it is often difficult to determine the exact quantity of a natural resource. Without knowing how much exists, it is difficult to calculate unit-of-production depletion.

Another way to determine depletion allowances is to assume that a certain percentage of the gross income from the exploitation of the resource represents the cost of the depletion of the resource. Unlike with unit-of-production depletion, the amount of cost recovery allowed is reflected in a fixed rule of thumb percentage of gross income, and total deductions may not be limited to the cost of the original investment. This is known as percentage depletion.

The German statute allows depletion allowances to be based either on a useful life analysis or on accurate unit-of-production depletion analysis, the latter of which must be based "according to the portion of the substance consumed."[159] The French and Japanese each have special provisions for depletion. The French statute provides two different fixed annual percentage depletion amounts for hydrocarbons and other minerals; there is no limitation on deductions relative to the total cost of the natural resource.[160] The Japanese allow unit-of-production depletion or the related system based on the estimated life of the mineral or on any other reasonable estimate.[161] The Indonesian rule is similar to the German rule.[162]

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[158]The unit-of-production method has also sometimes been used for depreciable assets other than minerals.

[159]DEU EStG § 7(6).

[160]FRA CGI arts. 39 *ter*, 39 *ter* B.

[161]JPN Reg. 21-3.

[162]The taxpayer is allowed to use either a single fixed period, or the unit-of-production method, although a rate is not prescribed. IDN art. 11(X), (XII), (XIII).

The U.K. statute is quite different. It provides a single, and apparently arbitrary, depletion rate for all minerals.[163] Unlike the British provisions, the Australian provisions are based on a useful life analysis.[164] The Lesotho rule is like the British.[165] The U.S. rule gives the taxpayer a choice: it allows depletion based on a reasonable allowance or allows percentage depletion as provided in the statute. The percentage allowed is based on a large number of different categories of mineral.[166] As with France, total allowable depletion is not limited to cost of the mineral. The Kazak statute is similar to both the British and Lesotho rules.[167]

Because of the relatively greater potential variability of natural resource exploitation, unit-of-production depletion should probably be required. The German phrasing seems adequate. However, because of the difficulty of administering such a rule and the often imperfect science of determining the size of at least some mineral wealth, providing rules of thumb for classes of minerals should also be contemplated. These rules of thumb should be based on empirical evidence of the local jurisdiction.

Probably one of the easiest ways of creating such rules of thumb is through a percentage depletion allowance, as is done in the United States. However, it makes sense to limit the total costs allowed through percentage depletion to the total costs of acquiring the depletable natural resource.

E. Transfer of Property

Depreciation (and depletion) allowances are designed to provide estimates of decreases in the value of property. However, except when they are based on the limited terms of nonphysical property, such decreases are unlikely ever exactly to equal the actual decline in the value of property. Therefore, if such property is transferred (or if it stops being used for the production of currently taxable income) before it becomes worthless, it is likely to have a value either greater or smaller than that predicted by depreciation. Also, in those instances where declining-balance depreciation is used, the property may well become worthless before or after the expiration of its useful life; if declining-balance depreciation is used, the property is nearly certain to become worthless before the balance reaches a trivial amount.

A transfer before the completion of depreciation allowances is therefore likely to result in an actual value at variance with its written-down value. If the actual value is lower, an additional deduction is required; if higher, the difference should be taken into income.

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[163]*See* GBR CAA § 98(5).

[164]AUS ITAA §§ 122DG; 124ADG.

[165]*See* LSO ITA § 43.

[166]*See supra* note 159.

[167]*See* KAZ TC art. 23(1).

The accounting-type jurisdictions as a general rule take into account gains and losses on the transfer of business assets; this includes those with written-down or depreciated values.[168]

The United States has a number of provisions whose net effect is similar.[169] For those assets that are not pooled,[170] the United Kingdom has a number of provisions that generally allow an immediate deduction for a loss and require immediate taxation of gain, although some special rules exist.[171] Australia, which allows pooling for most property, also has specific provisions that tax gains and losses, while permitting the rollover of gains in certain circumstances.[172] Both Kazakhstan and Lesotho include all gains on property as income.[173] Both laws also have specific rules regarding gains and losses on all depreciable physical assets.[174]

In order to ensure that no property, either physical or nonphysical, falls through the cracks, there should be a general provision that includes in income all gains and losses on the disposal of business property, including property subject to any depreciation or depletion allowances.

F. Partial Years

Not all depreciable property is acquired and used on the first day of the tax year; nor may it necessarily be eligible for depreciation allowances for an entire tax year. Therefore, many countries provide a mechanism for ensuring that a full year's depreciation is not deductible when an asset is in use for only part of a year. Again, different systems use different techniques. The accounting-type jurisdictions generally use the accounting rules in their jurisdictions. In France, this means that depreciation is prorated monthly, as of the first day of the month in which it was "acquired" or "built."[175] The Japanese rule is nearly identical.[176]

[168] *See* FRA CGI art. 38(2); DEU EStG § 6; JPN IT §§ 22, 31(2). The French law, which has a special provision for reduced taxation of long-term capital gains, specifically includes gain up to the amount of depreciation taken as fully taxable short-term gains. FRA CGI art. 39 *duodecies* (b).

[169] *See, e.g.,* USA IRC §§ 168(i), 197(f)(1), 1245(a)(1), (a)(3). This also ensures that "recapture" of depreciation is reflected as a short-term capital gain. Such recapture of depreciation is referred to in some countries as a balancing charge.

[170] For a discussion of pooling, *see infra* sec. III(G).

[171] *See* I.R.C. v. Wood Bros. (Birkenhead) Ltd. [1959] A.C. 487; *but see* GBR CAA §§ 4(2), 60(2), 79.

[172] AUS ITAA § 59(1)–(2), (2A)–(2E).The net effect of rollover is the same as generally found in pooling. *See infra* sec. III(G).

[173] KAZ TC art. 20(6), (7). LSO ITA §§ 41(4), (8), (9), (11), 59.

[174] KAZ TC art. 20(6), (7). LSO ITA §§ 41(4), (8), (9), (11), 59.

[175] *See* Précis, *supra* note 65, ¶ 1100.

[176] International Bureau of Fiscal Documentation, Taxation of Companies: Japan 94 (1992).

The general German rule is similar; however, this rule is trumped for movable physical property by an exception that lets the taxpayer round to the nearest half year.[177] The British rule allows a full deduction starting in the tax year in which the taxpayer's "obligation to pay . . . becomes unconditional,"[178] while the Australian and Lesotho rules require an apportionment based on the number of days from the moment the property is "used" or "installed."[179] The United States, on the other hand, generally assumes that physical property was "placed in service" during midyear, allowing for only one-half of the typically allowable deduction.[180]

Which rule is selected will depend on a balance between the relative importance of administrative simplicity and accuracy. There is probably a benefit to requiring consistent treatment among all types of depreciable or depletable property.

[177]DEU EStDV §§ 9a–11d; DEU EStR §§ 42–59c.

[178]GBR CAA § 159. Kazakhstan, which uses a pooling system, also allows a full deduction for the entire tax year in which the property is "used." KAZ TC art. 20(1), (4), (6). Correspondingly, the full value of sales proceeds from retired property is subtracted from the pool when property is disposed of, thereby denying depreciation for the year of retirement. (Sweden provides another example of allowing full depreciation in year 1.—L.M.)

[179]AUS ITAA § 56(1A)–(1C); LSO ITA §§ 41(3), 43. However, a half-year convention similar to that of the United States applies when pooling is used. LSO ITA § 41(8).

[180]USA IRC § 168(d)(1), (d)(4)(A).

G. Pooling

A number of countries, rather than requiring the separate tracking of assets for depreciation purposes, either permit or require certain properties to be "pooled."[181] Pooling can be accomplished using either closed-ended accounts (meaning that only property added in the same tax year is included) or open-ended accounts (meaning that property added in a different tax year is also included). Typically, in a pool, different properties with the same tax depreciation attributes are treated as if they were all one property. In the case of open-ended accounts, whenever a property is created or acquired, the appropriate costs are added to the sum in the appropriate pool, that is, the pool that includes all costs of assets with the same depreciation attributes as defined by the statute.[182]

If a property is sold or exchanged, the value received is subtracted from the pool.[183] If the value of the pool drops below zero, that amount is taken directly into income.[184] At the end of each tax year, a percentage of the entire pool is subtracted as a deduction for depreciation.[185] *De minimis* rules may provide for a complete deduction if the value of the pool drops below a certain amount.[186] A complete deduction for the closing balance is also allowed if all the assets in the pool have been retired or disposed of. As noted earlier, pooling can work only in the case of declining- balance depreciation. This is because no record is kept of the remaining useful life of any individual asset.

The principal difference in economic effect between pooling systems and separate accounting is that, under pooling, if allowable depreciation differs from actual (i.e., economic) depreciation and the asset is transferred before it is scrapped or becomes worthless, the gain or loss cannot be immediately reflected as taxable income (except when the value of the pool drops below zero). For example, under a separate accounting system, if an asset with a cost of $100 and a written-down value (i.e., after depreciation) of 0 were sold for $100, that $100 would be taken into income immediately.[187] Under pooling, however, the written-down value of the asset would not be recorded, so it would be impossible to determine the amount of gain. Instead, the

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[181]A number of jurisdictions permit or require pooling for different types of assets, including Australia, Canada, Denmark, Finland, Norway, Sweden, and the United Kingdom. *See* International Bureau of Fiscal Documentation, The Taxation of Companies in Europe (looseleaf). This discussion will focus primarily on the rules of Kazakhstan and Lesotho, which have recently adopted pooling systems.

[182]*See, e.g.*, KAZ TC arts. 20(4), (6)(2); LSO ITA § 41(5), (8).

[183]KAZ TC art. 20(6); LSO ITA § 41(8).

[184]KAZ TC art. 20(7); LSO ITA § 41(9).

[185]KAZ TC art. 20(6)(1); LSO ITA § 41(7).

[186]*See, e.g.,* KAZ TC art. 20(8); LSO ITA § 41(10).

[187]Some tax systems allow a rollover of capital gains reinvested in similar assets or simply other business assets, outside of the context of a pooling system.

$100 would be subtracted from the pool. This would mean that the taxpayer would not have to take into income $100 immediately, but only over the future in the form of lost allowances.

However, the present value of those future deductions will be less than $100 in immediate income. The extent of the benefit (or detriment) of pooling to a taxpayer over separate accounting will depend on the difference between tax and economic depreciation for each asset and on how often the particular taxpayer disposes of those assets.[188]

	Large Asset	Small Asset	Pooling
Year 1	9,000,000	1,000,000	10,000,000
Year 2	7,650,000	850,000	8,500,000
Year 3	6,502,500	722,500	7,225,000
Year 4	5,527,125	614,125	6,141,250
Year 5	4,689,056	522,006	5,220,062
Year 6	3,993,347	443,705	4,437,052

Year 6, sell asset B for $1,000,000

Amount realized: $1,000,000
Basis: $443,705
Gain: $556,295

Under a separate asset accounting system, the $556,295 would be taken into income, and no further deductions would be allowed for the $443,705 left to depreciate. In other words, the taxpayer would lose both the tax due on $556,295 and the present value (in year 6) of $433,705 in declining-balance deductions. Under pooling, this would be subtracted from the pool; that is, the taxpayer would lose the present value (in year 6) of $556,295 plus $443,705 in declining-balance deductions.

Because the present values of the $443,705 are identical, the only question is which is more beneficial to the taxpayer, paying tax currently on $556,295 or losing the present value of declining-balance deductions of $556,295? Current taxation on $556,295 will be greater than the loss of declining-balance deductions whose sum has a nominal value equal to the same number.

If all such assets sold were purchased by others who were taxed at the same rate, then the net effect of a sale of an asset on state revenues would be nil; the asset would continue to be in use somewhere, and while value would be subtracted from one depreciation pool, it would be added to another pool. However, this may not always be the case. Some purchasers of assets may pay tax at different rates. Others may pay no tax, either because they have offsetting losses, or because they are otherwise tax exempt as governmental or nonprofit entities, or because they are not residents. Some, for example, have reported that oil companies in particular like pooling systems, where different subsidiaries can trade large assets like drilling platforms or other

[188]For example, assume that Taxpayer purchases two assets, one large and one small. For tax purposes, Taxpayer keeps track of both assets in a 15 percent declining-balance pool. Taxpayer also keeps separate track of the depreciation of each asset for financial accounting purposes. Taxpayer has estimated that a 15 percent declining-balance approximates the actual decline in value of the asset.

equipment depending on the availability to the subsidiary of other losses and where such assets can be traded out of the pooling jurisdiction entirely.

The economic effects of rolling over the capital gain associated with errors in tax depreciation increase both as the error increases and as the cost of the property increases. Perhaps in part for this reason, jurisdictions that provide for pooling generally require that structures and often other large capital items such as ships, public utilities, or locomotives be depreciated separately.[189] Depending on the wording of the statute, this can be accomplished by requiring either that such property be kept out of the pooling system or that each item of property be kept in its own pool, that is, a separate account.[190]

The oft-stated benefit of pooling is that it encompasses simpler record keeping than single- asset depreciation. However, under typical financial accounting standards, larger taxpayers often must keep separate accounts for assets of any substantial cost. Obviously, for these taxpayers, it may not be particularly onerous to require separate asset accounting for such assets. For taxpayers who are not required to keep separate accounts, the simplicity argument is more compelling. However, for any taxpayer, keeping separate account of assets that are longer lived and of a substantial cost does not seem particularly onerous. How these items of property are identified will depend on earlier choices regarding the structure of the depreciation system. However, as a general matter they could be identified through one or more attributes of cost, type, and length of useful life (or rate of declining-balance depreciation).

For example, all property with total costs in excess of a certain amount, and with a useful life of greater than ten years or a declining balance of greater than 15 percent could be required to be depreciated separately. Therefore, while a statutory provision could allow a pooling method for assets with similar depreciation profiles (meaning that they have the same rate of declining-balance depreciation), the tax administration should be permitted to deny its use in certain cases. This would allow both for ease of administration (broad classification of some assets, pooling) and for selective, careful tracking of economic depreciation for important assets.

An additional consideration in deciding whether to use a pooling system is the interaction between the depreciation method used for tax purposes and that used for financial accounting purposes. It is convenient, although not necessary, for tax and financial accounting to be the same in this respect. Although financial accounting is generally done on a single-asset method, pooled methods are often permitted under national accounting standards.[191]

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[189] *See, e.g.,* LSO ITA § 41(5), sixth sched.; KAZ TC art. 20.

[190] *See* KAZ TC art. 20.

[191] *See, e.g.,* Accounting Standard D40, *reprinted in* Financial Accounting Standards Board, Current Text, Accounting Standards 12607 (1994) (unit for depreciation may be an asset or a group of assets); Donald E. Kieso & Jerry J. Weygandt, Intermediate Accounting 528-29 (3rd ed. 1980); Frank Minter, et al., Handbook of Accounting and Auditing C4-11 (1996).

18

International Aspects of Income Tax

Richard J. Vann[1]

> In the long run, the business unit or source will yield more revenue to the public treasury than the individual; and the place where the income is earned will derive larger revenues than the jurisdiction of the person.
>
> —T.S. Adams

I. Introduction

This chapter examines the details of international income tax as an aid to understanding and drafting the parts of the income tax law dealing with international issues. Given the large literature on basic policy issues in international taxation, I deal with general policy matters only in passing.[2] The chapter accepts the general parameters of international income tax law as it is now established without questioning whether the structure provides the best solution to international tax problems.[3] Within that structure, it seeks to provide a detailed discussion of policy, design, and drafting issues. Although the chapter draws on the experience of industrial countries with international taxation, the special concerns of developing and transition countries are emphasized throughout.

The major difference between international income tax law and the remainder of the income tax lies in the pervasive importance of treaties.[4] Most countries have entered into one or more bilateral tax treaties that supplement and sometimes replace the income tax law, but only as regards the parties to the tax treaty in question. This chapter gives considerable

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[1]Note: The author is grateful for comments from Reuven Avi-Yonah, Michael McIntyre and Victor Thuronyi.

[2]The usual starting point is Richard Musgrave, United States Taxation of Foreign Investment Income (1969); among more recent works see, for example, Assaf Razin & Joel Slemrod eds., Taxation in the Global Economy (1990) and Organization for Economic Cooperation and Development (OECD), Taxing Profits in a Global Economy (1991). The OECD Committee on Fiscal Affairs Working Party No. 2 on Tax Policy and Statistics is currently conducting a project on the policy of international taxation.

[3]A good deal has been written in recent years on the need for change in the international tax system, for example, Richard Vann, *A Model Tax Treaty for the Asian-Pacific Region*, 45 Bulletin for International Fiscal Documentation 99, 151 (1991); Sol Picciotto, International Business Taxation (1992); Vito Tanzi, Taxation in an Integrating World (1995).

[4]*See* vol. 1 at 31–33 for a general discussion of the relevance of treaties to tax law.

emphasis to tax treaties and to the work of the Organization for Economic Cooperation and Development (OECD) and the United Nations (UN) in this area.

II. The International Dimension of Taxation

In the development of a country's tax laws, the international dimension plays an increasingly important role that significantly restricts the rules that might be adopted if regard were had only to domestic considerations. The increasing role of international factors is mainly attributable to the globalization of the world economy.

A. Importance of International Taxation

International trade has existed since the birth of nations, but there has been an accelerating growth not only in trade but also in finance and investment since the end of World War II. This growth has far outstripped the general growth in the world economy. One important cause has been the gradual removal of barriers to international trade through the various negotiating rounds of the General Agreement on Tariffs and Trade (the GATT, which as of 1995 is administered by the World Trade Organization, or WTO). For finance, the removal of exchange controls in most industrial countries, commencing from the floating of exchange rates in the early 1970s, has been a notable factor leading to the globalization of world capital and financial markets. The international organizations most involved here have been the IMF and the Bank for International Settlements.

In relation to investment, the main multilateral push is yet to come. In recent years, the foreign direct investment laws of investee countries and the investment rules for various institutional investors in investor countries have been liberalized and bilateral investment treaties have grown. The Multilateral Agreement on Investment is currently under negotiation in the OECD. When this treaty is concluded in the near future, it is proposed to extend its regime worldwide through the cooperative efforts of the OECD and the WTO, which will see further global relaxation of investment controls. In addition, the end of the cold war has freed up the international transfer of technology, and labor is also becoming more mobile, especially for high-cost services (such as professional, management, and consulting services) and within trade blocs.

Overlaying all these developments and substantially contributing to many of them are the great advances in international communications and computer technology.

It is a corollary of this growth in international transactions that international tax laws (along with international trade, finance, and commercial laws) have become more significant to each country's legal system. Moreover, as restrictions in other areas are reduced or removed, taxation is brought increasingly into focus, but there is a significant difference in the tax case. Whereas it may be possible to liberalize or abolish rules in other areas affecting international transactions, taxation needs to be retained in some form for the financing of governments. The international challenge for taxation is the development of a system that does not act as an undue impediment to international transactions while protecting the revenue of each state.

Although this challenge is present for all kinds of taxes, this chapter deals with the income tax.[5] The income tax is usually the major source of revenue and the most complex tax in industrial countries. For both these reasons, the tax causes the most problems in the international arena. In developing and transition countries, the income tax may not be the most important tax in terms of revenue, but it is looked to as serving that role in the future and it will also generally be the tax of greatest concern to foreign investors and expatriate personnel.

B. The Challenge for International Taxation

There are two main categories of case that international tax rules have to deal with. First, there is the taxation of persons from outside a country who work, enter into transactions, or have property or income in the country. Second, there is taxation of persons who belong to a country and work, enter into transactions, or have property or income abroad. The usual term used in international taxation to denote the concept of a person's belonging to a country is "residence" ("resident" and "nonresident" being used to indicate whether a particular person belongs to a country or not); similarly the usual term for income arising in a particular place is "source" ("domestic" and "foreign" being used to indicate whether particular income is sourced inside or outside a country).

The two categories arise in virtually all areas and types of taxation. For the income tax, the issues are the taxation of domestic income of nonresidents and the taxation of foreign income of residents. In both categories of case, the main problem is the potential for double taxation or double nontaxation of the income. That is, more than one country may seek to tax without reference to tax levied in another country, or no country may tax (usually on the assumption that another country is taxing, although often it will be the result of the increased opportunities for tax planning or tax cheating on the part of taxpayers that international transactions offer). Double taxation is likely to act as a barrier to international transactions, and the nations of the world are generally agreed on the desirability of removing such barriers as a means of increasing global welfare.

By similar reasoning, double nontaxation of international transactions will create a bias in favor of international over domestic transactions, leading to a loss of global (and national) welfare, not to mention tax revenue. While, however, there is general agreement among taxpayers and governments on the undesirability of double taxation, double nontaxation is obviously desired by taxpayers and to some extent tolerated or even encouraged by governments. Developing countries often express the view that any increase in global welfare arising from the removal of international barriers accrues mainly to industrial countries. International agreements sometimes contain special regimes to deal with these concerns of developing countries, such as the generalized system of preferences in the

[5]For a discussion of the international issues for the value-added tax, see vol. 1, at 170–73, 196, 207–08 and 215–16; for excises, see vol. 1, at 248–49; for wealth taxes, see vol. 1, at 310–11 and 314–15; and for social security taxes, see vol. 1, at 384–91.

GATT, which allows industrial countries to confer tariff privileges on developing countries without being obliged to extend them to all GATT members.

In the income tax field, this developing country view finds expression in the desire to offer tax incentives to international investors in order to attract capital and to ensure that the tax systems of industrial countries do not negate the effect of the incentives by collecting the tax that the developing countries have given up. The desired result of developing countries is generally achieved by tax sparing provisions in bilateral tax treaties, which effectively sanction double nontaxation and hence create a bias in favor of international investment in developing countries. This particular policy in favor of double nontaxation is dealt with elsewhere in this volume.[6] In this chapter, the general premise is that the basic goal of the international income tax system is to avoid double taxation and double nontaxation.

C. Consensus on International Tax Rules

As the importance of the international dimension of income taxation has grown, an international consensus has emerged about the structure of the international income tax regime. The income tax is typically levied by a country on (1) the domestic and foreign income of its residents and (2) the domestic income of nonresidents. These basic rules are referred to respectively as the residence and source principles of taxation. The tax legislation of a country should in succinct terms state in some suitably conspicuous place (either the general provision levying the income tax, or the beginning of the group of provisions dealing with international issues, or both) whether and to what extent it has adopted these rules.

If a resident of one country earns income from a source in another country, double taxation is likely to result because one country will tax that income on a source basis and the other country on a residence basis. In this case, the internationally accepted regime is that the source country has the prior right to tax (although this right may be limited by treaty), and the residence country is responsible for relieving any double taxation that results. Such relief is generally achieved through one of two systems, the exemption system whereby the foreign income is exempted from tax in the residence country, and the foreign tax credit system whereby the tax of the residence country on the foreign income is reduced by the amount of source country tax on the income. Most countries employ some combination of the two systems.

The details of the rules necessary to implement these apparently simple concepts and their interaction with tax treaties will take up the remainder of this chapter. Before embarking on these rules, I will explore briefly the structure, purpose, and effect of tax treaties.

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[6]*See infra* ch. 23.

III. Tax Treaties

Tax treaties (also often referred to as double taxation conventions or double tax agreements) are international agreements entered into by countries and hence subject to general international law on treaties as codified in the Vienna Convention on the Law of Treaties.[7] Most tax treaties are bilateral, that is, involve two countries only, and cover income and capital taxes, though there are some examples of multilateral tax treaties. There are well in excess of 1,000 tax treaties and the number is growing rapidly.[8]

A. Structure of Tax Treaties

The history of tax treaties can be traced to the League of Nations, which was pressed to deal with the problem of double taxation after income taxes became important during the First World War and which developed a number of models for use in negotiation of bilateral tax treaties.[9] The major modern successor to these models is the OECD Model Tax Convention on Income and on Capital (the OECD Model), which itself has gone through various versions.[10] Of especial interest to developing and transition countries is the 1980 UN Model Double Taxation Convention (the UN Model), which was based on the 1977 OECD Model but designed to take into account the special interests of developing countries.[11]

The typical structure of tax treaties is most easily seen from the chapter and article headings of the OECD Model as follows:

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[7]1155 U.N.T.S. 331 (1980), *reprinted in* 8 International Legal Materials 679 (1969). Although the convention has not been adopted universally, it is regarded as largely declaratory of customary international law, and so its principles are for the most part applicable to treaties entered into by countries that are not parties to it. *See* Ian Brownlie, Principles of Public International Law 604 (1990).

[8]Because tax treaties are for the most part bilateral, it is difficult to keep track of the number of treaties actually in force; nowadays, research on tax treaties is greatly facilitated by two CD-ROM collections, which are regularly updated: International Bureau of Fiscal Documentation, Tax Treaties Database; and Tax Analysts, Worldwide Tax Treaties. The tax treaties cited in this chapter can be found on these CDs; therefore, only summary citations are given for these treaties below.

[9]The major League of Nations documents are collected in Joint Committee on Internal Revenue Taxation, 4 Legislative History of United States Tax Conventions, Model Tax Conventions (1962). *See also* Michael Graetz & Michael O'Hear, *The "Original Intent" of U.S. International Taxation,* 46 Duke L. J. 1021 (1997).

[10]The current version dates from 1992 and is in looseleaf format (updated 1994, 1995, and 1997); the earlier versions were the Draft Double Taxation Convention on Income and Capital (1963) and Model Double Taxation Convention on Income and Capital (1977).

[11]United Nations Model Double Taxation Convention Between Developed and Developing Countries (1980) (ST/ESA/102), *reprinted in* Klaus Vogel, Klaus Vogel on Double Taxation Conventions (1991). For documentation of the influence of the UN Model on treaties, *see* Willem Wijnen & Marco Magenta, *The UN Model in Practice,* 51 Bull. Int'l Fiscal Doc. 574 (1997).

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Article 28	Territorial extension

Chapter VII Final provisions

Article 29 Entry into force
Article 30 Termination

This structure (and even the numbering) is followed with only a few variations in nearly all existing tax treaties. The treaties apply to income and capital taxes[12] levied on residents of either of the countries that are parties to the treaty. Chapter III sets out the major substantive rules of the model treaty; they operate by dividing income into classes and setting out rules for each of the classes. These rules generally give the residence country an unlimited right to tax the income and at the same time limit or eliminate the source country's right to tax, with the source country rights the greatest with respect to active income (business, professions, and employment) and income from immovable property, and the least with respect to passive income from intangibles. The treaty recognizes the source country's prior right to tax by requiring the residence country to relieve double taxation of its residents for taxes levied by the source country in accordance with the treaty. Chapter VI deals with administrative matters, to ensure that the treaty is effective in practice, and with the important issue of nondiscrimination.

On the basis of these models and its own particular policies, each country generally develops its own model that serves as the starting point in negotiations to conclude a tax treaty with another country.[13] A bilateral tax treaty takes about two years on average to negotiate and bring into force. In view of this long period of gestation, most treaties fix a minimum time period for their operation (generally about five years), but the expected life of a treaty before replacement by an updated version will usually be of the order of 10–30 years. This long life dictates both that the treaty be expressed in general terms so __at it is flexible enough to handle the inevitable changes in the domestic tax laws of the treaty partners which will occur during the life of the treaty, and that the treaty contain mechanisms to deal with issues which arise during its life (primarily through each party keeping the other informed of changes in tax laws and through the consultative mechanisms provided by the mutual agreement procedure).

[12]Capital taxes as defined in art. 2 of the OECD model mainly encompass annual wealth taxes, but do not include estate and gift taxes and other wealth transfer taxes for which there is a much smaller network of special bilateral tax treaties based around the OECD 1983 Model Double Tax Convention on Estates and Gifts. The reference in vol. 1, p. 315, to the lack of treaties on annual wealth taxes is to stand-alone treaties on wealth; many countries include the capital (wealth) article from the OECD Model treaty in their bilateral tax treaties.

[13]The model used by the United States has been published: Model Income Tax Convention of September 20, 1996, *reprinted in* Charles Gustafson et al., Taxation of International Transactions (1997).

B. Purpose of Tax Treaties

The purpose of bilateral tax treaties is typically expressed in their preamble to be "the avoidance of double taxation and the prevention of fiscal evasion."[14] As most countries contain within their domestic law provisions to prevent double taxation of their residents in the most common case (where another country taxes the same income on a source basis), the main operation of tax treaties in this respect is for other types of double taxation that can arise as elaborated below. The prevention of fiscal evasion primarily refers to cases where taxpayers fraudulently conceal income in an international setting and rely on the inability of tax administrations to obtain information from abroad. The exchange of information article in tax treaties is the major provision dealing with this problem. Because of the capital flight experienced by many developing and transition countries, exchange of information is important, but in practice there are some considerable hurdles to successful exchange for reasons developed below.

From the perspective of developing and transition countries, there are a number of other purposes of tax treaties that are usually unstated but in many cases are more important. First, there is the division of tax revenues to be derived from income involving the two countries that are parties to the treaty. Where flows of income from business and investment are balanced between two countries, or even among a group of countries, it often does not make a large difference if each country agrees to significantly curtail its source jurisdiction to tax, as its residence taxation of income sourced in the other country is correspondingly increased. Where the flows are substantially unbalanced, the conclusion of a treaty under which each country gives up some of its source jurisdiction to tax generally has the effect of transferring revenue from one country to the other. Typically, developing and transition countries (and many smaller industrial countries) will be in the position vis-à-vis industrial countries of substantial net capital importers and hence will want to preserve source country tax rights.

Second, developing and transition countries nowadays generally desire to encourage capital inflows from capital-exporting countries. Tax treaties may facilitate this process in a number of ways. In a very general sense, entering into tax treaties acts as a signal that a country is willing to adopt the international norms. This symbolic function is reinforced by the nondiscrimination article of tax treaties, by which the country undertakes not to discriminate under its tax laws against residents of treaty partners. Many potential investors attach great importance to the nondiscrimination article, in light of the historical antipathy that many developing and transition countries have in the past exhibited to inward investment. It is no coincidence that many tax treaties with transition countries are negotiated alongside investment protection treaties.

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[14]The OECD and UN Models leave the contents of the preamble to be dealt with in accordance with the constitutional procedure of the negotiating states. The U.S. Model, *supra* note 12, uses this common formulation.

In the past, many developing countries took the view that they did not need tax treaties.[15] The countries very often adopted a policy that growth of their economies could best be achieved through domestic production by domestically (often state) owned firms of goods and services for domestic consumption. Hence, foreign investment was not needed and economic policy bolstered the natural human emotional response against ownership by foreigners. As tax treaties involved giving up part of the revenues from source taxation, there seemed little to be gained from them. Likewise, it was a consequence of the domestic focus that investment abroad by residents was not encouraged (a policy often enforced through very strict exchange controls). This situation has now changed, as demonstrated by the rapidly expanding tax treaty networks of many developing countries. Partly, the new attitude is due to a policy shift that accepts the benefits that flow from international trade and, in particular, from export-led growth in the model of the newly industrialized economies of Asia. Another factor has been the practical impossibility of making exchange and investment controls work effectively in a global economy.

Transition economies did enter into tax treaties in the past, but these were mainly political gestures given that there were no significant capital flows from the West.[16] The provisions of the old treaties were often inappropriate for the new situation and they therefore had to be speedily replaced (a phenomenon particularly noticeable in the case of the Russian Federation). The need to do so, along with the large needs for capital, has spurred many transition countries to develop their treaty networks in recent years. The tax laws of transition countries are often not sufficiently developed or clear to enable the tax administration to utilize treaty rules. For example, domestic legislation may lack rules for adjusting transfer prices between related parties. This is another matter that the countries are generally remedying.

The remainder of the discussion in this chapter therefore proceeds on the assumption that most developing and transition countries will be actively pursuing the development of a tax treaty network and that, in the case of the transition countries, changes will be made to domestic law to remove the elements that form impediments to this development. What effect does this assumption have on domestic law?

C. Relationship of Tax Treaties and Domestic Law

[15]This attitude was most noticeable among Latin American countries, while by contrast many Asian countries have extensive tax treaty networks; nowadays Latin American countries, including Chile, are embarking on active treaty negotiation programs. *See* Richard Vann, *Tax Treaty Policy of Dynamic Non-Member Economies, in* Tax Treaties: Linkages between OECD Member Countries and Dynamic Non-Member Economies (Vann ed., 1996). To the extent that countries did encourage foreign investment, tax treaties were necessary for tax sparing in relation to tax incentives; *see infra* ch. 23. The greater openness in the past of some Asian countries to foreign investment may explain the previous difference in treaty policy between Asia and Latin America.

[16]Tax relations among the transition countries used to be handled by the COMECON treaties, (involving Bulgaria, Czechoslovakia, East Germany, Hungary, Mongolia, Poland, Romania, and the Soviet Union) Council for Mutual Economic Assistance Agreement on the Avoidance of Double Taxation on the Income and Property of Bodies Corporate (1979) and Agreement on the Avoidance of Double Taxation on Personal Income and Property (1979). Both of these tax treaties adhere even more strongly to the residence principle than the OECD Model.

It is not necessary to incorporate into domestic law the contents of treaties that operate only between states and do not directly affect private persons. A tax treaty, however, is intended to confer enforceable rights on taxpayers against the countries that are parties to the treaty. How this occurs is a matter for the constitutional law of each state, but in many cases it is necessary for each country to carry out some formal law-making process, such as approval of the tax treaty by parliament.

Further, the provisions of tax treaties are intended to have precedence over any inconsistent provisions of domestic tax law. Again, how this is effected is a matter for the constitutional law of the countries concerned. A common practice is to insert such a provision either into the law giving effect to the treaty or into the domestic tax law itself.[17] The usual result of such a provision under the law of most countries is that, apart from the administrative treaty provisions on the mutual agreement procedure and the exchange of information, a treaty sets limits on the operation of domestic law but does not expand its operation.

Thus, if a country taxes business profits arising from sales to residents of the country by a resident of another country without reference to a permanent establishment concept, the business profits article of a tax treaty will usually prohibit such taxation, unless those profits are attributable to a permanent establishment in the country. The outcome is the same if the domestic law uses a permanent establishment concept, but the concept is wider than that used in a relevant treaty. Similarly, if the tax applied under domestic law to dividends and interest paid to a resident of the other treaty country exceeds the maximum rates permitted in the treaty, the source state is obliged to reduce its taxation accordingly.

If, however, a country levies no tax on dividends or interest paid to nonresidents, then the fact that a treaty allows such taxation up to a specified limit does not mean that such dividends and interest are taxable. It is possible, however, for domestic law to provide that if a treaty permits taxation that does not otherwise occur under domestic law, then the treaty rule will become the domestic rule for this case. This is the position in France[18] (and many Francophone African countries under their tax legislation) and in Australia with respect to source rules contained in treaties under legislation giving force to tax treaties.[19] Such a result is fairly uncommon, however.

By contrast, the administrative provisions of tax treaties (which may include articles on mutual agreement, exchange of information, and assistance in collection) by their very terms expand domestic law in the sense of giving powers that generally do not exist under

[17]AUS International Tax Agreements Act § 4(2); GBR ICTA § 788; compare the more equivocal treatment in USA IRC §§ 894(a), 7852(d)(1); Paul McDaniel & Hugh Ault, Introduction to United States International Taxation 174–75 (1989); GEO TC § 4 (8); LVA TF § 7; KAZ TC § 1 (3).

[18]FRA CGI §§ 165 bis, 209 I.

[19]This follows from AUS International Tax Agreements Act s 4(2) and the peculiarly Australian tax treaty article on source of income, for example, Australia-Vietnam art. 22 in sched. 38 to that act.

domestic law. Thus, the mutual agreement procedure as contained in article 25 of the OECD Model gives an avenue of recourse to challenge assessment to tax in certain cases that does not exist under domestic law and overrides domestic limitation periods. Article 26 gives power to exchange information that does not usually exist under domestic law and modifies the secrecy provisions of domestic law accordingly.

The consequence of this relationship between tax treaties and domestic law suggests an important guideline for drafting the domestic tax rules themselves. If the domestic rules by and large follow the rules typically found in tax treaties, this will simplify the question of the relationship between tax treaties and domestic law and provide transparency to foreign investors as well as indicating (even in the absence of an extensive tax treaty network) the intention of the country to adopt internationally accepted standards.[20] This approach also gives instant access to a substantial body of commentary that is accepted by international consensus as elaborating and explaining the wording in question. The consequences of following—or not following—this guideline will be explored below. Because an international consensus exists on the structure and content of tax treaties, no one country, except perhaps the United States, is able to depart substantially from international norms. Accordingly, having a country tax treaty model that departs radically from the existing international models and following that model in domestic law generally is not a viable option for developing or transition countries.[21] Moreover, no country can sensibly adopt a policy of residence taxation only (i.e., excluding the source principle). Neither would it make sense for developing and transition countries to adopt a policy of source-only taxation.

IV. Definition of Residence

Residence is almost invariably a central concept in the international tax rules of the domestic tax law of a country, with residents taxed on their worldwide income (or at least some categories of income).[22] It is difficult to enter into tax treaties without a concept of residence in domestic tax law because, by the first article of the international models, the tax treaty applies to the residents of each country that is a party to the treaty and the definition of resident in the treaty refers to a resident under the domestic tax law of the countries. The basic idea behind the residence concept is that a person is a resident of a country if the person has close economic and personal ties to the country. It is possible for a person to be a resident of more than one country.

[20]Even if a country intends to develop an extensive network, in many cases, it will take a significant amount of time to do so (perhaps decades). By following the pattern of tax treaties, a country can achieve quickly a tax regime that mimics what would obtain under a future tax treaty network.

[21]The COMECON treaties, *supra* note 15, did significantly depart from the OECD and UN Models without creating problems as they operated within a closed trading system; such an approach is no longer viable for transition countries. The Andean Model, which adopts exclusive source taxation (in line with the territorial tax systems in effect at the time in the signatory countries), has never received acceptance outside the Latin American countries that sponsored it; Commission of the Cartagena Agreement, Decision No. 40 Annex II (1971) reproduced in 28 No. 8 Bulletin for International Fiscal Documentation Supplement D8 (1974).

[22]Residence is of less significance for countries with a territorial system, but as discussed below, few countries have such a system any more.

A. Individuals

Applying this basic policy idea in the case of an individual usually leads in domestic tax legislation to the adoption of one or more of three approaches. First, there is a facts-and-circumstances approach where no criterion is definitive but all the facts are weighed to determine residence. In many countries, this approach is not specifically defined by statute, and it is left to the courts or tax administration to give content to the concept. Tax treaties in the article defining residence give an indication of the factors that are most often used for this purpose: permanent home, personal and economic relations, and habitual abode. The problem with this approach is its uncertainty, which can be ameliorated by combining it with one of the following tests.

Second, the tax legislation may adopt rules for residence that are used for other purposes in the civil law of the country concerned (such as entitlement to work or remain in the country indefinitely under immigration laws, domicile, or citizenship). Many European countries use domicile. The United States is the only major country that uses citizenship as a residence-type test and, in view of the very liberal nationality laws of many countries, the citizenship criterion does not seem appropriate in most cases.[23] The problem with civil law tests is that the policy underlying a test devised for other purposes may not be appropriate for tax purposes, but the advantage is that they are more certain than the facts-and-circumstances approach, unless the civil law concept itself is vague.

Third, a rule of thumb based on the number of days that a person spends in the country during either the tax year or a moving 12-month period may be employed, the usual period being half a year (expressed as 183 days or more). Under this test, physical presence in the country for any part of a day usually counts as one day except when the person is in transit between other destinations and does not pass the customs or immigration barrier.[24] The advantage of using the tax year for this purpose compared with any moving 12-month period that ends or begins in the tax year is that a person can determine residence in relation to a particular tax year at the time of filing the tax return for that year. For example, if the calendar year is the tax year and the due date for filing declarations is March 31, a person who arrived in the country on October 1 will not know until the following October 1 whether the person was a resident from the time of arrival under a moving 12-month test. The disadvantage of a rule that looks solely to the number of days of presence during the tax

[23]The United States taxes residents—defined under USA IRC § 7701(b)—as well as citizens, but citizenship is really an aspect of residence as that term is used in this chapter with the sense of some personal connection to a country. The U.S. jurisdictional rules are stated in the negative rather than in the positive; that is, it is initially provided that all individuals and corporations are taxable on all their income, USA IRC §§ 1, 11(a) and then an exception is noted, USA IRC §§ 2(d), 11(d), 871, 877, and 882, which limits the tax on foreign corporations and nonresident aliens effectively to domestic income.

[24]The Commentary, para. 5 to art. 15 of the OECD Model indicates the way in which the 183-day test is usually counted, although, in the case of the Model, for another purpose. A rule that counted only full days of presence could be avoided by an individual's crossing the border during a sufficient number of days, which might be feasible for an individual living or working close to the country's border. For other possible exceptions and details, see USA IRC § 7701(b).

year is that it effectively allows a person to remain in the country for up to 364 days consecutively spread over two tax years without becoming a resident. An intermediate rule that avoids these problems would look to presence in any consecutive 12-month period ending in the tax year in question.

In either form, the test can be criticized as unfair because it is mechanical—one individual can be treated as a resident despite very short periods of stay in the country (e.g., where a person drives to and from work through a neighboring country each work day),[25] while others can manipulate their period of stay to avoid crossing the 183-day threshold even when they are substantially connected to the country. Most countries use some variation of the 183-day test but, because of its problems, often adopt a more substantive test of residence in addition and enact other measures to ameliorate its arbitrary nature as discussed below.

Often, there is a special residence rule deeming specified government employees stationed abroad to be residents. The main purpose is to ensure that the diplomatic or other government staff of a country who may spend most of their working lives outside the country are nonetheless resident and therefore taxable on their salaries by the country (as they will often not be taxable in other countries, either by virtue of their diplomatic status or by virtue of the government service article in tax treaties).

Under all tests, questions arise as to whether a person can be a resident for tax purposes for part of the tax year and nonresident for part of the year. Most countries permit this possibility mainly to cover the case of migration where a person is moving permanently from one country to another. Where an individual is a resident for only part of a tax year, tax allowances tied to residence are often apportioned.
Some language encompassing these possibilities (other than when reliance is placed on other features of domestic civil law) follows.

1. Subject to 2. and 3., an individual is a resident of *X* for the entire tax year if that individual

(a) has closer social and economic relationships with *X* during the tax year than to any other country;

(b) is present in *X* for 183 days or more in any consecutive period of 12 months ending in the tax year; or

(c) is an official of the state service of *X* posted overseas during the tax year.

2. An individual who was not a resident in the preceding tax year shall not be treated as a resident for the period preceding the day the individual was first present in *X* during the tax year.

[25]It is, of course, possible to devise exceptions to cover this sort of case, but this tends to result in a more complex rule (e.g., USA IRC § 7701(b), and some unfairness will persist no matter how many exceptions and qualifications are devised.

3. An individual who is not a resident in the following tax year shall not be treated as a resident for the period following the last day on which the individual was present in *X* during the tax year if during that period the individual had a closer social and economic connection to a foreign country than to *X*.

4. For the purposes of 1(b),

(a) presence in *X* for part of a day is counted as a full day and

(b) presence in *X* without immigration clearance in transit between other countries is disregarded.

Some countries distinguish varying degrees of residence, such as residence and permanent residence, for different purposes under domestic tax law.[26] This approach may create confusion in the operation of the law unless the different terms are used with care in drafting. It can also cause problems in the application of the tax treaty article defining residence. Countries with a number of residence concepts need to review their model tax treaty to ensure that it is in harmony with the domestic tax law. Generally, it is better to avoid the use of differing residence concepts in the law and to deal with the concerns that give rise to them in other ways (such as special rules for expatriates; see section V(B) of this chapter).

Because countries use different tests of residence, individuals with dual residence are not uncommon. In fact, even if all countries adopted the most common definition of residence, namely the 183-day test, it would still be possible for the same individual to be resident in more than one country under each country's tax law at the same time. An example is the frontier worker who lives in one country but works in another and crosses the border between the two countries each work day. Dual residence creates problems of double taxation where each country taxes the worldwide income of its residents. The mechanisms for giving relief for double taxation arising from combined source and residence taxation of the same income are not able to solve this problem (sometimes called residence-residence double taxation). It is difficult for a country to solve this problem on its own, and so tax treaties provide a tiebreaker mechanism to allocate the residence of the individual to one country alone for the purposes of the treaty. This allocation is achieved through a hierarchy of tests involving the individual's permanent home, center of personal and economic relations, habitual abode, and nationality.[27]

For frontier workers, this mechanism may not solve the practical difficulties that average people face in being subject to two tax jurisdictions (either because a taxpayer is resident in one country and receives income sourced in the other country where the

[26] *See, e.g.,* U. K. Tax Guide 1603–13 (Tiley ed. 1995).

[27] OECD Model art. 4(2). This test applies for the purposes of the treaty only and so does not relate to matters not directly covered by tax treaties, such as personal tax allowances; some countries carry the tax treaty tiebreaker rules into domestic tax law more generally, especially in relation to companies, for example, CAN ITA § 250(5); GBR Finance Act 1994 § 249.

taxpayer's employment is conducted, or because the taxpayer is regarded as a resident of both countries). Accordingly, tax treaties between contiguous countries often contain provisions to ensure that frontier workers are taxed on their wages in one of the countries alone.[28]

B. Legal Entities

The residence of other taxpayers besides individuals, that is, corporations and other entities taxed as separate taxpayers, involves similar problems. From a policy perspective, legal entities are ultimately owned by individuals and the residence of the owners should determine the residence of the entity. This is not a practical test for a number of reasons: it may be necessary to trace ownership through many tiers of entities, which is not administratively feasible, and in any event the ultimate owners may themselves be resident in different countries. Hence, a number of other tests are used. The first test is the country under whose laws the entity came into existence, commonly referred to as the place-of-incorporation test. Even more than the 183-day rule, this test is quite mechanistic and susceptible to manipulation. Therefore, additional tests and other safeguarding mechanisms are often provided.[29]

The second test is usually based on the place of management of the legal entity. In Anglo-Saxon countries, this is often expressed in the phrase "central management and control," which basically means where the board of directors meets. European countries look to the location of the head office of the legal entity.[30] These tests are based in part on a facts-and-circumstances approach to residence and so are not quite as mechanistic as the place-of-incorporation test, but they are susceptible to manipulation nevertheless.

Tax treaties seek to deal with the problem of dual residence of legal entities as for individuals, but are much less successful in this area mainly because there is no real international consensus on the appropriate tiebreaker, even though the OECD Model uses the place of effective management.[31] Moreover, dual-resident companies can give rise to problems that are not adequately addressed in tax treaties, especially the double claiming of deductions on a residence basis. Hence, a number of countries have enacted rules denying

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[28]Examples are particularly common in Europe, as the following tax treaties show: Austria-Italy art. 15 (1981), Belgium-France art. 11(2)(c) (1974), Germany-Switzerland art. 15 and protocol (1971), Nordic Convention protocol art. VII (1989). Sometimes, special agreements dealing only with frontier workers are negotiated, such as France-Spain (1961).

[29]Some countries, for example, the United States, use this test exclusively in determining the basic jurisdiction to tax.

[30]*See* DEU AO § 11 ("Sitz" (seat)).

[31]OECD Model art. 4(3); this test seems to be closer to the place of executive management than the central-management-and-control test of Anglo-Saxon countries. The United States will accept only the place of incorporation as a tiebreaker for corporations (since it uses this test under domestic law; *see supra* note 28), and if the other country is not prepared to agree with this test, dual-resident companies are excluded from the benefits of the treaty, for example, Australia-United States arts. 3(1)(g), 4(1).

deductions to dual-resident companies in certain cases.[32] For developing and transition countries, it may be better to rely on general antiavoidance rules to deal with this kind of tax planning, as discussed below.[33]

These problems by no means exhaust the issues regarding residence of entities. Most countries have a variety of legal entities, not all of which can be easily fitted into the category of company or corporation for domestic tax law and tax treaty purposes. As exotic entities are being used increasingly in international tax planning,[34] countries should consider the need for special tax residence rules for various kinds of entities. Further, if it is not regarded as clear from definitions based on the above criteria that governments (central, regional or local) and other public bodies of a country are resident in the country, then provision may be made to that effect.

It is common to define both individuals and legal entities that are not resident under the definitions in the domestic law as nonresidents for the purposes of the law,[35] although this may simply be stating the obvious.

V. Definition of Source of Income

Residence establishes a relationship between a country and the taxpayer deriving the income, whereas source concerns the connection between the income itself and a country. The basic policy idea is that income should be sourced in the country with which it has a substantial economic connection. Obviously, income may often have substantial connections with more than one country, in which case it may be appropriate to determine source by apportioning the income between the countries. Source rules have traditionally used differing concepts for active and passive income. In broad terms, active income is usually sourced by a place-of-taxpayer-activity test, while passive income (where the taxpayer often engages in no significant activity in deriving the income) is sourced by the place of activity of the person paying the income. To the extent that a clear distinction can be drawn between active and passive income, the growth of international trade in services raises questions as to whether the place-of-taxpayer-activity test is always appropriate for active income.

A. Geographical Extent of Country

As source involves a geographic connection, it is necessary to define the geographical area in question. For landlocked countries, this definition question does not present a real

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[32]AUS ITAA §§ 6F, 80G(6)(ba), 160ZP(7)(ba), and GBR ICTA § 404; *see also* note 26 *supra* for more general domestic law provisions dealing with dual residents.

[33]Related problems of double-dipping and treaty shopping are dealt with *infra*, sec. (VI)(G)(5), (6).

[34]Such as limited liability companies (LLCs) of various states in the United States and the Anstalt and Stiftung of Germanic law.

[35]*E.g.*, GEO TC § 29 (8).

problem because the land area of the country is the relevant area. For countries with a maritime boundary, the territorial sea is treated under international law as part of the country and the country's jurisdiction also extends to the natural resources of the sea and seabed of the continental shelf. It is customary to extend source tax jurisdiction to the continental shelf. This extension may be effected in a way that reflects the limited rights that a country can exercise over the continental shelf (i.e., the country taxes only those continental-shelf activities over which it has sovereignty) or may be more general and cover all activities on the continental shelf. The resulting difference in tax jurisdiction over the continental shelf is shown by the example of a floating hotel owned by a nonresident and moored on the continental shelf; if the tax jurisdiction of a country is limited by reference to its sovereign powers under international law, the country cannot tax the profits of the hotel, whereas it can tax the profits if the broader formulation is adopted.

It is common to include a similar provision in tax treaties in the definition article. Given the importance of potential oil or gas resources in the continental shelf, oil-producing countries commonly include in tax treaties special provisions on this topic that preserve source country jurisdiction as far as possible. In the case of other resources of the continental shelf, such as fisheries, some developing countries levy license fees in lieu of income tax, although in either case there are significant enforcement problems.

There is no agreement in international law that countries must limit their taxing jurisdiction for nonresidents to income sourced in the country. Some international lawyers consider that a country can assert the right to tax everybody in the world on their worldwide income,[36] but it will never be able to enforce such a claim and may attract various forms of retaliation from other countries. In other words, the adoption of the residence and source principles of taxation has been very much guided by practical considerations of enforcement and reciprocity. In marginal cases, such as floating hotels moored on the continental shelf, an assertion of tax jurisdiction is not likely to cause any problems practically or in international relations.

[36]*See* Asif Qureshi, The Public International Law of Taxation 22–125 (1994), which deals with the unlimited and limited views.

B. Structure of Source Rules

Many industrial countries do not have elaborate source rules in their domestic tax laws,[37] instead relying on such general expressions as income arising (from activities) in the country to express the source concept. In these countries, there will usually be a well-developed body of practice as to the detailed application of the general principle,[38] and in any event, there will be an extensive network of tax treaties in place containing explicit and implicit source rules for virtually all types of income. In the past, it was possible for developing countries to elaborate their domestic tax laws without detailed source rules, both because international income tax was not as important for the reasons outlined above and because the countries could usually rely on the body of practice in industrial countries because their tax laws would usually be modeled on the law of one or other industrial country. Transition countries are in all cases actively encouraging foreign investment. However, there is no tax tradition and in most cases no tax treaty network on which they can call to fill in the gaps in their laws on sourcing rules. For both developing and transition countries, fairly detailed source rules will give comfort to foreign investors as to when their income will or will not be taxed.[39]

Tax treaties contain only a few source rules explicitly identified as such, for example, article 11(5) of the OECD Model dealing with interest. Nonetheless, for most kinds of income, there are implicit source rules. The source rule is implied by the way in which a country is given jurisdiction to tax income derived by residents of the other treaty country; for example, in the case of business income, under article 7 a country can tax income only if attributable to a permanent establishment in that country of a resident of the other treaty country. Some countries include a provision in their tax treaties to make clear that these implicit rules are effectively the source rules under the treaty.[40]

Countries can appropriately take these implicit treaty rules as the basic guideline for their source rules, subject to some caveats. First, in order to give the country negotiating room in the tax treaty process, the source rules in the domestic law should generally be more expansive than those found in treaties. Second (a related point), as the treaty rules operate to divide revenues between source and residence country, the source country will usually want in its domestic law to take full advantage of its taxing powers and have broader rules than

[37]The United States is usually quoted as the exception, USA IRC §§ 861–865 and regulations thereunder; see also FRA CGI § 164B; JPN Corp TL § 138.

[38]However, even with such a body of practice, uncodified source rules can lead to substantial controversy. For example, a number of judicial decisions in Hong Kong Special Administrative Region (SAR) in recent years have considered the source of income.

[39] In transition countries whose domestic tax law is very brief, the inclusion of a detailed list of source rules may not be appropriate. These countries can include the detailed rules in regulations or instructions as long as the availability of the rules is made known to nonresident investors. As transition countries develop more detailed statutes, source rules can be included there.

[40]*E.g.*, Canada-Germany art. 23(3) (1986); United Kingdom-Uzbekistan art. 22(3) (1993); *see also supra* note 18.

those found in treaties. Third, the rules in tax treaties are to some extent shaped by practical considerations of tax administration, with a country giving up taxing rights not because income cannot be regarded as sourced there but because it is simpler for taxpayer and tax administration not to attempt to tax the income. However, it is very helpful if the domestic law generally follows the categorization of income that occurs in tax treaties because this makes the interaction of domestic law and tax treaties easier to understand. It also allows an easy connection between the type of income, and the method of taxation and collection of tax, as outlined below.

Just as it is possible to have residence-source and residence-residence double taxation, so source-source double taxation can arise when more than one country asserts that the same income is sourced in each country.[41] Again, it is difficult for any one country to solve this problem unilaterally, and tax treaties are the usual mechanism for resolving it. The method adopted in treaties is to specify expressly or impliedly for a single source rule to apply between the parties to the treaty for particular categories of income.[42] In turn, this method creates some impulse for countries to adopt similar rules in their domestic laws as informal harmonization on the same approach will generally overcome source-source double taxation even without tax treaties. Against this background, the various categories of income are now considered basically in the same order as found in tax treaties.

C. Income from Immovable Property

For income from immovable property, such as the rental of buildings or mineral royalties, the income is sourced in the country where the property is situated, whether it is derived as part of a business or otherwise. Under tax treaties, the provisions based on article 6 of the OECD Model include income from agriculture and forestry in this category and have a fairly extensive definition of immovable property that includes reference to the domestic law concept of immovable property. These features can be incorporated in domestic law, although it is probably simpler to omit them. Their effect in practice is not significant.

D. Business Income

For business income, tax treaties start with the permanent establishment concept, which refers to a relatively enduring presence in a country whether by way of location (e.g., an office) or personnel. The definition article of this term is quite lengthy and can be simplified in domestic law by removing some of the qualifications that limit the concept. Further, some extensions of the concept found in the UN Model may be added, especially as

[41]For example, one country may have a source rule for services based on the place where the services are performed, while another may base source on the place where the services are utilized or paid for; if services are performed in the first state and utilized in the second, double taxation on a source basis will arise.

[42]In so-called triangular cases, where more than two countries are involved, the different bilateral treaties involved may produce differing source outcomes; in these kinds of cases, the other income article can often provide the solution if it follows the OECD Model by providing exclusive taxation for the country of residence, but not if the UN Model is used because it allows both residence and source countries to tax other income. *See* Vogel, *supra* note 10, at 916–17.

they were designed to increase the taxing reach of developing countries and add negotiating room in the tax treaty process. Special rules on oil and mineral exploration activities may also be appropriate for some countries. A provision with these features could take the following form:

> 1. A permanent establishment is a fixed place of business through which the business of a person is wholly or partly carried on.
>
> 2. A permanent establishment also includes
>
> (a) a building site or construction, installation or assembly project in the country, or supervisory activities connected therewith; and
>
> (b) an installation or structure used for the exploration or exploitation of natural resources in the country, or supervisory activities connected therewith.
>
> 3. Where another person is acting on behalf of the person and has, and habitually exercises, in a country an authority to conclude contracts in the name of the person, that person shall be deemed to have a permanent establishment in that country in respect of any activities which that other person undertakes for the person. This paragraph does not apply to an independent agent acting in the ordinary course of business.

The primary sourcing rule for taxing business income will then be through association with a permanent establishment. In addition to the OECD Model and the UN Model tests of connection, many countries also tax technical, administrative, and management fees paid to a nonresident by an enterprise that is resident in the country or that constitutes a permanent establishment of a nonresident in the country. Such a rule deals with cases where persons use deductible service fees to reduce the tax base in the country of the paying enterprise without corresponding taxation by that country of the fees received by the nonresident (which will often be a company that is related to the payer).[43] Alternatively, management and service fees may be taxed as royalties, which will usually be the preferable course. A suggested provision incorporating the UN features, but not technical etc. fees, follows:

[43]It is important to notice two different ways of dealing with such services. The position stated in the text uses a rule based on the residence or place of business of the payer to source the income. UN Model art. 5(3)(b) by contrast includes as an addition to the permanent establishment definition the furnishing of services, including consultancy services, in the country through employees or other personnel engaged for such purpose for a period or periods aggregating more than 6 months in any 12-month period. This method still requires the performance of the services in the country, whereas the rule in the text does not.

Business income is sourced in country *X* if

(a) it is attributable to a permanent establishment of the taxpayer in *X*;

(b) it arises from sales by the taxpayer in *X* where the taxpayer has a permanent establishment through which goods of the same or similar kind are sold; or

(c) it arises from other business activities carried on by the taxpayer in *X* where the taxpayer has a permanent establishment through which activities of the same or similar kind are carried on.

This provision will not exhaust the taxation of business income. First, there will often be special provisions for specific types of business income that take precedence over this general rule. Second, income of certain types that may or may not be income of a business depending on the circumstances (especially passive income, such as dividends, interest, royalties, or capital gains) will generally be taxable if it falls into either the business income rule or into the specific rules for the type of income in question (although the method of taxation will vary for each case as explained below).

Thus, tax treaties have special rules for international transport income, independent professional services, and income from entertainment and sporting activities. Many countries also add income from international communications and insurance. The OECD tax treaty approach for international transport income is premised on the view that the income will be equally balanced between the two countries, so that it is simpler from an administrative point of view to confine taxation to the country of residence of the company carrying out the international transport.[44] In the case of air transport, this assumption will generally be correct because of the restrictions in international airline agreements entered into by governments, which try to share revenues between the airlines of each country, while for shipping very few countries nowadays have substantial shipping industries because of the way that business is organized internationally. While the tax treaty approach thus does little harm, some countries find it easier to use a simple 50/50 rule that divides the income equally between the start and end points of the international transport, an approach also used for international telecommunications income (not separately covered in tax treaties partly because of its recent development and partly because international agreements between countries often share the income between companies in each country).

Professional services income nowadays is generally regarded as the same as business income, and the existence of separate articles in tax treaties is mainly to be explained historically.[45] As the outcome under such articles is similar to that for business income

[44]In fact the OECD Model refers to the place of effective management of the enterprise, but this will usually correspond to the place of residence. The OECD Commentary on art. 8 in para. 2 contemplates the use of residence directly in the treaty article, and many treaties in practice follow this suggestion.

[45]*Cf.* ch. 14, *supra*, sec. V. The OECD is considering dropping the relevant article from its Model.

generally, special sourcing rules for such income are not often included in domestic law, except where it is intended to include a time threshold, which is discussed below in relation to employment income.

The taxation of insurance is a very specialized topic. Because of the difficulties involved in calculating the profit of an insurance company, some countries simply levy tax on a percentage of the premium income, either generally or specifically for certain types of insurance or in the international area. The basic sourcing rule adopted is the insuring of risks located in a country.

Business (and employment) income from entertainment and sporting activities is sourced in a country when the activity is carried out there; this is because very high incomes can be earned in short periods within a country that may not be captured under the general business income rules.

When special sourcing rules are adopted for particular types of business income in domestic law, they override the general business income source rule. In turn, tax treaties will generally overturn the special rules for insurance and telecommunication income and adopt the general business income rule unless the special rules are preserved by provisions inserted for that purpose (which does occur in bilateral treaties and the UN Model for insurance but not for telecommunications). Dividends, interest, and royalties are often regarded as passive income but may be received in a business context, in which event the rules for taxing business income generally apply.

E. Dividends, Interest, and Royalties

Dividends are usually sourced under domestic law, and tax treaties by the residence of the company paying them. Interest under tax treaties also uses a basic residence of the payer criterion,[46] but where the interest is borne by the permanent establishment in connection with which the indebtedness is incurred, the interest is sourced by the location of the permanent establishment. Taken together, these rules on interest mean effectively that it is the place where the economic activity giving rise to the payment of the interest occurs that is its source.[47] Interest source rules under domestic laws show some variation from this pattern, most commonly adding the case where the interest relates to a loan that is secured by property situated in the country, but tax treaties generally override this rule. The tax treaty rule for the source of interest differs in one respect from the rule suggested in the text,

[46]"Payer" in this context does not mean the person who actually hands over the money (which will usually be done by the debtor's bank), but the debtor or obligor; in tax treaties, the OECD Commentary on art. 11 para. 5 also notes that "paid" in this context has the broad meaning of the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or custom.

[47]Where the debtor is a financial intermediary, it will in turn have loaned the funds to another but it is not necessary for this purpose to track down the ultimate user of the funds; the branch of the financier that has borrowed the funds will be the determinant of the source of the interest payment. The fact that many interest payments involve financial intermediation creates many problems in the structuring of international tax rules as discussed below.

apparently because of the bilateral nature of tax treaties. Sourcing by a branch rather than by the residence of the debtor occurs only where the branch is in one of the treaty countries; otherwise, the residence of the debtor prevails. This treaty rule can give rise to difficulties and is thus not followed by some countries in their treaties.[48]

Royalties do not have a detailed source rule in the OECD Model, given that taxation is exclusively reserved to the residence country, but almost half of the OECD countries and the UN Model do not follow this pattern. Rather, they replicate the interest source rule for royalties, that is, residence of the payer with the permanent establishment qualification. The United States has a sourcing rule of where the property giving rise to the royalties is used[49] and can usually have this accepted in its treaties, but less powerful countries may find it more difficult to go their own way. Certainly, domestic law should contain a clear rule for sourcing royalties, as they are one of the most important forms of income internationally—especially so in a world that is coming to be dominated by trade in technological innovation and services rather than goods.

One of the most important aspects of the source rules for dividends, interest, and royalties is the definition of the terms. Most domestic tax laws will have a definition of dividend in relation to the general rules for taxing distributions by legal entities,[50] and tax treaties effectively adopt this definition. The reliance on the domestic definition of dividend under tax treaties can cause difficulties, as countries have widely differing definitions, which can lead to the consequence that one country regards a payment as a dividend whereas another country regards it as something else. For example, one country may treat a payment on the liquidation of a company to its shareholders as, in whole or in part, a dividend, whereas another country may treat it as a disposal of the shares (and so covered by the capital gain article in tax treaties). Tax treaties do not usually provide any clear resolution of this "conflict-of-qualifications" problem, except the possibility of the mutual agreement procedure. It follows that whatever definition of dividend is adopted for domestic purposes, problem cases can arise internationally under tax treaties. No simple solution is available.

By contrast, the definitions of "interest" and "royalties" in tax treaties do not rely on domestic definitions. The definition of interest in the OECD Model is income from a debt claim (but excluding penalty charges for late payment). While this definition operates clearly in many cases, financial innovation in recent decades has given rise to many instruments that are effectively loans but that do not relate to a debt claim and are therefore outside the definition (e.g., foreign exchange contracts and swaps can be structured to produce interest equivalents). Increasingly, countries are moving in their domestic laws to ensure that such instruments are taxed consistently with interest, but the rules required for such a regime are likely to be very complex. The result is that what is assimilated to interest under domestic

[48]Australia is the main example; see Australia-Vietnam art. 11(5); the United States in some of its treaties has also taken this approach.

[49]USA IRC § 861(a)(4).

[50]*See supra* ch. 19.

laws varies greatly among countries and the definition used will depend on a number of fundamental policy choices in the taxation of interest.[51]

The definition of royalties is more straightforward. The essence of the definition in tax treaties, which is followed in the domestic law of many countries, is a payment for the use of intellectual property, including copyrights, patents, know-how, and secret processes. (The term “royalty” is also commonly used for payments to the owner of land or to the state for the right to extract natural resources, but these are income from immovable property and have already been dealt with above.) The OECD Model before 1992 covered equipment rentals in the definition of royalties by including payments for the right to use industrial, commercial, or scientific equipment; the deletion of this item in a bilateral treaty means that equipment rentals come within the business profits article under tax treaties. While the usage covering equipment leasing probably extends beyond the normal understanding of the term royalties, many countries still include equipment rentals in their domestic law definition of royalty.[52] As long as positive tax rates are specified for interest and royalties in tax treaties (not the case in the OECD Model but not uncommon in practice), one justification for this inclusion is that interest can be converted into rental income through the device of the financial lease (i.e., a lease that is the equivalent of a loan), but the treatment under the domestic law and tax treaties will effectively be the same.[53]

One problem of the royalty definition in the OECD Model is the reference to payments “for the use of, or the right to use” patents etc. This language apparently does not cover disposals of intellectual property and, if so, the royalty definition can be simply avoided as transactions for use can easily be converted into disposal transactions because of the flexibility of patent and copyright law in most countries. For example, a person could be given the right to use a patent in a particular country for a specific period of time in return for payments related to the number of items produced using the patented process, or the patent could be disposed of to the person in respect of that country and time period on the same payment terms. For this reason some countries provide that where some proportion of the payments in relation to intellectual property are contingent on use, then they will be treated as royalties even though the transaction takes the form of a disposal.[54]

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[51]*See generally* OECD, Taxation of New Financial Instruments (1994).

[52]*E.g.,* AUS ITAA § 6(1) (definition of royalty); JPN CorpTL § 143(7).

[53]One difference is that the rental payment under a finance lease is equivalent to principal and interest on a loan, and so taxation of the full rental payment is more extensive than taxation of interest. To deal with this problem, some countries restrict the tax on a finance lease rental payment to the component equivalent to interest, for example, AUS ITAA § 128AC. This will also be the result when a financial lease is treated as a loan for tax purposes. *E.g.*, GEO TC § 78.

[54]USA IRC § 865(d)(1)(B); alternatively, royalties can be defined to include payments for alienation as well as use, as in JPN Corp TL § 138(7).

In some countries, technical fees are assimilated into the definition of royalties or are taxed similarly to royalties.[55] In the context of tax treaties, similar issues arise. Payments for technical services and the like may be incorporated into the royalties article or subject to a separate but similar article.[56] If no such provision is made, then the domestic rules for taxing such income will be overridden by tax treaties.

F. Capital Gains

Capital gains are another area where variation in domestic laws can give rise to problems in their international treatment. Some countries (especially common law countries) have a general conception of capital gains as any gain on an asset other than inventory (and similar property) of a business and personal use assets of an individual (such as consumer durables). Within this group, a number of countries do not tax such capital gains while many others have beneficial rules and tax rates for them. Other countries, especially those based on civil law, have either a much narrower concept of capital gains or no such concept—business profits are taxed with no tax distinction drawn between gains on disposition of inventory and other assets, and individuals are simply taxed on gains on a list of assets without invoking any rubric of capital gain in either case.[57] Hence, the use of the term “capital gains” can cause some confusion in an international setting and it can be argued that it is better avoided even though it is used in the OECD Model.[58]

Following the tax treaty rules, gains on business assets are generally sourced at the permanent establishment to which the gain is attributable; gains on immovable property are sourced where the property is situated; and gains on other property are sourced where the person disposing of it is resident. A number of countries include special rules in their domestic law and tax treaties for sourcing gains on shares in resident companies in one or more of the following categories: companies whose major assets are immovable property, direct investment interests in companies (usually defined as a certain proportion of the shares, such as 10 percent or 25 percent) and, more rarely, any interest in a closely held company.[59] The first two of these are intended to buttress the rules on taxing gains on business assets and immovable property. A taxpayer can easily avoid those rules by holding the relevant assets in a company and then selling the shares in the company.

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[55]E.g., for Malaysia, *see* Ismail, *Experience of Malaysia*, *in* Vann, ed., *supra* note 14.

[56]All of Brazil’s tax treaties, except a very early treaty with Japan, provide for assimilation of technical fees to royalties in protocols to the treaties; a number of treaties and protocols recently negotiated by India, Malaysia, and some African countries have separate articles on technical fees; *see* Vann, *supra* note 14.

[57]*See generally supra* ch. 16.

[58]Although only in the title to art. 13, and not in the text of the article itself, which refers simply to gains; the 1996 U.S. Model, *supra* note 10, uses “Gains” as the title also.

[59]USA IRC § 897 for the first and AUS ITAA § 160T, CAN ITA § 115(1)(b) for the second and third cases.

While the purpose of the rules on companies is understandable, in practice it is not possible to prevent nonresidents from using variations on the same stratagem to avoid these rules. Rather than selling the shares in the resident company directly holding the relevant assets, a taxpayer can hold the assets through several tiers of companies (usually located in tax havens); it is then possible for one higher-tier nonresident company to sell the shares in the nonresident company below it in the tier and so effectively dispose of assets that may be several tiers below. While domestic law can have rules referring to disposal of shares in companies that amount indirectly to disposal of the relevant assets,[60] such rules will be almost impossible to enforce and will usually be overridden to a greater or lesser degree by tax treaties.

G. Employment, Services, and Pension Income

1. Employment Income

Employment income is usually sourced by the place where the employment is carried out (and if it is carried out in several places, the income is apportioned between those places). This is followed in tax treaties, with the exception that the OECD Model contains a 183-day presence threshold before a nonresident employee is taxable, if employed by a nonresident employer that does not deduct the relevant salary as part of the expenses of a permanent establishment in the country. Some short time threshold, such as 30, 60, or 90 days, subject to the same conditions, is a sensible rule for domestic law, as no country can successfully tax such employees who are in the country for very short periods. Especially in the context of developing and transition countries that are seeking to attract foreign investment, this kind of rule allows the important exploratory visits to take place before investment decisions are made without tax impediments so far as the employees of the potential investor are concerned. A monetary threshold can also be used as an addition to the time threshold to eliminate small amounts for ease of administration, or as an alternative to the time threshold to try to capture very high amounts of income earned in a short period.[61] Tax treaties contain time limits for employment income, but not usually monetary limits.

2. Fringe Benefits Tax

Following the lead of Australia and New Zealand, a few developing and transition countries have adopted fringe benefits taxes to deal with the problems of taxing benefits in kind provided by an employer to an employee.[62] The tax is levied directly on the employer at

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[60]The provisions in note 58 refer to shares in resident companies and so can be easily overcome through the use of a nonresident company to hold the relevant asset without a lengthy tier of companies. Canada has recently extended its rules to nonresident companies in certain cases, CAN ITA § 115(1)(b)(v)(D). The UN Model refers to shares in a company whose assets consist "directly or indirectly" principally of immovable property and so is apt to cover such cases if there is a suitable provision in domestic law. In practice, it is rare for tax treaties to cover indirect disposals.

[61]*E.g.,* USA IRC § 861(a)(3).

[62]*See supra* ch. 14, sec. III(c)

a flat rate and the benefit is then tax exempt in the hands of the employee. Even from a domestic viewpoint, the technical problems of this approach to the fringe benefits problem indicate that the tax should be adopted only when it is politically the only possible way to ensure that the benefits are taxed.[63] Otherwise, the more straightforward method of treating fringe benefits as the equivalent of cash wages is to be preferred.

From an international perspective, fringe benefits taxes cause significant problems. First, the application of the residence and source principles to the tax is unclear. Does the residence of the employer or the employee count? Is the sourcing rule the same as for wages? If so, one of the claimed advantages of the tax, the avoidance of allocating benefits to individual employees, is lost. Second, how is relief from double taxation effected in domestic law (especially as other countries may not be using the tax, but taxing employees instead)? At the moment, fringe benefits taxes often lack mechanisms to avoid double taxation. Third, no satisfactory tax treaty mechanism has yet been found for dealing with such taxes.[64] Where the traditional approach of taxing fringe benefits to the employee is adopted, tax treaties experience little difficulty as the matter is dealt with by the employment income article.

For developing and transition countries, this fringe benefits tax problem is more than theoretical. As already noted, the taxation of the salaries and benefits of expatriate employees of foreign investors can be a significant factor in investment decisions. If a fringe benefits tax is adopted, it will not be relieved in the country of the expatriate employees' residence if that country applies a foreign tax credit, with resulting double taxation. The foreign investor, rather than the employees, in practice will absorb the fringe benefits tax so that it is simply an additional cost of—and disincentive to—the investment. Given that fringe benefits for good reasons often figure importantly in the remuneration packages of expatriate employees, the cost can become significant. Indeed, even under the traditional approach to fringe benefits, there is an argument for special rules to deal with such employees. Carrying these rules over into a fringe benefits tax will ameliorate but not solve the problem that the fringe benefits tax causes in the international context.

3. Services Income

The employment income source rule is often extended to all forms of services income. This has two effects. First, not only is the employee taxable but also the employer, where the services of the employee are part of the rendering of services of the employer to a third party. Second, in the case of professional services and services with a high value added where no employment is involved, the person rendering the services is taxable without the need for some permanent presence as is generally true for business income. Because of the

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[63] *See* Vann, *Some Lessons from Hussey and Lubick*, 7 Tax Notes Int'l 268 (1993). *See also supra* ch. 14, sec. III(c).

[64] Australia has some provisions in a treaty with Indonesia over exploitation of the Timor Gap and its recent treaty with New Zealand. For all other tax treaties, however, the fringe benefits tax is simply not covered, because treaties are limited to income and capital taxes.

increasing significance of high-cost services in international trade, it is sensible for countries to seek to tax such services. They can do this either by adopting a general rule for services based on the place of performance or by including the rendering of services other than as an employee in the definition of permanent establishment. If either is done, it would be sensible to include a short time threshold, for similar reasons as in relation to employment income. Tax treaties based on the OECD Model will eliminate the tax in such a case but the UN Model would allow it, subject to a time threshold.[65] The addition of a monetary threshold in addition to or in lieu of a time threshold raises similar considerations as for employment income. The UN (but not the OECD) Model includes such a threshold for independent personal (i.e., professional) services but not for other services. Consistency across employment, professional, and other high-cost services makes sense from a policy viewpoint, but tax treaties will generally not produce this outcome.

Under domestic law, it is usually necessary (e.g., in relation to withholding on wage income) to draw distinctions between employment and business income.[66] Employers and employees may gain some advantage (in relation not simply to the income tax, but also to payroll-based taxes and even labor law) in converting what is essentially an employment relationship into a business one. One way to achieve this is for the employee to form a company that then contracts the services of the former employee to the former employer (the person is now an employee of the company the person owns but has control over how much income is received from the company as wages and how much in other forms). Domestic tax laws often deal with this problem by expansively defining employment to include such cases or by extending withholding to certain types of business income. As far as the former route is adopted, the rules will generally flow over into tax treaties (tax treaties have a special rule for directors of companies, sourcing directors' fees by the residence of the company, although under the domestic laws of most countries these fees are treated as employment income).

Arrangements designed to convert employment into business income have given rise to particular problems in international situations through manipulation of the time limits for taxing employment income under tax treaties. The OECD has accordingly developed rules for treaty purposes that seek to determine whether there is a genuine employment. These rules can be considered for use in domestic law. The rules address where the responsibility, risk, and authority to give instructions lies, where the work is carried out, the method of calculation of remuneration, who provides facilities, and the methods for the conduct of the work.[67]

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[65]The UN Model uses "six months within any 12-month period" in the permanent establishment article and "183 days in the fiscal year concerned" in the independent personal services article. It seems preferable to use uniform terminology in both cases. For issues surrounding the counting of days under time-bound tests in a different context, *see supra* sec. II (A) concerning the residence of individuals.

[66]*See supra* ch. 14.

[67]OECD,Trends in International Taxation: Taxation Issues Relating to International Hiring-Out of Labor (1985) and see the Commentary para. 8 to OECD Model art. 15. Some tax treaties incorporate the tests developed by the OECD, but most countries are content to rely on the Commentary as bringing about the application of the tests. The object of the tests is to determine whether the business that contracts for the services of the company

One form of high-value service that is usually the subject of special rules concerns entertainers and athletes. Their income can be structured, as they desire, as business or employment income (in the latter case through the use of "star" companies similar to the situation just dealt with). Whether the income is employment or business, it is sourced under treaties by reference to the place of performance of the services without time thresholds.[68] Monetary limits may be used to segregate highly paid pop stars from the lower-paid members of, say, a visiting symphony orchestra, although tax treaties usually employ other methods to make this kind of separation (usually based on exceptions for official cultural exchange programs). Tax treaties also usually contain special provisions to look through star companies to the entertainer or athlete and to attribute all the income to that person. A similar rule may be useful in domestic law.

Even with some or all of this panoply of rules to cater to the problems of taxing high-cost services, the growing importance of services in the world economy is going to increase pressure on both source and residence country taxation. A successful computer software company, for example, could locate its programming and management staff in some suitably pleasant tax haven and market its products through mail order solicited by advertisements in computer magazines or on the Internet. Taxing the profits of such a company and the salaries of its employees in the countries where its products are sold is almost impossible, is not provided for in the domestic laws of most countries, and may be prevented by tax treaties. Similarly, much of the income of entertainers and athletes comes from sources not directly related to actual performance, such as video and sound recordings and endorsements. Capturing this indirect income by the country of place of performance entails the same kinds of problems.[69]

As already noted in the discussion of business income and royalties, some countries are responding to this problem by employing a definition of source based on the residence of the payer.[70] As yet, such a shift does not have general international acceptance. This may, however, be a case where it is wise for domestic law in developing and transition countries to depart from the norms implicit in existing tax treaties and to seek to change their treaty practice accordingly. Considerable resistance will be encountered in tax treaty negotiations with industrial countries if a developing or transition country adopts this course.

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owned by the individual doing the work controls and provides for that person in a similar way as for an actual employee. *Cf. supra* ch. 14*,* note 60.

[68]For extended treatment of the domestic law and treaty issues arising from the income of entertainers and athletes, *see* Sandler, The Taxation of International Entertainers and Athletes (1995).

[69]Most of the problems under tax treaties in this area arise from the use of the permanent establishment concept.

[70]*E.g.,* DEU EStG § 49(1)(3), (4) (services performed in Germany, utilized in Germany, or paid for from public funds); COL TC § 24(6)(compensation for personal services paid by the State); *id.* § 24(8) (income from the rendering of technical services); Price Waterhouse, Individual Taxes: A Worldwide Summary 43 (1997) (for Brazil, source is determined according to place where payer is located); BRA RIR §§ 2, 743, 785; ECU RTI § 8(2) (income derived from residents).

4. Pension Income

A form of income often closely related to services income is pension income. Where the pension has been financed by contributions out of services income that have received favorable tax treatment in the country of performance (by exclusion of the contribution from income or a deduction for the contribution), a rule based on the place of performance of the services may be thought suitable for sourcing the pension. This approach will not be practical when the services have been rendered in many countries over a period of many years. For this reason and because pensions can take other forms (such as government benefits, distributions from social security schemes, and purchased annuities), they are often sourced by the residence of the recipient of the pension or by the residence of the payer of the pension. The OECD Model adopts the former while many tax treaties in practice adopt some form of the latter, especially in regard to social security and government benefits. The UN Model adds, in one of its variants, a permanent-establishment sourcing rule as a gloss on the residence-of-the- payer rule. Pensions and similar payments also give rise to some more general problems under international taxation, which are taken up below.

In developing countries, pensions of all kinds are much less common than in industrial countries, whereas they are widespread in transition countries. In both developing and transition countries, pensions tend to be small in amount (especially as a result of recent inflation in transition countries) and are often not taxable either because of an express exemption in the domestic tax law or because they fall entirely within the tax-free zone established by the tax rate scale or by personal allowances. Some developing and transition countries have already experienced immigration of pensioners from industrial countries in part to take advantage of a lower cost of living. It is not advisable therefore to be dogmatic on a source rule for pensions.

As with residence rules, there may be special sourcing-type rules for government employees. Although these rules are not often found in domestic tax laws, tax treaties generally limit taxation of the employee’s wages to the government employing the person, except for local employees. A variant of this rule is extended by tax treaties to pensions paid by the government to its former employees.

H. Other Income

For other income,[71] the OECD Model basically adopts a residence-only tax rule. The UN Model allows the country of source to tax the income in accordance with its own source rules without defining such rules. The domestic law of a transition or developing country can sensibly adopt this approach with some generally expressed source rule as a residual.

[71] *See supra* ch. 14, sec. V.

VI. Taxation of Residents

A. Rate Scale and Personal Allowances

The main reasons for taxing residents on their worldwide income have to do with the fairness of the tax system. When a country adopts a progressive income tax rate scale for individuals, it is usually motivated by the idea that it is fair for higher-income individuals to pay proportionally more of their income as tax. Unless, however, the individual is taxed on worldwide income, this goal may not be achieved for an individual with income from more than one country. If the progressive tax rates are the same in each country and each taxes only on a source basis, an individual receiving income from each country will pay less tax in total to both countries than an individual who receives the same total amount of income from only one of the countries. This is doubly unfair; not only are two like individuals taxed differently, but individuals are obviously encouraged to split their income between the countries, an avenue that is more likely to be availed of by a high-income taxpayer. There is also a lack of neutrality in such a system because of the splitting incentive that it creates.

Given that it is not practical for a country to tax all individuals in the world on a worldwide basis, the general policy that has been adopted is to tax only residents of a country in this way. A country can generally enforce its tax claims against residents (i.e., persons who have substantial personal contacts with the country), whereas a single source country is unlikely to know the total income of a nonresident taxpayer and will face enforcement problems in relation to income arising outside the country. From a policy viewpoint, it also seems appropriate for the country taxing on the basis of personal allegiance of the taxpayer to be the one that takes account of the taxpayer's personal attributes. This concept relates not just to the progressive rate scale but also to tax allowances, such as those relating to a zone of tax-free income (which is closely related to progressivity), family size and composition, medical costs, and subsidies for home ownership.

Conversely, for nonresidents, this approach implies flat-rate taxation of income sourced in a country and no tax allowances for personal attributes. If residence is changed part way through the tax year, then the taxpayer should change from one regime to the other and allowances should be adjusted to account for the fact that the entitlement is for only part of the year.

In practice, this approach to taxation of residents and nonresidents is often not fully realized. While dividends, interest, and royalties received by nonresidents are generally taxed on a flat-rate basis, the progressive rate scale is often applied to many other forms of income of nonresidents (although the zone of tax-free income is often not applied). Personal allowances (especially those applied by a developing or transition country to an expatriate from an industrial country) are often not significant in revenue terms in relation to nonresidents because of the small number of taxpayers affected. Hence, it is easier from an administrative perspective to apply them to all individual taxpayers and not just to residents or at least to apply them on a whole-year basis to any individual who is resident for part or all of the tax year.

Confining personal reliefs to residents of a country does not infringe the nondiscrimination rules of tax treaties, which generally seek to ensure that residents and nonresidents are treated alike under the tax law of a country. The reliefs are recognized as part of the residence jurisdiction of the taxing country, so that residents and nonresidents are not treated as being in the same circumstances, which is a threshold condition for the application of the nondiscrimination principle.[72] As tax treaties otherwise do not deal with personal reliefs, the tiebreaker rule in the tax treaty that addresses dual residence will not carry over into domestic law for this purpose. Hence, a dual resident will be entitled to the personal reliefs in more than one country, and a special rule in domestic law limiting entitlement to reliefs in such cases is necessary if it is desired to track the tax treaty rule. For developing and transition countries, this qualification seems an unnecessary refinement.

B. Expatriates

There are, however, a number of refinements that need to be considered by developing and transition countries in the taxation of expatriate employees who become residents of the country for a limited time. Expatriate employees will usually be brought into a country where the skills necessary for a particular job are lacking in the country and hence they will usually be very highly paid—especially in comparison with the general level of wages in the country. They can be employed either by foreign investors or by local employers. While in the past when colonial attitudes prevailed, foreign investors may have been inclined to use expatriate employees for all senior positions whether or not local skills were available, this position has now generally changed for cost reasons and out of greater sensitivity to national sentiment. It will be assumed in what follows that the expatriate employee is providing skills that are in short supply in a country and that the country wishes to encourage—or at least not discourage—the importation of the skills.

For the purposes of the discussion we can distinguish several different situations in which expatriate employees will be used in a country. First, there is the person who comes in to do a specific task and leaves when the task is complete; the stay is very short term. Such persons will generally not become residents under the domestic law of the country visited and, in the case of employment by a foreign resident investor, will often not be taxable on their employment income by reason of either tax treaties or provisions in domestic law that set time limits on source taxation of employees. Second, there is the person who comes for a more extended stay, say, six months to two years, but who leaves all or part of the person's family and a permanent home behind in the home country. This person will generally become a resident of the country where the work is performed under a 183-day rule while remaining resident in his or her home country, and under tax treaties residence will usually be allocated to the home country by the tiebreaker rule. Third, there is the person who comes for a yet more extended stay, but always with the intention of returning to the home country (as evidenced by the ownership of property there and the limited period of the assignment). This

[72]Words were added to para. 1 of art. 24 of the OECD Model in 1992 to make this point clear, but the addition was regarded as reflecting existing practice, Commentary para. 3 to art. 24; the second sentence of para. 3 of art. 24 also makes this point clear, Commentary para. 22.

person may cease to be a resident in the home country for the period of the assignment, but, if not, residence will usually be allocated by tax treaties to the country where the work is being performed. Finally, there is the person who, at the outset, or more usually after an initial period in the country, decides to remain in the country and "go local." This person will usually cease to be a resident of the home country entirely.[73]

Because of the high costs involved with expatriate employees, employers will usually require them to go local after two or three years in the case of placement in an industrial country and after a longer period, say, three to five years, in developing or transition countries; that is, they are thereafter treated in the same way as local employees and do not receive special expatriate allowances. The basic structure of the remuneration of employees in the second and third categories above (which are the most common problem cases) will be to provide them with salary and benefits designed to keep their after-tax salary before the assignment intact, compensate them for the additional costs incurred as a result of the assignment, and provide them with a bonus for undertaking the assignment, which will often be viewed as having an element of hardship (such as separation from family, personal security and general living conditions in the country of assignment, and complication of personal affairs).

Typical benefits will thus include free or subsidized accommodation in the country of assignment, payment of private education fees for children, free airfares between the home country and the country of assignment on a regular basis, tax supplements to remove additional tax burdens and free access to specialist tax advice, special pension scheme arrangements, special medical insurance, free car and driver, and general security arrangements, plus a bonus of, say, 25–50 percent of salary.

1. Rate Scale

If an expatriate has become a resident of a developing or transition country under its law, taxation of worldwide income under the progressive rate scale will occur. The appropriateness of the rate scale to the expatriate thus becomes an issue. Generally, it will have been enacted with local incomes in mind. This means in many cases that the maximum tax rate is reached very quickly in comparison with industrial country tax rate scales, because of the generally lower level of local incomes. The result is a greater tax burden on the expatriate than in the home country, even if the maximum tax rates in the countries are the same. There is also a tendency for maximum tax rates in developing and transition countries to be higher than in some major industrial countries.[74] The employer thus will pay a tax supplement to the employee to eliminate the additional taxation and, because the tax supplement is really just additional salary, it should also be taxable and grossed up for the additional tax accordingly.

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[73]An exception would be where the person's home country asserts taxing jurisdiction on a citizenship basis, as does the United States.

[74]In recent years, the top tax rate has come down in a number of developing and transition countries; however, in transition countries, the combined income and social security taxes can still be very high.

To obviate this problem, some countries provide in effect special tax rate scales for expatriates (by giving special additional personal allowances or by stretching the tax brackets) and do not impose tax on tax supplements. Both of these measures represent generous treatment of expatriates. They may be risky in a political sense as favoring wealthy foreigners, but they may send a very positive signal to both foreign investors and to potential expatriate employees. The amount of revenue at stake in terms of overall revenues will usually be small in view of the small numbers of employees involved.

2. Fringe Benefits

The case of fringe benefits given to expatriates is clearer, however. Benefits that are viewed as simply part of a person's working conditions are not generally taxable as fringe benefits (such as pleasant office accommodation, access to labor saving technology, or payment of costs of work-related travel). It can be argued that although many of the benefits received by expatriates would amount to taxable fringe benefits if received by local employees, in the case of expatriates they are simply part of the conditions of work in the country. Thus, free accommodation in the country of work when the expatriate has left family in a residence in the home country and airfares to return home on a regular basis are little different from payment of the cost of work-related travel. Arrangements to ensure personal security may also be regarded as part of the work conditions.

In addition, taxation of fringe benefits in many countries takes account of disadvantageous work conditions (such as working in remote locations), and, again, the expatriate situation can be assimilated into this thinking. For example, while the expatriate may have sent school-age children to a public school back home, the only realistic option for language and cultural reasons may be to send them to a private school in the country of work to get a comparable education that will allow the children to be absorbed back into the public schools on return home. Free provision of health care up to the standard in the home country can be justified in the same way.

Hence, provided the rules are carefully framed and judiciously enforced by selective audits of expatriates to prevent abuses, nontaxation of such benefits can be justified on the basis of the special position of the expatriate. Indeed, this approach can be generalized for the converse case where residents of the country become expatriates in another country, although in practice legislation on this topic will be much rarer. A provision to this end follows:

> 1. A foreign service allowance paid in respect of the additional expenses incurred by reason of employment in *X* is exempt income [in an amount not exceeding x percent of income (apart from this exemption)].
>
> 2. Paragraph 1 does not apply to any allowance in respect of income tax payable in *X*. Regulations may further limit the exemption provided under paragraph 1.
>
> 3. This article applies to a taxpayer if

(a) the taxpayer was a resident of another country under its tax law immediately before undertaking the employment in respect of which the allowance is paid;

(b) the taxpayer became a resident of *X* for tax purposes solely as a result of carrying out the duties of the employment; and

(c) the employment in *X* lasts no longer than three years.

As indicated by the material in the article in square brackets, the exemption may be limited to a percentage of the taxpayer's income before the exemption is applied, which is a method to limit abuse (e.g., to prevent an employer from paying such an employee a relatively low salary and a substantial foreign service allowance). A limitation is imposed by paragraph 2, which provides that the exemption does not extend to allowances in respect of income tax (tax supplements) that the individual may have to pay in *X*. Paragraph 3 provides a special test to determine whether the person is entitled to the allowance, based on where the person was resident before moving as a result of the person's employment, and limits eligibility to the allowance to employment in the country for a maximum of three years.

3. Foreign-Source Income

The next problem is the treatment of income of the expatriate derived outside the country where the work is carried out. As already noted, expatriates in the second category referred to above will normally be treated as residents of the home country under the tiebreaker rule in tax treaties, whereas those in the third category will usually be treated as residents of the country where the work is performed. Depending on the precise terms of the treaty, the effect on the second category may be to eliminate taxation by the country where the work is conducted on income derived by the expatriate from sources outside that country and to limit or exclude taxation by that country on dividends, interest, royalties, and other kinds of income derived from sources in that country. For the third category of expatriate, the effect of tax treaties will usually be to permit unlimited taxation of their worldwide income by the country where the work is performed and to limit or eliminate taxation in the home country of income derived by the expatriate from sources in the country of work, the home country, or other countries. Where there is no tax treaty, there will frequently be unrelieved residence-residence double taxation for both the second and third categories. The overall tax position is thus complex and very likely to lead to excessive tax burdens.

If the country where the work is to be done wishes to attract the skills of expatriates, it may seek to deal with the problem in its domestic law. As with fringe benefits, the simplest mechanism is to exempt for a limited time income (other than employment income) derived by the expatriate from sources outside the country. An example of possible statutory language is as follows:

The foreign-source income of a resident of *X* is exempt income if

(a) it is not employment income;

(b) it does not benefit from a tax reduction under a tax treaty entered into by *X*;

(c) the taxpayer became a resident solely as a result of employment exercised in *X*; and

(d) the employment in *X* lasts no longer than three years.

4. Pensions and Social Security

It is common in many industrial countries for higher-paid employees with special skills to become members of private pension schemes. Under the tax law of industrial countries, the contributions to, income of, and distributions from the pension scheme will usually be subject to favorable tax treatment as a means of encouraging the employee to save for retirement and so not require support from the state in old age. When such a person comes to a developing or transition country as an expatriate employee, it will often be found that the country has no similar provisions in its laws (because of a lack of pension arrangements for old age in developing countries or because of full state provision of pensions in transition countries), or that such provisions as do exist do not apply to foreign pension schemes, or that ceilings on tax-favored contributions to local pension schemes are low by international standards. As entitlements under private pension schemes are often not portable between schemes within a country, let alone across international borders, the expatriate usually has no option but to remain a member of the pension scheme in the home country. The result is an increased tax burden on the employee and employer simply to maintain the existing pension entitlements of the employee, which will not come into effect until many years after the employee leaves the developing or transition country.

Although tax treaties increasingly are seeking to deal with this problem, most existing treaties do not.[75] Hence, countries may wish in their domestic law to recognize the position of foreign pension schemes and to seek to remove the tax problems they and their members currently experience. How this is to be achieved depends on the existing arrangements for domestic pension schemes in the country where the work occurs. If the country has schemes similar to those used in most industrial countries, then it is possible to extend the same preferential treatment to foreign schemes on the basis of reciprocity. Alternatively, if there are no such schemes or if reciprocity is difficult to achieve, a

[75] *See* OECD, *The Tax Treatment of Employees' Contributions to Foreign Pension Schemes*, in Issues in International Taxation No. 4, Model Tax Convention: Four Related Studies (1992) for a discussion of the problems under domestic law and proposals for additional provisions in tax treaties that are now reflected in the Commentary on art. 18 of the OECD Model.

deduction may be provided for contributions from expatriate employees and their employers to pension schemes in the home country of the employee limited by reference to some proportion of salary and employer contributions (say, 10 or 15 percent).

Social security taxes present similar problems, especially in transition countries where they can amount to up to 50 percent of payroll before tax. Although such taxes are separate from income taxes and are not covered by tax treaties, they are intimately related as far as the employee is concerned, especially as regards provision for retirement. An expatriate employee (or the employer, depending on where the tax is formally levied) will often find that social security contributions must be paid in respect of the employee's salary in both the home country and the country where the employee is working on the basis of residence in each country (the definition of residence under the social security tax law being in question here, but with similar issues to the income tax).[76] There will generally be no relief from this double taxation, and in addition the expatriate employee or employer will often be insuring privately in respect of some of the matters that may be covered by the social security system (such as medical treatment) because of the difficulties of extracting adequate benefits from the systems of developing or transition countries in such cases. Even if there is no double tax, the local tax may be quite high.

For expatriate employees, the most relevant social security system is that of the home country, because they will avail themselves of very few or no benefits under the system of the country where the work occurs. Hence, it is sensible for the country where the work is carried out not to levy its social security tax on expatriate employees and at the same time to deny benefits under its system. This leaves the matter to be dealt with under the system of the home country or private insurance. Social security totalization agreements are nowadays being entered into between countries to deal with these kinds of problems, but the development of such treaties lags far behind tax treaties.[77]

C. Relief from Double Taxation

In industrial countries, the major residence country tax issue is generally seen as the relief of double taxation on income that has been taxed at source in another country. For developing and transition countries, this issue is less of a problem because residents will derive much less income from foreign sources. So far as there is foreign income, it will frequently be the result of (often illegal) capital flight to low-tax jurisdictions, in which event the problem for the residence country is detection and taxation of the income, not the relief of double taxation. Hence, the discussion of this issue will be fairly abbreviated and will not delve into all the well-known intricacies of credit and exemption systems of industrial countries.

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[76]This will not always be the case, as often expatriate employees will not be liable to pay social security tax at home on income earned abroad. *See* vol. 1, ch. 11, at 386–91; USA IRC § 3121(b).

[77]*See* vol. 1, at 391.

It is necessary to distinguish among four basic methods in this area. The first is for a country not to assert jurisdiction to tax foreign-source income of residents (either at all or for selected types of income). This territorial approach to taxation (taxing only income sourced in the country) means that the country is not following the usual international norm of worldwide taxation of residents and so is not strictly a method for relieving double taxation as residence-source double taxation will simply not arise for its residents.[78]

The second method is the exemption system, under which foreign-source income is exempted in the country of residence. If the exemption is unconditional and the exempted income does not affect in any way the taxation of other income, then in substance the result is the same as a purely territorial system. Most exemption systems are not of this kind and so are to be distinguished from territorial systems. Most countries using an exemption system adopt exemption with progression, under which the total tax on all income of a resident is calculated, and then the average rate of tax is applied to the income that does not enjoy the exemption.[79] Exemption systems are also increasingly subject to various conditions to ensure satisfaction of the assumption underlying the system (that the income has been taxed in the source country at its ordinary rates).[80] These conditions can consist of subject-to-tax tests (including the specification of tax rates) or selective application of exemption to foreign countries under domestic law or tax treaties.[81] In particular, the exemption is usually not given where the source tax has been reduced or eliminated by a tax treaty. The result is that there are no countries asserting jurisdiction to tax worldwide income that give an exemption for all kinds of foreign income; where a country is referred to as an exemption country, this generally means that it provides some form of exemption to business income, dividends received from direct investments in foreign companies, and often employment income, with a credit being used in other cases.

The third system is the foreign tax credit system under which a credit against total tax on worldwide income is given for foreign taxes paid on foreign income by a resident up to the amount of domestic tax on that income. This limit is designed to ensure that foreign taxes do not reduce the tax on the domestic income of residents and is calculated by applying the average rate of tax on the worldwide income before the credit to the foreign-source income. In its simplest form, this limit is applied to foreign income in its entirety, without distinguishing the type of income and the country where it is sourced.

[78]The territorial approach used to be common in Latin America, but the major jurisdictions there have moved to a worldwide system. It is still used in some Latin American countries, Hong Kong SAR, and South Africa.

[79]AUS ITAA § 23AG; FRA CGI § 197C.

[80]AUS ITAA § 23AH in relation to branch profits.

[81]Canada and Germany are two countries that confer exemption only in relation to countries with which they have a tax treaty.

The fourth system is to give a deduction for foreign income taxes in the calculation of taxable income. While this system is used in some countries, often as a fallback from a foreign tax credit where the credit may not be of use to the taxpayer,[82] it is not widely accepted as a method for use on its own and, more specifically is not used in tax treaties.

It can be argued that relief of double taxation in either credit or exemption form involves a number of complexities that are best avoided by developing or transition countries. Pure territorial taxation, however, simply invites tax avoidance through the moving of income offshore, and once qualifications on the pure territorial principle are admitted, such as limiting it to certain kinds of income, it is hard to see that any great simplicity is achieved as problems of characterization of income arise, as well as incentives to convert income from one form to another. Similar difficulties arise when a conditional exemption system is used. For this reason, a simple foreign tax credit system is probably suitable for most such countries—it asserts the worldwide jurisdiction to tax income of residents and does not require significant refinements of calculation. It leaves open the greatest scope for elaboration of the system by domestic law and tax treaties in the future without having to repeal or modify any exemption (often a difficult process politically because of entrenched interests). Given that tax treaties are premised on an item-by-item foreign tax credit limit, rather than on a worldwide limit aggregating all foreign income of the taxpayer, the item-by-item limit is probably easiest to use in domestic law.[83]

Whichever double tax relief system is adopted, some method of apportioning deductions between domestic and foreign income will be necessary. Where deductions allocated to foreign income exceed that income, the loss should not be available for use against domestic income. In practice, most credit countries do end up with some cases of effective exemption for foreign income.[84] One possible example in this context is in relation to the foreign income of expatriates discussed above.

Tax treaties invariably contain an article for relief of residence-source double taxation (they are built on the assumption that each country will assert jurisdiction to tax the worldwide income of residents, which is another reason for asserting this jurisdiction

[82]*See* USA IRC §§ 164(a), 901; GBR ICTA § 805.

[83]This approach is most clear in art. 23A para. 2 of the OECD Model, but also applies to art. 23B. Item-by-item limits can be overcome by using wholly owned subsidiary "mixer" companies in which all foreign income ultimately owned by a resident taxpayer is channeled through an offshore company so as to average differing foreign tax rates on various kinds of foreign income. To counter this kind of tax planning, elaborate provisions for looking through the mixer company to the underlying income are necessary. It does not seem worthwhile for developing and transition countries to adopt such measures. Alternatively as suggested in the following text, a country in the early stages of developing of its international tax rules may not adopt the underlying or indirect foreign tax credit on which this form of planning depends.

[84]Even the United States, which is generally regarded as the strongest proponent of the credit system, effectively exempts a significant part of foreign employment income of citizens living abroad. *See* USA IRC § 911(a).

in domestic law). The only methods specified in tax treaties are exemption and credit, but there is no need for the treaty method to follow that used in domestic law. Some countries have no relief method under domestic law, so that the only relief is under treaties,[85] while some countries have the credit method in domestic law but use the exemption method for selected kinds of income in treaties. Where the country has the credit method in its treaties, this is not generally regarded as preventing it from using the exemption method in domestic law, as exemption is seen as more generous than the credit method and therefore not inconsistent with the treaty obligation. Where the exemption method is adopted by tax treaties, the exemption-with- progression system is usually expressly authorized.

Special double tax relief rules are often provided for foreign direct investment. As already noted, the exemption system is often targeted to foreign-source business income and dividends received by a resident company from a direct investment in a nonresident company. Direct investment in a foreign company is equated with business income to ensure that no bias is created as to the business form used. If an exemption is granted for the business income of a branch in a foreign country, then it should make no difference that the business income is generated by a subsidiary in that country and then repatriated as dividends. By parity of reasoning under a credit system, a resident company should get a foreign tax credit not only for foreign tax paid by a branch but also for foreign tax paid by a subsidiary. This credit, referred to as an underlying or indirect foreign tax credit, in practice involves a number of complexities that most developing or transition countries would do well to avoid. It needs to be recognized, however, that failure to grant an indirect credit creates a bias against investment abroad by residents of the country in the form of subsidiaries. If such investment becomes important to the country, the indirect foreign tax credit issue should be addressed either in tax treaties or in domestic law, or both.

The article in tax treaties on relief from double taxation may also contain special rules for direct investment in a developing or a transition country by a foreign investor to preserve the effect of tax incentives granted by the developing or transition country. This topic is discussed in relation to tax sparing in chapter 23.

D. Capital Flight

The more important residence tax problem for developing and transition countries is capital flight. Many residents, especially those with the greatest wealth, will seek to send their wealth abroad. They may be concerned about devaluation of their own currency and wish to hold foreign currency, which may not be legally possible in their countries; they may be afraid of confiscation (by the state or criminal gangs) or civil

[85]In Switzerland, in the absence of a treaty, double taxation is relieved by the deduction method (i.e. as a cost of earning income), not by credit or exemption, and this occurs even in the case of a few treaties with respect to income where tax is permitted by limited at source. *See* Xavier Oberson and Howard Hull, Switzerland in International Taxation 128, 130 (1996). Several transition countries lacked relief mechanisms prior to the reform of their tax laws in the transition.

unrest; and they may seek not to pay tax on the income produced by the wealth, which itself may have been obtained by illegal means or may represent income that was not declared for tax purposes. Whatever the reasons in any given case, it is clear that capital flight from developing and especially transition countries is a major problem; the need of these countries, on the contrary, is to retain domestic capital for productive local investment.

Most of this fleeing capital finds its way to tax havens, which may be defined for this purpose as low tax jurisdictions that have bank and other secrecy laws that allow the ownership of assets to be concealed. For transition countries, it is well known that Cyprus is a major destination of nervous capital. For developing countries, there are any number of other tax havens only too willing to assist. Indeed, so lucrative does the business seem that many developing and transition countries actively consider turning themselves into tax havens.

If the money simply finds its way into an anonymous bank account and the income earned thereon is not declared for income tax purposes, then assuming that the residence country asserts jurisdiction to tax the income, this is a case of tax fraud (deliberate nondisclosure). The problem here is one of detection and tax administration. More sophisticated taxpayers may wish to ensure that no tax liability arises in respect of the wealth, and there are a number of stratagems that they can employ. The simplest form is to invest in shares in a tax haven company that in turn simply invests in a very safe form (such as U.S.-dollar denominated bonds with a high credit rating) and accumulates the interest income for further similar investment. If the shareholder desires the return of the original investment and the income that has accrued in the company, an associate simply buys the shares at a price based on their asset backing. The company is not taxed on the interest that accrues on the bonds (or is taxed at a very low rate) because it is located in a tax haven (from the point of view of the residence country of the investor, it is foreign-source income of a nonresident) and the investor is not taxable on the interest because it accrues to the company and not to the investor.[86] The investor will be taxable in the residence country, if at all, only on the profit on the sale of the shares, but can postpone this tax for many years by not selling. In any event, many developing and transition countries do not tax gains on the sale of shares.

To counter this kind of activity, special rules are required in the domestic tax law of the residence country, in effect to look through the company and tax the resident investor on the underlying income. A number of industrial countries have such laws but they are usually very complex. For developing and transition countries, a simpler provision can be inserted in the tax law to give a discretion to tax and thus to send a signal that such cases will be pursued when detected.[87] A provision may be drafted along the following lines:

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[86]Even when the company invests in bonds denominated in major currencies, such as the US dollar, there will often be no interest withholding tax in the country of issue because an interest withholding tax exemption is applicable (as to which, *see infra* sec. VI (C)).

[87]*E.g.*, GEO TC § 66.

1. Where a resident of *X* has entered into a transaction that converts income into foreign-source income derived from a tax haven by another person, the tax administration may adjust the income and foreign tax credit position of the resident to reverse the tax effect of the transaction.

2. The tax administration may treat a foreign country as a tax haven if that country has

   (a) effective tax rates significantly lower than those of *X*; or

   (b) laws providing for the secrecy of financial or corporate information that facilitate the concealment of the identity of the real owner of any asset or income.

This provision is not generally regarded as breaching tax treaty obligations in the unlikely event that there is a treaty with the tax haven. There will still be an information problem if such a provision is inserted into the law, and the investor will no doubt be relying on lack of information as much as the interposing of the company to avoid tax. To overcome this problem, it is necessary to have a question in the tax return or tax declaration that requires the taxpayer to disclose investments in nonresident entities, which will prompt the tax administration to inquire further. If the resident investor deliberately answers this question incorrectly, as is likely, the taxpayer's position is back to tax fraud and problems of detection.

The information problem is almost impossible to solve. The tax haven will usually not enter into tax treaties, or if it does, it will change the exchange-of-information article so as not to require disclosure in relation to banks' tax haven operations. As tax treaties generally provide the only way for tax administrations in different countries to exchange information, cooperation in the disclosure of the information from the tax haven will not be forthcoming. For this reason and many others, developing and transition countries should be wary of entering into tax treaties with tax havens. The best that developing and transition countries can do for now to deal with capital flight to tax havens is to try to remove the conditions that give rise to the flight in the first instance and to apply severe penalties in relation to tax fraud involving tax havens.

E. Change of Residence for Tax Reasons

One other residence country tax problem can be noted in conclusion. Some residents who anticipate deriving a substantial amount of foreign-source income may be tempted to change their residence before the income is received so that it becomes foreign-source income of a nonresident from the point of view of the former residence country. Obviously the change would be made to a country that would not tax the income (possibly a tax haven) and would occur only if there were no substantial source country tax on the income (because otherwise the residual residence country taxation is likely to be minor). Some industrial countries have special rules to deal with this problem, but they may be regarded as unnecessary for developing or transition countries. The main problem for such countries is in fact likely to be the other way around, that is, the rules of industrial countries in this area may create problems for expatriate taxpayers who become residents. The rules outlined above to deal with the tax problems of expatriates may also assist in overcoming this problem.[88]

VII. Taxation of Nonresidents

As already noted, general principles suggest that the income of nonresidents should be taxed on a flat-rate basis, as progression is a matter for the residence country. In practice, some taxes on nonresidents are collected on a flat-rate basis, but more for administrative convenience than principle. Because of the general rule found in most legal systems that one country will not assist another in enforcing its tax laws and because of the general administrative difficulties of dealing with persons and assets outside a country, the source country will be well advised to enforce its tax claim on the payer of the income before the payment leaves the country in cases where the recipient does not have any substantial connection with the country, such as a permanent establishment. Hence, it has become accepted as a general principle of international taxation that taxation of passive income unconnected with a business in a country is enforced by flat-rate final withholding taxes, whereas tax on business income arising from a permanent establishment is levied on net income and is collected by the normal assessment system applied to businesses of residents (which may also include some elements of withholding and payment of tax by installments).

For other forms of income, there is less consistency in practice between flat-rate withholding and tax by assessment, although where assessment is used it is normally in accordance with the rate scale applicable to residents, rather than with a special flat-rate scale for nonresidents (although personal allowances including a tax free amount are often confined to residents). The discussion of taxation of nonresidents will thus start with the related issues of tax rates, method of collection, the use or not of assessments, and the effect of tax treaties, taking the categories of income in turn as for the source area. It will then turn to a number of other issues affecting nonresidents of concern to developing and transition countries.

A. Income from Immovable Property

Income of nonresidents from immovable property is taxed by some countries on a flat-rate final withholding basis on gross rent and by others on an assessment basis. Some countries provide an option to nonresident taxpayers as to the method of taxation[89] since,

[88]In a number of industrial countries, for example, USA IRC § 877, the change of residence rules take the form of subjecting the person to tax on gains on the disposal of assets for a period of time after the person ceases to be a resident. If the developing or transition country exempts foreign income of expatriates (other than employment income) from tax for a certain period, the problem of conflicting tax jurisdiction is likely to be avoided.

[89]USA IRC § 871(d).

although final withholding is simple, it can prove very rough and ready because of the wide variation that occurs in the amount of deductions relating to income from immovable property (e.g., the full amount to purchase the property, or none of it, may have been borrowed, leading to very different amounts of interest deductions). As enforcement in this case is not generally a problem (assuming that the tax administration can execute against the immovable property for unpaid tax), tax by assessment on a net basis seems the fairer approach, and requiring private residential tenants to withhold on rental payments is unlikely to be enforced effectively. Tax treaties do not generally constrain domestic law in this case.

B. Business Income

In the case of business income of a nonresident sourced in a country, income attributable to a permanent establishment (or otherwise associated with a permanent establishment and sourced in the country) is generally taxed on a net assessment basis. Tax treaties usually require this approach in the case of income subject to the business profits article but, because of their convoluted drafting, the actual extent of this obligation is not obvious at first sight. The business profits article is usually expressed to be subject to other articles of the treaty, but then other articles either refer the matter back to the business profits article in respect of profits attributable to a permanent establishment (dividends, interest, royalties, and other income) or adopt in effect the same rule as the business profits article (capital gains and implicitly, at least according to the OECD Commentary,[90] income from independent personal services).

Articles that may involve business profits and that override the tax treaty requirement of taxation on a net basis concern income from immovable property (above), international transport, and entertainment and sporting activities. In the case of international transport, source taxation is generally excluded (although the UN Model has a little-used variant for shipping) and in the case of entertainment and sporting activities, taxation on a gross withholding basis is permitted. Taxation by withholding is usually permitted for dividends, interest, and royalties that are not attributable to a permanent establishment.

To the extent that the domestic law provides for taxation, on a net or a withholding basis, of technical fees paid to nonresidents, tax treaties will usually override and prevent the tax levy if the fees are not attributable to a permanent establishment while requiring as a result of the nondiscrimination article that a deduction be given to the permanent establishment or resident company that incurred the expenses, subject to the amount being arm’s length in the case of related parties. Nonresident companies may try to exploit this situation, but depending on the circumstances, it may be possible to find means within the tax treaty to levy tax on both the technical fees and on the salaries of the personnel providing the services.[91] It was noted above that most tax treaties do not

[90]Para. 3 of Commentary on art. 14.

[91]Where, as is common, personnel of a parent company are seconded on a rotating basis to a subsidiary in a developing or transition country, it is possible to apply the hiring out of labor analysis discussed *supra* sec.

deal separately with insurance and telecommunication income, so that the permanent establishment requirement applies, with the result that the profits from these activities in a country are often not taxable. A number of countries nonetheless apply (relatively low, say, 5 percent) flat-rate withholding taxes on insurance premiums, either in the international area specifically or more generally and seek to protect this levy in their tax treaties.

One particular problem that some transition countries experience in the area of business income is the treatment of deductions. In a number of countries, the tax laws, for the purpose of wage control, have denied deductions for wages in excess of a very low threshold. Deductions for other expenses, such as advertising and interest, may also be limited. There has been some debate on the extent to which the requirements of tax treaties that permanent establishments be taxed on a net basis override provisions of domestic law that deny deductions that affect the determination of profit. While it is unlikely that tax treaties will be interpreted to override the denial of deductions in marginal areas where denial is quite common under domestic laws (e.g., entertainment deductions), it is another matter where a fundamental matter of profit determination such as the treatment of wages is concerned.

A number of industrial countries have inserted special provisions in their recent tax treaties with transition countries to attempt to clarify the matter for permanent establishments and to ensure that subsidiaries of direct investors from their countries also get deductions for their full wage costs (because the only tax treaty rule that potentially covers the subsidiary case, the nondiscrimination article, is unlikely to be of assistance).[92] Some transition countries have modified domestic law so that the denial of wage deductions does not apply to branches and subsidiaries of foreign direct investors, and others have repealed the wage deduction denial entirely. For some industrial countries, these rules in the transition country tax systems have raised the more fundamental question of whether their "profit" taxes are income taxes at all in the generally understood sense and have consequently slowed down the development of tax treaty networks.

C. Dividends, Interest, and Royalties

In the case of dividends, interest, and royalties paid to nonresidents, domestic law usually provides for flat-rate final withholding tax on the gross amount if they are sourced in the country and not attributable to a permanent establishment. The tax rate is

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IV(G)(3), or to find that there is a permanent establishment of the parent company on the basis of the use of the subsidiary's facilities, which will mean that the business profits article of tax treaties will apply to the technical fees received by the parent company and the employment article to the employees so that both are taxed in the source country. Alternatively, tax treaties may provide for the taxation of technical fees through extension of the royalties article or addition of a special article on the topic; *see supra* note 51 and text.

[92]United Kingdom-Russia (1994 Exchange of Notes); the features of Russian law causing concern have since been modified but similar problems remain with other transition countries.

typically set at 20–30 percent in developing and transition countries and then is often reduced to 10–20 percent in tax treaties. The rates are set at this level in domestic law to leave negotiating room in the tax treaty process but usually to be below the normal company tax rate in recognition of the fact that the tax is gross and does not take account of expenses. In tax treaty negotiations, developing and transition countries will come under considerable pressure from industrial countries to reduce withholding tax rates on interest and royalties to zero or near zero (special considerations applicable to dividends are discussed further below). The argument used by industrial countries is that the gross tax often wipes out the entire profit, with the result that the price charged to the resident or permanent establishment in the country is increased (i.e., the tax is passed back to the payer) with adverse consequences for the import of capital and technology.

While gross-up for withholding taxes (usually by increase in the interest or royalty rate) undoubtedly occurs and is detrimental to developing and transition countries, reduction of tax rates to zero or near zero likewise produces problems and the appropriate course to take is a matter of judgment. If the treaty tax rate on interest is 10 percent, then banks that lend to residents of the country will find it difficult to make a profit. For example, if the cost of funds of the bank is 9 percent and its lending rate is 10 percent, then on a loan of $1,000 it will make $10 before tax and other expenses besides interest, but the withholding tax will be $10 and so wipe out the profit, forcing the bank to increase the interest rate (assuming that it cannot use the excess foreign tax as a credit against other domestic tax in its residence country). If the OECD Commentary's suggestion to deal with this problem is followed and loans from banks are exempted from tax,[93] this opens the way for simple back-to-back transactions, which will mean that the exemption will be effectively extended to nonbank lenders. If a nonbank nonresident lender deposits money in a nonresident bank and the bank then makes a corresponding loan to a resident (less a small fee), what is effectively a loan from a nonbank becomes for treaty purposes a loan from a bank and is protected accordingly. Some of the problems of this kind can be dealt with better by provisions in domestic law that remove the withholding tax on interest for borrowings in the international capital markets where the debt is widely held (often referred to as Eurocurrency loans). The widely held requirement substantially removes the problem of back-to-back transactions. Many industrial countries have such provisions in their laws.[94] Nonetheless, in a few cases, reduction of interest withholding to zero under treaties is common for developing and transition countries, especially for concessional loans made by development banks. A general lowering of the interest withholding rate to zero also worsens the thin capitalization problem described below.

Similar considerations apply to royalties, which are also particularly associated with the problem of treaty shopping discussed below. Hence, there is a good argument for developing and transition countries to have a reasonable positive tax rate on interest and

[93]Para. 15 of the Commentary on art. 11.

[94]Provisions that reach this kind of result, although by various means, are AUS ITAA §128F; CAN ITA § 212(1)(b)(vii), GBR ICTA § 349(3)(c); USA IRC § 871(h)(2)(A).

royalties under tax treaties (say, 10–15 percent). If royalties include equipment leasing rentals, there is also a strong argument for uniform tax rates under tax treaties on interest and royalties; indeed, the possibilities for conversion from interest to royalties or vice versa, especially in the case of related parties, extend beyond this area so that equivalence should be a goal in any event. Perhaps more important, because of the problem of treaty shopping, it is imperative to have the rates similar or the same across tax treaties with other countries in the case of interest and royalties. The industrial countries generally (but reluctantly) accept this position in their tax treaties with developing and transition countries; however, they often negotiate most-favored-nation clauses in protocols to the tax treaties in such cases, so that if the developing or transition country grants a more favorable rate or treatment to another developed country (often defined in terms of membership of the OECD), then either the more favorable treatment is automatically extended to that country or an obligation to renegotiate that tax treaty arises.[95]

D. Capital Gains

Capital gains of nonresidents present a more difficult problem for withholding. While it is possible to have flat-rate withholding based on the sale price either generally or specifically in the case of nonresidents, the gain part of the sale price can vary considerably, and so an option for net taxation should be provided for in domestic law with appropriate administrative safeguards.[96] Enforcement of such withholding is likely to be feasible only in the case of land (because land transactions are usually registered in some way and the collection of tax can be tied in with this procedure) or of a permanent establishment (with the gain taxed on a net basis like most other business profits). Many countries do without withholding in such cases, as it is possible with appropriate administrative mechanisms to deal with the capital gains.[97] Attempts to levy capital gains in other cases will generally be overridden by tax treaties and any attempt to protect the power to levy tax on gains on shares in resident companies is likely to be futile for reasons already explained.

E. Employment, Services, and Pension Income

Employment income of nonresidents is usually subject to the normal wage withholding and not to any special final withholding, despite the policy arguments that flat-rate withholding is the appropriate method for nonresidents. There are special collection problems where the employer is a nonresident, but tax treaties usually will

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[95]For example, most of Australia's tax treaties with European countries have such protocols.

[96]As long as inflation is significant and property rights have not been clarified in transition countries, the introduction of a capital gains tax is probably not a high priority generally, let alone in the case of nonresidents.

[97]For example, Australia has general power in AUS ITAA § 255 to require a person owing money to a nonresident to pay tax owing by the nonresident on receipt of a notice from the tax administration; this procedure can be utilized in the case of substantial capital gains that come to the notice of the tax administration (which may put a watch on land registers for that purpose).

protect the employee from taxation by the country where the work is performed in this event through the 183-day rule unless a permanent establishment bears the wages (in which event enforcement will not usually be difficult). If the employee is present for 183 days or more, residence will usually arise and the more permanent connection with the country will facilitate withholding, although it is easy for temporarily present employees to slip through the net unless attention is given to this issue by the tax administration. Powers in the domestic law for the tax administration to prevent a person from leaving a country unless taxes are paid can provide some assistance to tax collection depending on how easy or difficult it is to exit the country.

Some transition countries find it difficult to cope with withholding on wages of expatriates because their wages are paid into bank accounts in foreign countries. This is partly a function of some wage taxation laws applying only to wages paid in a country (which should be rectified if necessary, making clear that the law applies to wages sourced in the country, whatever the place of payment) and partly a surrender to the difficulties that the international border creates. Most employers, however, will not use such a device to avoid tax as the penalties on employers for failing to withhold are typically and appropriately severe. Moreover, this is one area where information exchange under tax treaties with the country of the employer can be effective in assisting the tax administration.

Although wage withholding often is not formally final, the way in which obligations to file tax returns are expressed in many developing and transition countries means that many employees are taxed through withholding only, so that in effect the withholding is final.[98] In the case of nonresident taxpayers, returns are not usually required or forthcoming so that the withholding is final in fact. For expatriate taxpayers, adoption of any of the special rules set out above may mean that special attention has to be given by the tax administration to withholding on wages and filing of returns in their case to prevent abuse of the rules.

Some countries extend withholding beyond the employment area (including deemed employments discussed above) to certain services rendered in a business context. As already noted, such income is required by tax treaties generally to be taxed on a net basis, but this obligation can be satisfied by permitting such taxpayers to file returns and to have the withholding credited against the tax liability (with refunds where necessary). The language of tax treaties (although not perhaps the OECD Commentary)[99] suggests that final withholding on professional income is permitted where there is a fixed base (or a presence time limit is exceeded if included in the treaty).

[98]*See generally supra* ch. 15.

[99]Commentary art. 14, para. 3 states that taxation under art. 14 should be levied on a similar basis to the net taxation of business profits under art. 7, although there is nothing in the wording of the article to suggest the limitation; the OECD is currently considering whether art. 14 should be dropped from the Model, which would have the result of net taxation under art. 7 applying in such cases.

For entertainment and sports-related income, flat-rate final withholding is clearly permitted under tax treaties and provides a simple and effective method of collecting tax via the promoter of the event. Provision for some form of withholding on this income at a reasonably substantial rate, such as 30 percent, should be provided in the domestic law and should apply whether the income accrues to the entertainer or athlete directly, which is very rare, or to some intermediary; that is, the law should permit the tax authorities to look through the intermediaries to the entertainer or athlete.

In the case of pensions, withholding in accordance with the rate scale for individuals is often provided for in domestic law in a similar way as for wage income. Tax treaties may override any tax depending on the source rule adopted (see above). Likewise, wage and pension income of the employees or former employees of foreign governments will usually be subject to withholding under domestic law in the same way as other wages and pensions, but tax treaties may remove the levy of this tax.

F. Company and Shareholder Taxation

The relationship of taxation of company and dividend income in the international setting raises a number of special issues. One major distinction is between direct and portfolio investment. Direct investment refers to the case where the investor in a company has a large enough interest to influence the operations of the company, while portfolio investment is the opposite case of no influence. This distinction often runs throughout the laws and commercial practice of a country (in such areas as takeovers, investment, banking, and accounting, as well as taxation) and may be defined differently for different purposes, although often the taxation definition is affected by treatment in other areas of the law. It is usually defined in terms of owning a certain percentage of the capital or controlling a certain percentage of the votes in a company, with 10 percent and 25 percent or more for direct investment being the most common in taxation laws. The OECD Model uses 25 percent of the capital, while a number of industrial countries use 10 percent of voting power in their tax treaties.[100] The discussion that follows will commence with portfolio investment and then move on to direct investment.

1. Integration Systems

The simplest tax system for companies and shareholders is the separate system; that is, the company is taxed on its income and then dividends paid by the company are taxed as part of the income of the shareholder without reference to any tax paid by the company. Whatever the method of tax collection under this system in a domestic case (where a resident company pays a dividend to a resident investor), frequently a flat-rate withholding tax is levied on dividends paid by resident companies to nonresidents. Tax treaties will often reduce the rate contained in domestic law, the OECD Model and most tax treaties specifying 15 percent for portfolio dividends.

[100]For example, Australia, the United Kingdom and the United States.

In recent years, many countries have moved away from the separate system because of its well-known potential for distorting economic decisions by companies and shareholders in the domestic context. Such "integration" systems may consist of some form of imputation, a split corporate tax rate, or a zero or low tax rate on dividends (in all cases with or without some form of equalization tax on dividends to ensure that corporate tax has been paid on distributions of company profits). Domestic tax laws usually confine the full integration benefits to resident shareholders and often continue to tax nonresident shareholders under a separate system with flat-rate withholding taxes.[101]

Most recently, with the growth of international investment, attention has become focused on the potential for international economic distortions from integration systems of these kinds. This issue has led some countries to extend some of the benefits of integration to nonresident shareholders unilaterally or by tax treaty, for example, by partly removing withholding taxes on nonresidents[102] or by giving imputation credits partly to nonresidents.[103] Some countries have sought to go further and completely equalize the treatment of residents and nonresidents. A simple approach is to align or approximate the corporate and maximum individual tax rates and to exempt dividends from further taxation whether paid to resident or nonresident shareholders.[104] From the point of view of the source country (where the company paying the dividend is resident), neutrality may be achieved with such a system. For nonresident portfolio investors, however, neutrality is unlikely because their residence country will almost invariably tax them on the dividends without any benefit of whatever integration system that country has for its resident companies (if any) and with a foreign tax credit only for any withholding tax levied on the dividend by the source country (as distinct from the corporate tax levied on the company paying the dividend).[105]

Hence, there is still a bias in the international tax system for resident shareholders to invest in resident companies that other countries cannot prevent under this or any other form of integration. This bias is now providing policy support for the separate system of company and shareholder taxation, as such a system does treat residents and nonresidents more or less alike if the country of residence of the company taxes shareholders resident

[101]For comprehensive treatment of the imputation system in the international setting, see Peter Harris, Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries (1996). *See also infra* ch. 19.

[102]AUS ITAA § 128B(3)(ga); countries with U.K.-style imputation systems simply do not levy withholding taxes on dividends, whether paid to residents or nonresidents, though they may levy equalization taxes on which see below.

[103]For example, France and United Kingdom.

[104]Ward Hussey & Donald Lubick, Basic World Tax Code and Commentary § 164 (1996).

[105]Some countries seek to overcome the tax credit problem in the residence country of the investor by in effect converting part of the corporate tax into a creditable withholding tax, for example, New Zealand under its domestic law and the United Kingdom in its typical treaties extending imputation benefits to nonresidents.

there on dividends received and if other countries tax shareholders resident there on the dividends, with a credit for any source country withholding tax.[106] In fact, the position is more complex, as a large proportion of international portfolio investment is made by institutions that are taxed under special regimes in their residence country.

From the point of view of developing and transition countries, a fairly standard treatment of nonresident portfolio shareholders with a flat-rate withholding tax and a tax treaty rate limit of 15 percent is the simplest solution. Any attempt to extend integration benefits to nonresidents generally is likely to produce a transfer of tax revenue to capital-exporting industrial countries without providing any incentive to invest to the nonresident (or rather without removing the disincentive to invest abroad that arises from the residence country tax system).[107] Even if it is decided to extend integration benefits to nonresident portfolio shareholders, it is better to do this unilaterally rather than in tax treaties (even if the domestic law confines the benefit to countries with which there is a tax treaty), because such treaty provisions can lock the country into the form of integration it has adopted. As integration (in the past at least) has been primarily a domestic tax policy issue, integration benefits in tax treaties can become the international tail that wags the domestic dog.

A removal of dividend withholding tax on foreign tax-exempt pension funds as part of a regime of reciprocal recognition of the special tax arrangements that many countries use to encourage private pension schemes may be considered. This is usually done outside tax treaties (though note the comments above in relation to tax treaty provisions dealing with contributions to pensions schemes by expatriates) and across all types of investment income, rather than just for dividends.[108]

A country employing an equalization tax as part of its integration arrangements[109] must take care in drafting it to ensure that it does not conflict with tax treaties. Often, such a tax will be effectively at the corporate tax rate and will be triggered by the payment of dividends. It can therefore be viewed as a withholding-type tax on the dividends, in which event there is potential for the tax rate limits in tax treaties to reduce the amount of the tax and so defeat or at least blunt its purpose. There are well-accepted

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[106]OECD, Taxing Profits in a Global Economy 195 (1991); the United Kingdom in its 1997 budget effectively abolished its imputation system in the international setting; *see* Edge, *The Last Piece of the Jigsaw,* The Tax Journal 2 (Aug. 4, 1997); Harris, *supra* note 100.

[107]The United Kingdom sought to remove this disincentive from its imputation system with the foreign income dividend scheme introduced in the early 1990s, but this scheme was withdrawn and the whole issue opened up for review in its 1997 budget; *see* notes 101, 105.

[108]AUS ITAA §128B(3)(a), referring to § 23(jb).

[109]This tax is designed to ensure that tax credits given under an imputation system to shareholders are in fact supported by tax paid at the corporate level; this can be achieved by levying tax on the company every time it makes a distribution, as in the United Kingdom or under an accounting mechanism that matches dividends paid with corporate tax and applies the equalization tax only when there is no matching corporate tax, for example, Australia, France, New Zealand, and Singapore.

drafting devices to ensure that such a tax is not regarded as a withholding tax on dividends.[110] First, no primary or secondary tax liability can be imposed on the shareholder in relation to the equalization tax, so that it is clearly a tax on the company rather than on the shareholder. Second, it helps to use the dividends simply as a measure for the amount of the tax and not to express the tax as being levied on the dividends as such. Technically, the tax also needs to be at the corporate rate on the amount of the dividend plus the tax, which is most easily done by expressing the tax rate as

$t/(1 - t)$,

where t is the corporate tax rate.

The drafting arrangements for the U.K. advance corporation tax provide a model that can be used to ensure that there is no conflict between the equalization tax and tax treaties (although the basic rate of tax and not the corporate rate is used in the United Kingdom).[111]U.K. imputation system, but these features initially remained intact, *see supra* note 105. A subsequent Inland Revenue consultative document of Nov. 25, 1997, proposed abolition of the advance corporation tax, which has been a critical part of the system, and gave rise to the issues considered in the text.

2. Reduction of Dividend Withholding Tax on Direct Investment

In the case of dividends generated by direct investment, the international tax position is very different from portfolio investment from a number of perspectives. A foreign direct investor (assumed in what follows to be a company) generally has a choice as to the legal structure of its investment in a country. It can establish a branch (permanent establishment) or a subsidiary (i.e., a separate company).[112] The residence country of the direct investor will grant relief for double taxation by way of a credit or an exemption for corporate tax levied on a branch by the source country (where the branch is situated). It will generally extend this relief to corporate tax levied on a subsidiary when dividends are paid to the direct investor so as not to produce a tax bias in the form of investment.

In its turn, the source country will, by various means, approximate the tax treatment of branch and subsidiary for the same reason. The major likely difference in source country tax treatment in the absence of special provisions in the domestic law or treaties will be that dividends paid by a resident subsidiary to a nonresident parent company are subject to flat-rate dividend withholding tax, while remittances by a branch

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[110]However, sometimes the tax is purposely structured in the opposite manner, in order to make it a creditable dividend withholding tax in the hands of the shareholders.

[111]GBR ICTA § 14, pt. VI, chaps. IV, V, VA. The 1997 U.K. Budget radically altered the

[112]The term "subsidiary" will be used in what follows although it is often used only to refer to the case of control of, rather than influence over, a company; as noted above, direct investment is usually defined in terms of influence rather than control.

to its head office (the functional equivalent of dividends) are not subject to any tax. The source country can address this disparity by reducing the tax on direct investment dividends, or by taxing branch remittances, or by a combination of both.

Although it is possible for domestic law to provide a lower tax rate on direct as opposed to portfolio dividends paid to nonresident shareholders, until recently this reduction was most commonly only effected by tax treaties (with 5 percent being the OECD Model norm). Developing and transition countries need not be too concerned with accepting such arrangements for direct investment in treaties, especially where an equalization tax is in place, but it is noticeable that a number of such countries (along with some smaller industrial countries) do not draw the portfolio/direct investment distinction in the dividend article of their tax treaties and apply the same rate of tax to both. Unlike the case of portfolio investment, a lower rate of tax on dividends on direct investment does not usually operate as a transfer of revenues to industrial countries because of the different tax regime in most of them for dividends on direct investment (exemption or underlying foreign tax credit). A small but positive tax treaty rate in the source country also provides some incentive for reinvestment of profits (a major source of investment) by foreign investors without unduly distorting the tax position in the residence country of the investor.

There is now a more general international trend for reducing withholding taxes on dividends paid to nonresident direct investors outside tax treaties. One effect of the tax reform that took place in many countries in the late 1980s was to more closely align the tax base and tax rate applied to companies in industrial countries. This meant, for direct investments through subsidiaries, that the corporate tax in the country of the subsidiary would approximate the corporate tax that the same amount of profit would attract in the country of the investor. As that country would relieve double taxation for the corporate tax paid by the subsidiary, the net effect was to wipe out any corporate tax in the residence country of the investor whether a credit or an exemption system was used, but the dividend withholding tax would remain as an additional tax levy above the residence country tax.

A number of major econometric studies in the early 1990s suggested that such withholding taxes were the main factor accounting for a bias against cross-border investment, and hence some pressure has developed for their removal, even though tax treaties typically contain lower tax rates on dividends from direct investment.[113] The fact that the United States typically demands for its resident investors a share of the action in integration systems adopted by foreign countries has also been an influence here. Developing and transition countries that do not have tax treaty networks may therefore wish to consider setting the cross-border dividend withholding tax rate on direct investment at a lower rate (say, 10 percent) than the traditional and typical 20–30 percent tax rate that has been adopted across the board by many countries for dividends, interest,

[113]OECD, Taxing Profits in a Global Economy (1991), CEC, Report of the Committee of Independent Experts on Company Taxation (1992). The initial enthusiasm for this analysis, which gave rise to a number of initiatives in the EU seems to have cooled.

and royalties. There is, however, little reason to adopt a selective zero tax rate on dividends in domestic law as part of regimes of tax incentives for foreign direct investors.[114] As the benefit is only likely to operate long after the initial investment occurs, it has little impact on initial investment decisions and does not encourage reinvestment of profits.

A similar pressure to reduce cross-border dividend taxes may arise when countries form a free trade bloc, given that one of their longer-term objectives is usually to remove not just trade barriers but also investment and other barriers to the creation of a common market. This means that taxes applying only at the border (such as a nonresident dividend withholding tax) become targets of the institutions of the common market. Thus, the EU after many years' debate has adopted a directive that will remove cross-border dividend withholding taxes in the case of direct investment.[115]

This trade bloc reasoning also applies to other income flows within corporate groups, and the EU has a draft directive extending the same treatment to interest and royalties in direct investment cases.[116] However, the reasoning here is very different from the more general argument in relation to dividends and does not make sense outside a trade bloc. The reasoning is that interest and royalties will be taxed in full in the residence country, which is a member of the bloc, and, as long as investment flows are balanced among the countries in the bloc, the revenues of members do not suffer (alternatively, government-to-government reimbursement mechanisms can be devised if flows are not equal), while at the same time the border impediment is removed.

For developing and transition countries, investment flows are not usually in balance with other countries (even in the Commonwealth of Independent States (CIS), the loose trading bloc formed by most of the countries of the former Soviet Union), and interest and royalties are payments that reduce the tax base (as they are usually deductible in the calculation of taxable profit), with significant potential for causing problems for the taxation of direct investment. Hence, the advice given in relation to these payments above was to maintain reasonable levels of tax at relatively uniform rates in both domestic tax law and treaties. The existence of a trade bloc does not change that advice.[117] More generally, developing and transition countries need to be very cautious in studying the tax arrangements in trading blocs of industrial countries, especially the EU, even where they

[114]*See infra* ch. 23 for a discussion of such incentives.

[115]Council Directive 90/435/EEC art. 5.

[116]COM (90) 571, OJ C53, 26 (1991).

[117]From the point of view of the residence country, it is imperative to tax interest and royalty income where source taxation has been reduced or eliminated by tax treaty or trade bloc arrangements and tax treaties and trade blocs assume such a regime; the arguments that can be made for operating an exemption system in relation to dividends on direct investment do not apply to interest and royalties because the underlying assumption is that dividends are not deductible in the source country in determining the taxable profit of the subsidiary.

have ambitions to become members of the bloc. Where a group of developing or transition countries form a trading bloc, care should be used in extending special free trade arrangements to taxes, as the countries may not have the capacity to deal with the more sophisticated rules often involved. For example, the international value-added tax and excise rules within the CIS have been an on-going problem.[118]

3. Branch Profits Tax

In the case of direct investment in the form of a branch, the branch profits tax represents a strategy to even up treatment of branches and subsidiaries. To produce precisely the same outcome, it is necessary to define branch remittances that equate to dividends and to tax them at the same rate that applies to dividends on direct investment.

While the statement of the principle is easy enough—the amount of remittance can be determined by comparing the branch's tax balance sheets at the beginning and end of the tax year—in practice the elaboration of the principle has generally proved very complex, even though to some extent it is based on the same information used to determine the taxable profit of the branch. Some countries therefore use a simpler but rougher measure, namely, the after-tax taxable profit of the branch. To take account of the fact that subsidiaries typically do not repatriate all of their after-tax profit as dividends, the rate is often set lower than the dividend withholding tax rate based on an assessment of the typical payout ratio of subsidiaries of foreign investors in the country (a tax rate of one-half the dividend rate or less being appropriate in most cases).

Certainly, some rules for calculating the amount subject to branch profits tax need to be set out in domestic law. It is neither sensible nor transparent to introduce the tax by the back door by defining all branches for tax purposes to be subsidiaries so that remittances (presumably) become dividends and, thus, subject to dividend withholding tax. The tax administrations of developing and transition countries will not be able to detect remittances as they occur (the possibilities of method of remittance being infinite and the only practicable measurement device being comparison of tax balance sheets at the beginning and end of the tax year). Although there will in some cases of more exotic legal entities be difficult cases of characterization as branch or subsidiary, this is not a reason for the tax law to impose an arbitrary rule that is contrary to generally accepted international norms of taxation in clear cases.

A number of developing and transition countries are considering or have enacted branch profits taxes, in some cases, without apparent regard to their tax treaties. Treaties based on the OECD and UN Models override the levy of a branch profits tax,[119] and the treaties in question do not generally contain the necessary modifications to the dividend and nondiscrimination articles to accommodate such a tax. Although new treaties that are

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[118]*See* Victoria Summers & Emil Sunley, *Analysis of Value Added Taxes in Russia and Other Countries of the Former Soviet Union*, 10 Tax Notes Int'l 2049 (June 19, 1995).

[119]See arts. 10(5) and 23(3) of the OECD Model.

negotiated can contain these modifications, the existing treaties will encourage treaty shopping to short-circuit the effect of the new treaties, and it will be many years before replacement treaties can be put in place.

Further, it is not possible to either tax all effective remittances or achieve in practice the close approximation of the tax treatment of branches and subsidiaries that the branch profits tax is aimed at, because of the interaction of the tax treatment of dividends and capital gains in the context of the branch or subsidiary. Both the dividend withholding tax and a branch profits tax based on remittances can be avoided by not paying dividends or remitting profits, as the case may be, that is, by reinvesting the profits. The gain in each case can then be realized by selling the shares in the company operating the branch or in the subsidiary (or in a holding company in the corporate group). This gain will usually not be taxable in the source country because of either tax treaties or the inability of domestic law to reach sales of holding companies based in other countries (not to mention the lack of the capital gains tax in many developing and transition countries).

Sale of shares in this way thus achieves an effective remittance of reinvested profits of the branch or subsidiary, but in practice it will be more difficult for a branch to achieve such a sale because the branch will usually be just one part of the operations of the company, with the result that sale of the shares will amount to much more than a realization of the reinvested profits of the branch. Further, as far as capital gains (in excess of those arising from reinvestment of profits) have been made on the investment, the tax treatment of branch and subsidiary will usually differ in practice for the same reason that disposal of the shares in the company operating the branch will often not be a practical possibility. Disposal of the branch will usually be effected by the sale of its assets, which will be subject to the capital gains tax of the country where the branch is situated (if any), while the profits on the sale of the shares in the subsidiary will not be taxed.

Hence, the value of a branch profits tax is doubtful. The tax pales into insignificance when compared with some of the other problems of protecting the tax base of the source country against the base-erosion techniques that are explored below. The main reason why it is sometimes thought to be important for developing and transition countries to have a branch profits tax is to fully tax income from natural resources where many foreign investors typically operate in branch form mainly because of the generous treatment of the early year start-up losses under their home country (especially U.S.) tax law.

4. Branches and Subsidiaries in Transition Countries

The transition countries face a special set of issues in the branch and subsidiary area, which demonstrates once again the problems caused by the lack of clear rules and by departures from international norms in these countries. Under the commercial laws of nontransition countries, there is a generally clear understanding of what is meant by a body corporate (company, corporation) and of when an entity recognized by the law has separate legal personality or not.[120] However, the commercial laws of several transition countries are still in the developmental stage, and it is often not clear when a separate legal person exists or, more important, whether in a particular situation there are two legal persons (parent company and subsidiary) or one legal person with a number of operations (head office and branch).[121]

When a foreign legal person commences operations in a transition country, it is usually required to "register" to do business under the commercial laws of the country. In some of the countries, registration is regarded as the creation of a legal person, because this is how the creation of a legal person is effected in a purely domestic case or, perhaps more accurately, registering to carry on a business in a purely domestic case of itself creates a separate legal person (as the registration is to get approval to do business, and the creation of a separate legal person is a by-product of registration). Representation offices of foreign persons are usually recognized and are not treated as separate legal persons (a separate registration procedure is required in this case), but the functions that such offices can perform under the laws of the transition countries are generally strictly limited as befits their name.

Before 1989, the question of registering foreign legal persons under domestic procedures did not arise for many transition countries because the only way a foreign legal person could operate a substantial business venture in the country was through the creation of a joint venture with foreign participation, for which special statutes existed. The joint venture in these cases was a separate legal person under the statues and the foreign joint venturer a substantial shareholder along with the state-owned enterprise also involved in the venture.

Moreover, in several transition countries (especially members of the CIS), the profits tax is not levied on a legal person as such, but on the separate operational units of the legal person (which may in turn be linked to separate registration of the operational units with the local or regional authority of the area where they are located).[122] Thus if a state-owned enterprise has a glass factory in one city and a television factory in another city, both the factories will often be taxed separately. This may affect rates of tax as in many of the countries there are varying tax rates depending on the nature of the business of an operational unit or the region where it is operating, and, more important, it may affect the treatment of losses, as a loss incurred by one operational unit may not be offset against the profit of another operational unit. This fact makes it less necessary under the systems of some transition countries to distinguish in a particular case whether one legal person is involved or two. Again, this system grew up in the closed days of central planning so that international issues did not intrude. Hence, putting aside the case of the representation office, questions did not arise as to whether a branch of a foreign legal

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[120]*See infra* ch. 21.

[121]*See* vol. 1, at 90 n.55.

[122]*See infra* ch. 19, sec. VII.

person was taxed in this way (assuming that a branch was possible under the system in question) and as to whether operational units (including those of foreign legal persons) were taxed on their worldwide profits.

These rules have a number of important implications for international taxation and tax treaties in cases of direct investment by industrial country resident companies in transition countries. In many of them, what the industrial country resident regards as a branch (permanent establishment) will often be treated as a subsidiary by the transition country because it is registered in that country. Indeed, in one unusual case, this result was regarded as arising from registration for turnover tax purposes. The "subsidiary" will be taxed as a resident legal person by the transition country, and distributions to the industrial country resident will be treated as dividends and subject to any tax treaty accordingly (although some of the transition countries have no taxes on dividends).

If the legal system of the transition country in question characterizes an operation within its borders as a separate legal person, then the private international law rules applied in most industrial countries will lead to the recognition of this characterization by the general law and usually the tax law of the industrial country in question. However, in many cases, the industrial country resident will not be aware of either the legal intricacies involved or the very different legal structures in some transition countries.

In a number of transition countries, the concept of a branch has become fully accepted for both commercial and tax law purposes, although even then exchange controls may make operation in branch form impractical. In most countries, the extension beyond the case of the representation office is piecemeal (e.g., banks and building sites) and seems to require special procedures separate from the business registration procedure. In some countries, the representation office is being put under a lot of pressure as nonresident taxpayers try to establish branches for various reasons. Part of the pressure results from the fact that the transition countries generally find it difficult to deal with cases where the taxpayer breaches the law—in this case, when representation offices engage in activities not legally permitted to them.

If the transition country in question taxes each operational unit separately, then further tax issues arise for the industrial country resident direct investor, whether branches are permitted generally or in special sectors or not at all. In the branch case, the industrial country investor may find that losses on one branch operation will not be offset against profits of another branch operation in the same country, which will be contrary to the expected treatment. This has been a problem in some transition countries, particularly in the oil and mining sector where each drilling rig or mine site is taxed separately.

There does not seem to be anything in article 7 of the OECD Model that precludes this outcome (indeed, the Model seems to follow the approach of treating each permanent establishment separately), and, as the same treatment is applied to domestic enterprises, nondiscrimination is unlikely to be an issue. It is certainly the assumption of industrial countries, however, that legal persons are taxed as a whole and not separately on operational units, although in the source country only profits attributable to the permanent establishment are taxable, and not the worldwide profits of the legal person.[123] A potentially more difficult question arises for the calculation of expenses. Treating each branch separately in the calculation of tax may naturally lead to the disallowance of head office expenses as deductions of the permanent establishment. The separate treatment of the operational units for tax purposes in transition countries does not seem, however, to produce the consequence that payments between them or to the head office receive dividend treatment.

This range of issues has been the cause of considerable confusion among industrial country investors, however (the precise legal situation varies from country to country), and has had an additional chilling effect on foreign direct investment in a number of transition countries and on the development of tax treaty networks with industrial countries. One alternative has been for foreign investors to enter into special tax contracts with the governments of transition countries that guarantee them a relatively normal tax treatment by market economy standards. While these contracts solve the problems of the particular direct investor, they are already complicating tax reform and tax treaty development in a number of transition countries.

In general, it is recommended that transition and developing countries refrain from entering into special tax contracts or at least limit the effect of the contracts to a relatively short time before reviewing them. Further, transition countries should seek to ensure that their commercial and tax laws accord with the general international distinctions between branches and subsidiaries and that the tax position of an investor with more than one branch in the country is aggregated across the branches. Several transition countries have already taken these steps in recent years.

G. International Tax Avoidance and Evasion

While the source country may be concerned with ensuring that direct investors are taxed in a way that does not bias the form of the investment and with collecting its fair share of tax from both direct and portfolio investors, nonresident taxpayers may seek to escape source taxation altogether or at least to minimize that tax. They may do so through techniques to avoid or minimize tax , that is, arranging their affairs so that under the law of the source country the tax is minimized, or through tax evasion, that is, deliberately not complying with the law of the source country even though income is taxable under that law.[124] As with the issues of company and shareholder taxation discussed above, it is helpful to draw a distinction between direct and portfolio investors; indeed, much of the discussion under this heading stems from a number of the points already made. The discussion below initially focuses on nonresident direct investors and then canvasses to what extent the techniques outlined are available to nonresident portfolio investors and to resident investors.

[123]U.S. regulations specifically deny a foreign tax credit in this case. *See* Treas. Reg § 1.901–2(b)(4)(ii).

[124]These terms are explained in vol. 1, at 44–46.

Within an international group of companies investing directly in various countries, what generally matters to the managers and the ultimate shareholders is the after-tax profit of the group; in other words, the corporate group usually has an economic incentive to reduce its total tax payments and is economically indifferent as to the countries to which it pays tax. In some cases, especially where the residence country of the parent company in the group operates an imputation system that ties tax credits available to shareholders to the company tax paid in that country by the parent and local subsidiaries, the economic incentive may rather be to pay as much tax as possible in the residence country. In any event, multinational companies investing in developing or transition countries are likely to have an economic incentive to reduce the tax burden in those countries, either as part of reducing tax burdens worldwide (i.e., reducing tax in both residence and source countries) or as part of moving the tax burden to a country that offers the greatest advantages to the ultimate shareholders of the company group.

This economic incentive may not always lead to tax avoidance or evasion. Cultural, ethical, and nontax commercial factors may act as a counterbalance. With the globalization of trade and investment, deregulation in many areas of international business law, and international financial markets that focus on the “bottom line” and are beyond the reach of any single government, the countervailing factors are likely to weaken in influence over time. Most large multinational companies will nevertheless want to conduct their tax planning within the law; that is, they are more likely to practice tax avoidance or tax minimization than tax evasion. Tax evasion internationally and domestically is more of a problem with small or closely held businesses and individual taxpayers (see the discussion of capital flight above for the problem of evasion in relation to resident taxpayers).

The simplest way to minimize tax is to make payments from the branch or resident subsidiary to a related nonresident company that are deductible in determining the amount of profit subject to corporate tax and that are not subject to withholding tax. Alternatively, as a second best option, payments can be made that are deductible under the corporate tax and are subject to a low rate of withholding tax.

In the past, two basic strategies (which can be combined) have been mainly used to achieve these ends: increasing the prices of payments and changing the type of payments. To take some simple examples, a local subsidiary operating an assembly plant can pay inflated prices for the components and the technical and management services it purchases from related companies; or a nonresident parent company can invest in the subsidiary by way of loan capital rather than share capital and receive interest payments (deductible to the subsidiary) instead of dividends (usually not deductible to the subsidiary). Similar results can be produced by reducing the amount of payments for goods or services to the local branch or subsidiary for goods or services it provides to other (nonresident) members of the group. Recently, international tax planning has become more sophisticated along with the financial markets. The following discussion will start with the simpler methods of tax avoidance and then move to more recent techniques.

1. Transfer Pricing

"Transfer pricing" is the general term used to refer to the problem of allocating profits among the parts of a corporate group. For the group as a whole, all that matters at the end of the day is the after-tax profit of the group rather than of its individual members. The prices charged within the group for goods or services provided and the financing methods used between the members of the group simply serve as means of moving funds around the group and do not in a commercial sense create profits for the group. Hence, there is often no obstacle to charging any price or structuring a transaction in any way within the group, and the fair or proper distribution of the overall group profits among the companies in the group is often a secondary consideration to tax consequences. In financial accounting, which seeks to determine profits for reporting to shareholders and others with financial interests in the group, the response is to require accounts for the enterprise (group) as a whole and to eliminate transactions within the group, as well as (in most countries) accounts for each company in the group.

In taxation, it is necessary to allocate profits among the companies in the group because under international tax norms a country will tax a nonresident only on the profits sourced in that country. While the country can tax a local (resident) subsidiary on its profits worldwide, affairs within a multinational group will usually be arranged so that the subsidiary only has profits sourced in that country. In theory, this allocation of profits can be effected in one of two main ways. A country can take the worldwide profits of the group and allocate some portion of those profits to a source in that country, thus bypassing the need to consider the pricing and nature of transactions within the group. Alternatively, the country can seek to determine the profits of a local branch or subsidiary separately from the rest of the group on the basis of the pricing and nature of the transactions engaged in by the branch or subsidiary with the rest of the group. In the former case, it is necessary to have allocation rules based on formulary criteria like relative assets, revenues, or salaries (and so this method is often referred to as formulary apportionment), while in the latter case rules are needed to deal with the problems arising from the special nature of transactions within the group.

While arguments range back and forth as to which method is preferable, in practical terms countries pursuing a policy of negotiating tax treaties are automatically tied into the separate accounting method because articles 7 and 9 of the OECD and UN Model treaties operate on the basis of taxing each company within the group separately and dealing with problems of pricing and the nature of transactions on the basis of the arm's-length principle. Under this principle, adjustments are made to transactions within the group to reflect the terms and nature of transactions that would have been entered into if the transaction had been made with an independent third party rather than with another part of the group.

A drafting issue for the domestic law is that the arm's-length principle should be provided for both branches and subsidiaries. This is most easily done by using language similar to that found in tax treaties. Such an approach ensures that there is a basis in domestic law for making transfer pricing adjustments. In many countries, it is not clear whether tax treaties on their own would provide a sufficient basis for such adjustments, and, in any event, it is necessary to have the rules in the case of residents of countries with which there is no tax treaty in force. Using statutory language based on treaties has the added advantage of giving a clear signal that the country intends to follow international norms.

Article 7(4) of the OECD and UN Models provides that a country can maintain a customary method of calculating the profits of branches, so long as the result is in accord with the arm's-length principle (a further provision in each case provides for the application of the same method from year to year unless there is good reason to the contrary). Some countries use simplified profit calculation methods for branch cases (such as a specific percentage of turnover of the branch). These methods can be retained in the legislation insofar as they reasonably reflect actual profits and can be used in cases where tax treaties are involved. The application of the arm's-length principle to branches is more complex in one way than in the case of subsidiaries, because the branch and the head office are part of the same legal person, and transactions cannot be sensibly reconstructed in some cases. For example, it is often difficult to allocate notional ownership of property between head office and branch.

Simplified methods in domestic legislation are not generally regarded as consistent with article 9 of the OECD and UN Models in the case of related companies, but this does not mean that countries are confined to making tax adjustments between related companies only in international transactions and on arm's-length principles. Some countries apply their transfer pricing rules in purely domestic cases; where there are different tax rates for different kinds of income or business, taxpayers can use transfer pricing to move profits to categories of income or business with lower tax rates. There are also a number of reasons why countries may wish to have special pricing rules for specific transactions. For example, some countries treat all disposals of property without consideration as having been made for market value— whether between related parties or not—while others treat gifts of property to charities as having been made for the higher of cost or market value. These rules do not directly deal with transfer pricing issues. To the extent that they can apply to international transactions between related parties, they will not generally be contrary to tax treaty arm's-length pricing rules. How all these rules are coordinated within the tax legislation depends on the specific rules adopted and should be reviewed carefully in each country.

To achieve the application of the international arm's-length principle in practice, the tax administration starts with the accounts of the local branch or subsidiary, makes the usual adjustments to reflect differences between financial accounting and tax rules, and then makes such further adjustments in accordance with the arm's-length principle as necessary. Nontax considerations may lead to the group preparing its branch or subsidiary accounts on this basis in any event. For management purposes, the group will wish to know the real profitability of its separate parts, local employees may be remunerated in part on the basis of the local contribution to group profit, and local accounting rules will likely require that the financial accounts give a proper view of the profits of the branch or subsidiary. In practice, the tax administration may use simplified methods and various financial ratios that are similar to formulary apportionment in order to test whether the profits reported by a local branch or subsidiary fall within acceptable boundaries. These methods frequently operate as a means of selecting taxpayers for further checking (audit). The use of such administrative methods will not be contrary to tax treaty rules so long as they are being used as a means to the end of establishing the arm's-length price.

The increasing integration of the activities of corporate groups, the growing importance of unique intragroup intangibles and services, and the sophistication of their financing operations mean, however, that application of the arm's-length standard is becoming more difficult, both conceptually and practically. The problems have been addressed in part by the OECD, which has updated and expanded its guidance on this issue.[125] The OECD standards represent the internationally accepted norms giving content to the arm's-length principle.

Transfer pricing adjustments on the arm's-length principle have traditionally been viewed as involving price only (as the name suggests) and not the reconstruction of transactions in the sense of disregarding the nominal transaction between the related parties and substituting another arrangement for tax purposes. The transfer pricing guidelines,[126] while recognizing that adjusting prices of actual transactions is the norm, do permit tax administrations to recharacterize transactions in two exceptional circumstances, first, "where the economic substance of a transaction differs from the form" and secondly, where the "arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price."[127] The example of thin capitalization is given for the first category (see next heading) and, for the second, the outright transfer of intangible property before its value is fully known when independent parties could have been expected to enter instead into a continuing research agreement (under which payments would not be irrevocably fixed in advance).

Increasingly, countries are enacting general provisions in their tax laws directed against tax avoidance, which give powers to reconstruct transactions.[128] It seems to be

[125]OECD, Attribution of Income to Permanent Establishments (1994); OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995, updated 1996, 1997). The problem that transfer pricing currently represents for developing and transition countries is one of administrative capacity. The development of advance pricing arrangements with the encouragement of the OECD (*see infra* note 160) may simplify the administrative task of transition and developing countries in the future by supplying readily applicable formulas for various economic sectors.

[126]*Supra* note 125, paras. 1.36–1.37.

[127]*Id.* at para. 1.37.

[128]*See* vol. 1, at 44–53.

increasingly accepted by the OECD that such rules are not in conflict with tax treaty obligations and can be applied to international transactions.[129] While such rules in conjunction with transfer pricing rules expressed in the general terms suggested above can deal with many problem situations, they can leave taxpayers uncertain as to their position. Accordingly, countries are increasingly enacting more specific provisions to deal with particular cases and to spell out the rules in more detail, as, shown for example, under the next heading.

2. Thin Capitalization

Thin capitalization is the practice of excessively funding a branch or subsidiary with interest-bearing loans from related parties rather than with share capital.[130] The fact that interest is usually deductible for the borrower and taxed to the nonresident lender at a low rate of withholding tax (or not at all in some cases) while in most cases company profits funding dividends are fully taxed makes the practice attractive taxwise to a nonresident investor. Although it is possible to deal with these problems under the arm's-length principle, taxpayers and tax administrators often want more guidance on the level of permissible loan funding for a subsidiary than to be told that related party loans can be made up to the point and on the terms that an independent third-party lender would allow, having regard to the other liabilities of the subsidiary. Thin capitalization rules seek to deal with this problem by denying deductions for interest in defined cases (and possibly recharacterizing the payments of interest as dividends).

Tax law provisions in this area can be drafted in a large variety of ways. One important constraint is the nondiscrimination article in tax treaties. In its typical OECD and UN form, this article overrides thin capitalization rules that apply only to payments of interest to related nonresidents by resident enterprises or by branches of nonresidents unless the rules are applied in accordance with arm's-length principles. Another constraint arises from tax administration concerns. If loans by certain lenders only, such as related nonresidents, are affected by the rules, it is possible to get around this limitation through back-to-back loans.[131] Rules can be drafted to deem such loans to have been made by the parent company—and so subject to the thin capitalization limits—but it is very difficult for the tax administration in the country of the subsidiary to detect such transactions, especially if the bank is located in a country with strict bank secrecy laws. One possible solution to problems of this kind is to make the rules generally applicable to all loans for which interest deductions are claimed. Hence, although the specific problem arises in the context of foreign direct investment, the solution for practical reasons may be across the board for all investment.

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[129]*See* OECD, Taxation of New Financial Instruments (1994) and the resulting change to the Commentary on art. 11 of the OECD Model in 1995 para. 21.1; David Ward, *Abuse of Tax Treaties*, *in* Essays on International Taxation in Honor of Sidney Roberts 397 (Herbert Alpert & Kees van Raad eds. 1993).

[130]*See generally* International Fiscal Association, International Aspects of Thin Capitalization, 81b Cahiers de droit fiscal international (1996).

[131]*See supra* text accompanying notes 92–93.

Further issues relate to the way in which the denial of interest deductions is calculated. One common approach is to provide express ratios of loan capital to share capital beyond which interest deductions are denied (debt to equity rules).[132] Another is to limit interest deductions by reference to a proportion of the income of the taxpayer (earnings-stripping rules).[133] What the appropriate financial ratios are in each case is also an issue (anywhere between 1.5:1 and 3:1 being common for debt-equity rules) as is the application of the rules to financial institutions whose business consists in borrowing and lending and which typically operate at much higher debt levels than other businesses. The following draft suggests a possible approach to these issues.

> 1. A taxpayer, other than a bank or a financial institution, is denied a deduction for interest in excess of the product of three times the net income-producing assets of the taxpayer and
>
> > (a) in the case of a loan denominated in the currency of *X*, 110 percent of the interest rate charged on loans by the Central Bank of *X* to commercial banks on the last day of the preceding tax year; or
> >
> > (b) in the case of a loan denominated in a foreign currency, 110 percent of the interest rate charged by the U.S. Federal Reserve on U.S. dollar loans to U.S. banks on the last day of the preceding tax year.
>
> 2. The net income-producing assets of a taxpayer are assets giving rise to income that is included in the gross income of the taxpayer less liabilities relating to those assets, each averaged between the beginning and end of the tax year.
>
> 3. With the prior written permission of the tax administration, a taxpayer may
>
> > (a) calculate net income-producing assets on an alternative basis; or
> >
> > (b) in the case of a loan denominated in a foreign currency other than U.S. dollars, use a different interest rate based on the interbank rate of the central bank responsible for that currency.
>
> 4. Any excess interest that is not allowed as a deduction in a tax year solely as a result of the application of this provision is treated as interest expense of the taxpayer in the following tax year.

Paragraph (1) limits the interest deduction to an amount obtained by multiplying a specified interest rate and three times the net income-producing assets (equity) of the taxpayer. This draft thus provides effectively a 3:1 debt-equity ratio. No limitation in

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[132]AUS ITAA § 159GZA (definition of foreign equity product); USA IRC § 163(j)(2)(A)(ii).

[133]USA IRC § 163(j)(2)(a)(I), (B).

terms of related parties or nonresidents is contained in the provision for reasons already given. Banks and other financial institutions are excluded from the provision altogether, but it would be possible to specify an alternative ratio for this case based on the prudential rules of the central bank for commercial banks. Rather than specifying the amount of loans on which interest is deductible, which is the approach many countries take, the provision directly calculates the amount of interest. This method has two effects. It eliminates the need to calculate the amount of loans, which can be complicated in certain cases, and deals with the problem of excessive interest rates being charged on loans between related parties rather than leaving this as a separate issue for the transfer pricing rules. If an explicit rule is to be provided for thin capitalization, it may as well spell out all the elements.

The interest rate is specified in paragraph 1 using the base rate charged by the central bank at the end of the previous tax year. The provision deals with loans in foreign currency by setting an interest rate based on the international reserve currency, the U.S. dollar, but also permits in paragraph 4 the use of other (major) currencies with the permission of the tax administration. Whether a reference to foreign currency is necessary depends on the rules adopted for dealing with foreign currency in the tax legislation, which are discussed in chapter 16. If, for example, foreign currency conversions are dealt with by recalculating foreign currency assets and obligations at the end of each tax year, giving rise to income or expense accordingly, then no rule for foreign currency is necessary in this provision. The interest rate is set by reference to the end of the previous tax year so that taxpayers know the operative rate at the beginning of the relevant tax year. The central bank rate is marked up by one-tenth on the assumption that most borrowers will not be able to obtain funding at central bank rates.

The net-income producing assets of the taxpayer are defined to include only assets that give rise to income that enters the calculation of taxable income. It is assumed in this draft that interest will be deductible only to the extent that it relates to the production of income included in the calculation of taxable income, which is not the position in all countries. Generally, the calculation is effectively the total assets less liabilities averaged between the beginning and end of the year. For resident companies, the capital and retained profits in the tax balance sheet are effectively equivalent to assets less liabilities (assuming there are no major categories of exempt income for such companies, such as foreign business income). Individuals will often not have a balance sheet as such, and so the calculations of assets less liabilities needs to be made specifically for each case. For nonresidents, only assets giving rise to income sourced in the country and taxed on a net basis after deductions enter the calculation along with their accompanying liabilities. Given that many countries employ final gross withholding taxes on the income of nonresidents, except for income from real property and business (see above), the loans to which the rules apply for nonresidents are likely to be limited.

Where the income-producing assets are shares, the appropriate treatment can be more complicated. Although dividend income is taxed in some countries at a final rate of tax on a gross basis for resident and nonresident shareholders, shares should be included for the purpose of this draft if interest expenses relating to such income will be allowed as a deduction. It is possible, for example, for intercorporate dividends to be exempted so as to eliminate the cascade of company taxation through chains of companies, but for interest expenses relating to the dividend income to be deductible. The rules here need to be coordinated with the interrelationship of the taxation of dividends and the allowance of interest deductions relating to dividend income, but beyond this general caution it is not possible to be specific.

The tax administration may give permission under this draft to vary the calculation of net income-producing assets where the calculations required above are difficult to apply in the particular circumstances of the taxpayer. Interest disallowed as a deduction under this draft is not permanently disallowed but is carried forward and treated as an interest deduction of the succeeding year. The same calculation is then done for that succeeding year under this draft, and it may turn out that the interest deduction is allowed in that year. The disallowed interest is not treated as a dividend or some other form of payment. Country practices vary widely on this aspect of thin capitalization. Where countries also have general rules relating to characterization of investments as share capital or loans, it will be necessary to consider how those rules should be coordinated with the thin capitalization area. Tax treaties also have standard definitions of interest and dividends that do not provide clear guidance in the thin capitalization area. The OECD Commentaries seem to indicate that it is permitted but not obligatory to recharacterize interest that is disallowed under thin capitalization rules as dividends.[134]

The carryover of interest deductions in the draft will need to be coordinated with the general carryover of losses in the tax legislation, although coordination is likely to be automatic. The general rule for loss carryover is likely to apply only to deductions that are allowed in a particular tax year and that exceed income; because interest in excess of the permitted amount under this draft for a particular tax year is not allowed as a deduction in that year, it cannot enter such a carryover loss.

While a number of detailed issues would require elaboration in the practical application of the draft (e.g., the identification and valuation of assets and liabilities that are used in the calculation of net income-producing assets), what the draft conspicuously fails to do is to define "interest." The reason is that, with the advent of modern financial instruments, interest is an increasingly difficult concept. We turn now to these instruments.

[134]Commentary on art. 10, para. 25 and Commentary on art. 11 para. 19. In the case of rules taking the form of the draft language set out in the text, it would be unusual to recharacterize interest as dividends, since specific debt is not recharacterized under the rule.

3. Modern Financial Instruments[135]

The previous heading left open the definition of interest, that is, the characterization of payments as interest or something else. Other issues that have to be considered in the international domain are the source rules, nonresident withholding taxes, and deductions available to the payer for payments under modern financial instruments. The specific focus of the discussion for the moment is direct investment involving related parties.

Because of the complexity of these issues, OECD countries are still searching for solutions. Hence, it is impossible to provide widely accepted methods that may be of use to developing and transition countries, but it is possible to suggest some partial solutions and note the problems that remain. The solutions that are adopted will need to be closely related to the more general question of how modern financial instruments are dealt with in purely domestic cases to ensure that the domestic and international regimes are consistent.

If a narrow definition of interest is adopted in domestic tax law (which is the typical case where new financial instruments have not been specifically addressed in the tax system), then it will be a simple matter for the taxpayer to use some financial instrument that does not generate interest but that is a functional equivalent so as to avoid rules that refer to interest. For example, an interest swap arrangement can be structured to be the equivalent of a loan, but swap payments are not regarded as interest in many countries. (An interest rate swap is a financial transaction in which two parties agree to make streams of payments to each other calculated by reference to an underlying or notional principal amount; in its simplest form, it involves an agreement between two parties to make each other's interest payments on their respective loans.) In this case, any attempt to deal with thin capitalization will be aborted unless some general antiavoidance rule is applied to recharacterize the payment as interest in the particular circumstances. If a broad definition of interest is adopted to deal with this and similar problems (such as any payment or accrual under a financial arrangement widely defined), then it is necessary to adapt the source, withholding, deduction, and related party rules to the broader scope. One particular problem arises from the fact that tax consequences—inclusions in income or deductions—under regimes dealing with modern financial instruments often occur on an accrual basis (i.e., on an internal-rate-of-return calculation or a mark-to-market rule) without any actual payment. Lack of a payment poses problems for withholding taxes, for example.

Take the relatively straightforward case of a zero coupon bond where the issuer receives $100,000 on issue and undertakes to pay $161,051 on redemption of the bond in five years. This transaction is the equivalent of a five-year loan of $100,000 at 10 percent

[135] For a general discussion of domestic and international issues, see OECD, Taxation of New Financial Instruments (1994), International Fiscal Association, Tax Aspects of Derivative Financial Instruments 836, Cahiers de droit fiscal international (1995); and Australian Treasury and Australian Taxation Office, Taxation of Financial Arrangements, An Issues Paper (1996).

annual compound interest with interest payment only on redemption. In a number of countries, this transaction would be treated as giving rise to interest income and deductions in a purely domestic case for the five tax years of $10,000, $11,000, $12,100, $13,310, and $14,641, respectively. If the holder of the bond is a nonresident, it is difficult to collect tax annually because there is no payment to subject to withholding tax, although it is possible to require the issuer to pay tax annually as if a payment had been made. If nonresident withholding tax is postponed until the end of the five-year period, the nonresident may sell the bond to a resident before redemption and avoid the tax (assuming that there is no final interest withholding tax on payments to residents). If tax is collected from the issuer annually and the nonresident sells the bond to another nonresident, the buyer and seller will have to be aware that the issuer has been paying tax and take account of the tax in the pricing of the bond; if the buyer and seller are resident in different countries, the issuer may have to adjust the amount of tax withheld after the sale because of different tax rate limits in the tax treaties involved.

Mechanical solutions can be devised to deal with the problems of withholding and timing of deductions, for example, levying the nonresident withholding tax only on payment and postponing deduction for the issuer until that time. These solutions usually bring with them practical enforcement problems and borderline issues where different regimes are being applied in different cases. What, for example, is the effect on accrued deductions and inclusions in income in this case where the nonresident transfers the bond to a resident and an accrual system is in place between residents? Not surprisingly, even in the relatively simple case of a zero coupon bond, there is little agreement as to the appropriate international tax regime and a large amount of diversity in practice. Some countries do not even assimilate such a payment to interest, let alone deal with timing and withholding issues.

For more sophisticated instruments, such as interest rate swaps and currency hedges, withholding tax can make legitimate transactions uncommercial for reasons similar to those discussed above in relation to interest withholding taxes on ordinary loans. Many countries have therefore not extended their interest withholding tax to these cases. This limitation creates a relatively simple way to avoid withholding tax, especially between related parties. If, in response to this problem, withholding taxes on new financial instruments are directed to transactions between related parties, problems arise with back-to-back transactions.[136]

As to source of income, it is possible to create special rules for payments under new financial instruments, even if the payments are not characterized as interest. Without special source rules or recharacterization as interest so that the interest rule applies, the source rules for whatever category the payments are placed in will govern (e.g., business income or capital gains), which may allow nonresident parties to avoid source tax on what is equivalent to interest by manipulating the source rules.

[136]*See supra* text accompanying notes 92–93, 130.

Modern financial instruments may also allow parties, especially by combining different instruments, to make an equity position look like debt and vice versa. In the international context, this could lead to substantial erosion of the corporate tax base in relation to subsidiaries in developing and transition countries for what is essentially equity investment. The thin capitalization discussion above dealt with this problem in the case of related parties, where, what is pure debt in a formal sense can be viewed in effect as share capital because no independent third party would have made a loan in the situation. Modern financial instruments open this position up more generally even for portfolio investors (see below) and allow related parties in many cases to escape thin capitalization rules.

Tax treaties further complicate the international situation because they were framed before the era of financial innovation and use traditional categories. The OECD Commentary on the interest article was recently changed to clarify the issue as follows:[137]

> The definition of interest in the first sentence of para. 3 does not normally apply to payments made under certain kinds of nontraditional financial instruments where there is no underlying debt (for example, interest rate swaps). However, the definition will apply to the extent that a loan is considered to exist under a "substance over form" rule, an "abuse of rights" principle, or any similar doctrine.

The import of this para. seems to be that hedges and swaps will not be regarded as giving rise to interest, except when a transaction has been deliberately manipulated to substitute a future or a swap for what would otherwise have been a normal borrowing operation and when domestic law has recharacterized the transaction to give rise to interest under an antiavoidance measure. Although the Commentary does not say so, payments of discounts under zero-coupon bonds seem to be accepted as interest for the purposes of tax treaties. The result is that many payments under modern financial instruments to nonresidents will be characterized as business profits, capital gains, or other income, and, for treaties in OECD Model form, the result is that the source country will not be able to levy tax unless the payments are connected with a permanent establishment of the nonresident in the country. To partially address concerns in the related-party area, the OECD Commentary on article 21 has also been revised to include a suggested treaty provision that will allow recharacterization of payments in this kind of case.[138]

Against this complex backgound, what action can a developing or transition country take to protect itself against the sophistication of modern financial markets and multinational enterprises? A number of factors suggest a focus on the deduction area in the form of a general thin capitalization rule, combined with a comprehensive definition of interest for the purposes of the rule to catch all payments under modern financial instruments to the extent they would otherwise be deductible. First, this approach is not contrary to tax treaties, whereas the scope for action in the withholding area is clearly

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[137]Commentary on art. 11, para. 21.1.

[138]Commentary on art. 21, para. 7.

limited by treaties; second, back-to-back problems with related parties can be avoided; and third, the problem of chacterization between debt and equity in relation to direct investors is addressed. How the definition of interest is framed for this purpose will depend on whether the country has comprehensive rules dealing with modern financial instruments for general domestic purposes, in which case definitions from that regime can be adopted. Experience to date suggests that a definition framed in general terms is preferable to a list of the kinds of instruments that are covered, given that the number of available instruments increases daily.

As regards withholding tax and source rules, the tax treaty position means that all that can be done directly is to maintain the traditional withholding tax on interest and consider extending it to zero-coupon bonds and similar instruments, although a number of technical problems will arise in doing so, as discussed above. The extract quoted from the OECD Commentary above strengthens the case for including a general antiavoidance provision in domestic law so that it can be applied (especially in the case of related parties) to recharacterize payments under modern financial instruments as interest and can subject them to the interest withholding tax accordingly. Back-to-back transactions may make the involvement of related parties difficult to detect, but the possibility of applying the antiavoidance provision and any resulting penalties may provide an incentive for related parties to fund local branches and subsidiaries by ordinary loans up to the limit permitted by the thin capitalization rules and to pay withholding tax on the resulting interest, thus limiting the problems.

4. Payments to Tax Havens

Where an industrial country resident makes a direct investment in a subsidiary in a developing or transition country, the residence country of the parent will be operating either an exemption system or a foreign tax credit system to relieve double taxation. At first sight it seems, in an exemption system, that there is no residence country concern if income is shifted out of the source country to the residence country because the income will be exempt. This, however, is not the outcome. If the profit shifting involves transfer pricing, whereby the parent charges inflated prices for the goods or services that it provides to the subsidiary, the increase in the parent's profits will be taxable in the residence country. This result follows because the profits will not usually be regarded as income sourced in the source country that attracts the exemption but rather as an increase of income sourced in the residence country (e.g., increased manufacturing profit) and so taxed there.

Similarly, if thin capitalization of the subsidiary by the parent is used to shift profits out of the source country, the interest received will probably not be exempt to the parent because the exemption usually extends only to business profits of a branch and dividends on direct investments in subsidiaries, and not to interest taxed by low-rate gross withholding in the source country (especially where the tax rate has been limited by a tax treaty). While there may be reasons why a parent company would find it advantageous to shift profits from the source country to the residence country (such as an imputation system in that country that bases tax credits to shareholders on residence country tax paid), often this form of profit shifting will effect little tax saving. In a residence country operating a foreign tax credit system, shifting profits out of the source country to the residence country as a means of lowering tax in the source country will usually lead to a corresponding increase in residence country taxation.

Accordingly, tax planning by multinational company groups is likely to be directed simultaneously to reducing source country and residence country taxation, which means in many cases that a third country needs to be found to which the profits can be shifted. Tax havens will be used for this end. In the transfer pricing case, one possibility would be for the parent company to sell the goods to a related company in a tax haven for cost plus an artificially small profit (thus shifting part of the profit out of the residence country). The tax haven company then on-sells the goods to the subsidiary in the source country at an inflated price that leaves little profit to that subsidiary and most of the profit with the tax haven company. Similarly, in the thin capitalization case, the parent company may invest in a tax haven company by way of share capital (equity), and that company then lends to the subsidiary. Interest paid to the tax haven company will not be taxed in the tax haven. In each case where the country of the parent company is an exemption country, the tax haven subsidiary may be able to pay a dividend tax free to the parent so that the profits end up with the parent company having suffered very little tax. If the residence country of the parent company is a foreign tax credit country, the profits can often be retained in the tax haven company and used for group operations in other countries without attracting tax in the parent's residence. Again, the overall result is payment of little or no tax in the source or residence country.

Given that both the residence and source countries are suffering from this tax haven activity, action can be expected from both. The source country may deny deductions for payments by resident companies or by branches of nonresident companies to tax havens or may permit deductions subject to special conditions.[139] A rule of this kind has a number of problems. It is necessary to have a list of countries that are treated as tax havens, and, although such lists are readily available, they need frequent updating. The rule reintroduces the problem of the back-to-back transaction, in that the tax-haven-related company in the thin capitalization case above can, for example, route the loan through a bank in a country that is not a tax haven. Such a rule may also affect quite legitimate payments to tax havens (which in a number of cases are major financial and trading centers in their own right). Finally, if a tax treaty is in force with the tax haven, the rule may fall foul of the nondiscrimination provision in the treaty (obviously, great care is needed in negotiating a tax treaty with a tax haven).

Nevertheless, a rule focusing on payments to tax havens should be considered in some form, for example, a tax clearance system for payments that, to the knowledge of the payer, are made directly or indirectly to tax haven entities. Another possibility is to

[139] *E.g.,* FRA CGI § 238A.

require all companies and branches in the country to report selected information on transactions with tax havens or more broadly on international transactions.[140]

5. Double-Dipping

Alternative techniques for reducing source and residence taxation that have been used in recent times seek to double up on favorable tax rules in both source and residence countries (generally referred to as double-dipping). A variety of methods are used.

One method is to exploit differences in the tax law treatments of the same transaction in the source and residence countries. A common example has been the financial lease of equipment. Some countries recharacterize finance leases for tax purposes as purchases and loans, while other countries treat them in the same way as operating leases (i.e., the lessee is treated as paying rent and the lessor as being the owner of the equipment).[141] The result is that two countries can end up treating two separate taxpayers (one country the lessor and the other country the lessee) as the owner of equipment and entitled to depreciation and interest deductions. Given that rent in economic terms is equivalent to depreciation and interest, the difference in treatment should not produce a substantial tax variance, but many countries have tax incentives for investment in capital equipment in the form of accelerated depreciation, investment credits, or allowances. Where two different taxpayers are treated as the owner of the equipment in different countries and each is entitled to these incentives in one of the countries, the taxpayers effectively double up on the incentives in a way not intended by either country.

It is not clear, however, which country is being disadvantaged in tax terms and which might therefore be expected to take remedial action. One of the affected countries could enact a rule that investment incentives will not be available under its law when similar incentives are being obtained in respect of the equipment under the law of another country, but the rule will lead to circularity if both countries adopt it. Alternatively, a country may limit investment incentives to equipment used in the country, which will work in most cases, although not for mobile equipment like airplanes. Another solution is for each country to do away with or reduce the investment incentives, as in fact happened in many industrial countries during the 1980s (for more general policy reasons having little to do with the problems of international tax avoidance). Where a developing or transition country adopts this kind of investment incentive, a rule limiting the benefit of the incentive to equipment used in the country is probably the easiest way to ensure that it does not suffer unduly from double-dipping of this form.

[140]For example, sched. 25A to the Company Income Tax Return in Australia requires extensive reporting of information on international transactions, and a number of countries have special powers for collecting information from foreign persons, AUS ITAA § 264A; USA IRC § 982.

[141]*See supra* ch. 16, sec. VI(A)(4).

Another form of double-dipping that has been much exploited involves dual-residence companies. Some countries permit grouping of the income and losses of commonly owned resident companies (often achieved by permitting the transfer of tax losses to related companies). If the same company is resident in two such countries and has borrowed to finance group operations (whether in those countries or elsewhere), it may be able to deduct the interest in each country. If it has little or no current income, a loss will arise from the interest deductions that may be able to offset the income of two related companies, one in each country where the loss company is resident. Again, it is not clear which country is the loser from this transaction. Nevertheless, a number of countries have enacted rules that prevent the losses of dual-residence companies arising from financing transactions being used to offset the income of any other related company in the country; that is, the losses can be used only to offset future income of the dual-residence company.[142] If a developing or transition country does not permit the transfer of losses within a group of companies, it is unlikely to suffer from this particular double-dipping problem. It follows that care should be exercised in permitting transfer or consolidation of losses for tax purposes among commonly owned resident companies.

The deduction of the same expense in two countries is not of itself a cause for concern. Where a resident of a foreign tax credit country has a branch in another country, it will typically get deductions for the same expenses in the source and residence countries. These deductions will generally be offset, however, against the same income that each country is taxing, with the residence country giving double tax relief. The double-dipping problem usually involves the offsetting of the same deductions against different income of different taxpayers. As there are probably as many ways for taxpayers to exploit differences in tax systems of different countries as there are differences, and as the outcome is often ambiguous in terms of whether tax avoidance is involved and which country is suffering an unfair reduction in tax, it is likely that double-dipping will continue to be a difficult international tax problem without a clear solution.

6. Treaty Shopping

Tax treaties themselves may become the object of tax avoidance activities, even though they often express the purpose of preventing tax avoidance. This possibility was of course never intended by the original framers of model tax treaties and is not in itself sufficient reason for a country to reject the negotiation of tax treaties as their benefits usually outweigh the detriments. The possibility of abuse arises from two features of the tax treaty network—its incomplete coverage of the world and its bilateral structure. The former feature flows from the latter because it is not possible to negotiate with virtually all of the countries of the world at once (as contrasted, say, to the Uruguay Round of multilateral trade negotiations of the General Agreement on Tariffs and Trade); the latter is regarded as flowing from the wide variations in tax systems around the world, so that it

[142]*See supra* note 31; because of more general problems involving dual-residence companies, a number of countries are enacting provisions to allocate residence usually in accordance with tax treaty tiebreakers; *supra* note 30.

is felt necessary for each country to handcraft a tax treaty accommodation with other countries one by one.

A resident of a country that does not have a tax treaty with a particular developing or transition country can simply incorporate a subsidiary in another country that does (usually one with which the investor's country also has a treaty) and route its investment through that subsidiary, which will be entitled to the reduced tax rates and other protections available under the treaty. Alternatively, a resident of a country with which the developing or transition country does have a treaty may seek what it regards as better tax treatment under another tax treaty by the same route.

For example, the treaty between the investor's country and country *X* may have a 10 percent rate limit on royalty payments. If that investor can find another country that has a tax treaty with country *X* that contains a zero tax rate on royalties, then it will be possible to route a licensing transaction through a subsidiary in that country and eliminate the source country royalty tax; if that third country in turn has a treaty with the investor's country containing a zero tax rate on royalties, it will be possible in turn to pay the royalty on to the investor without tax in that country. These examples assume that the royalties are deductible in each country by the person who is paying them. The nondiscrimination article of tax treaties will normally ensure that they are deductible on the same basis as royalties paid domestically, so that the assumption will be correct in most cases.

This kind of practice is known as "treaty shopping." A country can prevent treaty shopping by seeking to ensure that its treaties with other countries are uniform in their main elements, especially the tax rate limits on interest and royalties and the definition of permanent establishment. If all treaties to which country *X* is a party have a 10 percent tax limit on royalties, for example, the planning in the second example in the previous para. would not be possible. Many countries have been able to achieve this consistency in their treaty negotiations and have thereby reduced the problems of treaty shopping. Nonetheless, the possibility remains that residents of nontreaty countries will get treaty benefits through related companies in treaty countries.

One way to deal with the problem is to insert a general provision in tax treaties denying treaty benefits in such cases. The United States is the only country to practice this approach in a comprehensive way[143] although some other countries routinely insert more limited treaty abuse provisions in specific articles of treaties.[144] The Commentary on article 1 of the OECD Model contains a number of possible provisions for this purpose.[145] Developing and transition countries may instead prefer to rely on general

[143]See U.S. Model Income Tax Convention of Sept. 20, 1996, art. 22, Limitation of Benefits.

[144]The United Kingdom includes special rules in the interest and royalty articles; the beneficial owner rule in arts. 10–12 of the OECD Model also limits treaty shopping.

[145]Commentary on art. 1, ¶¶ 13, 15, 17, 19, 21.

antiavoidance provisions in domestic legislation to deal with treaty abuse. While a view is developing that such provisions are not inconsistent with tax treaties, it is probably safer to spell out in the negotiations that the general antiavoidance provision of domestic law will be applied to treaty abuses and to ensure that the general priority rule for tax treaties in domestic law makes this relationship clear.[146]

7. Combinations of Tax Avoidance Techniques

International tax avoidance in many cases will utilize a combination of the techniques outlined above. Thus, treaty shopping activities will often go hand in hand with the use of tax havens and the interaction of tax treaties and domestic law. For example, and by way of extension of the case of treaty shopping in the royalties area discussed above, some countries do not in their domestic law charge withholding tax on payments of royalties by residents to nonresidents for reasons that have been discussed earlier. If such a country has a treaty with a developing or transition country containing a zero royalty rate, a nonresident investor can incorporate a company there to receive royalties from the developing or transition country and then arrange to have the royalties paid to a tax haven company. If the royalties paid to this company equal the royalties received by the company in the tax treaty country, no tax will be collected in that country because the deduction for the royalties paid will wipe out the royalty income received and no withholding tax will be levied on the outgoing royalties. Hence, the result will be achieved of no tax at all being levied on the royalties (unless the residence country of the ultimate owner of the tax haven company has a controlled foreign company regime of the kind discussed below).

The financing of company groups often involves variations on double-dipping, treaty shopping, and tax haven use. For example, a parent company may borrow to finance investment by way of share capital in a tax haven finance subsidiary, which in turn lends to an operating subsidiary in a developing or transition country through a back-to-back transaction with a bank in a country that has a tax treaty with the developing or transition country, lowering the rate of withholding tax on outgoing interest. If the residence country of the parent is an exemption country but nonetheless permits deduction of the interest paid on the loan taken out to finance the investment in the tax haven subsidiary, it is likely that the dividends received from the tax haven subsidiary (representing the interest received by that subsidiary) will be exempt in the parent's residence country, and yet interest deductions may have been obtained in two countries (that of the parent and the operating subsidiary) for offset against different income of different taxpayers.

Because of the sophistication of international tax planning and its frequent combination of domestic law, tax havens, and tax treaties, the taxation of nonresident direct investors by developing and transition countries is not an easy task. An array of provisions in domestic legislation (such as provisions on transfer pricing, thin

[146]*See supra* note 95; Australia makes this relationship clear in International Tax Agreements Act 1953 s 4(2). *See also* GEO TC § 4(8), (9).

capitalization and tax haven payments, and a general antiavoidance rule) and great care in the negotiation of tax treaties will assist in dealing with the differing kinds of tax planning.

A developing or transition country should make clear through explanatory or administrative material that it does not intend to use (the threat of) multiple taxation to penalize taxpayers. If it is felt that the problems of international tax avoidance justify severer penalties than normal, then the tax penalty regime should provide for this directly. Similarly, if higher levels of disclosure of information are required in the international area, the legislation should provide for such disclosure explicitly. Care in drafting such provisions is necessary to ensure that they are not in breach of nondiscrimination provisions in tax treaties. For this reason as well as the considerations raised in relation to residents below, the provisions should apply to both inward and outward investment cases.

Stricter enforcement regimes may be viewed adversely by foreign investors and temper their willingness to invest in the country in question. Each developing and transition country has to judge this issue for itself. The same reluctance may also be triggered by legislation directed at international tax avoidance practices. One possible response (effectively giving in to the difficulties of enforcing international tax rules) is to not include antiavoidance provisions of the kinds outlined above in domestic tax legislation and so to allow nonresident direct investors to determine their tax level for themselves. Alternatively, such provisions can be coupled with special tax regimes for foreign investors conferring tax holidays and other tax privileges on them in specified cases. The alternative approach nominally gives control over the targeting of the tax benefits for foreign investors to the developing or transition country, although in practice, as noted in chapter 23, it generally leads to other forms of tax avoidance.

8. Nonresident Portfolio Investors

The position of nonresident portfolio investors differs substantially from that of direct investors. Because direct investors have control over the transactions undertaken within the company group, they can engage in transfer pricing, thin capitalization, and the like in ways not generally available to the portfolio investor. It is possible for portfolio investors to employ tax havens and treaty shopping in some of their activities (e.g., using tax treaties to obtain lower withholding tax rates on interest), but generally the scale of the investment in a particular company by a particular investor is unlikely to justify elaborate tax avoidance of the kind that may be practiced by direct investors.

The tax planning of the portfolio investor is likely to consist of portfolio choice. For example, purchasing shares in a company resident in a developing or transition country exposes the investor to the corporate tax and the withholding tax on portfolio dividends, which is probably higher than the tax on dividends paid on direct investment. Some portfolio investors (e.g., tax-exempt pension funds) will be tax privileged in their residence countries and so may not benefit greatly from double tax relief in this case. Failing special provisions in the law of the source or residence country (or both, possibly through a tax treaty) to deal with the international implications of its special tax position, the portfolio investor may adopt a different investment strategy, such as investing in (profit-related) debt of the company resident in the source country and options over the unissued capital of the company. In this way, it benefits from increases in the value of the company's shares and a share in its income stream without being exposed to much if any tax in the source country (interest withholding tax probably being the only tax applicable) while enjoying its tax privileges in the residence country. With the advent of modern financial instruments, more sophisticated strategies are available to the portfolio investor who wishes to be exposed to a particular market or company without the accompanying source tax liabilities.

Often, the influence of the portfolio investor will be felt not directly but indirectly in the source country through the foreign direct investor responding to the needs of the portfolio investor. Since portfolio investment opportunities are often limited in developing and transition countries (because of the lack of a stock exchange or very thin trading in whatever stock market exists), portfolio investors more often than not will invest in the multinational direct investors operating in the countries (and many other countries) as a way of exposing themselves to investment in many countries and at the same time minimizing risk by having multicountry coverage in the investment. As the totality of investment in many multinational companies will be dominated by institutional portfolio investors, such as pension schemes, banks, and insurers, the companies are likely to adapt their tax profile to suit the institutional investors. If the preference of the institutional investors is to have low taxed returns because of their privileged tax position in their residence countries, the optimal tax strategy for the multinational company may be to reduce its tax liabilities in all countries, which takes us back to the beginning of the discussion in this section of the chapter.

Increasingly in recent times, international investment has developed many tax niches, with offshore funds offering specialized investment products designed to appeal to particular kinds of investors. The discussion of capital flight above dealt with one kind of such fund in the case of resident portfolio investors. Here, the discussion concerns similar funds designed for nonresident portfolio investors. To the extent that the multinationals do not respond to the tax situations of their different classes of portfolio investor, it is often possible to find a fund that consolidates portfolio investors with a similar tax and investment profile and develops investment products that suit that profile. While it often may not be worthwhile for a single portfolio investor to use treaty shopping and tax havens for its operations, it is for such offshore funds. Hence, the other major effect of portfolio investors in developing and transition countries is being felt through the operations of such funds (with many specializing in investment in (particular) developing or transition countries). To the extent that this investment is highly tax sensitive, there is little that a developing or transition country can do to prevent offshore fund tax planning in which the nonresident portfolio investor decides to invest in a particular fund or to withdraw from the fund.

The major problem that the nonresident portfolio investor poses is the potentially deleterious incentives that the investor's tax position creates for direct investors to reduce source country taxation. Hence, additional antiavoidance provisions are not necessary in the law to deal with the tax position of the portfolio investor beyond what has been canvassed in earlier discussion. If the source country specifically wants to cater for the tax problems faced by foreign pension funds and the like, some suggestions have already been made.

9. Resident Investors

Although developing and transition countries will most often encounter the forms of tax avoidance outlined above in the case of nonresident direct investors, many of them are equally available to residents of the developing or transition country (resident in the sense that the ultimate investor is a resident of the country and is not foreign owned). It is necessary in this case to distinguish two investment situations, first, where the ultimate investment is made by the resident overseas and, second, where the ultimate investment is made in the developing or transition country itself.

The first case is the more obvious but less frequent in practice from the point of view of the developing or transition country. A resident engaging in direct investment overseas can engage in transfer pricing and the other kinds of activities outlined above for the dual purpose of reducing the tax in the country of source (where the investment is made) and in the country of residence. Avoidance of resident country tax will often involve the diversion of income from the country of residence to tax havens, combined with manipulation of the system of double taxation relief. Avoidance of source country tax in these kinds of cases is not directly the concern of the residence country, its main concern being to protect its own taxing rights. The mechanism to control tax haven use by residents that is increasingly being used in advanced market economies is to tax residents on their share of low-taxed foreign income derived by nonresident companies controlled by the residents. These "controlled foreign company" regimes are usually very complex in operation.[147]

As regards the second case, initially it seems unlikely that a resident of a developing or transition country would get involved in international tax avoidance for investment in that country. In fact, however, a resident direct investor can easily appear as a nonresident direct investor by channeling investment into the country through a nonresident company that the resident owns. By this means, the possibilities of reducing tax in the country by transfer pricing, thin capitalization, tax havens, and treaty shopping become possible in a similar way as for true nonresident direct investors. In addition, the resident can also by this route seek to enjoy any tax concessions given specifically to nonresident investors.

This possibility of residents assuming the guise of nonresidents is closely linked to the capital flight issue canvassed earlier, at least in transition countries. Capital flight

[147]The seminal comparative work on these regimes is Brian Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison (1986); for a more recent summary of current practice, see OECD, Controlled Foreign Company Legislation (1996).

was the first reaction of many wealthy people there to the uncertainty and instability created by the transition. As the situation has clarified to the extent that it is possible to conduct profitable business operations in the countries, it seems likely that a number of these people have reintroduced their capital into businesses as disguised foreign direct investment. While the capital is thus reexposed to the risks that it was originally fleeing, the ownership of the capital is usually hidden (as it often originates in tax havens), tax concessions may be available, and further flight remains possible to the extent that the capital remains mobile. There is some evidence that much of this capital is invested in import-export and similar activities that do not anchor the capital in the same way as investing in large-scale plant and equipment would.[148]

For both kinds of tax avoidance by residents, the provisions discussed above—such as rules on transfer pricing, thin capitalization, tax havens, and general antiavoidance—are available to deal with some of the problems. It was partly because of the need to control circular transactions of residents taking capital offshore and reintroducing it into the country that it has been suggested that many of the rules should not be directed to nonresidents. Eventually, controlled foreign company regimes will be needed, despite the difficulties that they entail. For the time being, the embryonic measure that has been outlined above for the capital flight case can at least be adopted to signal that a developing or transition country is aware of the international tax avoidance techniques that residents may use and proposes to combat them.

VIII. Tax Treaty Issues Not Covered in Domestic Law

A number of provisions found in tax treaties are not usually reflected in domestic law. This section briefly describes these provisions, together with their effect on domestic law, specifically nondiscrimination, exchange of information and assistance in collection, and the mutual agreement procedure.

A. Nondiscrimination

The nondiscrimination article of tax treaties is designed to ensure that foreign investors in a country are not discriminated against by the tax system compared with domestic investors. The OECD Model nondiscrimination provision is narrower, however, than similar provisions found in other areas of international law, such as trade. This difference is necessary because the international tax system operates on the residence and source principles and so necessarily distinguishes the tax position of residents and nonresidents. Hence, it is not usually regarded as discriminatory to collect flat-rate gross withholding taxes from a resident of the other state without a permanent establishment when a resident is taxed on the same income on a net assessment basis.

[148]*See* OECD, Taxation and Foreign Direct Investment: The Experiences of the Economies in Transition (1995), especially the discussion of Latvia in pt II.

The first paragraph of the nondiscrimination article in the OECD Model provides against discrimination on the basis of nationality, but makes it clear that distinctions on the basis of residence will not be regarded as giving rise to nationality discrimination (in other areas, such as EU law, residence distinctions can amount to nationality discrimination).[149] Hence, to breach this provision it is necessary for a country to treat a resident who is a national of the other state less favorably in the levy of tax or procedural requirements than a resident national, or a nonresident national of the other state less favorably than a nonresident national. Such forms of discrimination are rare in domestic tax laws. The second para. of the OECD nondiscrimination article applies a similar rule to stateless persons; this provision rarely appears in actual tax treaties.[150]

The third para. of the nondiscrimination article in the OECD Model requires that a permanent establishment of a resident of the other state shall not be less favorably taxed than enterprises of residents carrying on the same activities. This is the most important provision of the article in practice and, combined with the other articles of the Model, especially the business profits article, means that the profits attributable to a permanent establishment have to be taxed on a net basis[151] and that the permanent establishment must otherwise be taxed under the same rules as domestic enterprises. The article deals with the amount of tax liability and not connected requirements so that it is possible, for example, to apply withholding taxes on income derived by a permanent establishment of a nonresident even though such taxes are not applied to a domestic enterprise, so long as the ultimate tax is on a net basis (i.e., any withholding taxes are not final, are credited against the ultimate tax liability, and are refunded if there is an excess). If withholding taxes are applied to income derived by domestic enterprises, there is no question of breach of the nondiscrimination article in applying them to nonresidents, but even if the taxes are final for a resident enterprise, they cannot be for a permanent establishment of a nonresident because of the requirement of the business profits article that taxation be on a net basis.

The exact extent of the nondiscrimination obligation under this para. is not clear in all cases, especially as regards application of progressive rate scales to companies, tax relief for intercorporate dividends, and the granting of foreign tax credits to permanent establishments for any foreign tax levied on income attributable to the permanent establishment. The Commentary to the OECD Model contains a lengthy discussion of these issues.[152] The second sentence of the third para. does make clear that it is not necessary to grant personal allowances to a nonresident individual carrying on business through a permanent establishment (this sentence often appears as a separate para. in

[149]*See* Terra & Wattel, European Tax Law ¶¶ 3.2.1, 3.2.3.1, 3.2.3.2 (1993).

[150]In the 1977 OECD Model and in the UN Model, the second para. is a definition of national; this now appears in the definition article of the 1992 OECD Model.

[151]This requirement may have implications for certain forms of presumptive taxation that imposes a tax lien in the absence of net income. *See* vol. 1, ch. 12.

[152]Commentary on art. 24 ¶¶ 19–54.

actual treaties). Thin capitalization rules that are applied to a permanent establishment borrowing from related parties but are not applied to resident enterprises may be contrary to the paragraph, depending on how the rules are framed. The example of thin capitalization rules given above will not be contrary to nondiscrimination rules because they apply to all enterprises. Branch profits taxes may be contrary to the terms of this paragraph, so that its terms need modification if a country wishes to levy a branch profits tax.

The fourth and fifth paragraphs of the OECD nondiscrimination article ensure that resident enterprises whose capital is wholly or partly owned or controlled by a resident of the other state are not subject to discrimination. The fourth paragraph refers specifically to deductions for interest, royalties, and other disbursements and makes clear that deductions can be denied through the application of the arm's-length principle by way of exception to the requirement for the same treatment. If a developing or transition country adopts a rule denying deductions for payments to tax havens, the rule will generally be overridden by the fourth paragraph if a tax treaty is in effect with the tax haven. Hence, the caution above about negotiating tax treaties with tax havens. The fourth paragraph is more general, preventing heavier or different taxation or connected requirements than for other similar enterprises. While it can cover the same ground in part as the fourth paragraph, the fifth is more specific and therefore prevails in the event of overlap. Thin capitalization can be an issue under the fourth paragraph, but not if the rules are applied generally to all enterprises. The fifth paragraph would prevent, for example, a local subsidiary of a parent in the other state from being subjected to a higher tax rate than other companies.

The final paragraph in the OECD Model provides that, unlike the other provisions of a tax treaty, the nondiscrimination article applies to all taxes levied by a state. This provision is often omitted from actual tax treaties or altered to make clear that it applies only to taxes covered by the treaty (which it is not strictly necessary to state).

Because tax treaties are enacted in one way or another as part of domestic law and prevail over other taxing provisions, the nondiscrimination provision is self-executing and overrides domestic rules that conflict with it. Because of the general terms of the nondiscrimination article, it is necessary to be aware of its operation when drafting domestic rules. There is generally little point in devising domestic rules that are contrary to the nondiscrimination rules, except in the case of tax haven provisions.

The nationality paragraph aside, at first sight the nondiscrimination article seems to have a residence state bias because its provisions operate effectively only on the source state (where the permanent establishment or subsidiary operates). This view is not accurate if the structure of tax treaties is looked at broadly. It was noted above that the foreign tax credit system in particular may create an incentive for the source country to increase its taxation on nonresidents (or subsidiaries of foreign parent companies) up to the level of tax in the residence country. While tax treaties impose rate limits on source taxation or exclude source taxation altogether in some cases, for income of a permanent establishment or a subsidiary there are no such limits. Hence, the nondiscrimination article ensures that source countries do not target higher taxes to these cases and prey on the relief system of the residence country.[153] The equivalent undertaking of the residence country is in its treaty obligation to relieve double taxation for source taxes levied in accordance with the treaty. The residence country could not satisfy its obligations under this paragraph by levying tax rates on foreign investment that are higher than those on domestic investment and then purporting to relieve double taxation through a tax credit.[154] The nondiscrimination article does not prevent a country from discriminating in favor of nonresidents (as with tax holidays or other incentives that apply only to foreign investors). Nor does the article prohibit provisions in the domestic law that favor the location of investment in the country; for example, a country can have special tax incentives for research and development conducted in the country or for plant and equipment used in the country, as long as these locational incentives are not confined to residents or locally owned companies.

B. Exchange of Information and Assistance in Collection

Most countries have a domestic law rule that they will not directly or indirectly assist another country in the collection of its taxes.[155] This rule means that exchange of tax information and other forms of assistance in collection of taxes are not possible without a tax treaty that overrides this rule in domestic law. The tax secrecy rules of many countries also prevent the exchange of information. Exchange-of-information provisions are found in virtually all tax treaties, but other forms of assistance are less commonly provided for.

The standard OECD and UN Model exchange-of-information article requires a country to obtain information for its treaty partner where the information is necessary for carrying out the provisions of the treaty or of the country's domestic tax law. Exchanged information is required to be kept secret in accordance with the secrecy rules of domestic law of the recipient country and in accordance with the express treaty rules on this topic. In addition, the standard treaty article provides that information need not be exchanged when it involves commercial or trade secrets. Tax secrecy is often not as strong an institution in developing or transition countries as it is in industrial countries and so can be a very sensitive topic in tax relations between treaty partners. It is implicit in the

[153]Even in the absence of a treaty, this tactic may not be effective if the resident country denies a credit for so-called soak-up taxes, as does the United States, for example. *See* Treas. Reg. § 1.901–2 (c).

[154]This is implicitly recognized in the paragraph in the OECD Model allowing the residence country to apply exemption with progression to income, which it relieves from double taxation by exemption, arts. 23A(3), 23B(2). Exemption with progression takes the foreign income that has been exempted into account in determining the tax payable on domestic income. Usually an average rate of tax is worked out on the assumption that all the foreign and domestic income of the resident is subject to tax and this rate is then applied to the domestic income of the resident.

[155]This rule is not found in the tax laws of the country but in the rules of private international law (conflict of laws). Thus, in common law countries, it is simply part of the common law (*see* Government of India v. Taylor [1955] AC 491).

exchange-of-information article, however, that a country cannot refuse to give information to its treaty partner because of its own tax secrecy laws.

The exchange-of-information article also serves as a test of the lowest common denominator for procedures of collecting information. Information need not be collected if it could not be obtained under the procedures of either country. For example, the information being sought may be kept at the home of a taxpayer. If the tax procedure law of either treaty country forbids entry of domestic (as opposed to commercial) premises to obtain information, then there is no obligation to obtain the information. If, however, the impediment arises under the law of the country making the request and if the country that has received the request for such information is able to obtain the information under its laws, that country may (but is not obliged to) forward the information to the other country under the exchange-of-information article.

Unlike other articles of tax treaties, the exchange of information article is not limited in application to residents of the treaty partners. For example, one country could request the other to obtain information from a permanent establishment in that state of a resident of a third state. Although the Models do not so provide, information is being increasingly extended to taxes other than income taxes for the practical reason that many countries use the same tax officials to enforce a number of different taxes (e.g., income tax and value-added tax), and it is difficult for an official who has received foreign information to use it only in relation to one tax when it is relevant to several taxes.

The OECD provides considerable practical guidance on exchange of information.[156] The use of computers in tax administration is spilling over into this area, and the sophistication of the exchange process has increased rapidly. The OECD has developed a standard computer format for exchange of information.[157] In recent years, the exchange article has given rise to some novel extensions of its use, such as for simultaneous audits of the same or related taxpayers by each party to a treaty (and even by more than two countries through the use of exchange provisions in a number of treaties). The OECD has developed a model agreement for tax administrations to formalize the process.[158] Whether developing or transition countries will be able to participate in these recent developments will depend on their level of computerization and audit capacity.

In addition, provisions for assistance in collection are increasingly being included in tax treaties. Under these provisions, each country undertakes to collect the taxes of the other. As no OECD or UN Model provision currently exists for this purpose, the following text is provided as a sample.

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[156]OECD, Tax Information Exchange: A Survey of Member Countries (1994).

[157]Reproduced in Vann, *supra* note 14.

[158]OECD, Transfer Pricing Guidelines, *supra* note 124, ¶¶ 4.78–4.93.

Article 27. Assistance in Collection

1. The competent authorities of the Contracting States undertake to lend assistance to each other in the collection of taxes, together with interest, costs, and civil penalties relating to such taxes, referred to in this article as a "revenue claim."

2. Requests for assistance by the competent authority of a Contracting State in the collection of a revenue claim shall include a certification by such authority that, under the laws of that State, the revenue claim has been finally determined. For the purposes of this article, a revenue claim is finally determined when a Contracting State has the right under its internal law to collect the revenue claim and the taxpayer has no further rights to restrain collection.

3. A revenue claim of a Contracting State that has been accepted for collection by the competent authority of the other Contracting State shall be collected by the other State as though such claim were the other State's own revenue claim as finally determined in accordance with the provisions of its laws relating to the collection of its taxes.

4. Amounts collected by the competent authority of a Contracting State pursuant to this article shall be forwarded to the competent authority of the other Contracting State. However, except where the competent authorities of the Contracting States otherwise agree, the ordinary costs incurred in providing collection assistance shall be borne by the first-mentioned State, and any extraordinary costs so incurred shall be borne by the other State.

5. No assistance shall be provided under this article for a revenue claim of a Contracting State in respect of a taxpayer to the extent that the revenue claim relates to a period during which the taxpayer was a resident of the other Contracting State.

6. Nothing in this article shall be construed as imposing on either Contracting State the obligation to carry out administrative measures of a different nature from those used in the collection of its own taxes or that would be contrary to its public policy (*ordre public*).

7. Notwithstanding the provisions of article 2 (Taxes Covered), the provisions of this article shall apply to all taxes collected by or on behalf of the Government of a Contracting State.

Whether the last paragraph is included will depend in part on a similar extension being made to the exchange article. On the grounds of administrative capacity, developing and transition countries may not consider such an article appropriate to their circumstances (and, equally, industrial countries may not be willing to agree with them on this article). More elaborate stand-alone treaties dealing with tax administration have been developed, and the Multilateral Treaty on Mutual Administrative Assistance, which covers exchange of information, service of documents, and assistance in collection is open for signature to those countries that join the Council of Europe or the OECD.[159] It entered into force on April 1, 1995.

C. Mutual Agreement Procedure

The final provision of tax treaties that requires comment is the article on the mutual agreement procedure. Under the Model versions, this article performs three functions: it provides a dispute resolution mechanism in relation to the application of the provisions of tax treaties to specific cases; it allows the countries to settle common interpretations and applications of their tax treaty; and it allows them to resolve cases of double taxation not otherwise dealt with by their treaty. Some countries find that the third function and often the second are difficult to reconcile with their domestic laws and procedures and therefore omit them from their treaties. In practice, it is dispute resolution for the specific case that predominates, whatever the precise form of the article.

The ground on which the taxpayer can invoke this procedure is that the actions of one of the states result or will result in taxation not in accordance with the treaty. The taxpayer has three years to invoke the procedure from the first notification of the act complained of. The states are obliged under the article to consult on the problem raised by the taxpayer if the state with which the problem is raised is unable or unwilling to resolve it unilaterally, but they are not obliged to resolve the case. If a resolution is agreed to by the states, then under the Models it is to be implemented notwithstanding domestic time limits on amending tax assessments. Some countries are unwilling to agree to such overriding of domestic time limits in their tax treaties.

No specific procedure is provided, but it is made clear that the tax administrations can make contact directly and do not need to go through diplomatic channels. The major issue that arises in practice is the relationship between domestic appeal procedures provided for in tax laws and the treaty dispute resolution mechanism. To avoid competition or conflict between domestic appeals and the mutual agreement procedure, some countries provide in their tax laws or procedures that the taxpayer must waive or suspend appeal rights under domestic law, while other countries will not actively pursue the competent authority procedure until domestic appeal periods have expired and the taxpayer has not utilized them.

The mutual agreement procedure has also been the subject of novel uses in recent times. The main development concerns advance pricing arrangements under which the mutual agreement procedure is used to agree to a transfer price in advance, so that taxpayers and tax administration are spared disputes after the event. This is a sophisticated procedure that for the moment is probably only relevant to industrial

[159]Council of Europe and OECD, Explanatory Report on the Convention on Mutual Administrative Assistance in Tax Matters (1989).

countries.[160] Taxpayer dissatisfaction with the mutual agreement procedure has led some countries to adopt arbitration procedures in their tax treaties for cases where it is not possible for the competent authorities to resolve disputes. The main purpose of such provisions is to put pressure on the tax administration to resolve international disputes rather than to actually engage in arbitrations.[161]

IX. International Tax Priorities for Developing and Transition Countries

It will be evident from this chapter that the construction of the international elements of the income tax system in domestic law and tax treaties is a complex topic. Among developing and transition countries (as among industrial countries), there will be wide differences in the capability of the tax administration to deal with international tax issues. While priorities will vary from one country to another, this concluding part of the chapter indicates a line of development that should suit many developing and transition countries.

The priority of any tax system will always be to tax the domestic income of resident taxpayers.[162] With the increasing internationalization of economic relations, however, even this goal means that attention must be given to international income tax issues. For better or worse, the globalization of the world economy impinges on developing and transition countries, and it is not possible for a country to isolate itself or its tax system. The interdependence of market economies is a new phenomenon, and transition countries in particular retain a residual belief in the ability of regulation to deal with problems. In some developing countries also, the capacity of economic regulation in the current economic environment is overrated. Developing and transition countries face similar problems of international taxation as industrial countries, which means that, whatever may have been the case in the past, it is not possible to adopt the attitude that international issues can wait.

The incentives for capital flight are strong in developing and transition countries even apart from the tax system. If a country operates the source principle only, then it is necessary to have robust rules for the source of income to ensure that the source-based tax is not avoided. Even with such rules, there will be a strong incentive for residents to move income offshore in order to avoid taxation, which will be a relatively simple matter

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[160]OECD, Transfer Pricing Guidelines ¶¶ 4.124–4.166. In the medium term, Advanced Pricing Agreementss (APAs) developed by advanced countries may help to solve the difficulties for developing and transition countries in enforcing transfer pricing rules.

[161]For a discussion of these issues, see OECD, Transfer Pricing Guidelines paras. 4.167–4.171; the EU has implemented an arbitration procedure in transfer pricing cases, Convention of July 23, 1990, on the Elimination of Double Taxation in connection with the Adjustment of Profits of Associated Enterprises, 90/436/EEC, O.J. No. C304 of December 21, 1976, 4.

[162]With the possible exception of a few countries with small populations and large resource bases exploited by foreign investors.

for passive portfolio income (by investment choice). The residence principle should be adopted to prevent this form of tax avoidance. Once the residence principle is adopted, then measures for the relief of double taxation by way of exemption or a simple foreign tax credit are also necessary. At this point of development, the country has satisfied the basic norms for international tax rules on which tax treaties depend.

The ability of residents, again by simple investment choice, to derive foreign-source passive income through nonresident taxpayers (such as offshore mutual funds) indicates that further measures are necessary even for the simple goal of protecting the domestic tax base in the case of residents not engaged in active businesses. A simple provision indicating an intention to levy tax in these cases, together with enforcement efforts directed at tax evasion using foreign bank accounts, is the best that can be achieved to deal with the various kinds of capital flight. Residents involved in purely domestic business activities can also use the international tax system to avoid taxes. In this case, investments will be looped offshore and back into the country, creating the potential for such techniques as transfer pricing, thin capitalization, and profit stripping to move profits out of the country, usually to tax havens. The simplest approach for dealing with such problems is a brief provision levying tax on the resident owners of the offshore entities. Such provisions are necessary today simply to ensure collection of tax on the domestic income of residents.

With provisions in place to secure the domestic tax base, probably the next priority should be tax treaties. These marginally increase the capacity to enforce taxation of the domestic income of residents through exchange of information (although the use of tax havens for much of the offshore activity limits the effectiveness of tax treaties). Most important, they signal to foreign investors the country's intention to play by the generally accepted rules of international taxation and not to discriminate against foreign investors while leaving room (if negotiated in an appropriate form) to extend domestic taxes to foreign investors. Except in the increasingly unusual case of a country deciding not to pursue the negotiation of tax treaties, the contents of tax treaties overshadow the way in which a country should frame its tax laws for the taxation of foreign investors. It has been suggested throughout this chapter that the rules of tax treaties should generally be followed in domestic law for greater transparency and simplicity in the application of the tax law where a tax treaty is operative.

Taxation of foreign investors in developing and transition countries is a politically divisive issue. On the one hand, there is a natural resentment against the economic resources of a country being owned and exploited by foreigners. In the past, this attitude contributed in many developing countries to restrictions on foreign-owned operations. On the other hand, the need for foreign capital, technology, and management skills is increasingly felt as more and more countries compete for what is available, especially since the transition countries have entered the picture. The result is policy and administrative ambivalence to taxation of foreign investment.

Many countries offer tax incentives for foreign direct investors. While the efficacy of these incentives in attracting increased foreign investment may be doubted, any attempt to tax foreign direct investors effectively involves formidable problems of drafting the law and administering it. The basic provisions for taxing nonresidents consist generally of withholding taxes on passive and employment income and collection by assessment on business income. The investment choices for portfolio foreign investors and the tax avoidance techniques available to the foreign direct investor mean that such provisions are not adequate and that rules in domestic law on transfer pricing, thin capitalization, and tax havens are required. These will by no means cover the tax avoidance strategies available. A general antiavoidance provision or doctrine will assist the tax administration to cope with international tax avoidance, but requires considerable effort to implement. In short, any serious attempt to collect tax from foreign direct investors is fraught with drafting and administrative difficulties, while taxation of portfolio investors may simply induce them to move their investment out of the country. For these reasons, the taxation of foreign investors is probably the last international taxation issue that a developing or transition country should seriously tackle.

The number and significance of the international tax problems that confront the income tax is one reason why developing and transition countries do well to rely on alternative tax bases in addition to the income tax as a major source of tax revenue. The value-added tax, excises, social security, and property taxes generally present fewer international difficulties of drafting and enforcement than the income tax.

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Taxation of Legal Persons and their Owners

Graeme S. Cooper and Richard K. Gordon

> It is also obvious that the type of rules which we have been discussing, although they are unquestionably rules of binding law, have in no way the character of religious commandments, laid down absolutely, obeyed rigidly and integrally. ....The bundles of fish, the measures of yams, or bunches of taro, can only be roughly assessed, and naturally the quantities exchanged vary according to whether the fishing season or the harvest is more abundant.
>
> —Branislaw Malinowski

I. Introduction

A. In General

Two of the perennial issues in tax policy debates are whether a specific tax should be formally imposed on enterprise profits and collected from enterprise earnings, and, if so, how it should be constructed. Levying a separate tax on the earnings of large corporations is almost universal practice,[1] often existing at both national and subnational levels, and in fact predates the imposition of universal income taxes on individuals in some jurisdictions.[2] Yet, the tax is not without its detractors, and suggestions for its reform or even repeal are often heard.

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[1] *See supra* Introduction, note 10.

[2] The corporate tax in the United States was first imposed in 1909, four years before the personal income tax was introduced. Historically, the tax was justified as equivalent to a license fee or benefit tax, imposed for the privileges flowing from the creation by the state of a separate person. Those benefits include perpetual life despite changes of investors, limited liability for investors, transferable interests with standardized (but variable) rights for ease of transfer and the ability to sue (and be sued) in the corporation's own name. That justification has generally been regarded as insufficient because there is little relationship between the value of the privilege and the size of corporate profits.

Another view accepts the legal fiction—that a separate person has been created by the process of incorporation—and the imposition of the separate tax simply affirms this fiction in the tax context. This rationale too is regarded as unsatisfactory today because it conflicts with modern financial theory, which simply regards the enterprise as a group of investors acting collectively under one or more legal structures. The legal fiction of the separate legal person is simply inappropriate in a tax context.

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Given the prevalence of the corporate tax, it may seem curious that there is such a debate, and so this introduction will outline some of the main points of contention before their more detailed examination in the body of the chapter. At the policy level, critics have pointed to the perceived deficiencies of the tax, and their list is indeed long and daunting— the so-called economic double taxation of corporate income (when enterprise profits are taxed, as are distributions of those taxed profits), the conjectural incidence of the tax (because its effects might be shifted to shareholders, workers, or consumers), the indeterminate and discretionary amount of tax payable (because the amount of tax varies with such factors as the capital structure of the corporation and the timing and proportion of distributions and retentions), the apparent incentive for corporations to finance their activities through debt (because interest is usually deductible while dividends are not) and to retain earnings (because retained earnings are not taxed as dividends but are usually taxed at a lower effective rate as capital gains), and the possible tax-induced distortions of the way economic activities are organized and conducted (avoiding corporate form for less transparent but more lightly-taxed alternatives).

Despite the shortcomings of the tax—the significance of which is still the subject of much debate—its supporters have pointed to several important benefits. They argue that it could approximate the economist's ideal tax on pure "economic rents"—that is, a tax on the excess of revenue over the corporation's total input cost, including the cost of capital. Such a tax would have no distortionary effects because it taxes pure profit. Even detractors of the tax acknowledge that there are serious obstacles to removing it, not the least of which is the substantial windfall that would be conferred on holders of equity interests if the tax were removed. Other important obstacles to its removal arise from interdependencies: changing the corporate tax would also require changing the personal income tax and international tax systems. First, under personal income taxes as they typically currently operate, the enterprise tax is the principal means of preventing deferral of tax and arbitrage of ordinary income into preferentially taxed capital gains. In other words, the enterprise tax is necessary to protect the tax base of the personal income tax. Next, it is an important source of revenue from nonresidents under the existing allocation of taxing rights between countries. The current system allocates rights to tax capital income from equity investments primarily to the source country, and rights to tax capital income from debt investments primarily to the residence country. Unilaterally abandoning the right of the source country by repealing the corporate tax would confer an unrequited windfall on the residence country.

The other aspect to the debate is more operational—if the tax is to exist, how should it be constructed? At one end of the spectrum, the "separate entity view" would construct and operate the personal and corporate taxes independently. The other, the "conduit" view discussed below, would adjust the taxes to recognize the existence and operation of both. At present, and on balance, the conduit view has probably emerged in a majority of countries as the most satisfactory theoretical paradigm for imposing tax on income derived from an equity investment in a business enterprise.[3] Ultimately, if the

[3]For example, two successive government reports in Australia, the Asprey Committee in 1972 and the Draft White Paper in 1985, suggested that the ideal treatment for income derived through entities was to approximate the conduit approach—"[the] ideal arrangement ... would recognize for income tax purposes

conduit view is accepted, its implementation must lead to one of the three theoretical options—imposing tax at the investor level only, imposing tax at the enterprise level only, or imposing tax at both levels, with the corollary of adjusting one tax for the effects of the other.

This chapter considers these policy and operational questions. Section II examines imposing tax at the investor level only and discusses why a tax imposed at the enterprise level, rather than at the shareholder level only, has generally been regarded as necessary. Section III considers in more detail whether important benefits can be achieved by a tax imposed at the enterprise level only. Section IV examines some possible adverse consequences likely to flow from the decision to use an enterprise-level tax that makers of tax policy and tax officials must be aware of and, more important, be prepared to manage. Section V examines systems that have both enterprise-level and investor-level taxes, and some of the options for structuring the interaction between them. Section VI discusses the typology and effect of distributions in their interactions with different enterprise and investor systems. Section VII examines how to define the taxpayer. Section VIII draws some general conclusions.

B. Relationship Between Enterprise Income and Investor Income

Most countries permit various legal structures for organizing profit-making enterprises. These include sole proprietorships, different types of partnerships, companies, and trusts. Modern financial theory views each form of enterprise as a group of investors acting collectively under one or more legal structures. Those structures are all based on contract law and include partnership law, trust or foundation law, and company law.[4] The traditional forms of organizing an investment include equity, debt, and leases[5] of movable, immovable, and intellectual property. Each different form of investment,

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the shareholder's interest in both the distributed and undistributed earnings of the company and would tax the combined amount at each shareholder's marginal tax rate; the company would be taxed only as a withholding arrangement to collect personal tax on the income." Australia, Reform of the Australian Tax System ¶ 17.9 (1985) [hereinafter Draft White Paper]. In contrast, the United States has always had a completely separate system and continues to do so despite a number of recommendations by the U.S. Treasury Department to the contrary. *See*, *e.g.,* U.S. Dep't of the Treasury, Blueprints for Basic Tax Reform (January 1977) [hereinafter Blueprints] (arguing for full integration between corporate and personal income taxation); Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth 117–20 (November 1984) [hereinafter Treasury I] (arguing for partial integration); The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (1985) [hereinafter Treasury II]; Department of the Treasury, Integration of Individual and Corporate Tax Systems: Taxing Business Income Once 27–35 (1992) [hereinafter U.S. Treasury Report] (arguing for full integration).

[4]The theory that each business enterprise is the product of different contractual relationships among investors was first advanced in the English-speaking world by the economist Ronald Coase. *See* R.H. Coase, *The Nature of the Firm*, 4 Economica 386 (1937).

[5]The term "lease" is used in a broad sense that would include a rental agreement or a licensing agreement as well as finance leases and operating leases.

whether stock or partnership interest, bank loan or bond, or lease, creates for the investor a different type of claim to the income and property of the joint business enterprise.[6]

Traditionally, equity holders receive their income in the form of a mixture of periodic payments (partnership distributions or dividends) and increases, or perhaps decreases, in the value of their investment (capital gains or losses). Depending on the local law, equity investments in companies can take other traditional forms, such as preferred stock.[7] The bondholder or banker is typically entitled both to a fixed rate of return on his or her loan and to repayment of the original amount invested; he or she may sue the company if these amounts are not paid.[8] A typical creditor generally has no direct say in managing the company.[9] However, a creditor may also experience increases or decreases in the value of his or her investment depending on changes in the creditworthiness of the company, as well as on changes in interest rates or in rates of inflation.[10]

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[6]For example, the typical partner or common stockholder has no right to receive either a fixed rate of partnership distributions or dividends, or a return from the partnership or company of his or her equity contribution. The common stockholder does, however, have other rights: he or she is entitled to what is left of the partnership or company property after other investors have been paid what they are legally entitled to. The partner or stockholder has some direct say in how the company is managed, thereby providing a mechanism for increasing the likelihood of higher rates of return. Limited partners do not participate in the day-to-day running of the partnership, but their liability, as with stockholders in companies, is limited to the amount of their investment. *See* Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 Emory L.J. 835 (1988).

[7]Preferred stockholders are paid dividends before other types of equity investors, but those dividends are limited by a cap. *See generally* Richard A. Brealey & Stewart C. Meyers, Principles of Corporate Finance 303–05 (3d ed. 1988).

[8]As will be discussed at greater length *infra*, there may be no clear dividing line between "equity" and "debt." *See generally* Franklin Allen, *The Changing Nature of Debt and Equity: A Financial Perspective*, *in* Are the Distinctions Between Debt and Equity Disappearing? 12 (Richard W. Kopcke & Eric S. Rosengrew, eds. 1989), and Charles P. Normandin, *The Changing Nature of Debt and Equity: A Legal Perspective*, in *id*. at 49. However, statues, regulations, and courts have often tried. In the United States, the Court of Appeals in Gilbert v. Commissioner, 248 F.2d 399, 402 (2d Cir. 1957) defined debt as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof." *See also* David Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369, 404 (1971). In the United Kingdom, the Court of Appeal in Lomax v. Peter Dixon & Co, Ltd [1943] 2 All ER 255, 259–62, noted that each case of whether a payment constitutes interest must be "decided on the facts," and that the relevant factors in making such a determination would be the contract, the term of the loan, the stipulated rate of interest, and the nature of the capital risk. *See also* Butterworths UK Tax Guide 1990–91, at 338–90 (John Tiley 9th ed. 1990) [hereinafter Butterworths Guide]. The doctrines developed in case law go beyond "thin capitalization," where equity investors also contribute debt capital.

[9]However, most substantial creditors may, through the terms and conditions of the loan agreement, exercise considerable control over certain aspects of management.

[10]The simple unsecured creditor is only one type of traditional debt investor. There are also secured creditors, who typically have a better chance of getting paid than do unsecured creditors. A secured creditor may also experience increases or decreases in the value of his or her investment depending upon changes in the value of the creditor's security interest. The change in value will be more acute for

A lessor is in a legal position similar but superior to that of a creditor whose note is secured by assets. He or she may also see the value of the investment vary on the basis of the value of the security or leased good, as well as the general creditworthiness of the company.[11] A lease can shift the risk of loss from the owner to the person who leases the asset, while the owner may retain the opportunity of increase in value.

Different legitimate market-based reasons exist for packaging investments in different economic forms.[12] Risk is among the most important. As risk increases, investors will demand compensation for assuming that risk. Unsecured loans are riskier than secured loans or leases; partnership interests and common stock may have the greatest risk of all, but also the greatest opportunity for gain.

Changes in the value of the interest of any particular investor should be equal to the investor's share of the change in the total value of the enterprise. In other words, the value of an investor's interest will equal the total change in value of the enterprise minus everyone else's share. However, to make this calculation, one must first determine the income or loss of the enterprise. Forms of investment that have been traditionally referred to as "debt" or "leases" periodically pay or accrue interest, rent, or royalties to the investor. Therefore, the change in the value of the taxpayer's investment in the enterprise can be determined largely from the amount of interest, rent, or royalties that has been paid or accrued to him or her. Debt that is accrued over time, but that is not currently payable, can be recalculated so that the "reinvested" portion of the unpaid interest is included.[13] However, as noted above, the value of the debt or lease investment may not be completely reflected in the stated interest or rent. Even in simple debt

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nonrecourse creditors. A lower debt-to-equity ratio means that there is a greater amount of funds in the business (from the equity capital) to serve as a "cushion" for payment of fixed obligations, which reduces the likelihood of default on the obligations. Other factors affecting the level of risk include the history of payment of the interest and the use of the advanced funds. *See* David V. Ceryak, *Note: Using Risk Analysis to Classify Junk Bonds as Equity for Federal Income Tax Purposes*, 66 Ind. L.J. 273, 283–84 (1990).

[11]Rent compensates the lessor for any accruing capital loss plus the opportunity cost of the asset. *See* George V. Mundstock, *Taxation of Business Rent*, 11 Va. Tax. Rev. 683, 684–85 (1993); George V. Mundstock, *The Mistaxation of Rent: Eliminating the Lease/Loan Distinction*, 53 Tax Notes 353, 353–54 (1991).

[12]*See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 310–11 (1976).

[13]For example, in the United States, original issue discount is accrued over the lifetime of the debt and is compounded semiannually. *See* USA IRC § 1272(a). *See generally* David C. Garlock, A Practical Guide to the Original Issue Discount Regulations (1993). A similar regime exists in the United Kingdom. *See* GBR ICTA § 57, sched. 4; Butterworths Guide, *supra* note 8, at 397–405. Similar treatment is afforded in Australia. *See* AUS ITAA Div. 16E. *See also* Graeme S. Cooper, *Tax Accounting for Deductions*, 5 Aust. Tax F. 23 (1988).

relationships, changes in the creditworthiness of the enterprise, or changes in interest rates, will affect the value of the underlying indebtedness.[14]

The legal structures of investments have become increasingly varied and complex and have mixed many of the traditional attributes of equity, debt, and lease.[15] Examples include debt with call options or contingent interest, shared appreciation mortgages, and notional principal contracts. Instruments that allocate risk in different ways are constantly being created.[16] In the more advanced economies, these instruments have a long history. However, even in developing markets, there has been a proliferation of forms of financial instruments representing different types of investments in for-profit enterprise. The internationalization of finance and financial advice has resulted in the prompt spreading of those diverse investment forms throughout the world, or at least to those jurisdictions whose legal structure can accommodate them. As investments become more complicated, the difference between the stated "current yield" and the actual net income of the investor can become quite great.[17]

The various types of equity investors are entitled to the income of the enterprise minus the amounts paid or accrued to creditors and lessors. Because of the occasionally bewildering forms of equity participation, exactly how this income is to be divided may be clear only to the lawyers who draft the forms of participation. Nevertheless, the earnings of the equity participants are the principal object of the taxation of legal persons.

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[14]The difference between pure interest income and gain or loss from interest rate changes is relatively easy to determine. However, unless the debt is an instrument publicly quoted on an exchange, changes in default risk are difficult to determine. *See generally* David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111, 1164 (1986).

[15]A high-yield high-risk "bond," such as a deeply discounted debt instrument, may more closely resemble traditional equity than a low-yield redeemable cumulative preference share. *See generally* Jeremy I. Bulow, et al, *Distinguishing Debt from Equity in the Junk Bond Era*, *in* Debt, Taxes and Corporate Restructuring 135 (John B. Shoven & Joel Waldfogel, eds. 1990). In economic terms, these are all investments, and returns on investments, with different allocations of risk of gain or loss. While the economic realities of investments can be described with some accuracy, it is often difficult to put these realities into clear legal categories.

[16]*See* the discussion of these forms of investment, and the relationship to risk allocation, in Daniel N. Shaviro, *Risk and Accrual: The Tax Treatment of Nonrecourse Debt*, 44 Tax L. Rev. 401, 404, 429–31 (1989), and Alvin C. Warren, Jr., *Commentary: Financial Contract Innovation and Income Tax Policy*, 107 Harv. L. Rev. 460, 483–89 (1993).

[17]Leif Mutén refers to it as "the floating borderline between capital gain and current yield, which is barely discernable...[in] sophisticated financial instruments." Leif Mutén, *International Experience of How Taxes Influence the Movement of Private Capital*, 8 Tax Notes Int'l 743 (1992). However, with regard to fixed-interest debt instruments with a final redemption date, the variation is limited to downside risk over the life of the instrument. Equity, in the form of either securities or direct ownership, constitutes a residual claim to the assets themselves and may fluctuate freely in value; there is no inherent limit on fluctuations. Debt, however, constitutes a finite stream of payments already specified in nominal terms. Debt can decline to zero, but its value cannot exceed the undiscounted sum of nominal payments. With debt, while market value may deviate, the sum of deviations over time will be zero. *See* Theodore S. Sims, *Long-Term Debt, the Term Structure of Interest and the Case for Accrual Taxation*, 47 Tax L. Rev. 313, 358–59 (1992).

II. Enterprise Income Taxation as a Withholding Tax on Investors

In principle, it would be possible to tax all income of a business enterprise directly to its equity investors by treating all business enterprises as "flow-through" entities and allocating income to investors on a yearly basis.[18] However, treating the business enterprise as a separate taxable entity has a number of advantages over flow-through treatment. One problem with flow-through treatment is that it may be difficult to allocate earnings among a large number of increasingly bewildering types of equity holdings. Another is that, as the number of equity investors increases, allocation becomes more difficult.[19] As a result, no country has implemented such an approach.

Some or all of the enterprise earnings may be paid out to the equity investors, often at the option of enterprise managers or the investors themselves.[20] Taxing such distributions does not pose any great difficulty; they can simply be added to the income tax base of the shareholder.[21] A problem arises with the earnings retained by the enterprise. Most of the value of retained earnings is expressed primarily as increases in the value of the interests of those equity investors who have the legal right to the earnings retained by the company.[22] It would, in theory at least, be possible to tax the equity investor on the change in the value of the equity participation.[23] The tax base of such a system would include not only the amount of retained taxable earnings of the enterprise, but total economic income as well, including earnings not typically included in the income tax base, such as unrealized gains in the value of assets.[24] It would also include changes in the value of the equity interest that are not related to the economic income of the enterprise, for example, a systemic shift in stock market prices if the interest is a

[18]*See infra* sec. V(B)(6); ch. 21.

[19]These arguments, as well as others, are summarized in U.S. Treasury Report, *supra* note 3, at 27–35.

[20]In the case of preferred stock, payment typically is not optional.

[21]*See supra* ch. 16.

[22]Of course, some of the value can be realized by other investors. A company that retains earnings is likely to be more creditworthy, and the value of its bonds would therefore be likely to increase.

[23]Changes in the value of debt investments could also be taxed on an accrual basis. *See* Sims, *supra* note 17, at 336, 338, 356–57. However, valuation problems could be insurmountable, as they may be with equity interests.

[24]This would also include any special tax benefits provided the enterprise, such as the excess of tax depreciation over economic depreciation. *See* U.S. Treasury Report, *supra* note 3, at 82, and The American Law Institute, Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes: Reporter's Study of Corporate Tax Integration (Alvin C. Warren, Jr., Reporter: 1993) [hereinafter ALI Integration Report], at 129–32.

traded share.[25] Such a change in value would have to be assessed as part of the tax base annually; if not, the taxpayer would benefit from the time value of money on the deferred taxes.[26]

A number of suggestions have been made in favor of such accrual taxation of gains (and losses) on ownership interests in business enterprises. Yet, while such systems might be practicable for equity interests that are regularly traded with enough liquidity to determine a price, they would be difficult indeed for other interests.[27] For other equity interests, it might be possible to make periodic valuations and to adjust them for errors once the interest is actually traded, or whenever a fair market value can be ascertained with certainty.[28] However, a system of periodic valuation would ignore the possibility that the value of the interest can shift, perhaps even wildly, during the holding period.[29] This can create difficult problems for tax administration.[30]

Even if one could accurately determine changes in the value of equity interests on an annual basis, including these changes in the tax base would still be problematic. First, and perhaps most important, is the problem of collection. Taxes on capital gains are among the most difficult to enforce and collect. Except where there is direct reporting to the tax administration from exchanges or from broker-dealers, each individual

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[25]*See* the discussion of "speculative" gains in Michael L. Schler, *Taxing Corporate Income Once (Or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Models*, 47 Tax L. Rev. 509, 525 (1992).

[26]*See* Henry Simons, Personal Income Taxation 100 (1938).

[27]Such a system is outlined in David Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 Yale L.J. 623 (1967). However, there could be strategic selling of traded securities as a way of driving down the price on the valuation date. This could be countered by taking an average price over a limited time period. *See also Note*: *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 Stan. L. Rev. 857, 871-76 (1982); Victor Thuronyi, *The Taxation of Corporate Income—A Proposal for Reform*, 2 Am. J. Tax Pol'y 109 (1983). Such proposals have also been made for debt interests. As noted above, in many instances it is difficult to determine whether a particular interest is "equity" or "debt"; it can also be difficult to divide instruments with characteristics of both into their equity and debt parts. See the general discussion of such instruments and how they might be taxed in Warren, *supra* note 16, at 474–82.

[28]The correction would have to include the time value of money. This could be done by adjusting the amount of tax due by imputing an interest rate during the time that the taxpayer held the asset. *See* Mary L. Fellows, *A Comprehensive Attack on Tax Deferral*, 88 Mich. L. Rev. 727, 728–31, 733 (1990). *Cf.* USA IRC §§ 1291–1297 (imputed interest rate to account for the benefit of tax deferral).

[29]The more volatile the value of the asset, the more frequently it must be assessed if over- or under taxation is to be avoided. Because risky assets do not reveal their "value path," there are many possible paths between the starting and ending value and, for each possible path, there is a different continuous tax. Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implications*, 99 Yale L. J. 1817, 1822, 1865–79 (1990). *See also* Fellows, *supra* note 28, at 744.

[30]*But see* Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?* 47 Tax L. Rev. 377 (1992), who argue that real value paths might be constructable using computers if the data are available.

taxpaye__must voluntarily disclose the amount of gain or loss. The taxpayer must then remit the correct amount of tax. Even in the United States, which has a relatively effective tax administration, taxpayer compliance in reporting capital gains on traded securities and remitting the required tax is low. The most likely reasons are the lack of withholding for such tax and the absence of accurate information reporting.[31] And, because there may be a plethora of equity investors, the problem of administration is magnified. Obviously, the less sophisticated the tax administration, or the less likely taxpayers are to report income voluntarily, the worse this problem becomes.

A second problem would result from any difference in tax treatment between ownership interests in business enterprise and business income earned directly or through flow-through entities. As noted earlier, accrual taxation of ownership interests would include not only what is commonly accounted for as taxable income, but also accrual taxation of unrealized gains in the value of assets held by the enterprise.[32] While proposals have also been made for accrual taxation of all assets used in the course of business,[33] no tax jurisdiction has adopted the rule. If the effective tax rate on the income of business enterprise were substantially different depending on the form of the enterprise (flow-through or non-flow-through), there would be a tax-induced preference to operate in the form that produced the lower effective tax rate. For equity, efficiency, and administrative reasons, such tax incentives should usually be avoided.

The problems inherent in taxing equity interests on an accrual basis can be avoided by levying a tax on the income of the business enterprise as a surrogate for the tax that equity participants would pay if all company income were distributed. In that way, the enterprise would not be able to defer tax simply by not paying dividends. If the enterprise tax were levied at the same effective rate as the tax paid on dividend income by the owners of the enterprise, there would be no deferral benefits. Because most direct equity investors are likely to be taxed either at the top marginal personal rate or at a final schedular rate, business enterprises should also be taxed at this top or schedular rate.[34] A

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[31]*See* Steven Klepper & David Nagin, *The Role of Tax Practitioners in Tax Compliance*, 22 Pol'y Sciences 167 (1989); G.A. Feffer et al., *Proposals to Deter and Detect the Underground Cash Economy, in* Income Tax Compliance: A Report of the ABA Section on Taxation, Invitational Conference on Income Tax Compliance (P. Sawicki, ed. 1983); Steven Klepper et al, *Expert Intermediaries and Legal Compliance: The Case of Tax Preparers,* 34 J.L. & Econ. 205 (1991).

[32]The Meade Committee in the United Kingdom defined a true profit tax base as "the real current profits of the corporation, whether these be distributed or undistributed. It involves the deduction from gross profits of net interest on debt, an allowance for true economic depreciation...a calculation of real accrued capital gains made by the company on its assets [plus inflation adjustment]." Institute for Fiscal Studies, The Structure and Reform of Direct Taxation 229 (1978) (Report of the Meade Committee) [hereinafter Meade Committee Report].

[33]David J. Shakow argues that all business assets should be subject to accrual taxation. David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111, 1119–23 (1986). *See also* Strnad, *supra* note 29, at 1903–04, and Fellows, *supra* note 28, at 741–42.

[34]A detailed discussion on rate relationships can be found in Alvin C. Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 Harv. L. Rev. 717 (1981). *See also* 4 Report of the Royal Commission on Taxation [Canada] 51–57 (1966).

single-rate tax on business income would obviate the need to distinguish among different types of equity holders and, at least initially, to allocate income among such holders.

Income already taxed at the enterprise level may eventually be distributed to physical persons. If the tax system elects to levy a schedular, final tax on income from capital, the tax paid at the enterprise level can serve as that final tax on any distributions. If, instead, such income is taxed at progressive marginal rates, the tax paid at the enterprise level can serve as a withholding tax, for which a credit can be given the investor and for which a refund can be paid if necessary.[35]

Using a separate enterprise tax as either a final schedular tax or a withholding tax has proved to be an effective way of collecting tax on business income. Such a tax is typically levied as a separate legal liability on the enterprise. Because there are fewer enterprises than there are investors, and because they are more easily identifiable, having an enterprise as the principal taxpayer makes administration much easier than having only the investors as legal taxpayers. It also makes it much easier for the tax administration to distribute or collect adjustments resulting from audit.[36]

A number of technical reasons also favor a separate business enterprise tax over flow-through treatment. The first is that losses suffered at the enterprise level may be prevented from flowing through to equity investors and will then not be set off against other, taxable income.[37] Second, transactions that might not typically be viewed as giving rise to taxable income in the case of flow-through entities can more readily be deemed to do so under a separate enterprise tax. The most important of these is the entity may make distributions to its investors of economic income that was not taxed at the enterprise level. For example, income that benefits from tax incentives, or from the inexact science of tax bookkeeping (such as unintended acceleration of depreciation or income from unrealized capital gains), would not normally be taxed currently. However, under a separate system of business enterprise taxation, if such income were distributed as a dividend it might then be subject to tax.[38]

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[35]The conclusion that a separate company tax should serve as a withholding tax on the earnings of equity investors has recently been advanced in the European Union's Ruding Committee Report and in the American Law Institute's Federal Income Tax Project. Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation [Onno Ruding, Chairman] 31–32 (1992), [hereinafter Ruding Committee Report]; ALI Integration Report, *supra* note 24. However, the U.S. Treasury recently advanced the theory that a final, separate company tax, without deductions for interest, could serve as a part of a schedular tax on income from capital. *See generally* U.S. Treasury Report, *supra* note 3; Nicholas Brady, *Letter to Congress*, *in* Department of the Treasury, Treasury Integration Recommendation 2 (1992) [hereinafter U.S. Treasury Recommendation].

[36]*See* George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 Tax L. Rev. 431, 431–33 (1992).

[37]*See id*.

[38]*See infra* sec. V(B)(1).

However, treating a business enterprise as a separate taxable entity, even if the tax raised is then treated as a prepayment or withholding of tax on income eventually received by the equity investor, can create a number of serious administrative problems. These problems vary depending on (1) whether investors who are physical persons are to be taxed at graduated rates on a global income basis or at a final schedular rate, and (2) how close a connection is made between the tax on the business enterprise and the tax due at the level of both the equity investor and the nonequity investor. The elaboration of these problems, and how they might be dealt with in an income tax law, constitutes the principal subject of this chapter.

Most jurisdictions employ a system of flow-through taxation for certain types of business enterprise and separate taxation for others.[39] The choice of which business enterprises to subject to business entity tax and which to tax on a flow-though basis depends on a number of considerations. The greater the difference in outcome between the separate entity tax and flow-through treatment, the greater the incentive for taxpayers to engage in tax planning by selecting the more favorable form.[40] Such tax planning may make tax administration more difficult and may affect the economy adversely if more efficient legal forms of business enterprise are eschewed in favor of those that are less efficient, but tax preferred. While inefficiencies may result from requiring small partnerships to be treated as separate taxpayers, as a general matter, making the net of inclusion for separate business enterprise tax as wide as possible will, in most instances, ease tax administration. For example, including all legal persons and entities engaged in business or profit-making activities (depending on how such organizations are defined under the applicable law), unless they have a very small number of owners, may be preferable to providing flow-through treatment for all partnerships.

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[39]*See infra* ch. 21. Guidelines as to which entities are subject to company tax are discussed in app. A.

[40]For example, in the United States, where failure to achieve flow-through taxation means not only that losses do not flow through to equity holders, but that business earnings are subject to a second level of taxation on distribution, there has been a particularly strong incentive for enterprises to organize so as to avoid such double taxation. *See* Francis J. Worth & Kenneth L. Harris, *The Emerging Use of the Limited Liability Company*, 70 Taxes 377 (1992).

III. Separate Taxation of Business Enterprises and of Distributions to Investors

While theory suggests that, in general, an enterprise income tax should be levied only as a withholding tax or a final schedular tax for business income of legal persons, a number of major income tax systems continue to apply the "classical" system of separate taxes on the income of certain business enterprises and physical persons, resulting in double taxation of that income.[41] A number of arguments have been advanced in favor of the classical system.

A. Tax on Economic Rents

Some economists have supported the imposition of a separate business enterprise tax in order to capture "economic rents", or pure profits, which an investor earns in excess of the "cost of money"—that is, the given risk-free rate of return to capital.[42] In theory, economic rents can be taxed without adversely affecting investment because they represent a return in excess of that otherwise required to make the investment.[43]

Taxing both enterprise income and enterprise distributions would not necessarily tax economic rents. Instead, a system of double taxation would more likely result in inaccurate taxation of the amount paid to equity investors. With equity investments, the risk of low dividends or capital losses will largely be offset by the possibility of dividends or capital gains that are higher than the risk-free cost of money. Therefore, over time, earnings will include compensation for that risk. In other words, part of the excess of the return to equity investment over the risk-free average cost of capital is

[41]For example, the United States has always had a completely separate system and continues to have one despite a number of recommendations by the U.S. Treasury Department to the contrary. *See, e.g.,* Blueprints, *supra* note 3 (arguing for full integration between corporate and personal income taxation); Treasury I, *supra* note 3, at 117–20 (arguing for partial integration); U.S. Treasury Report, *supra* note 3 (arguing for full integration). Although the Japanese moved from a system of integration to a fully separate system in 1990, the general movement has been in the opposite direction—from a separate system to a fully integrated one. For example, France integrated its system in 1965, the United Kingdom in 1973, Germany in 1976, Australia in 1987, and New Zealand a year later. *See* K.C. Messere, Tax Policy in OECD Countries: Choices and Conflicts 346 (1993). Reports from both the OECD and the EU have, although sometimes obliquely, supported full integration over separate income taxation; Meade Committee Report, *supra* note 32; OECD, Taxing Profits in a Global Economy: Domestic and International Issues 25–30 (1991) [hereinafter OECD Report]; Ruding Committee Report, *supra* note 35, at 31–34.

[42]Another way of putting it is that economic rents are the part of a return on an investment that exceeds the amount needed to induce the investment in the first place. A patent, for example, can produce economic rents.

[43]For example, if the cost of money is 8 percent, any amount in excess of 8 percent can be taxed away before the investor will select another investment, which, by definition, pays only 8 percent. *See* Ruding Committee Report, *supra* note 35, at 31–32; OECD Report, *supra* note 41, at 21–23 (1991). *See also* Richard Musgrave, The Theory of Public Finance 262–67 (1959); Carl Shoup, Public Finance 266–69 (1969).

likely to be not economic rents, but a risk premium. Taxing this risk premium as economic rent could cause substantial distortions.[44] Methods have been developed to tax such rent; however, these methods appear seriously flawed.[45]

B. Subsidy Recapture

Some commentators have tried to justify a separate enterprise tax as a surrogate levy for the cost of government goods and services provided to those enterprises.[46] The argument is that all investors operate in an environment deeply affected by free government benefits and that the level of government spending may increase the profitability of economic activity. This additional charge would, it is reasoned, ensure that the government does not distort the market allocation of resources.

It is difficult to see how the cost of government services provided to enterprises can be realistically related to additional income that is attributable to the equity holders of

[44]For example, if the risk-free cost of capital is 5 percent, then an investor will be willing to put her or his money into a risky investment if the chances are, on average, that she or he will receive 5 percent. Assume that a person at a 40 percent marginal tax rate invests $100 in a company and that income in excess of the cost of capital is taxed away as economic rents. If, in year 1, the company's return on equity were 10 percent, and if it then distributed all of its earnings, the company would pay tax of 5, and the stockholder would pay tax of 2 (40 percent x 5), for a total tax of 7. However, assume that the extra 5 percent earned in year 1 did not constitute economic rents, but a risk premium for investing in equity. The next year the investor would be as likely to earn nothing as she was to earn 10 percent the year before. Therefore, assume that the company had no earnings in year 2. Neither company nor investor would owe any tax. That would mean that, over a two-year period, the investor would have paid tax at a rate of 70 percent. This approach would clearly result in a bias away from risky investments.

[45]One is to permit companies to deduct the full cost of all capital investments. The effect of such a deduction would be to eliminate company tax on earnings equal to the risk-free cost of money. In other words, only returns on capital in excess of the cost of money, represented by the present value of a full deduction for capital investment, would be subject to tax. Such a tax on rents would not look like a withholding tax on company income. However, it could be added as a separate tax to a withholding tax on company income. *See* Meade Committee Report *supra* note 32, at 232–33. However, there are a number of caveats: (1) tax rates must remain the same, (2) the tax savings from the expensed asset must be invested at the same rate of return, (3) there must be no preexisting assets on which income can be exempted, (4) all expensed assets must be subject to taxation on disinvestment, (5) the taxpayer must benefit fully from a current deduction, and (6) the investor must be able to borrow any needed funds at a fixed rate of interest. Michael Graetz, *Implementing a Progressive Consumption Tax*, 92 Harv. L. Rev. 1575, 1597–605 (1979).

Even if such a redesigned company tax on rents were added to a withholding tax on company income, there could still be an adverse effect on the economy. For innovation to occur, a higher rate of return from innovative ideas may be necessary. This is not just compensation for risk; it is also compensation for the labor that goes into innovation, but for which there has been no other compensation. This theory holds only if the innovators (or those who select them) have an equity participation in their product, something that anecdotal evidence suggests is often the case. The theory can be extended to portfolio equity investors. They are able to pick "winners" only because they apply their own labor to pick them. If these profits were taxed as rents, a decrease in innovation, and the money to finance it, would result.

[46]This argument has been raised directly with the authors by a number of officials in countries in Eastern Europe and Asia.

those enterprises. The argument seems to be that the total benefits provided free to the company would equal the total company income tax collected and that a particular enterprise's share of the benefits would equal its share of the tax. This relationship seems highly implausible. Specially designed excise taxes (or alternatively charges for the services) would be a more efficient way of compensating for such benefits.

C. Increased Vertical Equity

Some have argued that, because companies tend to be owned by the wealthy, company taxes should constitute a separate tax so that the vertical equity or fairness of the overall tax system can thereby be increased. A higher tax on all forms of income from capital would increase overall progressivity. Presumably, the most effective way of increasing the vertical equity of an income tax system is to increase its progressivity on all forms of income. However, under double taxation, only equity investments are subject to a separate tax. Removing existing tax benefits that favor the wealthy or imposing a more progressive income tax rate structure or, perhaps, a wealth tax would be more likely to raise the overall progressivity of the tax system than would taxing the income from equity capital twice.

D. Retention of Existing Double Taxation

Some have argued that, while a separate enterprise tax regime is not preferable in theory, if one is established it should be retained, at least for existing equity.[47] First, eliminating double taxation would reduce revenues.[48] Second, it could result in a windfall to current equity holders because the effect of double taxation would already have been capitalized by a reduction in the price of equity.[49] Equity investors will have demanded that other investors compensate them for the double tax burden they bear, so that the after-tax rate of return on equity would equal the after-tax rate of return on other investment forms. If the separate corporate tax were removed, equity investors would receive a windfall as the value of equity increased.

[47]American Law Institute, Federal Income Tax Project, Reporter's Study Draft—Subchapter C (Proposals on Corporate Acquisitions and Dispositions) 327 (1989).

[48]This is probably one of the most important arguments against eliminating double taxation in industrialized countries such as the United States as well as in developing countries. *See, e.g.,* U.S. Treasury Report, *supra* note 3, at 33. In Ghana, until 1975, the Income Tax Law provided for complete integration of company and personal income taxes. An official tax commission stated in 1977 that it was unable to establish the rationale for adopting the classical system in 1975. However, once enacted, the classical system was difficult to repeal for revenue reasons. *See* Seth E. Terkper, *Ghana, Trends in Tax Reform (1985–93)*, 8 Tax Notes Int'l 1267 (9 May 1994). *See also* Meade Committee Report, *supra* note 32, at 227–29.

[49]*Id*. *See also* American Law Institute, Federal Income Tax Project, Reporter's Study Draft— Subchapter C (Supplemental Study) (1989); Report of the Royal Commission on Taxation to the Federal Government of Canada (Kenneth Le M. Carter, Chairman), Dec. 1966 [hereinafter Carter Commission Report], ch 19.

While these arguments have merit, the effort to preserve a separate tax on old equity is unlikely to be worth avoiding the inequity of potential windfall benefits. First, potential losses in revenue can be made up with higher rates, or by eliminating investment incentives and other tax expenditures; jurisdictions that have recently eliminated double taxation have relied primarily on the latter technique.[50] Second, investors take many forms of risk: one is that the tax system will change in a manner that affects them. If total revenues from capital income do not decrease, then eliminating double taxation will shift wealth from debt investors to equity investors, a risk that both forms of investors would probably have anticipated and for which some discounting may already have occurred. In addition, some have suggested that the burden of the separate enterprise tax is often substantially reduced through tax planning and that the amount of windfall shifting would therefore be small.

IV. Problems with Retaining Double Taxation of Business Income

A. Aggravation of Tax Planning

A system of double taxation of equity income creates incentives to avoid double taxation through tax planning, and may involve opportunities to avoid tax altogether. Among the techniques are the following:

(1) Choosing business forms that are not subject to double taxation, where feasible. For example, commercial laws may allow taxpayers to set up entities that will be treated as transparent for tax purposes—partnerships or trusts might be available options—and that have enough of the properties investors want, particularly limited liability and free transferability of interests.

(2) Raising capital through legal forms that allow deduction of payments to investors, such as rental payments and interest. As was mentioned above, modern financial instruments give taxpayers opportunities to structure their investment in a form that is classified as debt, so that the return on the investment reduces the corporate tax base, but that has enough of the desired attributes of equity, particularly the opportunity to share in the potential gains from corporate success.

(3) Distributing earnings to equity investors through techniques that do not give rise to the second tax.[51] Corporate law may allow corporations to return amounts to investors through a variety of devices, including the redemption of redeemable preferred stock, partial reductions of capital, or the repurchase of common stock. These amounts will be a desirable substitute for a distribution of a similar amount that is labeled a dividend.

[50] *See* Dale W. Jorgenson, *Tax Reform and the Cost of Capital: An International Comparison*, 6 Tax Notes Int'l 981 (1993); David R. Tillinghast, *Corporate - Shareholder Integration as an Obstacle to the International Flow of Equity Capital*, 5 Tax Notes Int'l 509, 510 (1992).

[51] *See* ALI Integration Report, *supra* note 24, at 21; George R. Zodrow, *On the "Traditional" and "New" Views of Dividend Taxation*, 44 Nat'l Tax J. 497, 501 (1991).

(4) Making deductible payments to investors (and their associates) in their capacity as directors or employees. Small businesses in particular will be able to reduce the corporate tax base by paying salaries to owner-managers and to family members, thus achieving two benefits—a reduction in the corporate tax base and the splitting of income within the family.[52]

(5) Retaining, rather than distributing, profits. The event that triggers imposition of the personal income tax will usually be the payment of a dividend or the sale of shares.

Insofar as it is possible for the corporation's managers to delay triggering this event by retaining profits, the shareholder tax can be delayed and thus reduced.

Such incentives can lead to inefficiencies in the operation of enterprises. How significant these inefficiencies prove to be depends upon the circumstances—a more benign view of these devices regards them as self-help remedies employed by investors to alleviate the problem of double taxation informally.

These issues are symptomatic of the problems that arise whenever one legally defined form of investment is taxed at a higher rate—taxpayers will usually try to recharacterize that investment as a form taxed at a lower rate. This legal recharacterization is time consuming, expensive for the tax administration to prevent, and frequently a losing battle. These problems do not necessarily go away once taxation of equity income is limited to a single level of tax. As long as the final, effective rates of tax on different types of income from business enterprise are different, these problems will exist. While eliminating the second level of tax generally reduces the incentive to recharacterize interests to a preferred type, as long as final effective tax rates differ, the incentives will remain, albeit in a less virulent form.

That is to say, even if a system is formally designed to tax business enterprise income once, the way in which the system is designed may result in income being taxed differently depending on whether capital is in the legal form of equity or debt or lease, or on whether earnings are distributed to equity investors other than through normal distributions.

B. Profit Retention

More generally, two concerns have been expressed about the overall economic impact of the corporate tax on economic activity. One is that it tempts corporate managers to retain rather than distribute profits. The other is that it encourages the financing of investment through debt rather than equity.

The effect of the corporate tax on required rates of return and, by inference, on the cost of capital can be illustrated in the following example. Assume a corporate tax rate of 30 percent and a personal income tax rate of 40 percent. Assume also that investors have

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[52]*See supra* ch. 14, secs. IX, X.

enough other investment opportunities with the same risk profile and that the corporation needs to provide investors with an after-tax return of 6 percent to induce them to part with their savings. In these circumstances, the investment would need to offer a pre-tax return of 8.5 percent [6/(1-0.30)] if it could be financed out of retained earnings and the corporation did not need to distribute profits, 10 percent [6/(1-0.40)] if the investment were to be financed through debt, and more than 14.3 percent [6/(1-0.3)(1-0.4)] if the corporation needed to finance the investment with new equity and investors expected to receive dividends.

Not surprisingly, therefore, commentators have tried to assess the consequences of the incentive to retain profits. Insofar as retained earnings are used to finance corporate expansion, they serve as a substitute for raising that capital through formal borrowing, leasing, or further equity issues. These substitutes are likely to be conducted under the scrutiny of the market—bankers will examine the corporation's solvency and cash flow before making further loans, underwriters and investment houses will examine the prospectus for a further share or bond issue, and so on. This scrutiny is not applied when the managers of the corporation can choose how much profit to retain. The fear is that the tax system will encourage managers of existing mature companies to retain funds unnecessarily and invest in projects that are less than optimal in order to use the excess funds. These retained earnings should instead be liberated for the use of fast-growing innovative companies.[53] Some argue, however, that retained earnings are a source of additional private savings within an economy.

There is no unequivocal evidence that these outcomes have occurred systematically and that, where they do occur, it is the tax system rather than independent corporate financial policy that is the motivating cause. There are competing visions of the economic effects of these incentives. According to the so-called traditional view, the increased tax cost associated with dividend payouts is likely to be significant, and corporations will therefore tend to rely on retained earnings. When retained earnings prove to be inadequate, and corporations have to issue further equity, they will have to raise their payout ratios to meet the added tax costs, increasing their cost of capital. But an important qualification to this prognosis is the recognition that systemic factors may prevent excess profit retention from becoming a problem—nonfiscal considerations may outweigh the fiscal advantages. The market may not allow shareholder distributions to be deferred indefinitely, and shareholders may insist on receiving some return as an indication of the ongoing soundness of the corporation.[54]

An alternate vision, the so-called new view of corporate taxation, argues that because the tax disadvantages of dividend payouts are well known, corporations will indeed finance their activities largely through retained earnings. Paradoxically, however,

[53]*See generally* OECD Report, *supra* note 41, at 25; Sijbren Cnossen, *Corporation Tax in OECD Countries*, *in* Company Tax Systems 73–77 (John G. Head & Richard E. Krever eds. 1997).

[54]*See generally* Richard A. Brealey & Stewart C. Meyers, Principles of Corporate Finance, ch. 16 (4th ed. 1991); Frank H. Easterbrook, *Two Agency-Cost Explanations of Corporate Dividends*, 74 Am. Econ. Rev. 650 (1984); Merton H. Miller & Myron C. Scholes, *Dividends and Taxes*, 6 J. Fin. Econ. 333 (1978).

the higher taxation of dividends will be of little consequence.[55] According to this theory, shareholders might save the personal income tax on the dividends they would otherwise have received, but, adopting a longer-term view, they have simply converted the immediate tax on distributions into a deferred capital gains tax liability that will be triggered on the disposal of their investment. If this is so, buyers of the security will discount it to reflect the deferred liability, and so the additional tax is capitalized into the price of the share. The additional tax is a real cost that the original holder of the share will bear whether or not the distribution is paid. The buyer of the share recoups the additional tax because he or she has been able to buy the share at a reduced price, reflecting the implicit tax liability. If this new view is correct, the additional tax on distributions becomes almost irrelevant for mature companies because the existing shareholders are affected in both cases and the buyer is not affected in either case.

C. Debt and Equity

The final question is whether the corporate tax system encourages firms to finance their investments excessively through debt. If so, it is feared that firms would be vulnerable to bankruptcy in times of economic downturn and that increased numbers of bankruptcies would exacerbate the destabilization of the national economy during such a period.

Whether there is an incentive to finance new investments through debt or retained earnings, and how significant it is, will depend on the differences between the tax treatment of the investor under the personal income tax and the corporate tax—that is, the corporate tax rate on retained earnings must be compared with the personal income tax rate on interest income

In an international context, the substitution of debt for equity has additional consequences. For an individual country, it implies the diminution of the domestic tax base because the return on corporate equity is taxed in the source country through the imposition of the corporate tax on the resident corporation. The return on corporate debt, by contrast, is often taxed only in the residence country because the interest reduces the domestic corporate tax base and there will often be no withholding (or only limited withholding) on interest payments paid to another country. The result is that the investor's country of residence instead of the source country will tax the interest payment.[56]

V. Relationship Between Enterprise Income and Investor Income

A. Single Schedular Tax on Income from Capital

[55]James Poterba & Lawrence Summers, *The Economic Effects of Dividend Taxation in* E. Altman & M. Subrahmanyan (eds.), Recent Developments in Corporate Finance (1985); Zodrow, *supra* note 51; Leif Mutén, Bolagsbeskattning och kapitalkostnader (1968) (The Corporate Income Tax and the Cost of Capital).
[56]*See supra* ch. 18.

1. Equity Interests

As noted earlier, there are two basic systems for taxing income derived from an equity investment in a business enterprise. The first is to tax the income at a single rate that is applied to all investors and applied on a schedular basis to the net income of the enterprise. The second is to tax the income at different rates (typically graduated) depending on the circumstances of each investor; that is, the particular rate applied is determined by reference to the investor's total net income. Typically, then, the income from the business enterprise is added to the total net income of the investor, and the appropriate rate is applied on the basis of that total net income. Which system is chosen and how the system is implemented are exceptionally important to the operation of the enterprise income tax. A related issue is which system is used to tax income from deductible debt (or lease) investments.

Chapter 14 discusses a number of issues surrounding the choice between taxing income at schedular rates or at multiple, typically graduated, rates applied to a global income base. In addition to those issues, there is often considerable support for exempting not-for-profit organizations and pension funds from income tax. However, it should be noted that the economic and social arguments in favor of such exemptions are often less than fully convincing.[57] In addition, existing bilateral double taxation agreements might provide for varying rates of tax depending on the residency of the investor. It is, however, quite possible, and perhaps even advisable, to exempt nonresidents from any withholding tax (in addition, that is, to enterprise level tax.[58] There have also been a number of concerns that a schedular tax is less equitable than a graduated tax. However, schedular tax on income from property or capital, with a progressive tax on income from labor, has been advanced as a technique that would combine the added fairness of progressive taxation with the simplicity of schedular taxation.[59] In spite of these arguments, it might still be difficult to fully implement a policy of a single, schedular rate of tax on income from business enterprise.[60]

The main administrative benefit of a single schedular rate is that the tax can largely be levied at the company level, without reference to the investor. As will be discussed later in this chapter, in particular, when a single schedular tax rate is combined with a highly effective enterprise tax and full imputation, problems involving levying

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[57]*See* Richard K. Gordon, *Law Reform and Privatization*, 13 Boston Univ. Int'l L. J. 264 (1995)

[58]*See supra* ch. 18. The elimination of additional withholding tax on distributions ot non-residents is the system used in Singapore, for example.

[59]*See, e.g.,* 4 Carter Commission Report, *supra* note 49, at 51–57; OECD Report, *supra* note 41, at 32; U.S. Treasury Report, *supra* note 3, at 2–4.

[60]For example, the U.S. Treasury recommended a single rate of tax on all business income, primarily because it would aid in the administration of the income tax. Nevertheless, it bows to political reality by failing to recommend one at the present time. *See* U.S. Treasury Report, *supra* note 3, at 2–4.

taxes on distributions at the shareholder level more or less disappear. As can be immagined, this makes for perhaps the easiest type of enterprise-shareholder tax system to implement. There are two possible exceptions to this rule. The first involves the taxation of capital gains and losses realized by the investor when he or she sells the equity investment. However, as will be discussed, the more effective the enterprise tax, the less important the investor level capital gains tax. In such cases, one can probably exempt most investors most of the time from tax on such gains without much loss of revenue or equity.

The second exception is that, if income from each separate business enterprise is taxed on a schedular basis, the losses associated with an investor's share in an unprofitable enterprise will not be used to offset the income of a profitable enterprise. This will raise concerns of tax administration and taxpayer equity, as investors try to accomplish this offset by other means. This problem is, by and large, not completely solvable unless losses of all business enterprises are flowed through along with income. Because levying a tax on business income is designed in part to avoid having to allocate earnings and losses among equity investors, the problem of schedular taxation is shared by all separate enterprise income tax systems.

The most obvious problem with multiple rates is that discussed briefly earlier: to avoid the deferral problems that the entity tax is designed to combat, the rate of entity income tax must be the highest rate at which investors are taxed. Thus, some investors will be taxed at rates higher than the marginal rate that applies to their other income. The problem does not come up if there is a single rate of tax.[61]

A single rate of tax on all earnings from equity investments is clearly preferable from a tax administration viewpoint. The problems that need to be addressed under a multiple-rate system are discussed later in the chapter.

2. Debt and Lease Interests

Taxing *all* income, including that from debt and leases, at the same schedular rate eases administration markedly. First, one of the more difficult and complex areas in tax administration involves distinguishing equity interests from debt. While limiting taxation of income from equity investments to a single level of tax is an essential step toward equal taxation of equity and debt, it is not the only issue. If income from both equity and debt investments is taxed once, but the income from one or the other is taxed at a different rate, an incentive will still exist to design the legal form of the investment to fit

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[61]Many systems, particularly transition economies, that subject at least some business enterprise income to double taxation do so by levying a final withholding tax on the amount of the distribution, often at a rate lower than the top marginal rate of individuals. However, the rates of the final withholding tax vary among nonresident taxpayers, and the tax does not generally apply to investors that are legal persons. *See, e.g.* KAZ TC Arts. 31–33. Systems that tax enterprise income only once, at a single schedular rate, do not need to levy an additional withholding tax. *See* McLure et al., Taxation of Income from Business and Capital in Colombia 91–95 (1990). The Dominican Republic imposes a withholding tax that is essentially an advance corporate tax, because the corporation receives a credit for it. *See* DOM TC §§ 297, 299, 308.

the category of income that is taxed at that reduced rate. It is in part for this reason that the U.S. Treasury Report recommended that the income from both equity and debt investments be taxed identically, at a single schedular rate.[62] The usual administrative response to different tax treatment for income from equity and debt interests is to establish rules of "thin capitalization" or "earnings stripping."[63]

Even if the income from both debt and equity investments is taxed formally at the same rate, the method by which an entity income tax is typically levied causes the tax treatment of income from equity and debt investments to differ in some cases. This is because the general treatment of income accruing to a debt investor is to allow the entity to deduct the interest accrued or paid.[64] The deduction at the entity level ensures that the interest is not subject to tax at that level. Instead, the interest income can be taxed as income to the lender.[65] By contrast, income on equity investments is generally taxed at the entity level and perhaps also at the shareholder level.

The tax administration problem arises under three circumstances. One of these arises from the mismatching of preference income and deductions: the income of the taxpayer entity is largely tax exempt, while deductible interest (or lease) payments that can be used against income that is not tax exempt are allowed. This issue will be addressed below.[66] The others arise because of the different treatment of income from equity investment and debt investment, shareholder and creditor; even if these categories are taxed formally at the same schedular rate, they are not taxed at the same effective rate.

Deductions are clearly worth more to taxpayers who are in higher tax brackets.[67] If a deduction by one taxpayer is followed by an equivalent inclusion for another, as is generally the case with interest payments, overall taxes will be reduced if the taxpayer paying the deductible amount is in a higher rate bracket than the recipient of the payment. There will then be an incentive for those paying at the higher rate to accrue as many deductions as possible. They can then share the benefits with those paying the lower rate. Of course, if the borrowing can be structured so that a deduction by the borrower is not followed immediately by an inclusion by the lender, a tax benefit will accrue even if the lender is taxed at the same rate.

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[62]*See infra* note 88.

[63]*See supra* ch. 18.

[64]Where, in the exceptional case, interest on debt is not deducted, it will usually be capitalized into the cost of an appropriate asset, to be subtracted in calculating the gain or loss made on the disposal of the asset.

[65]See generally the discussion in chs. 14 and 16 on interest expense.

[66]*See infra* sec. V(A)(3)(A).

[67]For examples, see William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309, 337-41 (1972).

The borrowing taxpayer can structure investments in a number of ways to increase or accelerate deductions. First, the taxpayer can overstate total amounts of interest. As discussed earlier, payment of interest is directly related to risk.[68] Even if inflation risk is eliminated from taxation through adjustment,[69] differences in default risk will result in different interest rates being paid by different borrowers.[70] Therefore, it can be difficult for tax authorities to determine how much of a payment would constitute actual economic interest and how much a return of invested capital.

Debt instruments can also be designed to accelerate interest payments in early years. One way is to structure the instrument so that it pays interest through discount. The payer can then seek to accrue interest on an annual basis without including the compounding effects of the discount. Although both of these avoidance techniques can be countered with proper accounting rules for interest imputation,[71] financial product innovation has made such accounting increasingly difficult.

If, however, both the borrower and the lender are taxed at the same schedular rate on this periodic income, the incentive to shift income is eliminated. Any benefit that the debtor might derive by mischaracterizing interest in order to take a deduction when one is not legitimately due is canceled by the taxation of such income to the creditor.[72] Also, and of great importance, the schedular tax on the creditor can be levied at source.

Identical rates of schedular tax on equity and interest earnings (as well as among different types of interest)[73] would not end all problems of the allocation of payments between interest and principal or of interest over time. This is because it is impossible to effect a single, schedular tax at the entity level. Normally under an entity-level tax, losses at the entity level do not flow through to the investor.[74] Therefore, if the entity has

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[68]*See supra* sec. I.

[69]*See* vol. 1, ch. 13.

[70]Some commentators have suggested that, over the past 60 years in the United States, the real risk-free rate of return has been less than 1 percent, with an inflation risk of only 3.1 percent. With nominal interest rates for most borrowers often vastly exceeding this amount, the difference can largely be attributed to default risk. *See* Bankman & Griffith, *supra* note 30, at 337–38, 387–90.

[71]*See* the discussion regarding discounted instruments, *supra* note 13. See also the discussion of accrual accounting of interest in ch. 16.

[72]*See* the discussion of mismeasurement and accrual of interest income and its relationship to different effective rates for debtor and creditor, in Joseph Bankman & William A. Klein, *Accurate Taxation of Long-Term Debt: Taking into Account the Term Structure of Interest*, 44 Tax L. Rev. 335, 335–37, 348, 367 (1989), and in Shaviro, *supra* note 16, at 432–33.

[73]If rates differ among creditors, allocation of payments between interest and principal and temporal allocation of interest will continue to be necessary. *See* U.S. Treasury Report, *supra* note 3, at 53–54.

[74]There are possible exceptions where the equity investor might be able to realize the loss. *See infra* note 79. However, even if losses did flow through, the investor might not have enough other income against which the loss can be taken, and from which a benefit would accrue for the deduction. Although many tax

no taxable income, and if any carrybacks for current losses do not result in a refund, an interest deduction at the entity level may not be worth any current tax benefit.[75] In such cases, there will be an incentive for the creditor to reduce or eliminate interest payments by mischaracterizing interest as principal or by delaying interest deductions.[76]

There are two major reasons that an entity may have no taxable income. First, it may be a for-profit business enterprise, but have no taxable income[77] either because it has no economic income or because it benefits from tax preferences—deferral or complete exemption. If the entity has no economic income, mischaracterization of interest and principal or delay in accruing interest should not be a significant tax policy concern. The reason that the entity would mischaracterize interest and principal is that the genuine, economic loss resulting from the payment of interest could not be effectively reflected in a reduction in the tax base. Under a Haig-Simons analysis, a decline in wealth should be reflected in a decrease in the taxpayer's tax base.[78] It is only the practical operation of the entity-level tax that prevents this loss from being accrued. Therefore, with certain exceptions,[79] the equity owner is unfairly penalized for being unable to realize the value of the deduction for any interest actually accrued or paid. If there is an offsetting reduction in the tax owed by the creditor, there will be no net loss to the exchequer; any shifting of tax benefits between entity and creditor can be adjusted by the two actors. If the creditor's tax is collected through withholding at source the adjustment could be implemented quite easily.[80]

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systems permit taxpayers to carry back losses for a refund if they had paid tax in previous years, or to carry forward losses against income tax due in the future, it is likely that no existing income tax system allows for a refund for business losses if no tax has been paid in the past or if none is paid in the future. Even in the latter case, a deduction that can be taken in the future bears the loss of time value of money.

[75]There may be other reasons for an entity losing the benefit of a current deduction for interest, such as earnings stripping rules or interest "quarantining" rules governing borrowings used to finance investments in income-preferred assets. *See infra* sec.V(A)(3)(A).

[76]Of course, the benefit received by the creditor can then be shared with the entity.

[77]Including as a result of loss carrybacks. *See supra* note 74.

[78]*See generally* Stephen Lewis, Taxation for Development 57–58, 87–90 (1984); David Bradford, Untangling the Income Tax 15–43 (1986).

[79]These exceptions relate to whether the entity, or its equity investor, can realize the loss in another way. One way would be for the investor to sell his or her interest at a loss, with the loss being reflected in the interest payment or accrual made at the entity level. If this loss can be used to reduce taxes at the investor level, such as through the application of a capital gains tax at the investor level that permits the deduction of losses, then the value of the interest deduction can, in fact, be used.

[80]This also raises the question of deductibility of interest by the physical person investor or flow-through entity on debt to acquire equity interests in entities subject to separate taxation. *See supra* ch. 16, sec.VI(A).

Second, the entity may be a governmental, charitable, or other entity that is statutorily exempt from tax.[81] Pension funds are also typically exempt from income taxation. The problem posed by exempt entities may be reduced by taxing them on their investment income, which may well be advisable from a purely economic perspective as well. Such taxation would create a tax base from which the entity could deduct interest expenses.[82]

It is also possible that there is economic income at the entity level, but that this income is "tax preferred", such that no tax is currently due. The preference can be intentional; for example, provisions in the law may exempt some income from tax, tax some income at a lower rate, or delay the inclusion of some income until a later time. Some income may be unavoidably subject to a timing preference because of the deferral of tax on unrealized capital gains. In these instances, there will also be an incentive to understate deductions at the enterprise level, so as to have a mirror understatement of income at the creditor level. Unlike the earlier case, the tax administration should be concerned about understatements of income tax at the creditor level.

These problems can be minimized by reducing or eliminating special tax benefits. However, if a realization system of taxation is retained for most capital gains, the problems will never be eliminated, although this chapter will argue that the distortions caused by the realization event system can be greatly minimized by marking certain financial assets to market, and by taking into income currently total borrowings in excess of the total adjusted cost of assets. However, if these ideas are not implemented or only partially implemented, the tax administration will have to ensure that interest accrues to the creditor.

As noted earlier, it is difficult to impute interest on debt whenever a risk premium is due. It is also increasingly difficult to impute interest on many financial instruments. One possible solution is to require a minimum imputation of interest on all debt instruments, based on the amount of capital invested. This minimum imputation could be based on a provision in the income tax code that would give the tax administration the authority to impute an interest component on any debt obligation of a legal person.[83]

One possible technique for more completely equating the tax treatment of income from equity and debt might be to extend deductibility treatment to returns on equity investments. Some proposals have arisen in the past to do so, particularly to partially

[81]*See infra* appendix A.

[82]The general issue of taxing otherwise exempt entities on their investment income is discussed *infra* in appendix A.

[83]*See*, *e.g.*, USA IRC §§ 7872, 462(a) and (g). Continental systems such as the French and German have separate, although general, rules for imputation of interest income for legal and for physical persons, as well as specific rules for imputation of interest between or among related parties. *See* chs. 14, 16.

integrate entity and investor taxes.[84] Extending deductibility treatment would not solve the problems discussed above. If the entity had no taxable income, there would still be a benefit to the debt investor and therefore, by extension, to the equity investor who might share the benefit. However, with regard to distributed income, equivalent treatment would certainly prevail. No major income tax system currently affords such treatment, for a number of reasons. Two of the most important are the passing along of foreign tax credits to investors and the treatment afforded nonresident equity investors under most double taxation agreements.[85] Dividend deduction models are largely missing from the world tax scene.

Some have suggested that equation of treatment could be reversed; instead of allowing a deduction for payments of earnings on equity investments at the enterprise level, deductions for interest expense could be disallowed. The 1991 U.S. Treasury Report on integrating company and investor taxes recommended taxing income from both equity and debt investments entirely at the entity level by denying a deduction for interest payments. This would turn the entity tax into a comprehensive business income tax.[86] The problems of understating interest or delaying its payment or accrual would disappear in that the interest deduction would no longer formally be part of the income tax system. However, the net economic result would be the same; the recipient would be able to defer tax on interest income when the entity had economic, but not taxable, income.[87] Once again, the obvious answer is to, where possible, apply a system whereby taxable and economic income most closely approximate each other.

Eliminating deductions for interest could be a technique for ensuring that, at least with regard to interest accrued, such payments would be taxed at the same rate, that is, the entity rate. In this sense, disallowing deductions is analogous to integration schemes that tax entity income only and exempt the distribution from tax at the shareholder level. Such treatment would certainly reduce debt-equity and earnings-stripping problems. However, such a system has not yet been attempted in any major tax jurisdiction (except partially, as part of a regime to prevent earnings stripping.)[88] Once again, much of the

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[84]In 1984, the U.S. Treasury recommended a 50 percent deduction for dividends, *see* Treasury I, *supra* note 3, at 136–37, while the White House recommended a 10 percent deduction, *see* Treasury II, *supra* note 3, at 122–26.

[85]*See supra* ch. 18. A deduction for an imputed return on equity is allowed in Croatia. *See* HRV PT §§ 7–9; Manfred Stöckler and Harald Wissel, *Die Gewinnbesteuerung in der Republik Kroatien*, Internationale Wirtschafts-Briefe 527 (June 14, 1995).

[86]The comprehensive business income tax would levy tax on a schedular basis at the entity level on both debt and equity investments by denying a deduction for interest, levying a single tax on entity income, and exempting from tax at the investor level both equity distributions and interest payments. U.S. Treasury Report, *supra* note 3, at 39–58.

[87]This would be because, without accrual of taxable interest to the creditor, no tax would be levied on that interest.

[88]See the discussion regarding earnings-stripping provisions in chs. 16, 18.

reason for this may stem from the existence of double taxation agreements and the problems that would arise if all interest income were effectively taxed to nonresidents at the enterprise rate of tax, rather than at the rates specified by those agreements.[89] However, treating interest in this way is logically consistent with taxing equity income only at the entity level and—if a decision is made to tax income from capital at a single rate and if the international dimensions can be negotiated—may constitute the easiest system of entity taxation to administer.

3. *Treatment of Preferred Income*

A. DEDUCTIONS FOR INTEREST EXPENSE

As noted earlier, problems arise with regard to the like tax treatment of debt and equity, or of different types of debt and different types of equity, when the entity has tax-preferred income. The tax effect on the equity investor may also be problematic. If the tax on the "preferred" income is deferred or if this income is tax exempt, there will be an incorrect tax result, either a reduction in tax (because of the time value of money) or a complete exemption. However, the taxpayer may be able to finance the investment with borrowed money. Normally, the payment or accrual of interest leads to a real decline in wealth. As noted earlier, under a Haig-Simons analysis, a decline in wealth should be reflected in a decrease in the taxpayer's tax base.[90] However, a taxpayer with no taxable income cannot benefit from the deduction. The benefit of the exclusion afforded the taxpayer on the preferred income would be reduced by the denial of interest deductions. While it is unlikely that denying the interest deduction would have the same effect as the benefit afforded through the preferred income, it would have the effect of a partially compensating disallowance.[91] However, if the taxpayer has other *taxable* income, the taxpayer may use the interest deductions against this income, thereby avoiding tax on this income as well.[92] The effect would be to eliminate the (only partially) compensating distortion caused by the inability to benefit from the deduction of interest, which may compound the problem of having preferred income in the first place.

Tax policy analysts normally recommend for reasons of economic efficiency and administrative ease, eliminating tax preferences whenever politically possible. If all preferences were eliminated, in theory at least, this mismatching problem would cease to exist. And, although many tax systems have attempted to travel far in the direction of eliminating preferences, the problem of tax deferral under the mixed accrual/realization

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[89]Moreover, problems may arise in applying a foreign tax credit for the creditors. See the discussion of these regimes in ch. 18.

[90]*See supra* note 78.

[91]To do so is to "to achieve a second-best state through the creation of compensating distortions." Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 Harv. L. Rev. 925, 983–84 (1967).

[92]*See* Shakow, *supra* note 33, at 1165.

event system of accounting is unlikely to go away entirely. This means that a taxpayer can borrow against assets that have appreciated in value, but on which the gain has not been taxed, while still being able to deduct interest. This situation has been described as allowing the taxpayer to "realize" the gain (by borrowing against it) without having to pay tax on it.[93]

Chapter 16 discusses techniques of "quarantining" or otherwise disallowing interest deductions when they relate to the financing of tax-preferred income.[94] An alternative approach is to recharacterize not the deduction of interest, but the borrowing itself.

As noted earlier, tax-preferred income can take a number of different forms, the main ones being statutory incentives (which the legislature can avoid enacting) and preferences related to the realization event (which are difficult to avoid). The benefit of the latter is not permanent, but is related to timing. In effect, by delaying the taxation of accrued gains, the taxpayer benefits from the time value of the deferred tax. When the taxpayer realizes the gain by selling or transferring the gain asset, tax is incurred; obviously, if possible, the taxpayer would prefer to avoid such a taxable event.

However, if the taxpayer needs cash, he or she can instead borrow the money. In effect, borrowing the money is analogous to selling or transferring the asset. Instead of quarantining interest by disallowing a deduction in a "compensating distortion," it would be possible to treat the borrowing as a realization event, at least to the extent that the borrowing exceeds the adjusted cost (book value or written-down value) of the asset. If the borrowing is secured by a single asset, the amount of gain could be determined on the basis of that asset alone. To the extent that the borrowing is not secured by a single asset, the amount of the gain could be determined on the basis of all assets held by the taxpayer.

For example, if the taxpayer holds a single asset with an adjusted cost of $10 and borrows $20, he or she would include $10 in taxable income. The asset's cost basis would be increased to $20, and the full amount of interest due on the $20 debt would be deductible. If the taxpayer has a large number of assets, with a total adjusted cost of

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[93]Although there is also a shift in risk to the lender. *See* Shaviro, *supra* note 16, at 442–43.

[94]As ch. 16 discusses, many jurisdictions limit interest deductions for financing tax-preferred income. The U.S. Internal Revenue Code provides for one of the most exhaustive limits on interest deductibility. *See* USA IRC §§ 56(b)(1)(C) (limitation on interest deduction for purposes of minimum tax); 163(d) (limitation on deduction of interest on investment indebtedness); 170(f)(5) (limitation on deductibility of interest on debt incurred to purchase or carry bond given to charity when interest relates to period during which donor is not taxed on income from bond); 264 (disallowance of deduction for interest on indebtedness related to insurance contracts); 265 (disallowance of deduction for interest on indebtedness related to tax-exempt income); *cf*. USA IRC §§ 263A(f) (capitalization of construction-period interest); 246A (limitation on dividends received deduction for debt-financed portfolio stock); 291(e)(1)(B) (partial disallowance as tax preference of interest on debt incurred by financial institutions to purchase or carry tax-exempt bonds); 1277 (deferral of interest deduction allocable to accrued market discount); 1282 (deferral of interest deduction allocable to accrued discount); 7701(f) (regulations to be prescribed to prevent avoidance through related parties of provisions that deal with linking borrowing to investment).

$100,000, and borrows $200,000, he or she would include $100,000 in income, and the adjusted cost of all assets would be increased by $100,000. However, because each individual asset would have to be adjusted, the $100,000 increase would have to be apportioned among all the assets, for example, on a proportional basis.[95]

Although no jurisdiction currently treats borrowing as a realization event, the logic of such an approach seems compelling. It would have additional benefits with regard to taxing economic earnings at the entity level that are distributed to the equity investor; this issue will be dealt with at greater length below.

In addition to this technique, other accounting methods can be used to reduce the amount of accrued but unrealized capital gains (and losses as well). The most important of these is to require enterprises to mark assets to market whenever reasonable. In particular, such marking to market could be done for foreign exchange, precious metals, and securities and financial derivatives for which a listed price could be easily obtained.

B. TAXATION OF EQUITY DISTRIBUTIONS FROM PREFERENCE INCOME

Tax-preferred income of flow-through entities can normally be distributed to the investor without any immediate additional tax consequence, although typically there are consequences for the taxation of capital gains and losses when the entity interest is transferred.[96] For investors in entities without flow-through treatment, similar tax rules could apply; all income tax would be levied at the entity level on the preferred income.[97] If the preferred income were of the permanent, or exclusion variety, no tax would ever be paid. If the preferred income were of the deferral type, tax would be paid when the preference expired at the entity level.

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[95]Using the formula: amount of increase in adjusted cost of a particular asset = adjusted cost of the particular asset/sum of adjusted costs of all assets X total increase of adjusted cost of all assets. Such a formula is used in the United States when a company is purchased through the sale of its shares. To ensure that the adjusted cost of the assets of the company equals the adjusted cost of the shares of the company, the company may "step up" the adjusted cost of its assets. *See* USA IRC § 338(a) and (b)(1), (4), and (5). *See also* Treas. Reg. §§ 1.338-3(b), 1.338-4. See also the discussion of related issues in ch. 20. This ensures that gain on the assets is paid only once and results in better correlation of what the Americans call "inside basis" (the adjusted cost of assets held by the enterprise) and "outside basis" (the adjusted cost of the equity interests in the enterprise). *Cf. infra* ch. 21, sec. II(G). Such a system of comparing total adjusted costs of assets with total borrowings can perhaps be more easily implemented if the balance sheet method of entity taxation is used. *See supra* ch. 16. In fact, an adjustment for an increase in adjusted cost for each individual asset can be analogized to the balance sheet inflation adjustment described in vol. 1, ch. 13.

[96]Typically, the adjusted cost of the entity equity interest is reduced by the distribution. Once the adjusted cost drops to less than zero, the difference between the cost and zero may be included in income. When the equity interest is transferred, there may be a taxable capital gain (or loss) on the transfer. *See* ch. 21.

[97]Once again, excluding the issue of taxing capital gains and losses on the transfer of an entity interest.

Such tax treatment of the distribution of preference income to equity investors is extremely rare.[98] In the vast majority of jurisdictions, tax is levied on distributions out of income that was not already fully subject to tax at the entity level. Tax can be levied in various ways, and those variations have considerable effect on the administration of the tax (see discussion below). However, levying tax on such untaxed income has two basic and important effects on tax administration, one somewhat positive and one quite negative. Therefore, before examining the specific effects of different forms of implementation, we discuss why distributions of preference income should be taxed in the first place.

Various arguments have been raised as to why distributions from preference income should be taxed.[99] One reason is that specifically enacted tax preferences may have been designed to encourage investment. Whenever a business entity distributes such income, the implication may be that it is to be used for consumption and not for investment. Therefore, a tax should be levied. Another argument, which applies only to systems that tax all distributions of *economic* income not previously taxed, is that any income arising from timing preferences that can be realized without otherwise incurring entity income tax (primarily through borrowing) should be taxed as if the distribution were a realization event. Finally, if equity holders are taxed at different rates, distributions should always be subject to tax to ensure that a higher-rate investor will pay tax at the higher rate on such distributions.[100]

Again, of course, these problems are reduced, or may disappear entirely, as the amount of preference income is curtailed or eliminated.

B. Multiple Taxes on Income from Capital

A single schedular tax on capital income derived through legal persons may be considered unacceptable for a variety of reasons, not the least of which is the difficulty of finding an acceptable single rate. The “conduit view” is not fully implemented if the single tax rate imposes higher tax burdens on low-income investors or reduces the tax burden of high-income investors.[101]

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[98]One of the few examples is the treatment afforded partnerships (and similar legal forms) in Indonesia. IDN IT § 4(1).

[99]*See* U.S. Treasury Report, *supra* note 3, at 18–21; ALI Integration Report, *supra* note 24, at 58–66.

[100]*Id*.

[101]Although this section focuses on the relationship between individual investors and legal persons, the issues discussed below and the choice of mechanism also arise when the investment is made through the mediation of another legal person. In other words, these kinds of mechanisms are even more necessary to prevent the cascading of corporate taxes and dividend withholding taxes as corporate earnings are passed through a chain of corporations to the individual who is the ultimate investor.

Consequently, many countries find it necessary to operate in tandem both the enterprise-level profit tax and the investor-level personal income tax. This section reviews some of the more commonly used options for reducing or eliminating the double taxation of capital income that these systems can induce. It describes in detail some of the principal interaction mechanisms between the enterprise and personal income tax used in the taxation systems of various countries. Except for one case, the interaction mechanisms attempt to deal only with the double tax on distributions and leave untouched the double tax on retained corporate profits.[102] Given that the issue they try to resolve is the double taxation of equity, they deal only with returns on equity investments, not interest or rent.

Even with these restrictions, it is common to see a wide variety of idiosyncratic mechanisms for integrating the enterprise and individual tax, and so this section will describe the most important features of a few representative types seen in practice.[103] The design of these interaction systems involves many issues, but the most important are the following:

- The level at which the relief is to be provided. The mechanism for reducing double tax on dividends can operate at either the enterprise or the shareholder level.

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[102]The after-tax return to the shareholder will depend significantly upon the form in which profits are made available to shareholders: cash distribution, distribution of enterprise assets in lieu of cash, allotment of new shares paid for from profits, redemption of existing shares paid for from profits, retention of profits, and so on. In the following discussion, it is assumed that the enterprise's managers choose only the first and last alternatives, distributing some fraction of the enterprise's profits as cash and retaining any balance for reinvestment. It will also be assumed that the cash distribution is not a liquidating distribution (or that, if it is, the distribution is dealt with in an identical manner to a cash distribution).

It is also assumed that all distributions made are taxable so as to prevent managers from recharacterizing detected evasion as the return of capital to shareholders. This assumption accords with the probable wish of the enterprise's managers that shareholders believe that the distribution is from profits, not a return of their investment.

[103]There is a voluminous body of literature on this issue. For descriptions of various methods of interaction and differing taxonomy, see generally 4 Carter Commission Report*, supra* note 49, at ch. 19; Blueprints, *supra* note 3; OECD, Company Tax Systems in OECD Member Countries 9–11 (1973); Alvin C. Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 Harv. L. Rev. 719 (1981); George F. Break, *Integration of the Corporate and Personal Income Taxes*, 22 Nat'l Tax J. 39 (1969); Charles E. McLure Jr., *The Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 Harv. L. Rev. 532 (1975); Charles E. McLure Jr., *Integration of the Income Taxes: How and Why*, 2 J. of Corporate Tax'n 429 (1976); Charles E. McLure Jr., Must Corporate Income Be Taxed Twice? (1979); J. Pechman, Federal Tax Policy 179–89 (5th ed. 1987); Richard M. Bird, Taxing Corporations (1980); Martin Norr, The Taxation of Corporations and Shareholders (1982); OECD, Theoretical and Empirical Aspects of Corporate Taxation, chs. 1, 2 (1973); Martin Feldstein, Capital Taxation, ch. 8 (1983); Congressional Budget Office, Revising the Corporate Income Tax, ch. 8 (R. Lucke ed., 1985); Julian Alworth, *Piecemeal Corporation Tax Reform: A Survey, in* The Political Economy of Taxation 72–73 (Alan Peacock & Francisco Forte eds., 1981); Alan J. Auerbach, *Debt, Equity and the Taxation of Corporate Cash Flows, in* Debt, Taxes and Corporate Restructuring 108–26 (John B. Shoven & Joel Waldfogel, eds. 1990); R.A. Musgrave & P.B. Musgrave, Public Finance in Theory and Practice 395–98 (4th ed., 1984); Richard J. Vann, Eliminating the Double Tax on Dividends: Legal and Practical Issues, chs. 4, 5 (1986); Sijbren Cnossen, *Alterna*tive Forms of Corporation Tax, 1 Australian Tax Forum 253 (1984); Peter Harris, Corporate/Shareholder Income Taxation (1996).

- The form that the relief is to take. Generally, the options are to use a tax deduction, a tax credit or an exemption system. A subsidiary issue is whether the application of relief is to be made conditional upon some tracking or verification of other tax payments.
- Whether the relief is to be afforded to nonresident shareholders. The extent to which nonresidents can be further burdened, especially by withholding taxes, will often be controlled by any applicable tax treaties, but the extent to which they may be benefited is largely a matter for domestic law.[104]
- Whether relief is to be afforded to income from equity investments derived by tax-exempt investors.
- Whether different types of shareholders are to be treated differently. These mechanisms often distinguish corporate from individual shareholders, and resident from nonresident shareholders, but other possible distinctions might differentiate holders of controlling interests from holders of portfolio interests.
- The treatment of corporate tax preferences. Tax preferences can be preserved in full for the benefit of shareholders, be preserved but at a reduced value, or be recaptured entirely at the shareholder level.
- The treatment of foreign-source income. This income can be viewed as raising issues similar to those surrounding corporate tax preferences. In both cases, domestic corporate tax is not paid on income that is to be distributed or retained (although for foreign-source income, some foreign tax may well have been paid), but the arguments about imposing tax on the distributions are slightly different.

The analysis concentrates on the major aspect of the problem and the topic of this chapter—the treatment of income earned by resident individual shareholders—but is expanded, where relevant, to examine the position of nonresident individual shareholders and income earned by intermediaries, such as other enterprises.[105]

The idiosyncrasies of the mechanisms that countries have adopted (not to mention the peculiarities of nomenclature[106]) make it difficult to generalize. Nonetheless, once the classical system is abandoned, the mechanisms for recognizing the impact of both enterprise- and shareholder-level income tax can be combined into a few illustrative

[104]If nonresidents are not to benefit, there may be an issue about whether denying benefits to nonresidents is allowed under the tax treaties of the country. Many tax treaties will contain rules prohibiting discrimination against the nationals of the other treaty partner, and it is a matter of debate whether this denial would breach the nondiscrimination provisions of the treaty. The United Kingdom deliberately chose to implement its interaction mechanism at the enterprise level to avoid this issue.

[105]Many jurisdictions will use a combination of systems—using one for individuals another for corporations or other intermediaries, and yet another for nonresident shareholders. For example, the United States employs a classical system for individual shareholders and a partial dividend-received deduction system for corporations; Canada employs an imputation system for individual shareholders and a full dividend-received deduction system for corporations; Australia employs an imputation system for individual shareholders and a tax credit system for corporate shareholders.

[106]*See* Messere, *supra* note 41, at 342–43 (lamenting the imprecise usage in this area).

groups: split-rate systems and dividend-paid deduction systems, dividend-received exemption or dividend-received deduction systems, dividend-imputation systems, and full integration systems.[107] The first three are often referred to as systems for dividend relief—adjusting the combined tax rate on distributions—while the last, integration, is more ambitious— reducing the combined tax rate on all enterprise profits.

Table 1. Interaction Systems

Classical System	**Dividend Relief System for Distributed Profits**				**Integration System for All Profits**
	Corporate level		***Shareholder level***		
	Dividend-paid deduction system	Split-rate system	Dividend-received exemption / deduction system	Imputation system	

There are virtues and vices to each interaction system, which explains why a standard regime has not emerged.[108] To illustrate, systems that reduce the enterprise's primary tax liability (such as dividend-paid deduction systems) will benefit both resident and nonresident shareholders equally, a result the source country may dislike.[109] Systems

[107]Even the number of interaction mechanisms is a matter for debate. *See* Pechman, *supra* note 103, at 175–81 (who says there are five groups but lists six); OECD, Company Tax Systems, *supra* note 103, at 10 (which lists three). The discussion will not pursue some of the more unusual types of interaction mechanism that have been proposed at various times but not yet implemented.

[108]For example, the U.S. Treasury praised the imputation systems for their "flexibility to respond to different policy judgments on the most important issues of integration." U.S. Treasury Report, *supra* note 3, at 93. The systems may also be seeking objectives beyond those described above as the defects of the classical system, and possibly also objectives different from each other. For example, it is claimed that imputation systems in Europe were introduced to encourage more people to hold shares, to increase compliance with the corporate tax, and to encourage capital-export and capital-import neutrality within the European Union. *See* Bird, *supra* note 103, at 232–35; Harry G. Gourevitch, *Corporate Tax Integration: The European Experience*, 31 Tax Lawyer 65 (1977); Hugh J. Ault, *Introduction*, *in* Imputation Systems—Objectives and Consequences 10 (Hugh J. Ault ed., 1983) ("it was generally hoped that a more favorable treatment of dividend distributions would increase investment in corporate stock, especially on the part of small investors"); Cnossen, *The Imputation System in the EEC, in* Comparative Tax Studies: Essays in Honor of Richard Goode 85, 105 (S. Cnossen ed. 1983) ("it seems desirable that shareholdings be spread more widely than is the case at present. The imputation system might promote that objective."). The different goals that various interaction mechanisms may be pursuing are most apparent in the more unusual systems suggested, such as the Institute of Fiscal Studies' ACE system, which creates a notional deduction to the corporation for the value of shareholder equity employed by the corporation, with the principal objective of equalizing the return to investors on debt and equity. *See* Institute for Fiscal Studies, Equity for Companies: A Corporation Tax for the 1990s (1991); *see also supra* note 85. The U.S. Treasury report set out with the explicit goals of retaining the implicit tax collected at the corporate level on tax-exempt investors, taxing business income only once (rather than in two offsetting installments). U.S. Treasury Report, *supra* note 3, at 13.

[109]Cnossen, *supra* note 108, at 92, for example, notes that "under the imputation system the double tax is mitigated at the level of the shareholder. It would also have been possible, of course, to provide relief at the corporate level by providing a deduction for dividends paid in computing taxable profits.... This

that reduce the enterprise's primary tax liability would also reduce the implied tax paid at the enterprise level by tax-exempt investors.[110] Dividend-paid deductions would need to be targeted to deny the tax benefit when distributions are paid to tax exempt entities or nonresidents if the double taxation of dividends is to be sustained for these groups. Dividend-received deduction systems and some imputation systems will not ensure that the enterprise has actually paid any tax on the dividend received by the shareholder although they do preserve the full nominal value of enterprise tax incentives for shareholders.[111] Some systems can result in overtaxation of the enterprise when the tax collected exceeds the enterprise's own tax liability, while others require elaborate record keeping.[112] Integration systems, which tax shareholders on the value of retentions, can cause solvency problems for individual shareholders when distributions are small but profits are large and are generally considered impractical for large corporations in part because of the difficulties of administering them[113] and because the substantial international treaty network assumes that nonresident shareholders are not currently taxed on retentions.[114]

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avenue, which should yield the same result as imputation, has not been followed, however, because governments did not want foreign shareholders to share automatically in the relief." *See also* Bird, *supra* note 103, at 232–35, 239; OECD, Company Tax Systems, *supra* note 103, at 23–30; U.S. Treasury Report, *supra* note 3, at ch. 7.

[110]This latter concern seems to have played a major role in the decision of the U.S. Treasury to suggest a dividend-exemption system, because it collects at least some tax from otherwise exempt investors. U.S. Treasury Report, *supra* note 3, at ch. 6.

[111]Reuven S. Avi-Yonah, *The Treatment of Corporate Preference Items Under an Integrated Tax System: A Comparative Analysis*, 44 Tax Law. 195 (1990); Pechman, *supra* note 103, at 180; U.S. Treasury Report, *supra* note 3, at 93 ("an imputation credit can extend the benefits of integration to tax-exempt and foreign shareholders by allowing refundability of imputation credits or it can deny such benefits by denying refunds").

[112]This is particularly true of the imputation systems in Australia, France, and Germany. *See* Avi-Yonah, *supra* note 111, at 214 ("as the German example shows, however, tracking of income can lead to very complicated account-keeping requirements").

[113]*See* Pechman, *supra* note 103, at 179 ("experts agree that it would not be practical to extend the partnership method to large, publicly held corporations with complex capital structures, frequent changes in ownership, and thousands or millions of stockholders"); Auerbach, *supra* note 103, at 105 (describing proposals for integration as "pure in concept, ambitious in scope, and unadopted in practice"); 4 Carter Commission Report, *supra* note 49, ch. 19 (recommending an optional profit-attribution system because of the solvency and administrative problems); Vann, *supra* note 103, at 30–34.

Some others believe that these administrative difficulties have been overstated. John G. Head & Richard M. Bird, *Tax Policy Options in the 1980s*, *in* Comparative Tax Studies 16 (Sijbren Cnossen ed., 1983) ("although the difficulties are considerable, there appear to be no insuperable problems"); Anthony P. Polito, *A Proposal for an Integrated Income Tax*, 12 Harv. J. L. & Pub. Pol. 1009 (1989); Peter L. Swan, *An Australian View on Integration*, *in* Taxation Issues of the 1980s (J.G. Head ed., 1983). It is interesting to note that the U.S. Treasury considered even an imputation system unnecessarily difficult to administer. U.S. Treasury Report, *supra* note 3, at 93.

[114]*See* 4 Carter Commission Report, *supra* note 49, ch. 19.

Not surprisingly, therefore, in a 1993 study, the OECD found representative types of almost all possible systems among the corporate tax systems of its (then) 24 member countries (see Table 2 for a classification of the systems then existing).

Table 2. Degree of Reduction of Economic Double Taxation (Central Government

None or very little	***Reduction of economic double taxation***				***Elimination of economic double taxation***	
	Corporate level		Shareholder level		Corporate level	Shareholder level
Classical System	Split rate system	Partial dividend deduction system	Partial imputation system	Partial shareholder relief schemes	Zero rate system	Full imputation system
Belgium	Germany	Iceland	France	Austria	Greece	Australia
Luxembourg		Spain	Ireland	Canada	Norway	Finland
Netherlands		Sweden		Denmark		Germany
Switzerland				Iceland		Italy
United States				Japan		New Zealand
				Portugal		Turkey

Source: OECD, Taxation in OECD Countries Table 9, at 67 (1993).

The variety of interaction systems that existed in 1993 suggests that the effects of each system on the after-tax returns to shareholders and the cost of enterprise capital will differ. This section analyzes the classical system and four systems of enterprise and shareholder interaction. The models described are stylized to capture the fundamental relationships of the systems discussed, rather than being precise descriptions of the exact rules employed in any particular jurisdiction.

1. Separate (or Classical) System of Enterprise Tax

The pure classical system is declining in industrial countries' tax systems.[115] Among the countries of the EU, Belgium, the Netherlands, Luxembourg, and Sweden[116] retain the classical system, but only for distributions to individual shareholders.[117]

[115]The United States is the most obvious example of a country that still retains the classical system for individual shareholders, although even it has had a fully integrated system for small corporations in Subchapter S of the Internal Revenue Code 1986. But in respect of larger corporations with more than one class of shares, non-resident shareholders or passive income, the United States moved clearly against the current trend toward interaction in 1986 by eliminating the $100 dividend-received deduction for individual shareholders. IRC § 116 (repealed). The United States also reduced the size of the deduction for corporate shareholders in some cases from 80 percent to 70 percent of dividends received depending upon the degree of affiliation between the companies. For corporate shareholders, the United States still retains the dividend received deduction system; IRC § 243. For a discussion of the Netherlands and Luxembourg, see J-M Tirard, Corporate Taxation in EC Countries, 1990–91, at 12–13 (1991).

[116]Sweden, inspired by the full imputation systems applied in Finland and Norway, exempted dividend income in the hands of shareholders in 1994, only to restore the full classical system (without the previous partial deduction system) from 1995.—L.M.

A. RESIDENTIAL INDIVIDUALS

In a pure classical system, there is no formal interaction between the enterprise and individual income taxes, and each is levied without explicit regard for the operation of the other. But even in a classical system, there may be implicit recognition of the dual operation of both taxes in the rate imposed under either tax or in the definition of its base. For example, a lower marginal rate imposed upon an individual's capital income or substantial investment concessions offered to industry may each be a method for recognizing the existence of the two layers of tax. The first reduces total tax by encouraging retention of profits by the enterprise and extraction of gain by the individual selling the shares, while the second reduces the total tax collected from the enterprise [118]

The first option can be seen in the following example.

Example

Assume that the enterprise tax rate is 33α percent, the top marginal rate under the personal income tax is 50 percent, and dividends are taxed at a flat rate of 25 percent imposed on individual shareholders (or perhaps collected by withholding at source). This rate alignment offers a good approximation of the after-tax return [$100*(1-0.33)(1-0.25) = $50.25] that would be earned if the income from the investment had been earned by a high-income shareholder directly [$50].

Such a system would probably, however, have several serious consequences. First, it might discourage distributions of enterprise profits—indeed, some rule would probably be needed to oblige distributions. If distributions were not obliged, serious strain would be placed on the administration of the capital gains tax as the means of collecting the deferred tax on retained earnings. It would also deliver a sizable benefit to tax-exempt institutions because the enterprise tax is the principal tax that they pay on capital income.

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[117]*See generally*, OECD Report, *supra* note 41, at 9–41; McLure, Must Corporate Income Be Taxed Twice?, *supra* note 103, ch. 3.

[118]*See* Myron S. Scholes & Mark A. Wolfson, Taxes and Business Strategy 56–57 (1992).

The position of a shareholder in such a system can be expressed algebraically as follows. Under the classical system, the enterprise pays tax (T_c) on its taxable profits (P), and the individual resident shareholder pays income tax (T_i) at progressive marginal rates on the proportion (d) of after-tax profits distributed by the enterprise as dividends. Retained profits ($1 - d$), reflected as accretions to the value of the shares, are taxed as capital gains (T_g) on a deferred basis when the shares are sold by the shareholder, and are sometimes taxed at a lower nominal rate.[119] Given an enterprise tax system bearing these features, the return (R) to an individual shareholder after payment of enterprise tax on all profits and personal tax on distributions and retentions is[120]

$$R = dP(1 - T_c)(1 - T_i) + (1 - d)P(1 - T_c)(1 - T_g).$$

B. PREFERENCE INCOME

Because the enterprise and the shareholder are taxed separately, this system applies also to distributions of untaxed income, such as income that enjoys tax preferences or foreign-source income that is not subject to tax in the residence country.[121] Earnings that are untaxed or not fully taxed at the enterprise level would, nevertheless, be subject to full shareholder tax:

$$R = dP(1 - T_\mathrm{i}) + (1 - d)P(1 - T_g).$$

C. NONRESIDENT SHAREHOLDERS

As the example illustrates, one can achieve the same result as under conduit treatment by reducing the enterprise rate below the top individual rate and imposing a withholding tax on distributions. Another reason for adjusting the personal tax rather than the enterprise tax is the position of nonresident shareholders. For nonresidents, the enterprise tax rate is an important determinant of the total tax that they will pay to the source country, and reducing it will confer a substantial benefit on them. Treaties generally allocate the enterprise tax to the source country and limit its ability to impose substantial withholding taxes on payments to nonresident shareholders.[122] Consequently,

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[119]The effect of deferral is the same as formally imposing a lower rate, or as the revenue authority's making an interest-free loan of the unpaid tax to the taxpayer. Hence, the discussion will treat (T_g) as being a rate less than (T_i), even though this may not appear formally to be the case.

[120]Robert R. Officer, *The Australian Imputation System for Company Tax and Its Likely Effect on Shareholders, Financing, and Investment*, 7 Aust. Tax F. 353, 376–77 (1990).

[121]To facilitate the discussion, foreign income will be called "not taxable" as a shorthand reference to the results of the system for eliminating double tax on foreign-source income. Most countries will have in their domestic laws (and supplemented by international double tax treaties) either a credit system to reduce domestic tax on foreign income or a formal exemption system for foreign income. When foreign income has been comparably taxed at source, and either of these domestic system applies, the result is that no further residence country tax will be imposed on the income.

[122]*See* Article 10, Model Tax Convention on Income and on Capital, OECD Committee on Fiscal Affairs, Organization for Economic Cooperation and Development, Paris (updated as of Sept. 1, 1995[hereinafter OECD Model Treaty]. *See supra* ch. 18.

a country's treaties and the international norms for taxing enterprise income will most likely make it impossible for the country to impose substantial additional taxes on a nonresident shareholder to compensate for a low enterprise tax rate.

2. Dividend-Paid Deduction System

A dividend-paid deduction system operates at the enterprise level to impose different rates on an enterprise's distributed and undistributed profits. The system achieves this result by giving to the enterprise a tax deduction for distributions made and then imposing tax on the distribution at the shareholder level.[123] A tax deduction for distributed profits means that the profits incur no tax at the enterprise level and are effectively taxed as if they were payments of interest by the enterprise.[124]

A. RESIDENT INDIVIDUALS

Under a dividend-paid deduction system, the enterprise is able to reduce its taxable profits by the amount of any distribution. The enterprise therefore pays no tax on distributed profits, but pays tax at the enterprise rate on retentions. This system has some of the same effects as a split-rate system (discussed below) under which the rate on distributed profits is set at zero. The individual shareholder who is a resident pays income tax at marginal rates on the proportion of profits distributed by the enterprise as dividends, and any retained profits already taxed to the enterprise are taxed as a capital gain on a deferred basis to the shareholder. No deduction or tax credit is given to the shareholder for taxes paid by the enterprise. The after-tax return of an individual shareholder after payment of enterprise tax on all profits and personal tax on distributions and retentions is

$$R = dP(1 - T_i) + (1 - d)P(1 - T_c)(1 - T_g).$$

Again, tax-exempt investors will benefit from the elimination of all tax on distributed earnings.

[123] *See* Norr, *supra* note 103, at ch. 5/C. Before June 1992, Greece, for example, had a dividend-paid deduction system. Tirard, *supra* note 115, at 102–03. A dividend-paid deduction system is used in Iceland and Hungary and was used in the United States in 1936–37. *See* Cnossen, *supra* note 103, at 54–55; Pechman, *supra* note 103, at 176–77.

[124] *See* Cnossen, *supra* note 103, at 92 (noting that the effect of a dividend deduction system is to treat equity as debt, giving the enterprise a deduction for its dividend payments as it does for its interest payments).

B. PREFERENCE INCOME

Other forms of untaxed income, such as income enjoying tax preferences or foreign-source income that is not taxable in the residence country, would be subject to enterprise tax only if retained.

Example

Assume a corporation has operating profits in the current year of $30,000, but taxable profits of $24,000 (prior to making any dividend payment) because of a $6,000 enterprise tax preference. Its potential tax liability at a 25 percent rate is thus $6,000 if it makes no distributions. If, in the current year, the company retains $12,000, its tax liability is $3,000 [25 percent of $12,000]. The shareholder will pay tax at personal rates on the $12,000 of taxable profit that is distributed. Tax will thus be collected currently on $24,000, part from the corporation at enterprise tax rates and part from the shareholders at their marginal rates. The other $6,000 of nontaxable operating profit will be taxed as a capital gain to the shareholder when the gain is realized, reducing the value of the tax preference from a permanent to a temporary reduction of tax.

Such a system raises a few stacking and ordering issues, which the example below addresses:

Example

Assume a corporation has operating profits in the current year of $30,000, but taxable profits of $20,000 (prior to making any dividend payment) because of a $10,000 enterprise tax preference. Its potential tax liability at a 25 percent rate is thus $5,000 if it makes no distributions. If the corporation distributes $25,000, two related questions arise: what is the treatment of the $5,000 in the hands of the shareholder, and does the enterprise generate a carryover loss from this transaction? It has an additional deduction of $25,000, which exceeds its taxable profits of $20,000.

The answer should depend on whether the government wishes the enterprise tax preference to be lost or not. If it is to be recaptured, the shareholder should be taxable on the $25,000, and the enterprise should not recognize a loss from this transaction. If the preference is to be preserved and enjoyed immediately, the shareholder should be exempt from tax, but the enterprise should not have a further deduction. There is an intermediate point, however, that would preserve the preference, but at a reduced value. That position would tax the entire $25,000 distribution to the shareholder under the personal income tax, but allow the enterprise to carry forward the $5,000 as a loss against future income.

A further complication would arise if the enterprise had retained profits from prior years.

Example

> Assume a corporation has operating profits in the current year of $30,000, but taxable profits of $20,000 (prior to making any dividend payment) because of a $10,000 enterprise tax preference. Its potential tax liability at a 25 percent rate is thus $5,000 if it makes no distributions. The corporation has $2,000 in retained profits from a prior year. The corporation distributes $32,000.

The same questions would arise: What is the treatment of the $12,000 in the hands of the shareholder, and does the corporation generate a carryover loss from this transaction, given that it has a further deduction of $12,000 that exceeds its taxable profit? The added complication is that the $2,000 of retained earnings was presumably already taxed to the corporation the previous year and perhaps ought not be taxed again if distributed now. An ordering rule would be necessary to resolve this question, one that would identify (and perhaps immunize) the amount paid from taxed retained profits and then identify and deal with the $10,000 paid from the preference income.

C. NONRESIDENT SHAREHOLERS

One important qualification to the desirability of a dividend-paid deduction system is the position of nonresident shareholders. Current international tax practice is to allocate the enterprise tax to the source country, while a dividend-paid deduction system will effectively abandon any entity-level tax on distributed earnings. Consequently, substantial withholding taxes on a nonresident shareholder would be needed to compensate for the reduction in the enterprise tax. Such an option might be limited by treaties.[125]

3. Split-Rate Systems

Split-rate systems reduce the enterprise tax payable on distributed profits or formally impose tax only on retained earnings.[126] The same effect can also be achieved with a tax surcharge on undistributed enterprise profits.[127]

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[125]*See supra* ch. 18.

[126]For example, Germany and Hungary apply different rates to distributed and undistributed profits, Germany applying a higher rate on retentions and Hungary a higher rate on distributions. Tirard, *supra* note 115, at 71–72, 87–88; Cnossen, *supra* note 103, at 54–55. This was also the first of many suggested interaction mechanisms proposed for uniform adoption in Europe. Tax Harmonization in the Common Market (Neumark Report) (1963). See Bird, *supra* note 103, at 227–28.

[127]*See* Norr, *supra* note 103, ch. 5/B. For example, a further tax was imposed on retained profits in both Australia and the United States. AUS ITAA Div. 7 (repealed). This was not done apparently to formalize the interaction of the corporate tax and personal income tax although it had the effect of reducing one distortion from the lack of coordination—different rates applying to retained and distributed earnings. The surcharge was imposed to encourage distribution so that there was no gain from sheltering income within the corporation and the classical system could collect the further tax from the shareholders.

A. RESIDENT INDIVIDUALS

Under a split-rate system, the enterprise pays tax on its retained profits (T_{cr}), but generally faces a lower rate of tax (T_{cd}) on the proportion of pretax profits distributed as dividends.[128] A resident individual pays income tax at ordinary marginal rates on distributions (T_i), while retained profits are taxed as capital gain (T_g) on a deferred basis to the shareholder, offsetting to some extent the higher rate paid by the enterprise when the profits are earned.[129] The after-tax return to a resident individual shareholder is[130]

$$R = dP(1 - T_{cd})(1 - T_i) + (1 - d)P(1 - T_{cr})(1 - T_g)$$

A lower corporate rate on distributions, combined with an increased personal income tax on distributions, is likely to suffer from some of the same problems alluded to in the discussion of the classical system—it might discourage distributions of enterprise profits. Again, tax- exempt institutions would benefit from the lower tax on distributed capital income.

B. PREFERENCE INCOME

As in a dividend-paid deduction system, distributions of other forms of untaxed income, such as income that enjoys enterprise tax preferences or foreign-source income that is not taxable in the residence country, would be subject to enterprise tax only if retained. The same stacking and ordering issues would also arise. The after-tax return on preference income would be

$$R = dP(1 - T_i) + (1 - d)P(1 - T_{cr})(1 - T_g).$$

C. NONRESIDENT SHAREHOLDERS

As with a dividend-paid deduction system, split-rate systems can confer benefits on nonresident shareholders that withholding taxes may not be able to offset.[131]

[128]This system is used in France and Germany, although in both countries in combination with an imputation system. There is also a disparity in actual practice, with Germany imposing a lower rate on distributed profits, while France imposes a lower rate on retained profits.

[129]In some cases, $T_g = 0$, for example, in countries like Germany that generally do not tax capital gains of individuals, except for cases of substantial participation.

[130]In the discussion that follows, an issue arises about whether the division of profits (P) occurs before or after the tax is subtracted—that is, does the shareholder receive d percent of after-tax profits or d percent of P, from which tax is taken out? For the purposes of the subsequent presentation, it is assumed that the shareholder receives d percent of P, the pretax profits, and the tax applicable to each share is then taken out at the appropriate rate.

[131]Germany found that its split-rate system offered excessive benefits to foreign-owned companies, which could distribute profits taxed at T_{cd}, enjoy reduced withholding tax, and reinvest without being subject to tax in their home countries. For example, keeping up a high enough withholding tax in these cases reportedly cost Germany dearly in its treaty negotiations with the United States.

4. Dividend-Received Deduction (or Dividend-Exemption) System

The systems discussed above all reduce the enterprise-level tax paid on distributions. Dividend-exemption or dividend-received deduction systems operate at the shareholder level,[132] by giving the shareholder a deduction from income for some or all of the distributions received or by exempting some or all dividends received from tax.[133] This type of system was in place in the United States until 1986 for a limited amount of dividends received by individuals[134] and is still retained in many countries as the means for adjusting the total tax paid on dividends flowing through chains of enterprise [135] or as a general integration mechanism.[136] Because these systems leave the enterprise's tax liability untouched, they solve some of the problems surrounding tax-exempt and nonresident shareholders mentioned in the prior discussion, but they also raise new issues.

In a dividend-received deduction system, as under the classical system, the enterprise still pays tax on the profits it derives during the year. The shareholder includes in income dividends received. A deduction from income is, however, given to resident shareholders for enterprise distributions received, which may be as much as the amount of dividends received but is sometimes limited.[137] In a dividend-exemption system, a percentage of (or all) dividends received are exempt in the hands of the shareholder. In both systems, retained enterprise earnings are taxed to the enterprise and to the shareholder under the capital gains tax, with no adjustment for the enterprise tax already paid.

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[132]A version of this system, allowing a deduction for 50 percent of dividends paid, was proposed for the United States in 1984. *See* Treasury I, *supra* note 3. It was later revised to a deduction for 10 percent of the amount of dividends paid. *See* Treasury II, *supra* note 3. *See* Bird, *supra* note 103, at 235-36; Avi-Yonah, *supra* note 111; U.S. Treasury Report, *supra* note 3, at ch. 12A.

[133]*See* Norr, *supra* note 103, at ch. 6/B. Belgium and the United States, for example, have a dividend-received deduction system for intercorporate dividend distributions; Denmark has an exemption system.

[134]*See* USA IRC §116 (repealed).

[135]This is the case in Canada and the United States. In Australia, the deduction of the dividend is replaced by an automatic credit of the amount of tax payable on the dividend. The effect of this credit system is the same as an automatic, full dividend-received deduction.

[136]*See, e.g.,* Charles McLure et al., The Taxation of Income from Business and Capital in Colombia 91–95 (1990).

[137]*See* USA IRC §116 (repealed) (which limited the individual's deduction to the lesser of the amount of dividends received or $100).

A. RESIDENT INDIVIDUALS

If the deduction available to the shareholder is for the entire amount of the dividend received, the position of the shareholder after payment of enterprise and personal income tax on the profits is

$$R = dP(1 - T_c) + (1 - d)P(1 - T_c)(1 - T_g).$$

For tax-exempt shareholders, the position now changes from that reached under the systems described above. Because the enterprise tax remains intact and the adjustment occurs under the shareholder's tax, no benefit is conferred on tax-exempt shareholders through the interaction mechanism—the benefit of their exemption is not increased because no tax deduction is available to a tax-exempt entity.

B. PREFERENCE INCOME AND FOREIGN-SOURCE INCOME

When a resident enterprise distributes preference income, the value of the preference is retained and passed through to the shareholders—the enterprise pays no tax on this income because of the incentive, and the investor pays no tax because of the dividend-received deduction.

When a resident enterprise is distributing foreign-source income, the effect of the foreign tax credit system (or system of exemption for foreign income) will in most cases replicate the outcome for preference income; that is, the resident shareholder will receive the dividend income free of further (residence country) enterprise tax and is entitled to a deduction for the amount of the dividend received. The position of the shareholder becomes

$$R = dP + (1 - d)P(1 - T_c)(1 - T_g).$$

But when the shareholder invests directly in a foreign enterprise, there is an added complication. In many countries, dividends received do not qualify for the dividend-received deduction if the paying enterprise is not also a resident. Where this is the rule, and any withholding tax on the dividend is fully creditable in the residence country, the position of the shareholder approximates the position of a shareholder under the classical system, with the important exception that the enterprise tax paid is the foreign enterprise tax (T_{fc}), rather than the domestic enterprise tax. The after-tax position thus becomes

$$R = dP(1 - T_{fc})(1 - T_i) + (1 - d)P(1 - T_{fc})(1 - T_g).$$

This result need not be the case, of course. The tax system of the residence country might simply include dividends received and then allow a deduction as its means of eliminating double taxation. The effect would be similar to an exemption system for foreign dividends.[138]

[138]One important difference would arise, however, if other provisions in the tax system denied a deduction for interest on money used to derive exempt income and if foreign dividends were treated as exempt. In this case, interest on loans used to finance investments that yielded dividends from foreign enterprises

C. NONRESIDENT SHAREHOLDERS

When a nonresident shareholder invests in a domestic enterprise, the relationship between the (source country) enterprise tax and the (residence country) investor-level tax is principally a matter for the residence country to resolve because the international norm, as well as most tax treaties, allocate the enterprise tax exclusively to the source country and limit the ability of the source country to impose withholding taxes on dividends. Indeed, some countries will take that position to its logical conclusion and choose not to impose any withholding taxes on dividends paid to nonresidents.

5. *Imputation Systems*

The four systems just described adjust the double taxation of distributed earnings by effecting changes at either the enterprise or the shareholder level. Many countries now operate tax credit or tax imputation systems[139] that retain both the separate enterprise tax and the personal tax but treat the payments of one tax as also satisfying a tax liability arising under the other. They achieve this by giving a tax credit of some amount, either to the shareholder or to the enterprise, reflecting more or less accurately the amount of tax that the profits have already borne.[140] This section examines three versions of the wide variety of imputation systems.

Imputation systems should not be confused with simple withholding systems in which the enterprise is obliged to withhold tax on distributions and the tax withheld is credited to the shareholder. The difference between imputation and withholding systems is that a pure withholding system is simply a collection mechanism on behalf of the shareholder, and not an attempt to change the consequences of the separate or classical system. For example, most European jurisdictions see the need both to impose a withholding tax at a constant rate on enterprise distributions and to have some other interaction mechanism, such as an imputation system that attributes payments of the enterprise's own tax liability to the shareholders or a dividend deduction system. Even the Netherlands, which retains the classical system, has a withholding system in which

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would be nondeductible. That result would not necessarily follow if the law contained no similar provision for interest on money used to derive income that was both included and then deducted.

[139]Some of the countries with an imputation system are Australia, Canada, Finland, France, Germany, Ireland, New Zealand, Norway, and the United Kingdom. *See generally* Cnossen, *supra* note 103, Table 1.

[140]As will be seen below, some countries, such as Australia, simply impute company taxes paid and then require the shareholder to pay over any additional tax due on untaxed distributions. Other countries apply an additional withholding amount or "compensatory tax" on distributions out of accounting income that have not borne company tax. Called simply withholding in New Zealand, the Advance Corporation Tax (ACT) in the United Kingdom, the *précompte mobilier* in France, the *imposta di congualio* in Italy, and the *Ausschüttungsbelastung* in Germany, its principal point is to enforce collection of tax on distributed income not taxed at the company level. There can be ancillary purposes as well. The United Kingdom does not integrate company and investor taxes completely. The ACT serves in part to ensure some double taxation of income.

tax is collected from the enterprise on distributions. The tax is creditable to the shareholder, but does not further reduce the total tax payable by either the enterprise or the shareholder.

Although all imputation systems have elements in common, within this broad framework, there are also many differences. Common to all systems are the survival of the separate enterprise tax, the attribution to shareholders of at least some enterprise tax paid on distributed profits, and the denial of a credit for enterprise tax paid on retained profits. Differences are manifested, for example, in the accuracy with which imputation systems take account of enterprise tax payments.[141] In some systems, the amount of tax credited to the individual shareholder may not reflect the total tax paid by the enterprise. At one extreme, the Canadian system simply increases the amount of any distribution by a constant amount to represent enterprise tax paid and then gives the shareholder a credit for a portion of the grossed-up amount. This grossing up and credit occur whether or not tax has actually been paid at the enterprise level.[142] The United Kingdom's ACT system is slightly more careful to ensure that the tax has been paid, but occasionally at the expense of collecting payments of ACT that exceed the enterprise's own "mainstream" (i.e. enterprise) tax liability.[143] Of the three systems modeled, the most accurate is that used in Australia and New Zealand. It attempts to track the amount of tax an enterprise actually pays on its profits and attributes only those payments to the profits distributed.

Which system a country chooses to put in place will depend upon many factors, but probably the most important are the desired treatment of enterprise-level tax preferences,[144] the treatment of exempt shareholders, the preferred treatment of nonresident shareholders, the importance of equity concerns, the treatment of foreign source income, and administrative convenience.

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[141] *See* Avi-Yonah, *supra* note 115.

[142] France and Germany also give a credit to shareholders (for supposed payments of enterprise tax) that is calculated by reference to the enterprise tax rate rather than the enterprise's actual tax payment. *See* Tirard, *supra* note 115.

[143] The ACT is payable at a flat rate on a distribution regardless of whether the profits out of which the distribution is made have already borne tax and regardless of the actual rate of tax that will be imposed upon the enterprise. The payment of ACT discharges the enterprise's primary tax liability to the extent of the ACT payment, and the individual shareholder is credited with the ACT payment against the shareholder's tax liability on the dividend received. *See generally* R. Bramwell, et al., Taxation of Companies and Company Reconstructions ch. 9 (4th ed. & Supp., 1988).

[144] Enterprise-level tax preferences (and credits for tax paid on foreign income) are an issue under an imputation system that traces actual payments of enterprise tax because the value of the preference (or foreign tax credit) will be recaptured if (untaxed) profits are distributed and even, to a lesser extent, for taxed profits if they are retained. The value of the preference under such a system is reduced from a tax exemption to a tax deferral, which may not be consistent with the level of subsidy intended by the government. It would be possible to solve the problem by specific adjustments to the tax credits offered to shareholders: either to gross up the tax the enterprise actually pays by an amount to represent tax not paid but attributable to preference items or foreign income, or to gross up the shareholder's tax credits. *See* Avi-Yonah, *supra* note 111.

A. AUTOMATIC IMPUTATION MODEL

The first imputation system to be described, which is based on the system used in Canada, appears to be the least accurate. It will be seen, however, that except in some unusual circumstances, the alleged accuracy of some systems may be more apparent than real.[145] This system increases the shareholder's distribution by an amount assumed to represent some of the enterprise's tax payment on the distribution and then gives to the shareholder a credit for a proportion of that assumed enterprise tax. For the purposes of this chapter, the automatic operation of the system is the interesting element of the interaction mechanism.[146]

In the Canadian system, the enterprise pays tax on its taxable profits, whether distributed or retained, at the enterprise tax rate.[147] The shareholder must include in income the amount of distributed profits increased by a multiple representing the enterprise tax that is assumed to be paid on the distribution.[148] The factor by which the dividend is increased is set at a constant rate, which is currently 25 percent. The shareholder then pays personal tax on the amount of increased distribution and is given a tax credit against this liability for an amount that is a proportion (currently 66 percent) of the grossed-up amount.[149] Retained earnings are taxed to the enterprise, and the balance after enterprise tax (to the extent reflected in the sales price) is taxable to the shareholder on realization as capital gain.[150] All the steps involved in making the interaction between

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See, for example, the adjustment made in Australia to the tax liability on trust distributions where part of the distribution represents untaxed profits, reduced because of the building depreciation deduction. AUS ITAA § 160ZM. This same adjustment is not made to distributions from companies with similar deductions.

Even for retained profits, the value of the tax preference is reduced but in this case by less. The value of the preference will possibly be recaptured when profits on the sale of the shares are taxed as capital gains. The size of the recapture depends on how soon the shares are disposed of, the interest discount factor, and the tax rate applicable to capital gains. In the right circumstances, it is possible for the amount of recapture to approach zero.

[145]*See* U.S. Treasury Report, *supra* note 3, at appendix B2.

[146]*See* Bird, *supra* note 103, at 236 ("as in Belgium, Italy and Denmark, the amount of the dividend tax credit is completely independent of whether any tax was paid at the corporate level at all"); U.S. Treasury Report, *supra* note 3, at 164 ("because the shareholder credit is not dependent on the actual payment of corporate tax, the Canadian system does not require rules allocating credits to dividends").

[147]*See* CAN ITA §123(1).

[148]*See* CAN ITA § 12(1)(j). The section requires an individual shareholder resident in Canada to include in income any "dividend paid by a corporation resident in Canada on a share of its capital stock," and § 82(1) in effect requires the shareholder to include 125 percent of the amount of any dividend in income.

[149]CAN ITA § 121 provides a credit against tax on the increased dividend of "two-thirds of any amount that is required by paragraph 82(1)(b) to be included in computing his income for the year."

[150]The real possibility that the capital gain may also escape tax under Canada's rather unusual lifetime $100,000 capital gain exemption introduced in 1985 will not be explored. *See* CAN ITA § 110.6.

enterprise- and investor-level taxes are effected by the operation of the imputation system at the shareholder level.

1. Resident Individuals

Rather than be distracted by the complexities of the system as it actually operates,[151] this section will abstract a little from reality and concentrate on the effect of the automatic interaction mechanism. We therefore treat the imputation process as if the shareholder is given credit under the imputation system at full rates: the gross up occurs at the full enterprise rate, and the tax credit against the personal income tax occurs in the same amount. If the Canadian system is modeled in this way, and the level of the enterprise tax is lower than the investor level tax, the after-tax return to the shareholder becomes

$$R = dP(1 - T_i) + (1 - d)P(1 - T_c)(1 - T_g).$$

This treatment comes about from the following steps. The shareholder includes in income the amount of the dividend received increased by an amount set by reference to the enterprise tax rate:

$$dP(1 - T_c) + [dP(1 - T_c) \times T_c / (1 - T_c)],$$

which can be simplified to dP.

This total is then subject to investor's income tax (dPT_i), and the shareholder is entitled to a credit against the investor income tax liability of the same amount that was

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[151]The following explanation gives a flavor of the actual complications. When the corporation reports all of its profits, the balance available for distribution is $[P(1 - T_c)]$. The net amount distributed $[dP(1 - T_c)]$ is then increased by the gross up amount representing tax that the corporation is assumed to have paid. This step is effected by multiplying the net dividend by a fraction and adding this amount to the net dividend. When all profits are reported, this step becomes: $dP(1 - T_c) + dP(1 - T_c)a = dP(1 - T_c)(1 + a)$, where (a) is a gross-up factor applied to dividends received by a resident. The total amount is then subject to personal income tax $[dP(1 - T_c)(1 + a)T_i]$ and the shareholder is entitled to a credit against the personal income tax liability of a proportion (b) of the amount that was included by the grossing up procedure $[bdP(1 - T_c)a]$. The net tax at the shareholder level on distributed dividends is thus the balance of the liability remaining after subtracting the credit $[dP(1 - T_c)(1 + a)T_i - bdP(1 - T_c)a$ and the shareholder, after paying tax, retains $dP(1 -T_c)(1 + a)(1 - T_i) + bdP(1 - T_c)a$.

Some of the more important adjustments are the current tax surcharge of 3 percent, the provincial tax credit, the small business tax credit (referred to rather confusingly as the "small business deduction"), and the manufacturing and processing tax credit. *See* CAN ITA, division E, subdivision b. The basic individual rate is currently 29 percent. CAN ITA § 117(2). Each province then imposes further tax on the federal tax payable—the basic rate in Ontario, for example, is a further 52 percent of the federal tax, giving a combined provincial and federal rate of 44 percent. The federal tax rate is also increased by a 5 percent surtax and a further 3 percent "super surtax" on high-income taxpayers. *See* CAN ITA § 180(1). Given a current corporate tax rate in Canada of 38 percent with a multitude of further tax adjustments, and personal marginal rates approaching 50 percent, it is clear that something less than full integration of the corporate and personal income tax is achieved by this system. Full relief from double taxation for dividends is almost achieved in practice if the average (and marginal) corporate tax rate is about 20 percent. *See* Bird, *supra* note 103, at 236.

included by the grossing up procedure. The net tax at the shareholder level is thus (dPT_i - dPT_c). The procedure operates on the assumption that enterprise tax (dPT_c) was collected from the enterprise and gives effect to the goal of taxing distributed profits (dP) ultimately at the investor's income tax rate (T_i) although the tax is collected at two points. No gross up and credit system operates for retained profits and they are taxed as under the classical system.

Several interesting design questions arise under such a system. The first is the question of *surplus credits*—what happens when the assumption that the entity-level tax is lower than the investor level tax is relaxed? That would be the case, for example, with investors who are tax exempt or have carryover losses, and with individuals who are taxed at a low marginal tax rate, most commonly individuals in retirement who are living off the dividend income from their savings. The tax credit is usually conceived as partly satisfying the shareholder's liability for tax on the dividend income, but the shareholder might not have a tax liability on that income. The following example demonstrates the point:

Example

A corporation pays a dividend of $7,500 to a shareholder who is a resident individual. The shareholder has no other income. The enterprise tax rate is 25 percent. The personal income tax has a tax-free zone of $10,000 a year. Income over $10,000 is subject to a 20 percent rate. The shareholder will report income of $10,000 and will be entitled to a tax credit of $2,500, but will still have no tax liability.

Tax credits that exceed the taxpayer's current need for credit can be dealt with in many ways. It would be possible to refund the excess to the investor in cash; deny cash refunds, but allow the taxpayer to carry forward any excess credits to future years; allow the taxpayer to transfer (or perhaps even sell) the credit to another taxpayer, such as a related corporation in a corporate group; or deny any further benefit.

A second, though slightly different, issue is *spillover*—what would happen if the taxpayer had derived other income? Here, the taxpayer could benefit from the tax credit to reduce or eliminate the tax on the other income.

Example

A corporation pays a dividend of $7,500 to a shareholder who is a resident individual. The shareholder has other interest income of $4,000. The enterprise tax rate is 25 percent. The personal income tax has a tax-free zone of $10,000 a year. Income over $10,000 is subject to a 20 percent rate.

The shareholder will report income of $14,000 and will be entitled to a tax credit of $2,500. The shareholder's tax liability is $800 (20 percent of $4,000), which could be fully satisfied by the tax credit with a surplus of $1,700. The interest income would be effectively shielded from tax by the credit for corporate tax paid.

While this transaction may seem innocuous, a variation on this example will show how these enterprise tax credits can be used in tax-sheltering activities.

Example

A corporation pays a dividend of $7,500 to a shareholder who is a resident individual. The taxpayer has a deductible interest expense of $10,000 incurred for the purchase of the shares (the taxpayer obviously assumes capital growth in the value of the shares, which is presently untaxed). The shareholder has employment income of $22,500. The enterprise tax rate is 25 percent. The personal income tax has a tax-free zone of $10,000 a year. Income over $10,000 is subject to a 20 percent rate.

The shareholder will report taxable income of $22,500. The shareholder's tax liability is $2,500 [20 percent of $12,500], and the shareholder will be entitled to a tax credit of $2,500. All the salary income is effectively shielded from tax by the credit for corporate tax paid.

There are several solutions to this problem, assuming it is seen as a problem. One solution, a rule that the tax credits for enterprise tax are quarantined and can be used only to satisfy the tax liability on dividend income, would address both this example and the prior one.[152]

2. *Enterprise-level Tax Preferences*

A second series of issues arises from the automatic nature of the process. An automatic gross up and credit mechanism automatically passes through to shareholders the benefit of preference items offered to enterprises. This is because distributions of untaxed preference income come with tax credits attached; the enterprise pays no tax on this income because of the preference and the investor pays no tax because of the automatic tax credit. The following example demonstrates the outcome:

[152]Another approach would attack the interest deduction claimed by the taxpayer. The United States, for example, has loss limitation rules for passive activities. *See* USA IRC § 469. Rules of this type would defer the interest cost, driving up the taxpayer's income in the current year and generating a tax liability against which the tax credit would be needed. A third possibility would be a dual income tax system as practiced in Finland, Norway, and Sweden. *See* Leif Mutén et al., Towards a Dual Income Tax? (1996).

Example

The corporation has pretax financial profits of $30,000. It is entitled to a special tax deduction of $6,000 for making an investment and therefore has taxable profits of $24,000. The enterprise tax rate is 25 percent and so the corporation pays $6,000 in tax. The corporation pays a dividend of $24,000 to a shareholder who is a resident individual. The personal income tax rate is 25 percent on income up to $40,000 and 40 percent thereafter.

The shareholder reports as income $32,000—the sum of the dividend of $24,000 and the gross-up for assumed corporate tax on a dividend of that size of $8,000 ($24,000 x 0.25 / 0.75). The taxpayer has a tax liability of $8,000 (25 percent of $32,000) and a tax credit of $8,000. The total tax paid is $6,000—one corporate tax payment of $6,000 and no further shareholder tax payment.

	Amount (In units of local currency)	Rate (In percent)	Tax (In units of local currency)
Nonpreference income	24,000	25	6,000
Preference income	6,000	0	0
Total	30,000		6,000

The same outcome would have occurred if, instead of being a tax incentive, the difference between commercial profit and taxable income had been brought about because the enterprise earned $6,000 of foreign-source income that was treated as exempt in the residence country. It would also have happened if the $6,000 of foreign-source income had been taxable but the enterprise was entitled to a tax credit of $1,500.

If, as is more common in industrial economies at the moment, the investor’s rate is higher than the enterprise rate, the outcome changes in this way:

Example

The corporation has pretax financial profits of $30,000. It is entitled to a special tax deduction of $6,000 for making an investment and therefore has taxable profits of $24,000. The enterprise tax rate is 25 percent and so the corporation pays $6,000 in tax. The corporation pays a dividend of $24,000 to a shareholder who is a resident individual. The personal income tax rate is 30 percent on income up to $40,000 and 40 percent thereafter.

Again, the shareholder reports as income $32,000—the sum of the dividend of $24,000 and the $8,000 gross-up for assumed enterprise tax. The taxpayer now has an initial tax liability of $9,600 (30 percent of $32,000) but still has a tax credit of $8,000. The total tax eventually paid is $7,600—one corporate tax payment of $6,000 and a further shareholder tax payment of $1,600.

In this case, the outcome is just as if the investor had faced the following tax rates:

	Income (In units of domestic currency)	Rate (In percent)	Tax (In units of domestic currency)
Non-preference income	24,000	30	7,200
Preference income	6,000	6.66	400
Total	30,000		7,600

The outcome in each case occurs because the computation made at the shareholder level is based not on the amount of enterprise tax paid, but on the enterprise tax rate and occurs automatically. That is, the shareholder must gross up at the rate of

$$T_c / (1 - T_c).$$

There are, of course, other options. One is a nonautomatic tracking system that traces only the amount of tax payments made, a system discussed in more detail below.[153] Automatic systems do have the advantages of simplifying somewhat compliance and administration. However, tying the imputation process to a stipulated rate can lead to a problem, sometimes referred to as *over integration*. If the gross-up and tax credit are simply a constant proportion of the dividend received, and are not tied to the current enterprise tax rate, the system can become misaligned, for example, when there are multiple enterprise and investor rates:

Example

The corporation has pretax financial profits of $100,000 but has taxable profits of only $94,000. The enterprise tax rate is 10 percent up to $50,000 and 25 percent thereafter. The corporation pays $19,000 in tax ($50,000 x 10 percent plus $44,000 x 25 percent). The corporation pays a dividend of $81,000 to a shareholder who is a resident individual. The investor's tax rate is 30 percent on all income up to $40,000 and 40 percent thereafter.

The shareholder reports as income $108,000—the sum of the dividend of $81,000 and the gross-up computed as one-third of the amount of the dividend $27,000 ($81,000 x 1/3). The taxpayer has an initial tax liability of $37,200 ($40,000 x 25 percent plus $68,000 x 40 percent) and a tax credit of $27,000, leaving a net liability of $10,200. The total tax paid is $29,200—one enterprise

[153]If only the $6,000 of corporate tax actually paid had been used in the imputation calculations, the value of the incentive would have been recovered at the investor level. In the first example, the shareholder reports as income $30,000—the sum of the dividend of 24,000 and the enterprise tax paid. The taxpayer has a tax liability of $7,500 (25 percent of $30,000) and a tax credit of $6,000, leaving a net tax payment due of $1,500 and total tax of $9,000. In the second example, the shareholder reports as income $30,000—the sum of the dividend of $24,000 and the corporate tax paid. The taxpayer has a tax liability of $9,000 (30 percent of $30,000) and a tax credit of $6,000, leaving a net tax payment due of $3,000 and total tax of $9,000.

tax payment of $19,000 and a further shareholder tax payment of $10,200. This is an average tax rate of 29.2 percent.

The alignment of rates in the example may appear bizarre, but common circumstances and plausible arguments can lead to these kinds of situations. The low rate in the enterprise tax might be intended as an incentive or concession for small business. The marginal rates in the investor tax might be intended to reflect government goals about progressivity and wealth redistribution. The choice of a constant 1/3 ratio to represent the gross-up could have been chosen because it is the right gross-up rate for the higher enterprise rate. The 1/3 ratio is too high a gross-up for the lower enterprise rate — for a 10%enterprise rate, the correct gross-up should be 1/9 — but it might be a deliberate decision intended to ensure that the benefit of the small business rate is permanent, like the tax incentives discussed above, and is not recovered when the small business distributes its profits to its shareholders. But this benefit is itself subject to the proviso that the progressive rate scales in the investor-level tax will be allowed to operate thereafter to recapture some, though not all, of the benefit delivered to high income earners. This juxtaposition of policies, each of which may have some merit in isolation, explains how profit of $100,000 can become subject to an average rate of 29.2 percent.

3. The Equalization Tax Variant

The problem highlighted above in relation to untaxed enterprise income and the potential for over integration can be solved, even within the broad parameters of an automatic tax credit system, with a common European variant of the automatic credit process just described.

Many countries in Western Europe—in particular, France, Germany and Italy—apply an additional withholding amount or "equalization tax" on distributions out of accounting income that have not borne enterprise tax.[154] Called the *précompte mobilier* in France, the *imposta di congualio* in Italy, and the *Ausschüttungsbelastung* in Germany, its principal point is to collect tax on distributed income not taxed at the enterprise level. However, while these systems do try to recapture some enterprise preferences, they do not attempt to levy a compensatory tax on *all* distributions of economic income. In particular, foreign-source income distributed by a resident enterprise to resident shareholders will typically not trigger the equalization tax.

The system in France is typical of this variant.[155] In France, the *précompte* operates within the framework of the basic automatic imputation system. The enterprise pays tax at 33α percent. Every dividend paid by a enterprise carries a tax credit, the *avoir fiscal,* of 50 percent of the amount of the dividend. The shareholder grosses up the dividend by the amount of the tax credit and is taxed on the total with an automatic credit in the manner described above.[156]

[154]*See generally* International Fiscal Association, Corporate Tax on Distributions (Equalization Tax) (1994).

[155]*See generally* Michael P. Devereux, The Integration of Corporate and Personal Taxes in Europe: The Role of Minimum Taxes on Dividend Payments (Working Paper 96–5) (unpublished paper prepared for

Unlike the Canadian variant, however, the automatic process of gross-up and credit is not intended to have the effect of passing enterprise tax preferences through to investors. So, for distributions of untaxed income from domestic sources, and for distributions of profits retained for more than five years, the *précompte* can apply.[157] The rate of *précompte* varies and operates as a supplement to the actual rate of enterprise tax paid, so that the total of enterprise tax and *précompte* equals 33α percent—in other words, the amount needed to fund the *avoir fiscal*.[158] The automatic process is unaffected and functions in the usual way at the shareholder level, but the imposition of the *précompte* at the enterprise level has been interposed to correct for some of the problems noted above.

Example

> The corporation has pretax financial profits of $30,000. It is entitled to a special tax deduction of $6,000 for making an investment and therefore has taxable profits of $24,000. The enterprise tax rate is 33α percent and so the corporation pays $8,000 in enterprise tax. The corporation pays a dividend of $20,000. The corporation will be liable to *précompte* of $2,000 (33α percent of $6,000).
>
> The automatic process can now resume at the shareholder level. The personal income tax rate is 40 percent. The shareholder reports as income $30,000—the sum of the dividend of $20,000 and a further one-half of the dividend—the amount of the *avoir fiscal*. The taxpayer has a tax liability of $12,000 (40 percent of $30,000) and has a tax credit of $10,000. The total tax eventually paid is $12,000—$8,000 enterprise tax, *précompte* of $2,000, and the shareholder pays a further $2,000.

In order to operate the *précompte*, the French system requires enterprises to keep accounting records to determine whether the income being distributed has borne enterprise tax at the full rate. However, that process of tracing taxed and untaxed profits raises important administrative questions that recur throughout the remainder of this discussion:

Technical Committee on Business Taxation, Canada); Patrick de Fréminet, *Perspective of France*, *in* International Fiscal Association, Corporate Tax on Distributions (Equalization Tax) 55 (1994).

156 *See* FRA CGI § 158 *bis*.

157 Foreign-source income is partially excluded from the *précompte* system by the operation of France's foreign income system. Typically, profits from foreign branches or dividends from foreign subsidiaries are exempt from tax in France, but for the purposes of operating the *précompte* system, foreign taxes are also treated as a credit against French tax, in this case, the *précompte* rather than the mainstream French enterprise tax.

158 FRA CGI § 223 *sexies*.

- Since the *précompte* is triggered by payment of a dividend out of untaxed profits, can the corporation avoid the tax by retaining all profits?
- If it does not want to retain all profits, can the corporation choose which profits are being distributed and to whom, allowing a process generally referred to as *streaming*?
- If not, what are the *stacking* rules, that is, what rules determine the order in which various types of profits are distributed?

These questions also arise in the examination of the remaining systems, and are discussed below.

B. ADVANCED CORPORATION TAX MODEL

An advanced corporation tax (ACT) system, modeled on the system used in the United Kingdom, uses a distribution-related tax as both a collection mechanism and the interaction mechanism between the enterprise tax system and the personal income tax.[159] The essence of the ACT mechanism is that a flat-rate tax is imposed on the enterprise making a distribution, and this tax is then credited against both the enterprise's liability for enterprise tax payable on its taxable income and the shareholder's liability for tax on the distribution. While the system used in the United Kingdom is not actually a withholding tax, at least not for the purposes of international tax treaties, an ACT can best be understood as a withholding tax that is credited twice—once for the benefit of the enterprise making the payment and again for the benefit of the investor receiving the payment.

The ACT system described below also abstracts from reality in order to identify more clearly the major policy choices involved. The mechanism of the system operates in these steps. Each dividend distribution made by a enterprise is subject to ACT at a flat rate, and the enterprise subtracts the ACT payment made during the year from its own liability for enterprise tax on its profits.[160] The balance of enterprise tax remaining to be paid after the credit for ACT payment is usually referred to as the mainstream corporation tax (MCT) liability, and it can come about either because the ACT rate on dividends is less than the adjusted corporate tax rate on distributed profits or because the enterprise has elected to retain some profits. Where the corporation retains profits, there is no ACT payment and hence no change to the classical system's consequences for the enterprise and the shareholder. If we assume that the ACT rate (T_a) is less than the enterprise tax rate (T_c), the position of the enterprise after payment of tax is therefore

$$dP[1 - T_a - (T_c - T_a)] + (1 - d)P(1 - T_c) = dP(1 - T_c) + (1 - d)P(1 - T_c).$$

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[159] *See generally* S. James & C. Nobes, The Economics of Taxation 287 (3d ed., 1988); U.S. Treasury Report, *supra* note 3, at app. B6.

[160] GBR ICTA §239(1) provides that "advance corporation tax paid by a company ... in respect of any distribution made by it in an accounting period shall be set against liability to corporation tax on any profits charged to corporation tax for that accounting period and shall accordingly discharge a corresponding amount of that liability."

1. Resident Individuals

The shareholder is treated in respect of distributed profits in the same way as under other imputation systems. The shareholder is taxed on the net distribution increased by the amount of ACT and then receives a credit for the ACT.[161] The shareholder includes in income

$$dP[(1- T_a - (T_c - T_a)] \times [(1 + T_a) / (1 - T_a)].$$

Where (T_a) is set at a lower rate than (T_c), the position for distributions is equal to

$$dP[(1 - T_c)] \times [(1 + T_a) / (1 - T_a)].$$

The shareholder receives a credit equal to the amount of ACT (dPT_a). If the ACT rate (T_a) is set at the same rate as the investor's rate (T_i),[162] and the ACT is lower than the enterprise rate, the after-tax return of the shareholder becomes

$$R = dP(1 - T_c) + (1 - d)P(1 - T_c)(1 - T_g).$$

There is obviously a lot of importance to be attached to the *rate alignments* under such a system; that is, what are to be the relative sizes of the ACT rate, the enterprise rate, and the personal tax rate? At the enterprise level, dividends will effectively be taxed at the higher of the two enterprise rates as the following examples of different rate alignments show:

Example

The corporation has pretax financial profits of $24,000. The enterprise tax rate is 25 percent, and so the corporation is in principle liable to pay $6,000 in mainstream corporate tax. The corporation pays a dividend of $18,000 to a shareholder who is a resident individual. The ACT rate is 15 percent of the amount of dividends paid, and so the corporation is liable to pay $2,700 in ACT. The personal income tax rate is 15 percent on income up to $40,000 and 40 percent thereafter.

[161] GBR ICTA § 20(1), sched. F. The amount taxed is "the aggregate of the amount or value of [any] distribution and the amount of [any] credit." The credit is provided in GBR ICTA § 231, which states that "where a company resident in the United Kingdom makes a qualifying distribution and the person receiving the distribution is ... a person resident in the United Kingdom..., the recipient of the distribution shall be entitled to a tax credit equal to such proportion of the amount or value of the distribution as corresponds to the rate of advance corporation tax..."

[162] It will be the same rate if T_i is a marginal rate rather than an average rate since income is subject to reliefs, progressive rates, losses, and so on, while T_a is set at a gross rate.

The corporation pays ACT of $2,700 and MCT of $3,300 ($6,000 - $2,700). The shareholder reports as income $21,176—the sum of the dividend of $18,000 and the $3,176 gross-up for ACT (18,000 x 0.15/0.85). The taxpayer has a tax liability of $3,176 (15 percent of $21,176) and has a tax credit of $3,176. The total tax eventually paid is $6,000—ACT of $2,700 and MCT of $3,300, with no further shareholder tax payment.

Where, as here, the enterprise rate is higher than the ACT rate, it is the higher enterprise rate that is collected on distributed profits, but the gross-up occurs at the shareholder level only at the lower ACT rate. Indeed, in the United Kingdom, the ACT rate is approximately the same as the rate charged on taxable enterprise profits under the enterprise tax to avoid some of these problems.[163]

Where the ACT rate is higher than the enterprise rate, the ACT is the amount that is collected before the dividend leaves enterprise-level solution:

Example

The corporation has pretax financial profits of $24,000. The enterprise tax rate is 20 percent and so the corporation is in principle liable to pay $4,800 in mainstream corporate tax. The corporation pays a dividend of $18,000 to a shareholder who is a resident individual. The ACT rate is 33α percent of the amount of dividends paid, and so the corporation is liable to pay $6,000 in ACT. The personal income tax rate is 33α percent on income up to $40,000 and 40 percent thereafter.

The corporation pays ACT of $6,000 and MCT of 0 ($4,800 - $6,000 = -$1,200). The shareholder reports as income $27,000—the sum of the dividend of $18,000 and the $9,000 gross-up for ACT ($18,000 x 0.33/0.66). The taxpayer has a tax liability of $9,000 (33α percent of $27,000) and has a tax credit of $9,000. The total tax eventually paid is $6,000—an ACT payment of $6,000, no MCT payment, and no further shareholder tax payment.

2. Enterprise-Level Tax Preferences

Because the tax is imposed upon distributions, it is collected whether or not the source of enterprise profits from which the distribution has been paid has borne tax or is even taxable. Nor, usually, does the reduction in the enterprise's tax liability for payments of ACT generate a refund of enterprise tax if the enterprise distributes more than its taxable profits, or if it is taxable at less than the ACT rate on its profits.[164]

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[163]The United Kingdom currently imposes tax at 25 percent on corporations with profits less than £150,000 and 35 percent for other corporations.

[164]This consequence is dealt with in the variety of provisions dealing with surplus advance corporation tax. If the corporation has insufficient tax liability, it can carry the credit back and recover tax paid in prior

Effectively, tax is collected from the enterprise at the higher of the ACT rate or the enterprise tax rate on distributed profits and at the enterprise tax rate on retentions. An ACT system can thus generate the consequence that all distributions are reduced by an amount of ACT, while some will be reduced by the enterprise tax rate if that is higher. This outcome is especially important for the treatment of tax preferences, which will reduce the enterprise's MCT tax liability by reducing either its taxable income or its tax.[165] Unfortunately, however, under an ACT system fashioned in this way, these items have no effect on the enterprise's ACT liability. This problem is referred to as "surplus ACT"; that is, the enterprise can distribute more profit than its own tax payments would indicate. In such a case, surplus ACT is generated on the difference—the amount by which the ACT on distributions exceeds the enterprise's own MCT liability.

One question that arises is, what should be done with these *surplus ACT credits*? As was discussed above, with all tax credits it is possible to refund them, allow the taxpayer to carry forward any excess credits to future years, allow the taxpayer to transfer (or perhaps even sell) the credit to another taxpayer such as a related corporation in a corporate group, or simply deny any further benefit. Each option will obviously have different consequences under an ACT system. If the excess credits are lost, it means that tax preferences are effectively recaptured at the enterprise level, but are taxed at the ACT rate, not at the personal or the enterprise rate.

If the enterprise reduces its primary enterprise tax liability, for example, by using domestic tax preferences, the after-tax position of the shareholder remains the same for distributions of declared earnings. But lower enterprise tax means that the enterprise's managers can attribute the ACT payment on distributions of undeclared earnings toward the mainstream enterprise tax liability on declared earnings. The gross-up and credit procedure occurs automatically as in the Canadian system, but on the basis that ACT has actually been collected on distributions. No enterprise tax will be collected on retained earnings where tax has been successfully reduced, and no ACT will be collected because profits have been retained. Consequently, only capital gains tax will be collected on the sale of the shares.

Example

> The corporation has pretax financial profits of $30,000. It is entitled to a special deduction of $6,000 for making an investment and therefore has taxable profits of $24,000. The enterprise tax rate is 25 percent, and so the corporation is in principle liable to pay $6,000 in mainstream tax. The corporation, which could pay a dividend of up to $24,000, decides to pay a dividend of $18,000 to a shareholder who is a resident individual. The ACT rate is 33α percent of the

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years or forward to use against the tax liability of future years, the liability of other companies in the group or controlled foreign corporations. *See* GBR ICTA §§ 239, 240. This complication will be ignored.

[165] It also used to be a major problem for the taxation of distributions from foreign income. This issue was resolved in 1994 by the introduction of a special regime, the Foreign Income Dividends system. Under this system, ACT on dividends paid from foreign income, where there is no MCT liability to offset, can be refunded to the corporation. GBR ICTA §§ 246A–246Y.

amount of dividends paid, and so the corporation is liable to pay $6,000 in ACT. The personal income tax rate is 33α percent.

The corporation pays ACT of $6,000 and MCT of 0 ($6,000 - $6,000 = 0). The shareholder reports as income $27,000—the sum of the dividend of $18,000 and the $9,000 gross-up for ACT ($18,000 x 0.33/0.66). The taxpayer has a tax liability of $9,000 (33α percent of $27,000) and has a tax credit of $9,000. The total tax eventually paid is $6,000—an ACT payment of $6,000, no MCT payment and no further shareholder tax payment. The shareholder's shares will have grown in value by an amount related to the $6,000 retained profits.

	Amount (In units of domestic currency)	Rate (In percent)	Tax (In units of domestic currency)
Nonpreference income	24,000	25	6,000
Preference income	6,000	0	0
Total	30,000		6,000

Under an ACT system, there is no problem with allocating tax credits to particular shareholders or groups of shareholders. There is, however, a different allocation question—about the "spillover" of ACT credits to preference income—which this example demonstrates. ACT is collected on distributions, but can ACT payments be used to offset all MCT liabilities, even the MCT on retained earnings? Or are ACT payments to be quarantined, so that they can be used to reduce the MCT only on distributed earnings?

The example above shows how, by retaining the $6,000 in preference income, the corporation paid ACT only up to the point where the MCT liability was completely eliminated. Thus, the ACT in this case does not ensure that the correct enterprise tax is actually paid when the enterprise enjoys tax preferences but makes distributions. Rather, the ACT simply permits the enterprise's managers to reduce the amount of any final MCT to be paid on declared profits. More enterprise tax will be paid under the ACT mechanism when the enterprise proposes to report less taxable profit than the amount of profit (both taxed and untaxed) that it proposes to distribute. But in the reverse situation—when the enterprise's managers propose to retain the untaxed profits—the ACT system does not recapture preferences.

At the shareholder level, the rate alignment question involves the relationship between the ACT rate and the shareholder's personal rate. Where the amount of ACT is less than the individual shareholder's tax liability, the shareholder can be made to report the deficiency and make a top-up payment, as was shown in prior examples. Where the amount of ACT exceeds an individual shareholder's tax liability, there is a further question about the treatment of the excess ACT paid, as far as the shareholder is concerned. In the United Kingdom, the ACT rate is set at a level equal to the basic personal income tax rate so that the ACT is the effective collection mechanism for the personal tax liability.[166] However, for low-income shareholders who receive dividend income, typically retired individuals, the ACT rate may exceed their own personal income tax rate. When this occurs, there is again the issue of the proper treatment of the surplus credits. It is possible to refund them, allow the taxpayer to carry forward any excess credits to future years, allow the taxpayer to transfer (or perhaps even sell) the credit to another taxpayer, or simply deny any further benefit. In the United Kingdom, the ACT credit, if it exceeds the shareholder's tax liability, is refundable to the shareholder.[167] When the ACT rate is set equal to the highest personal rate rather than the lowest, and there is no intention of refunding "excess" credits to low- rate shareholders, the gross-up and credit procedure achieves nothing, and it is possible to simply exempt dividends received from further tax.[168]

C. TAX-TRACING MODEL

The final imputation system to be modeled is similar to that used in Australia and New Zealand.[169] Of the three imputation systems discussed, it appears to be the most accurate measure of the interaction of the enterprise and personal income tax, at least on distributed income. The Australian system tries to trace tax payments actually made by the enterprise and to attribute tax credits for those payments to individual shareholders only to the extent that verified tax payments have been made by the enterprise. The stylized Canadian system modeled above assumes that enterprise tax has been paid on all distributions; in other words, it disregards the possibility that distributed profits may not have borne tax. The U.K. system forces the payment of a tax on all distributions through the ACT mechanism, even when no MCT is owed. The Australian system traces the tax actually paid by the enterprise on its profits and attributes only tax actually paid to the profits distributed. It does permit untaxed profits to be distributed, but identifies them as such in the hands of the shareholder.

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[166]GBR ICTA §14(1) provides that, "where a company ... makes a qualifying distribution it shall be liable to pay an amount of corporation tax in accordance with subsection (3)." Section 14(3) formally expresses the ACT rate in the form: *I/(100-I), I* being "the percentage at which income tax at the basic rate is charged...." Since, at present, the United Kingdom has only two rates of personal income tax (25 percent and 40 percent), this ACT rate is currently 25/75 or 33α percent. The reference to a "qualifying distribution" is the way that returns of capital and certain other distributions are excluded from tax. Distributions from corporations are not subject to further tax because ACT is collected only on the excess of distributions made over distributions received. GBR ICTA § 241.

[167]GBR ICTA § 231(3).

[168]This is done in Estonia and Lesotho. EST ITL § 9(2)(6) ("income of a resident taxpayer does not include ... dividends taxable under Article 32 of the present Law"). EST ITL § 32 establishes the ACT system for corporate tax. LSO ITA § 87(6) ("a dividend paid by a resident company shall not be included in the gross income of a resident shareholder").

[169]*See generally* R.J. Vann, Company Tax Reform (1988); Richard E. Krever, *Companies, Shareholders and Capital Gains Taxation*, 3 Aust. T. F. 267 (1986); Robert Richards & Ross Doherty, The Imputation System (1987); Robert Officer, *supra* note 120; U.S. Treasury Report, *supra* note 3, at app. B1.

As under the previous imputation systems, the enterprise still pays tax on its taxable income, whether distributed or retained (PT_c) and will have a balance available for distribution [$P(1 - T_c)$]. The net amount distributed to the shareholder [$dP(1 - T_c)$] is increased by the gross-up that represents corporate tax, effected by multiplying a fraction of the net dividend[170] by the factor [$T_c /1 - T_c$] and adding this amount to the net dividend. A resident shareholder pays income tax at marginal rates on the proportion of after-tax profits distributed by the corporation as dividends,[171] and a tax credit is given to the shareholder for the amount of the gross up.[172] Retained profits are still taxed as a capital gain when the shares are sold by the shareholder; no explicit credit against capital gains tax is given for enterprise tax already paid on retained profits—the tax paid on reported profits that are retained is effectively lost.[173] In this respect, the Australian imputation system, like the other imputation systems discussed, operates in a way similar to the classical system for retained profits.

[170]AUS ITAA § 160AQT requires the shareholder to include in income the "franked amount" of the dividend increased by this factor.

[171]*See* AUS ITAA § 160AQT.

[172]*See* AUS ITAA § 160AQU.

[173]Generally, no tax credits are attached to retentions. Some minor exceptions to the proposition that tax on retained enterprise profits is not credited to shareholders arise in the case of share buyback arrangements and the attributed income of controlled foreign corporations. *See* AUS ITAA div.16J of pt. III, § 461. These exceptions will not be discussed further here.

1. Resident Individuals

The shareholder reports the portion distributed increased by the gross-up for enterprise tax (dPT_c).[174] However, this gross-up does not occur as a simple increase of the net dividend by a constant rate. Rather, it is calculated on the amount that has been debited to the enterprise's franking account, which may or may not correspond to the net amount of dividend distributed, as will be shown later. Where the full taxable profits have been declared, this step becomes

$$dP(1 - T_c) + [(1 + T_c) / (1 - T_c)] = dP.$$

This amount is then subject to personal income tax (dPT_i) and the shareholder is entitled to a credit against the personal income tax liability of the same amount that was included by the gross-up procedure (dPT_c).[175] The net tax at the shareholder level on distributed dividends is thus ($dPT_i - dPT_c$). The after-tax return to the shareholder is

$$R = dP(1 - T_i) + (1 - d)P(1 - T_c)(1 - T_g).$$

The total tax is paid in two parts: enterprise tax (dPT_c) is collected from the enterprise, and when the enterprise rate is less than the personal income tax rate, the deficit ($dPT_i - dPT_c$) is collected from the shareholder.

Example

The corporation has pretax financial profits of $24,000. The corporate tax rate is 25 percent and so the corporation pays $6,000 in enterprise tax. The corporation pays a dividend of $18,000 to a shareholder who is a resident individual. The payment of $6,000 in enterprise tax will be recorded as a credit in the corporation's tax-paid account, and the payment of the dividend of $18,000 will be a debit of $6,000 to its tax-paid account.

The personal income tax rate is 33α percent. The shareholder reports as income $24,000 —the sum of the dividend of $18,000 and the $6,000 debited to the corporation's tax-paid account. The taxpayer has a tax liability of $8,000 (33α percent of $24,000) and a tax credit of $6,000. The total tax eventually paid is $8,000—corporate tax payment of $6,000 and a further shareholder tax payment of $2,000.

When the amount of enterprise tax paid is more than the shareholder's own personal liability—for low-income shareholders who receive dividend income, there is again the issue of the proper treatment of the surplus credits—it is possible to refund them to the shareholder, allow the taxpayer to carry forward any excess credits to future

[174] *See* AUS ITAA § 160AQT.

[175] *See* AUS ITAA § 160AQU.

years or to transfer (or perhaps even sell) the credit to another taxpayer, or simply deny any further benefit.

2. Enterprise-Level Tax Preference Income

Even if the two rates are identical, a further shareholder payment also comes about when for some other reason, such as the existence of foreign tax credits or enterprise-level tax preferences, all of the profits distributed by the enterprise's managers have not borne domestic tax at the full enterprise rate.[176]

One purpose of the system is to provide tax credits only for enterprise tax actually paid in the country where the corporation is resident.[177] This has the consequence that corporate tax preferences or foreign tax credits are recaptured at the shareholder level.

Example

The corporation has pretax financial profits of $30,000. It is entitled to a special deduction of $6,000 for making an investment and therefore has taxable profits of $24,000. The enterprise tax rate is 25 percent and so the corporation pays $6,000 in corporate tax. The corporation pays a dividend of $24,000. The payment of $6,000 in corporate tax will be recorded as a credit in the corporation's tax-paid account, and the payment of the dividend of $24,000 will create a debit of $6,000 to its tax-paid account.

The personal income tax rate is 33 percent. The shareholder reports as income $30,000— the sum of the dividend of $24,000 and the $6,000 debited to the corporation's tax-paid account. The taxpayer has a tax liability of $9,900 (33 percent of $30,000) and a tax credit of $6,000. The total tax eventually paid is $9,900— a corporate tax payment of $6,000 and a further shareholder tax payment of $3,300.

[176]Any excess that arises—that is, where dPT_c is greater than dPT_i—can be used as a credit against the shareholder's other tax liabilities, but is not refundable.

[177]This is, of course, not consistent with any neutrality principle—either capital-export or capital-import neutrality —and is accordingly open to criticism.—LM

	Amount (In units of local currency)	Rate (In percent)	Tax (In units of local currency)
Nonpreference income -	24,000		
corporate tax component		25	6,000
shareholder tax component		(33 -25)	1,920
Distributed preference income -	6,000		
shareholder tax		33	1,980
Total	30,000		9,900

This example involves the same problem of the "leakage" of tax benefits that was discussed in relation to the ACT system: is it possible to use tax credits from taxed but retained profits to immunize untaxed distributed profits from tax? If we relax the assumption that the corporation distributes all corporate profits, the treatment of untaxed profits distributed as dividends will depend on how the account is debited and how the tax credits are attached to dividends—an issue similar to that raised both in the ACT system and under the equalization tax variant. It is clear that the balance in the account (PT_c) would be insufficient to permit the corporation's managers to distribute a dividend with full tax credits greater than ($P(1 - T_c)$. But if the corporation's managers retain a proportion of the profits [$(1 - d)P(1 - T_c)$], the "unused" credits in the account (representing tax on taxed but retained profits) can be applied against the undeclared but distributed profits. If so, distributed undeclared profits can also be distributed tax free to shareholders under this system, as they are under an ACT system.

Example

The corporation has pretax financial profits of $30,000. It is entitled to a special deduction of $6,000 for making an investment and therefore has taxable profits of $24,000. The enterprise tax rate is 25 percent, and so the corporation pays $6,000 in corporate tax. The corporation, which could pay a dividend of $24,000, decides to pay a dividend of $18,000 to a shareholder who is a resident individual. The payment of $6,000 corporate tax will be recorded as a credit in the corporation's tax-paid account, and the payment of the dividend of $18,000 will be create a debit of $6,000 to its tax-paid account.

The personal income tax rate is 33α percent. The shareholder reports as income $24,000 —the sum of the dividend of $18,000 and the $6,000 gross-up for the amount debited to the corporation's tax-paid account. The shareholder has a tax liability of $8,000 (33$\alpha$ percent of $24,000) and a tax credit of $6,000. The total tax eventually paid is $8,000—a corporate tax of $6,000 and a further shareholder tax payment of $2,000. The shareholder's shares will have grown in value by an amount related to the $6,000 retained profits.

	Amount (In units of local currency)	Rate (In percent)	Tax (In units of local currency)
Nonpreference income -	24,000		
corporate tax component		25	6,000
shareholder tax component		33α -25	2,000
Undistributed preference income	6,000	33α	0
Total	30,000		8,000

3. *Streaming of Taxed and Untaxed Dividends*

The systems in operation actually allow more flexibility than this simple matter of leakage would suggest—hence, the comment above that the accuracy of the crediting mechanism may be more apparent than real. That flexibility raises an issue that is commonly referred to as "streaming"—that is, directing the tax credits to shareholders who can use them most advantageously. The examples above assume that the enterprise's managers will (and must) debit the tax-paid account with its full credit balance if the size of the dividend being paid permits them to do so. But if such a rule does not exist—in other words, if the corporation's managers have discretion about how much of the credit balance in the account to use and when—the possibility of streaming arises. For example, if the enterprise has shareholders in both high and low tax brackets, it might try to direct the credits predominantly to the former group (and not to the latter, where excess credits at the shareholder level might be unusable). Various devices and techniques would be needed, but having shares with differential rights or declaring successive dividends might be feasible tools, especially in closely-held companies.

To reduce this problem, the systems in place try to ensure that all dividends carry the same proportion of credits, where there are insufficient credits to cover all dividends to be declared in a year.[178] But this rule does not apply if the enterprise's managers plan to make distributions from undeclared profits up to the amount of retained declared profits, that is, if the total distribution is less than the balance in the account. This would mean that all dividends, whether out of declared or undeclared profits, up to

[178]AUS ITAA § 160AQF provides that all dividends paid under a resolution of the company are taken to be franked to the percentage specified in a declaration made in relation to the dividend. The declaration cannot be varied or revoked. Section 160AQG treats all dividends paid during the year on the same class of shares as being franked to the same percentage declared for the first dividend. The purpose of these sections is to prevent streaming of distributions whereby distributions carrying tax credits are paid to taxpaying entities, while taxable distributions (if any) are directed to tax-exempt bodies. Streaming of this kind would permit the enterprise to increase the after-tax return to both groups of shareholders. The section tries to prevent this practice by insisting on a pro rata attaching of credits rather than a first-in-first-out rule.

that amount could effectively be distributed tax free to shareholders. If, however, the enterprise's managers plan to distribute all of the declared profits and some portion of the undeclared profits, the rule does apply and all dividends will carry only fractional credits.[179] The enterprise's managers can effectively attach tax credits to a distribution up to an amount of taxed profits regardless of whether some portion of the amount distributed has actually borne tax. If there are insufficient credits, the gross-up and credit procedure described above will still operate for taxed profits but not for untaxed profits. If the profits are not taxed, they carry no tax credit and the shareholder simply includes the distributed portion of untaxed profits in income with no gross-up or credit and is taxed in the same way as under a classical system.

4. Nonresident Shareholders

The position of nonresident shareholders raises a few novel questions in the context of an account-based imputation system.

One reason for the imputation systems described above is that benefits can be, although they need not be, confined to resident shareholders. But if benefits are so confined, the issue will arise whether the tax-paid account must be debited in the case of dividends paid to non-resident shareholders because the shareholders will derive no benefit from the tax credit. Indeed, this is an area where streaming could be expected to occur—allocating all the credits for enterprise tax paid to resident shareholders where the system does not afford any benefit to nonresident shareholders.

International experience in this area is not uniform, although most, but not all countries choose to confine the benefits of their imputation system to resident shareholders. One interesting exception is Singapore, which levies no additional withholding tax on distributions. In addition, some of the treaties negotiated by France, Ireland, and the United Kingdom levy withholding taxes, but allow partial or full credits to flow to non-residents by refunds in cash.

For example, Australia's tax treaties with France, Ireland, and the United Kingdom allow Australian resident shareholders who are individuals some access to foreign imputation credits. Article 9(6) of the Australia-France treaty provides that an Australian resident who is an individual and receives a dividend from a company resident in France is entitled to a payment from the government of France equal to 85 percent of the tax credit (*avoir fiscal*) that would be attached to the dividend if received by an individual resident of France. Fifteen percent remains in France by way of withholding tax.

6. Full Integration System

[179]The Act also offers the corporation's managers the choice of franking the distribution of untaxed profits to 100 percent, but the corporation will be obliged at the end of the year to pay additional tax to repay the deficit balance in the franking account. That is, the corporation effectively prepays the next year's corporate tax.

The last option to be explored is a full integration system for enterprise.[180] An integration system operates at the shareholder level and attributes the enterprise's income, whether distributed or not, to the shareholders who are taxable on all the enterprise's profits. There are two varieties of full integration systems. One, usually referred to as the partnership version of the integration system, implies that no tax is imposed on the enterprise's profits, unlike the other systems already discussed. Under the other version, where the enterprise remains taxable, the enterprise's tax is then credited to the shareholders as a credit against their liability on the attributed profits.

Non-single rate schedular integration systems are intended to offset the effect of the enterprise income tax entirely so that all enterprise profits are ultimately taxed at individual marginal rates in the current year, regardless of whether the profits are distributed. This system promises the model treatment to which the other systems aspire, because all profits are taxed at exactly the shareholder's personal income tax rate (although portions of the total tax might be collected from both the enterprise and the shareholder), and there is no gain to the taxpayer from deferring the recognition of income by retaining profits within the enterprise.[181]

The so-called partnership-style integration achieves this result by eliminating the enterprise tax altogether and taxing the shareholders as if they were in partnership—all enterprise profits are included in the individual's taxable income. The United States permits shareholders to elect this treatment under Subchapter S of Chapter I of the Internal Revenue Code for domestically controlled corporations with few shareholders and little foreign-source or passive income.[182] One consequence of the election is that the benefits of corporate losses and tax preference items are passed through to the shareholders.[183] For the reasons discussed in section II above, this style of integration is generally considered unfeasible as a model for all corporations and will not be considered further in this chapter.

With this exception and for the reasons referred to earlier, no country has adopted a full integration system for the taxation of domestic enterprise and their resident shareholders, despite the support of many commentators and several government

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[180]*See generally* Pechman, *supra* note 103, at 178–81; McLure, Must Corporate Income Be Taxed Twice?, *supra* note 103, at 2–9; Bradford, *supra* note 79, at 54–56; Blueprints, *supra* note 3, at 63–69; Bird, *supra* note 103, at 235. To add to the complexity, there are also partial integration systems. Under a partial integration system, some (or all) of the corporation's profits are attributed to the shareholders and some (or all) of the corporation's tax is credited to the shareholders. McLure, *supra* note 103, at 15–18.

[181]*See* Cnossen, *supra* note 108, at 98; Bird, *supra* note 103, at 235.

[182]*See generally* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ch. 6 (5th ed., 1987).

[183]USA IRC § 1372(b)(1) (corporation not taxable); § 1373(b) (shareholders taxable on all income); § 1374 (corporate losses deductible to shareholders). In this model, the corporation effectively ceases to exist as either a separate taxable entity or a withholding point.

reports.[184] But, somewhat surprisingly, a second style of integration system is more common for taxing nonresident enterprises controlled by resident shareholders, where the system is usually referred to as a controlled foreign corporation (CFC) tax system. In this context, the system is used not because it approximates the economist's ideal of eliminating the double taxation of enterprise profits, but rather as an antiavoidance mechanism to prevent the accumulation of untaxed passive or tax-sheltered income offshore.[185] This section considers a theoretical CFC-type system, but for domestic enterprises.[186] Such a system is not in use in any domestic tax system, but the one described here would achieve the central element of an integration system, taxing shareholders currently on all declared enterprise profits, but with the innovation of retaining the enterprise tax as a pure withholding mechanism.

A. RESIDENT INDIVIDUALS

For this integration system, it is assumed that the enterprise still pays tax on its profits and that the individual shareholders pay income tax at progressive marginal rates on all the taxable profits of the enterprise, whether or not they are distributed. A tax credit is then given to the shareholders for the entire enterprise tax paid. Again, a decision would have to be made whether the tax credit mechanism traces actual payments of enterprise tax or operates automatically. Any retained profits are taxed to the shareholders at the appropriate personal rate when earned (and appropriate credits are also attributed). The shareholder's cost in the shares is increased by the amount of profit taxed to the shareholder, to avoid double taxation when the shares are disposed of.[187] Any further capital gain beyond the value of retained taxed earnings is taxed in the usual way as capital gain. When the enterprise's managers report and pay tax on the enterprise's full profit, the after-tax position of the shareholder is

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[184]*See supra* notes 103, 183.

[185]*See* USA IRC subpt. F, AUS ITAA pt. X. CFC regimes exist in Australia, Canada, France, Germany, Japan, New Zealand, Norway, Sweden, the United Kingdom, and the United States. *See* B. Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison (1986). Curiously, while CFC systems were originally developed as a means of eliminating the gain from accumulating lightly taxed income offshore, the substantial income tax rate reductions of the 1980s mean that some taxpayers may now benefit from creating a CFC. *See* Paul McDaniel & Hugh Ault, Introduction to United States International Taxation 118–20 (3d ed. 1989). *See also* OECD, Controlled Foreign Company Legislation (1996).

[186]*See* Pechman, *supra* note 103, at 178–81. It is one of the prototypes suggested by the U.S. Treasury Report, *supra* note 3.

[187]The result might be prevented in several ways, including, for example, through a further gross up and credit procedure that increased the basis in the shares by (T_g/1 - T_g) and gave to the shareholder a credit against capital gains tax for the same amount that could be carried forward and used when the shares were sold. Instead, the procedure described here is the one used in the United States to reconcile the capital gains tax and personal income tax on shareholders in *S* corporations, with appropriate modifications to reflect the fact that the corporate tax has been retained in this discussion. *See also* Blueprints, *supra* note 3, at 64. An alternative procedure—used in Australia for the attributed profits of CFCs—writes down the proceeds of sale by amounts already attributed, permitting shareholders to sell retentions of previously taxed income without further tax. AUS ITAA § 461.

$$R = P(1 - T_i)$$

This result would be achieved in several steps. First, enterprise tax (PT_c) is collected from the enterprise. The amount of any distribution is included in the shareholder's income together with the usual gross-up for enterprise tax:

$$dP(1 - T_c)[(1 + T_c) / (1 - T_c)] = dP.$$

This approach generates a tax liability at the personal income rate (dPT_i) and the shareholder receives a credit (dPT_c) against this tax liability for the enterprise tax paid. The element that makes this system different from those described earlier is that retained earnings and a further gross-up for enterprise tax on the earnings would also have to be included in the shareholder's current assessable income

$$(1 - d)P(1 - T_c)[(1 + T_c) / (1 - T_c)] = (1 - d)P.$$

This creates a tax liability of $[1 - d)PT_i]$ and a credit of $[(1 - d)PT_c]$ is set off against the tax liability.

The capital gains tax is retained to capture items not taxed on a current basis, such as unrealized enterprise profits, tax preferences, or stock market gains.[188] A further adjustment is necessary to reflect the fact that some of the retained profits reflected in the price of the shares will already have been taxed. The adjustment involves annually increasing the shareholder's cost in the shares by the amount of retained earnings taxed in that year.[189] If the taxpayer realizes only the accumulated value of retained taxed profits, the shareholder's basis equals this amount and no capital gain arises.

[188]U.S. Treasury Report, *supra* note 3, at 82 ("not all capital gains from increases in the value of corporate equity arise from accumulated retained earnings. Gains from other sources may imply different tax consequences than those applicable solely to gains from fully taxed retained earnings"); Head & Bird, *supra* note 113, at 15 note 22 ("a capital gains tax at the personal level would still be needed to tax 'goodwill gains'—those arising from such factors as improved market position, technological developments, and natural resource discoveries").

[189]In the United States, this process occurs in two steps. USA IRC § 1367(a)(1)(A) increases the shareholder's basis in the share holding by the "items of income described in subparagraph (A) of section 1366(a)(1)." This is the provision that includes in the shareholder's taxable income "the shareholder's pro rata share of the corporation's items of income (including tax- exempt income)." USA IRC § 1366(a)(1)(A). A subsequent provision states that this increase in basis occurs "only to the extent such amount is included in the shareholder's gross income on his return." USA IRC § 1367(b)(1). The shareholder's basis is then reduced by "distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368." USA IRC § 1367(a)(2). Section 1368 exempts distributions by an S corporation up to the lower of the shareholder's basis in the shares or the balance in the "accumulated adjustments account." The result of these provisions is that the shareholder will increase his or her basis in the shares by the net of the income actually disclosed by the corporation and distributions up to the amount actually disclosed.

The annual increase in the shareholder's cost in the shares comes about through a series of steps.[190] Given that the enterprise's managers have distributed some after-tax profits, the enterprise still retains an amount $[(1 - d)P(1 - T_c)]$ on which enterprise tax has already been paid. The shareholder's cost in the total retained earnings is calculated in the following way. First, the shareholder's cost is increased by the amount of taxable profits remaining after corporate tax $[P(1 - T_c)]$. Then the shareholder's cost is reduced by the amounts already "liberated" from the enterprise for the benefit of the shareholder—the distributed taxed profits and the tax attaching to all profits. Thus the taxpayer's basis in the earnings is increased by $[(1 - d)P(1 - T_c)]$. The system operates in this fashion:

Example

The corporation has pretax financial profits of $24,000. The corporate tax rate is 25 percent and the corporation is liable to pay $6,000 in enterprise tax. The corporation pays a dividend of $15,000 to a shareholder who is a resident individual and retains $3,000. The personal income tax rate is 30 percent on income up to $40,000 and 40 percent thereafter.

The corporation pays tax of $6,000. The shareholder reports as income $24,000—the sum of the dividend of $15,000 and a tax credit attached to it of $5,000 [($15,000 x 0.25/0.75] and the retained earnings of $3,000 and the tax credit attached to it of $1,000 ($3,000 x 0.25/0.75]. The investor is liable to gross tax of $7,200 and has a total tax credit of $6,000. The shareholder's cost is increased by $3,000.

B. PREFERENCE INCOME

The treatment under such a system of the untaxed enterprise profits, such as enterprise-level tax preferences or foreign income, raises several policy issues. The decision about the crediting mechanism will be the basis for the answer. If the decision is made that preference income is washed out at the shareholder level, then only actual tax payments, rather than an automatic credit, should be used for computing the tax credit. The shareholder's cost is increased by the amount of taxable profits (P) remaining after enterprise tax $[P(1 - T_c)]$ and reduced by the amount of profits distributed without further personal income tax $[dD(1 - T_c) + d(P - D)]$, up to the amount of the taxable profits. Thus, the taxpayer's basis in the earnings is increased by only $[(1 - d)D(1 - T_c) - d(P - D)]$; that is, untaxable but distributed profits effectively reduce the increase in basis by the amount distributed. This means that the capital gains tax calculation becomes

$$\{ (1 - d)D(1 - T_c) + (1 - d)(P - D) - [(1 - d)D(1 - T_c) - d(P - D)] \} (1 - T_g).$$

which becomes $[(P - D)(1 - T_g)]$.

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[190]These steps have to be modified from those described in note 192 *supra* because the enterprise tax still remains in operation, unlike the position of *S* corporations in the United States.

The eventual after-tax position of the shareholder becomes

$$R = D(1 - T_i) + (P - D)(1 - T_g).$$

Example

The corporation has pretax financial profits of $30,000. Because of a special incentive, it is entitled to a special tax deduction of $6,000. It therefore has taxable profits of $24,000. The enterprise tax rate is 25 percent, and so the corporation is liable to pay $6,000 in corporate tax. The corporation pays a dividend of $15,000 to a shareholder who is a resident individual and retains $3,000 of its taxable profits. The personal income tax rate is 30 percent on income up to $40,000 and 40 percent thereafter.

The corporation pays tax of $6,000. The shareholder reports as income $24,000—the sum of the dividend of $15,000 and a tax credit attached to it of $5,000 ($15,000 x 0.25/0.75) and the retained earnings of $3,000 and the tax credit attaching to it of $1,000 ($3,000 x 0.25/0.75). The investor is liable to gross tax of $7,200 and has a total tax credit of $6,000. The shareholder's cost is increased by only $3,000.

If the corporation distributes some of the untaxed profits, the deficiency will be recaptured in the taxation of dividends. But because the tax preference income is not taxable income, it is difficult to see how it could be attributed to shareholders and taxed on a current basis. Therefore, it remains to the capital gains tax to collect tax, albeit deferred, on this income.

Example

The corporation has pretax financial profits of $30,000. Because of a special incentive, it is entitled to a special tax deduction of $10,000. It therefore has taxable profits of $20,000. The enterprise tax rate is 20 percent, and the corporation is liable to pay $4,000 in corporate tax. The corporation pays a dividend of $24,000 to a shareholder who is a resident individual and retains $2,000. The personal income tax rate is 30 percent on income up to $40,000 and 40 percent thereafter.

The corporation pays tax of $4,000. The shareholder reports as income $28,000, the amount of the dividend and the tax credit attached to it of $4,000 (because of the tracing process). The investor is liable to gross tax of $8,400 and has a tax credit of $4,000. The shareholder's cost is not increased so that the retained untaxable earnings of $2,000 will be taxed as capital gain only. Total tax paid is $8,400, $4,000 by the corporation and $4,400 by the investor.

In this case, the outcome is just as if the investor had faced the following tax rates:

	Amount (In units of local currency)	Rate (In percent)	Tax (In units of local currency)
Distributed non-preference income	20,000	30	6,000
Tax on non-preference income	4,000	30	1,200
Distributed preference income	4,000	30	1,200
Retained preference income	2,000	0	0
Total	30,000		8,400

C. NONRESIDENT SHAREHOLDERS

Although on the basis of the discussion in previous sections, it might be thought that a full integration system is eminently desirable, its apparent virtues are subject to one major and probably insuperable impediment—the difficulties presented in taxing of nonresident shareholders.

As has been mentioned already, the general consensus that has developed on the appropriate international allocation for taxing enterprise profits is that the source country is able to tax the enterprise in full and has limited rights to tax dividends paid out of those profits. A system of full integration challenges this consensus by attempting to tax the nonresident shareholder on undistributed profits, an option that tax treaties do not explicitly countenance.[191] It is unclear whether the source country has the right to tax this amount prior to distribution, what rate would be applied, and, correspondingly, whether the shareholder could insist that the tax system in its country of residence give relief for the tax so collected.

Taxing undistributed profits is a challenge not only to the existing tax base orthodoxy, but also to a tax administration. The ability to tax resident shareholders on undistributed income is facilitated by having both the enterprise and the shareholder as residents —any top-up tax on undistributed profits can be collected when the resident files a return. For nonresident shareholders, the tax administration would have to collect both the profit tax and the tax on undistributed profits from the enterprise directly because there is no dividend to tax, and the shareholder is not necessarily within the

[191]This problem already arises when a residence country taxes a resident on the accumulated profits of a foreign controlled corporation under its CFC rules. For a discussion of this problem of the interaction of tax treaties and domestic CFC systems, *see generally* OECD Model Treaty, *supra* note 122, paragraphs 23–26, commentary to article 1. *See also* OECD, *supra* note 188.

jurisdiction of the source country's tax administration. While this result is technically feasible, it is not clear what rate should be applied because there is no real information about the marginal tax rate applicable to the nonresident.

Moreover, as a practical matter, in a world where taxes are an important factor in decisions about locating real investments, no country can afford to be the sole country to tax resident enterprise on such a basis.

VI. Distributions

A. Typology of Distributions

For the purpose of this section distributions are defined as any payment made by a company to its shareholders with respect to the shareholders' capital investment. Distributions can take various forms, the most common of which are amounts paid by companies as dividends and amounts paid to repurchase company shares, or to purchase the shares of a subsidiary of the company. However, inventive finance and tax experts are constantly developing new techniques of making company distributions to shareholders. In addition to assuming various different forms, distributions can have different economic origins. They can be paid out of profits that have been taxed at the company level, out of profits that have not been taxed at the company level, or out of no profits at all (meaning, they constitute a return of capital).

B. Tax Consequences of Distributions from Different Origins

The tax consequences of a distribution arising from one of these three different origins will vary significantly depending on the type of tax system in place. One constant among income tax systems, however, is that shareholders do not include as income distributions that constitute a return of capital. In addition, shareholders whose tax base includes capital gains and losses on sale or transfer of their shares must make a downward adjustment to their share cost in an amount equal to such a distribution.[192] Therefore, all tax systems are concerned with whether a distribution constitutes a return of capital.

In addition, fully integrated tax systems are concerned with techniques that allow enterprises to declare taxable bonus shares or to use other techniques that allow shareholders whose tax base includes capital gains and losses on sale or transfer of their shares to, in effect, increase the cost of their shares by the amount retained. In addition,

[192]From a purely theoretical perspective, it would be possible to require a shareholder who included capital gains and losses on its shares in its tax base to include the return of capital in the tax base, and not require any adjustment of the share's cost. When the shareholder sold or transferred the shares, the shareholder would realize a loss equal to the return of capital previously taxed. If tax rates on income and capital gains and losses were the same, and if the taxpayer could claim the entire loss, the taxpayer would be made whole.

in imputation systems where the enterprise tax is at a higher rate than for some shareholders, these techniques may also allow the sharheolder to receive a credit for the difference between the two rates.[193]

The different treatment accorded distributions made from taxed income and from untaxed income will vary depending on a number of factors. The most important is whether there is an integrated enterprise-shareholder tax with the enterprise rate equal to or higher than the shareholder rate. In such system, distributions of income fully taxed at the enterprise level need not be taxed at the shareholder level, although depending on the integration system the shareholder may be entitled to a refund of all or part of the accompanying credit. However, as discussed in the previous section, any distribution from income that was either not taxed at all or not fully taxed at the enterprise level raises the question of whether tax should then be levied.

Obviously, this question can only arise when enterprises are not taxed on a base that closely approximates their economic income, or at a rate less than the top shareholder rate. As was discussed at length in the previous section, the tax system can either not tax distributions from untaxed income, or tax them in some way. Also as discussed at length in the previous section, some of the more common techniques employed to tax distributions from untaxed or partially taxed income include using a compensatory- type tax levied on payment at the enterprise level, levying tax on receipt at the shareholder level, or combining the two techniques into a hybrid system.

In jurisdictions without full imputation, the issue is different still. These jurisdictions impose tax on distributions from both taxed and untaxed income, although typically at the same rate. While the reasoning for imposing double taxation on company income is not particularly compelling, it requires levying a tax on all distributions other than those that constitute returns of capital. Withholding or shareholder level taxes, or a hybrid of both, can be used to levy this additional tax on the distribution.

C. Implications of Different Tax Consequences for Distributions

As can readily be seen, it would benefit an enterprise's shareholders if it could make distributions of untaxed or partially taxed income without drawing additional tax. For this reason, and depending on the rules the particular jurisdiction has in place, enterprises may attempt to disguise distributions that draw additional tax as distributions that do not draw additional tax. For example, in integrated systems, an enterprise may try and make a dividend look as if it were paid from previously taxed income. In both integrated and unintegrated systems, an enterprise may try and make a dividend or a redemption appear as if it constitutes a return of capital.[194] And, as noted earlier,

[193]This issue is discussed in greater length *infra* at .

[194]With imputation systems the incentive for the company to find ways to make non-taxable distributions exists only with regard to its untaxed income, while in unintegrated systems the incentive extends to all company income, whether taxed or untaxed at the company level.

inventive finance and tax experts are constantly developing new techniques of making enterprise distributions to shareholders, techniques that may not be adequately addressed by existing rules, or that may not be sufficiently understood by hard-pressed tax administrators.

D. Simplified Systems

Given these incentives for enterprises to avoid tax, and the inventiveness with which they may try to do so, it would greatly simplify the design and implementation of enterprise- shareholder tax systems if it were unnecessary to tax distributions. As discussed in the previous section, if nearly all income were taxed at the enterprise level in a fully integrated system, the question would not arise as to whether any distributions should be taxed, in that all distributions would either be paid out of taxed income, or would represent returns of capital to shareholders. And, if a single-rate schedular tax at the shareholder level equal to and integrated with the tax of the enterprise level were applied, then no distribution would be taxable as income by the shareholder.[195] In such a simplified system, the only tax effect a distribution would have would be on those shareholders subject to capital gains tax, who would have to determine whether the distribution were a return of capital; if so, they would be required to adjust downward the share's cost by the amount of the distribution.

In the case of non-schedular imputation systems it would only be necessary to distinguish between distributions carrying imputation credits (which would be included as income, along with a credit) and those that did not (which would be treated as return of capital).[196]

[195]This would include non-resident investors, who would be exempt from additional withholding tax.

[196]In the former case, distribution plus credit would be added to the shareholder's income, with a credit given against tax due, with only share cost adjustment in the latter case. In these systems there may be instances where shareholders are subject to tax at a rate less than the enterprise rate. While it would be one thing to allow small amounts of profits untaxed at the enterprise level also to go untaxed at the shareholder level, it would be another thing to allow these shareholders to claim credits for enterprise tax that was never actually paid. For this reason, it might be advisable to limit the total amount of credits that can be claimed to total amounts of enterprise tax.

E. Rules for Distinguishing Between Distributions of Income and Returns of Capital

In the absence of a single tax rate schedular system it may sometimes be necessary to determine whether a distribution constitutes a return of capital. In addition, in a system where a fair amount of income can escape enterprise tax, or where there is no integration or incomplete integration, there is an incentive to describe distributions as nontaxable returns of capital. However, in a system where substantially all enterprise income is already fully taxed, and where there is complete integration, there is no such incentive. In fact, if anything, there may in some cases be an incentive to disguise distributions of capital so as to avoid reducing the adjusted cost of the share for capital gains purposes. While the latter incentive would presumably be considerably less of a problem than the former, it would still be helpful to have simple techniques for determining what constituted a return of capital and what did not.

Unfortunately, most jurisdictions have systems where a fair amount of income can escape enterprise tax, or where there is no integration or incomplete integration, and are therefore more concerned with proving distributions to be taxable than not to be taxable. One technique for policing distributions is to rely, in effect, on the operations of corporate law.[197] Corporate law governs the circumstances and manner by which a company may make a distributions to its shareholders. Under the corporate law of many jurisdictions, distributions to shareholders are subject to a number of restrictions designed to protect the rights of creditors. In the most restrictive company law regimes, distributions are restricted to dividends paid out of company profits (as determined by special corporate accounting rules), and to the redemption of certain limited types of stock (usually preferred);[198] other types of stock redemptions, including the purchase of shares in a subsidiary, are prohibited. In these cases, only the price paid for the redemption of preferred stock would be treated as a return of capital.

However, corporate law rules concerning shareholder distributions are, at least in many jurisdictions, being liberalized. The repurchase of nonredeemable shares is now often permitted, as is, in at least some jurisdictions, the payment of dividends out of capital. In these cases it still may be possible to rely on the corporate law rules for purposes of defining for tax purposes what is a return of capital. In particular, the rules would have to determine when a dividend is not made out of company income, and how much of the purchase price of a share buy back would have to be deemed to be a return of capital.

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[197]Of course, corporate law would not govern enterprises other than corporations. However, most large economic enterprises in most jurisdictions operate in corporate form. In certain cases, it may be possible to apply corporate law to other enterprises that function like corporations.

[198]Such a rule would greatly restrict the ability for a company to borrow against appreciated assets and make distributions to shareholder of the proceeds of the borrowing. On the other hand, if a tax rule were adopted which required the taking into income of such proceeds, it should also be treated as income for corporate law purposes.

A helpful modification of this approach may be to combine corporate law rules with special tax rules, particularly with regard to determining a corporation's income. If comprehensive income tax rules are applied, taxable income can, for example, be substituted directly for traditional definitions of corporate "profits."[199] However, the rules concerning what constitutes a repayment of capital in the case of stock redemptions would continue to apply.

In a fully integrated system that effectively taxes nearly all of a company's income, such rules should be relatively easy to apply.

F. Complex Systems

However, it is a different story in systems that do not capture most income through the enterprise tax, or where the shareholder level tax is equal to and integrated with the tax at the enterprise level. Considerable additional care on the part of tax administrations will likely be required if they wish effectively to capture distributions from untaxed income (in imputation systems), or from both untaxed and taxed income (classical systems). This is because the incentives to make otherwise taxable distributions look like nontaxable distributions will be greater. In these cases, corporate law rules may be too easily manipulated, and may require additional tax rules to prevent tax avoidance. For example, if there is untaxed income at the enterprise level, it will always be preferable to make distributions to shareholders through redemptions if those payments are treated as returns of capital and therefore not taxable.

G. Examples

As described in the previous section, France has a partial imputation system.[200] It levies a compensatory tax on distributions out of income not fully taxed at the enterprise level. The tax system does so in what is essentially a two step process. It first determines if the distribution is from profits (whether taxed or untaxed). It next determines if the distribution is from income already subject to full tax. If so, the *précompte mobilier* is applied.

Essentially any distribution to shareholders (other than bonus shares that represent capitalization of reserves or earnings) is deemed to be out of profits, unless it qualifies for treatment as a redemption or a liquidation.[201] The enterprise keeps track of what profits it has retained and which have born full tax, and a stacking rule provides that distributions come first from after-tax profits, then from untaxed profits.[202]

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[199]*See supra* note 6.

[200]This discussion is based on Hugh J. Ault et al., Comparative Income Taxation: A Structural Analyis 304–05 (1997).

[201]Under French law corporate stock dividends can be received in cash at the choice of the shareholder.

[202]Although a time limit is in effect, after which the after-tax profits can no longer be distributed without bearing the *précompte mobilier*.

The French rules on the treatment of redemptions is rather complicated. Where redemptions are permitted, a portion of the distribution may be deemed to be taxable. A number of steps must first be followed to determine what portion. For those shareholders not subject to capital gains tax, the portion of the distribution that exceeds the greater of the shareholder's actual gain or the amount of the share's paid in capital is taxable as a dividend, up to the extent of the enterprise's accounting profits. All amounts paid out of untaxed profits are subject to the *précompte mobilier*. A different, and more complicated rule applies to shareholders subject to capital gains tax.

These tax rules appear to allow enterprises to borrow against appreciated assets, and then use the proceeds of the borrowing to pay exempt dividends or to make exempt redemptions. However, French corporate law mitigates these options substantially. It prohibits companies from making distributions of dividends except out of accounting profits, and severely restricts the ability of companies to make redemptions. However, if corporate law were to change, so too might these conclusions.

As described in the previous section, the United Kingdom has only a partial imputation system, and uses the ACT as its primary technique of capturing distributions from untaxed income. Under this system, it is necessary first to determine which distributions are from income (whether taxed or untaxed), for those distributions will attract ACT. Distributions from capital do not attract ACT. Next, it is necessary to determine whether the distribution is from taxed income. This is done by keeping track of total taxes paid, and by assuming that distributions are made first from taxed income, next from untaxed income. A partial credit for the ACT is then given against the corporate tax paid. If the ACT credit were given in full, the net effect would be that only those distributions from untaxed income would be subject to tax.

The U.K. law defines taxable distribution as including any dividend allowed under corporate law, as well as any other distribution unless defined as repayment of capital.[203] U.K corporate law allows dividends to be paid from unrealized capital gains; these are taxable. However, a dividend from capital is not permitted. As a general matter, amounts returned to the shareholders in a redemption of capital in excess of the paid-up capital allocable to the shares in question are deemed to be non-capital distributions.[204] There is also a rule that where a company repays share capital and at any time thereafter it issues any share capital as paid up otherwise than by the receipt of new consideration, then the amount so paid up will be treated as a distribution.[205] A distribution of bonus

[203]GBR ICTA § 209.

[204]*See* Barry Pinson, Pinson on Revenue Law 283 (1981). Generally, the paid-up capital for corporate law purposes is the stated capital of the class of shares in question as shown in the company's financial statement.

[205]GBR ICTA § 210.

shares is not treated as a distribution, although the bonus shares may be subject to what is in effect a special tax at the shareholder level.[206]

The U.K. rules do capture borrowings against appreciated assets that are paid out to shareholders as dividends. However, the rules also make it possible for enterprises to turn otherwise taxable distributions into non-taxable returns of capital through share redemptions. While corporate law limits the ability of companies to make redemptions, the opportunities are still greater than under French law.

Canada maintains a partial imputation system without the levying of additional tax on any distributions. This is due in part to the presumption that distributions to shareholders in the form of dividends have already born enterprise-level tax. Dividends are therefore deemed to have been paid out of taxed income, save for certain instances where the dividend is deemed to be a return of capital.[207] Because the imputation system is only partial, additional tax may be due at the shareholder level on dividends. However, if the distribution is deemed to be from capital, there will be no additional tax.

The term "dividend" is not defined by statute, but has been interpreted by the courts and the tax administration as meaning any distribution except as an authorized reduction of capital. In addition, the statute defines dividends to include stock dividends. The statute treats all or a portion of distributions made during share redemption or reduction in capital as non-taxable returns of capital. The amount treated as a dividend is the amount distributed in excess of the paid-up capital allocable to the shares in question.

H. Taxable Bonus Shares and Constructive Dividends

Enterprises may wish to retain earnings rather that to distribute them to their shareholders. These retained earnings will be reflected in an increase in the value of the enterprise's shares. If these earnings have been subject to tax, the increase in shareholder value will represent already taxed gains. In a fully integrated tax system, there will be a tax disincentive for retaining these earnings unless the shareholder who is subjected to capital gains taxation is not taxed on these gains. Therefore, such systems typically allow enterprises to take measures to ensure that such shareholders are not so taxed. In addition, in imputation systems where the enterprise tax is at a higher rate than for some shareholders, these techniques may also allow the shareholder to receive a credit for the difference between the two rates.

[206] *See* Barry Pinson, *supra* note 206, at 284.

[207] This discussion is based on Brian Arnold et al., Materials on Canadian Income Tax 698 (1993).

Two typical methods include allowing enterprises to declare either taxable bonus shares or what has sometimes been termed "constructive dividends." Taxable bonus shares are typically shares paid as dividends that represent capitalized earnings through the issuing of additional shares of stock,[208] although there is no particular tax reason why capitalization under company law should be required. The value of a dividend distributed as a bonus share equals the proportionate amount of capitalized earnings. The result is a decrease in the value of the existing shares equal to the cost of the new shares, which is itself equal to the amount of retained earnings. Systems must ensure only that the bonus share represents after-tax income.[209]

Another technique is to allow enterprises to declare "constructive dividends."[210] These are notional dividends that are declared but not actually paid, and are designed to allow shareholders to increase their share cost by the amount of the retained earnings. This can be effected by an enterprise simply reporting to a shareholder the per share amount of after tax income the enterprise has retained; a shareholder subject to capital gains taxation can then increase cost by this amount.[211]

VII. Defining Which Business Enterprises Should be Subject to Separate Corporate Tax

An enterprise tax law must spell out, usually at the beginning of the statute, which entities are subject to tax. As with the individual income tax, a distinction must be drawn between residents and nonresidents, nonresidents typically being taxed only on income sourced in the jurisdiction. The definition of residence is discussed in chapter 18.

One definitional technique that is often used in civil law countries is to rely on an entity's legal status. Under this approach, if an entity is considered a legal person under the civil code, then it will be subject to enterprise tax. This rule may then be supplemented by listing specific forms of legal persons that are subject to tax, listing as taxpayers certain entities that are not legal persons and excluding certain legal persons from tax. For example, the German corporate income tax law lists the most common types of commercial companies, adds "any other legal persons under private law," adds certain entities (such as *Stiftungen*) that may not be legal persons, and also includes

[208]In a number of countries taxable bonus shares can only be issued if the company has capitalized the retained earnings. *See* the discussion in Hugh J. Ault et al., Comparative Income Taxation: A Structural Analysis 314-317 (1997).

[209]In some imputation systems a shareholder taxed at less than the enterprise rate may qualify for a credit for the difference.

[210]The ALI Integration Report describes them as this way, while the U.S. Treasury Department Report refers to them as reinvested dividends. ALI Integration Report 125-27; U.S. Treasury Report 87-8, 106-7,

[211]As noted *supra*, in some imputation systems a shareholder taxed at less than the enterprise rate may qualify for a credit for the difference.

enterprises administered by entities that are legal persons under public law (even when the enterprise may not itself be a legal person).[212]

The French approach is broadly similar. The law lists certain forms of company and then refers to "any other legal person carrying out an exploitation or operations of a profit making nature." It then lists certain forms of companies that are subject to corporate tax on an elective basis.[213]

Although, as illustrated in the above examples, corporate tax laws in civil law countries typically start from the status of entities as legal persons, these countries do not uniformly subject entities to corporate tax if and only if they are legal persons.[214]

Common law countries take different approaches. Canada relies on legal personality, imposing the income tax on any "person."[215] The United States imposes the corporate income tax on "every corporation," but corporation is defined as including "associations."[216] In turn, the regulations have adopted a test of corporate resemblance, holding that entities with sufficient corporate characteristics are taxed as associations. Hybrid entities can now elect whether to be treated as a corporation or as a partnership.[217]

In the United Kingdom, corporation tax is imposed on "profits of companies."[218] Company "means... any body corporate or unincorporated association but does not include a partnership, a local authority or a local authority association."[219] This differs from the U.S. approach in that partnerships cannot be recharacterized as associations and therefore treated as corporations. In addition, some non-corporate entities such as unit trusts are taxed in essentially the same manner as companies, only at different rates and with more complete integration.

Some transition countries treat as taxpayers under the corporate tax not just legal persons, but separate divisions of legal persons.[220] This practice arises from the treatment of these divisions as separate enterprises under the former command economy. The fact

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212 *See* DEU KStG § 1.

213 *See* FRA CGI § 206.

214 *See infra* ch. 21, note 18.

215 CAN ITA § 2.

216 *See* USA IRC §§ 11, 7701(a)(3).

217 *See infra* ch. 21, note 38.

218 GBR ICTA 1988 § 6.

219 *Id.* § 832(1).

220 *See, e.g.,* ALB PT § 4; RUS PT § 1(1)(b). Georgia used to tax divisions separately, but has now changed this rule. *See* GEO TC §§ 12, 44(2).

that these enterprises were not separate legal persons may have been of little importance in the past. However, their treatment as separate taxpayers under the profits tax can be problematic. In particular, how can systems designed to tax dividends operate when the dividends are paid not by each separate division but by the legal person? How are transfers of property among divisions to be accounted for? Although taxing divisions separately may not fit very well with a market economy-type corporate tax, there has in some countries been resistance to changing the system of taxing divisions separately. The divisions may be accustomed to keeping separate accounts, and tax officials may also be accustomed to auditing and dealing with divisions separately (corruption may be involved here). Local governments may be used to receiving their share of the revenues from the divisions located in their jurisdictions (they are often entitled to a share on this basis under laws governing the division of revenues from taxes). Eventually, however, as revenue sharing laws are adjusted, it can be expected that these special rules treating divisions as separate taxpayers will be abandoned.

The opposite issue is consolidation of taxpayers. Consolidation is allowed, for example, in the United States under extremely complicated rules. A few transition countries also allow consolidation.[221] Generally, countries whose tax system is not highly developed should steer clear of allowing consolidation.

Some transition countries impose a tax not on legal persons or corporations but on enterprises, which in some cases can include sole proprietorships. For example, in Latvia, taxpayers of the enterprise income tax are defined as enterprises, with a cross reference to the Law on Taxes and Fees.[222] That law in turn defines as resident an entity that is "registered" in accordance with the legislation of Latvia.[223] The enterprise income tax excludes from the definition of taxpayer individual enterprises that are not required to submit annual reports in accordance with the Law on Annual Reports of Enterprises. Therefore, sole proprietorships that are required to submit such reports are taxed under the enterprise income tax. And in Vietnam, the new Business Income Tax applies generally both to individuals engaged in production and trade and to business entities. The law itself does not provide for flow-through treatment for partnerships, thereby leading to some confusion when business is carried out in partnership form (particularly when the partners themselves are companies). Who is the taxpayer in that case? The partnership, the partners, or both? The enterprise income tax law of China likewise taxes enterprises, which are defined as state-owned enterprises, collective enterprises, private enterprises, joint-venture enterprises, and "any other organizations deriving income from production and business operations and other income."[224]

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[221] *E.g.,* KAZ TC § 6(4), second paragraph (allowing consolidation in limited circumstances upon decision of the government); AZE PT § 1(2)(consolidation for certain taxpayers by government decision).

[222] *See* LVA EIT §§ 1, 2.

[223] *See* LVA LTF § 14.

[224] *See* CHN EIT § 2.

Imposing tax on enterprises as described in the preceding paragraph can be faulted for lack of clarity. The basic problem is that "enterprise" is generally not a clear legal concept.[225] It is much better technique for the law to refer to legal persons because it will be clear whether an entity is a legal person.[226] However, one can see the counter argument. If everyone carrying on a business is required to register as an enterprise, it seems an attractive proposition to tax separately each registered enterprise, regardless of its legal status.[227] Again, the same arguments can come up as with corporate divisions. Enterprises may be registered locally. An administrative mechanism may have grown up around the concept of enterprise registration. The basic problems with this approach are that (1) a single legal or physical person may have more than one registered enterprise or branch, and the boundaries around these enterprises may be difficult to draw, and (2) a person may carry on a business without registering it. Using instead the concept of legal person provides for greater certainty because it derives from the legal personality of the taxpayer as defined in the civil code.

The definition of taxpayer also needs to specify exemptions. Government agencies, but not government-owned enterprises, are typically exempt. Also typically exempt are various forms of nonprofit organization, whose definition will differ from country to country. When a system of incorporation and registration of such organizations exists outside the tax law, it may be possible to simply make a cross reference, rather than to put all the necessary qualifications into the tax law. It is necessary to determine which agency (for example, the tax agency or some other licensing agency) will be responsible for ensuring that the entities in question qualify as nonprofit. While some countries completely exempt certain organizations from tax,

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[225]Particularly problematic are enterprises that are operated as partnerships (with greater or lesser degrees of formality) and sole proprietorships. These are generally not legal persons and may or may not be formalized. In China, sole proprietorships are regulated by the Provisional Regulations on the Management of Individual Industrial and Commercial Households in Urban and Rural Areas, promulgated by the State Council on Aug. 5, 1987.

[226]For example, in China, art. 36 of the General Principles of Civil Law of the People's Republic of China, *reprinted in* Robert Guillaumond & Xie Zhao Hua, Code chinois du droit des affaires (Maison Larcier 1995), establishes the concept of a legal person. The Company Law, *reprinted in id.,* establishes two forms of commercial company: limited companies and share companies. Both are legal persons. The law distinguishes between branches of companies, which are not legal persons, and subsidiaries, which are. *See id.* art. 13. Foreign companies are allowed to establish branches in China and must obtain a business license in order for the branch to be allowed to operate in China. *See id.* art. 200. However, such branches are not considered separate legal persons. *See id.* art. 203. The Company Law came into force on July 1, 1994. Companies established before this date are required to take steps to conform to the requirements of this law. *See id.* art. 229. Procedure for registration is governed by the ordinance of June 24, 1994, *reprinted in id.*

[227]For example, in China, the ordinance of June 24, 1994, contemplates the registration of branches, even though branches are not separate legal persons. *See* Ordinance of June 24, 1994, art. 39–44, *reprinted in* 2 Guillaumond & Hua, *supra* note 210. There is also a registration procedure for permanent representative offices of foreign companies. *See* Detailed Regulations of the Ministry of Foreign Commerce and Economic Cooperation Concerning the Approval and the Administration of Permanent Representative Offices of Foreign Enterprises, *reprinted in id.* The distinction is that representative offices cannot "directly engage in profit-making activities on the territory of the People's Republic of China." *Id.* art. 4.

others tax nonprofit organizations on their business income if they carry on a business that is not related to their nonprofit purpose. The United States has developed quite detailed rules and practices on what is known as "unrelated business taxable income."[228] A more aggressive approach would be to tax nonprofits not only on their business income but on all their business and investment income. One advantage of such an approach is that it is not necessary to distinguish between business and investment (e.g., how would rental activity be classified?). Whether such an approach is taken is very much a political decision because of possible reluctance to impose tax on entities that are considered to be carrying on good works.

VIII. Concluding Remarks

This chapter began with a discussion as to the merits of an income tax system including a separate enterprise tax, and continued with recommendations as to how such a tax should be structured. It elaborated a number of arguments in support of a system that taxes enterprise income once, at the highest shareholder marginal rate, and that collects such tax to the greatest extent possible at the enterprise level. In addition, it advocated an enterprise level tax that sought to capture, as accurately as possible given practical constraints, all income as it accrued, and at the same tax rate.

The arguments favoring such a system were primarily rooted in economics, that such a system was likely to result in the fewest distortions, and would allow the market to function with greater efficiency. However, an important byproduct would be that the system would be far simpler to administer, and also considerably less prone to tax avoidance. The primary reasons for this are that, with nearly all economic profits taxed at the enterprise level, there is no need for levying dividend taxes, nor for rules to determine what consitutes a distribution. Incentives to make non-equity payments would be greatly reduced.

In addition, where there is little untaxed income at the enterprise level, there is a corresponding reduction in the need to tax capital gains at the shareholder level, in that more of any share's increase in value due to the enterprise's economic income will already have been subject to tax at the enterprise level. This reduces the need to administer a capital gains tax at the level of the individual shareholder (including having to provide for the adjustment of cost of shares for amounts of retained earnings or distributions of capital), a difficult undertaking in developed countries, and correspondingly more difficult in developing or transition economies.[229]

[228] *See* USA IRC §§ 501(b), 511–515.

[229] In addition, gains and losses of non-residents are typically extempt either by statute or through bilateral treaties. Of course, this is not to say that there are not benefits to having capital gains taxes, and this chapter argues for the inclusion of gains and losses at the enterprise level. There may in some cases be unleveraged (and therefore untaxed) gains at the enterprise level, and a capital gains tax at the shareholding level would end deferral of tax on those gains when the shares were sold or transferred. Also, there may be gains reflected in the value of shares that are not also reflected at the enterprise level, such as market expectation that an enterprise will earn profits in the future.

Next, rules providing for the stacking of income or against the streaming of distibutions become unnecessary, in that all income bears the same rate of tax. Finally, the chapter argues that if the enterprise tax is final, meaning that the tax on enterprise income is schedular, there is additional improvement in administrative ease and reduction in tax avoidance possibilities because the tax system would not need to tax distributions at the shareholder level.

It may be argued by many income tax designers that implementation of a completely effective enterprise level tax on economic income is impossible. Even if this turns out to be the case, to the extent that preference income can be reduced by ending as many intentional enterprise-level tax preferences as possible (such as investment credits, accelerated depreciation, and the like), and deferred capital gains can be reduced by marking to market as many assets as possible for which objective values can easily be ascertained (such as precious metals, foreign exchange, quoted securities, derivatives and the like) and by including in corporate income total borrowings net of written-down asset value, the need to capture distributions from untaxed economic income will be reduced to the same extent. This would mean, in effect, that some or all of the elaborate mechanisms described in sec. V to capture untaxed income, or to allow shareholders to be taxed at marginal rates might raise so little additional revenue as not to be necessary, or if necessary in occasional cases, unnecessary in most. It would also mean that any of the elaborate rules described in sec. VI to distinguish among different types of distributions would become similarly less necessary or less important. With significant progress having been made toward such a simplifiled system, the methods described in those sections can be either enacted, applied, or both only on a selective bases, based only on what is required to do the job.

It may also be argued that it is politically difficult to tax enterprises at the highest shareholder rate. But to the extent that enterprise income and shareholder income were taxed at as close to the same rate as possible, any incentive by enterprises to retain earnings or to make non-taxable distributions to take advantage of the lower enterprise rate would be reduced.

Finally, tax designers may also argue that it is unfair to implement a schedular tax on enterprise income. However, to the extent that a non-schedular tax can be limited to the fewest taxpayers as possible, the need to file returns, or for enterprises to shift ownership to those taxed at lower rates, would be reduced.

Therefore, even if complete adherence to a simplified system is impossible for whatever reason, there still is considerable merit in designing a tax system with as many features as described in the above simplified system as possible.

While these arguments apply in varying degrees to all economies, they have particular relevance to developing countries and to economies in transition. Even in these jurisdictions, many enterprises, particularly larger companies or companies with foreign management, may have developed considerable tax planning expertise. The globalization of sophisticated tax planning ability, and therefore tax avoidance, has been a remarkable, another perhaps unexpected consequence of the general globalization of markets and financial information. The authors have experienced in a number of cases of developing and transition countries with complex systems, and where a surprisingly large amount of tax administration resources were dedicated to attempting to prevent sophisticated income tax avoidance schemes. However, because of inadequacy of resources, these tax administrations were less likely to be able to design and implement the rules necessary to operate their complex systems without diverting administrative resources from other tasks. These other tasks, while perhaps more mundane, were also more likely to be productive in the collection of needed revenue.

Therefore, in these circumstances it is perhaps best to design the most effective simple system as possible, and to direct limited bureaucratic resources not to trying to capture the relatively meager income that will escape through the tax avoidance net, but to more productive, if less intellectually challenging, activities.

20

Taxation of Corporate Reorganizations

Frans Vanistendael

> You can do anything in Subchapter C. [Subchapter C contains reorganization and other corporate provisions]
>
> —Martin Ginsburg

I. Introduction

In designing tax laws for developing or transition countries, drafters often neglect, and sometimes completely forget, provisions for corporate[1] reorganizations.[2] This chapter reviews the forms of corporate reorganization that might be available under company law and the tax consequences of reorganizations in the absence of special tax rules.[3] It then considers the tax

Note: Victor Thuronyi contributed to the writing of this chapter.

[1]This chapter assumes that the entities being reorganized are corporations or share companies. As discussed in ch. 21, the tax on legal entities may tax as separate entities various organizations (e.g., forms of partnership) that are not share companies. In countries with such rules, appropriate reference to the legal forms that reorganizations of such organizations take will have to be made in the rules on reorganizations. *E.g.,* FRA CGI § 160 (refers to *droits sociaux* (interests in a company), which is a broader term than *actions* (shares)). There may be substantial differences in the legal form taken by such reorganizations, compared with the reorganization of share companies. To avoid complicating the discussion, we will not address further the necessary adaptations that would have to be made in such cases.

[2]EST IT § 25 provides for nonrecognition treatment for reorganizations in accordance with conditions established by the Minister of Finance. The tax codes of Kazakhstan and the Kyrgyz Republic do not contain provisions concerning reorganization, nor does the income tax decree of Saudi Arabia or the profit tax decree of Romania. In some countries, the absence of provisions relating to reorganization can be explained by the fact that capital gains are not subject to tax. *See also infra* note 45.

[3]Further discussion on comparative law can be found in Tax Consequences of International Acquisitions and Business Combinations, 77b Cahiers de droit fiscal international (1992)(since many international acquisitions take the form of *taxable* acquisitions of shares or assets, this work is a good source for discussion of taxable acquisitions; it also deals with taxfree acquisitions and with international business combinations, as well as with related tax planning issues such as the deductibility of acquisition indebtedness and the impact of imputation systems on acquisition strategies); Peter Begg, Corporate Acquisitions and Mergers (looseleaf 1997)(covers tax, corporate law, employment law, and regulatory matters in the U.K. and the other EU countries); Svetlana Almakaeva, *Effects of Russian Tax Treaties and the EC Parent-Subsidiary Directive on the Tax Planning Strategies of European Multinational Groups Investing in Russia*, 23 Review of Central and East European Law 77 (1997). *See also infra* note 15.

treatment of reorganizations if there are special nonrecognition[4] rules and the considerations in designing those tax rules. The discussion supports the desirability of having at least some basic reorganization provisions if policymakers consider that the tax system should not discourage corporate restructuring.

In transition countries, reorganizations can occur as part of the privatization process or thereafter as the ownership of companies changes hands. Even when the top priority is to make existing businesses work rather than to reorganize them through merger or division, it is necessary to think from the start about rules in civil or commercial law that would allow mergers, acquisitions, or divisions, and about their tax implications. It is better not to wait until the first practical cases arise. In developing countries, reorganizations may or may not take place very often. Even if they are not frequent, however, it makes sense to have a set of rules in place so that business reorganizations are not impeded by the tax system. In addition, foreign investors will be more confident when they notice that the legal system in general, and the tax system in particular, provides for such transactions, to which they are used in their own business environment.

Industrial countries generally have specific rules for tax-free reorganizations. In the absence of such rules, business reorganizations could lead to taxable transfers of assets or shares. The resulting tax liabilities could be so large as to obstruct business reorganizations. The general policy view in most countries is that it is economically not efficient to tax corporate reorganizations, because taxation would discourage reorganizations. Where there is a continuation of business activities and of the interest of the shareholders in the company, a corporate reorganization may be considered as tantamount to a legal restructuring of the same business, which does not constitute a sufficient change in economic position to merit taxation.

In developing and transition countries, the basic issues in designing the rules for corporate reorganizations are the same, although these countries will generally want to adopt rules that are as simple as possible given that the volume of reorganizations will be relatively small. In addition, special issues will be involved in the treatment of investment funds and in privatization, to which we refer in this chapter from time to time.[5]

II. Forms of Corporate Reorganization

Reorganization is used here in a general way to describe transactions involving significant changes in the legal or economic structure of one or more business enterprises. In some countries neither company law nor tax law defines the term, although specific forms of reorganization may be defined,[6] while other countries have a general tax law concept of reorganization.[7]

[4]This term is explained *supra* ch. 16, sec. V(B)(7).

[5]*See* Yolanda Kodrzycki & Eric Zolt, *Tax Issues Arising from Privatization in the Formerly Socialist Countries*, 25 Law & Policy in Int'l Business 609 (1994). *See* ch. 21 for taxation of investment funds.

[6]Canada has a definition of an amalgamation in sec. 87 (1) ITA, but no overall definition. Council Directive of July 23, 1990 (90/434/EEC) refers separately to "mergers, divisions, transfers of assets, and exchanges of shares."

The forms of reorganization are described below in general terms.[8] Because of differences in company law, the descriptions will not be accurate for some jurisdictions. However, most jurisdictions provide for transactions that more or less correspond to the forms described. In drafting for a specific country, it will of course be necessary to consult the company law, special reorganization law (if any), bankruptcy law, civil law, and other applicable commercial laws of that jurisdiction.

The following parties[9] to a reorganization can be identified: (1) the acquired or transferor[10] company, (2) the shareholders of the transferor, (3) the acquiring or transferee company, (4) the shareholders of the transferee, and (5) all other persons, in particular the creditors, having a contractual or other legal relationship with the transferor or transferee. Reorganizations can be distinguished according to whether or not a legal entity party to the reorganization disappears as part of the transaction. In mergers, consolidations, and corporate divisions, one of the parties may disappear by the mere fact of the transaction. In asset and share[11] acquisitions, the transferor may or may not disappear depending on whether it is liquidated or not. Whether an entity disappears may be relevant for several issues, including the taxation of shareholders and the carryover of tax attributes.

[hereinafter Merger Taxation Directive]. Similarly, the French tax code refers separately to a merger (*fusion*), CGI §§ 160 I *ter,* 210A, division (*scission*), CGI § 160 I *ter*, and a transfer of assets (*apport partiel d'actif*), CGI § 210B.

[7]In the United States, reorganizations are defined for tax purposes in IRC § 368. In Germany, for corporate reorganizations in general the word *Umwandlung* is used. Reorganizations are regulated in the *Umwandlungsgesetz* (UmwG) (Reorganization Law) and the Reorganization Tax Law; *see* Klaus Tipke & Joachim Lang, Steuerrecht 432 (1991); Dieter Endres & Pilny, *Germany Releases Draft Regulation on the Reorganization Tax Act*, Tax Notes Int'l 1867 (June 9, 1997).

[8]Other corporation-shareholder transactions relevant to reorganizations— liquidations and redemption of shares— are dealt with in ch. 19. Nonrecognition rules for the incorporation of sole proprietorships, as well as other corporate and partnership formation transactions, are dealt with in ch. 16.

[9]Not all of the listed persons are parties in some reorganizations. For example, the shareholders of the acquiring company may not be parties if their share ownership does not change in the reorganization. The list given in the text is a broad concept of party used in a general sense. A somewhat narrower, more technical concept (which includes only the corporations involved) is defined in USA IRC § 368(b).

[10]Throughout this chapter, we use the term "transferor" to indicate the person or entity transferring assets, shares, securities, or other forms of consideration to another person and the term "transferee" to indicate the person to which such consideration is transferred. The transferor company can also be indicated as the acquired, merged, or divided company, while the transferee company can be indicated as the acquiring, surviving, or newly established company. The terms transferor and transferee are preferred, because they have the same meaning in different kinds of reorganizations.

[11]This chapter refers to "shares," whose American equivalent is "stock."

A. Merger

A merger, also called amalgamation,[12] is a transaction in which all or substantially all the assets and liabilities of one or more transferor companies are transferred to a single transferee company, whereby the transferor companies cease to exist by operation of law, that is, not on the basis of a consensual agreement between parties and not through liquidation. In most countries this transfer must take place exclusively or substantially in exchange for shares.[13]

B. Consolidation

A consolidation[14] is a transaction whereby two or more companies transfer their assets and liabilities to a single newly established company. The basic legal mechanism for a consolidation is identical to that of a merger: all or substantially all of the assets are transferred by operation of law in exchange for shares. The only difference is that in a merger the transferee company is a preexisting company, while in a consolidation the transferee is a newly established company.

C. Corporate Divisions

A corporate division is the opposite of a merger or consolidation: all or substantially all the assets of one company are transferred in exchange for shares to at least two or more newly established or preexisting companies, unless these assets are already in the hands of a subsidiary. Three types of divisive reorganizations can be identified.[15] In a spin-off, the shares of a subsidiary are distributed to the shareholders of the parent company. In a split-off, the shares of a subsidiary are distributed in exchange for the surrender of shares of the parent company. In a split-up, the parent company distributes its shares in two or more subsidiaries in complete liquidation.

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[12]CAN ITA § 87. In French this transaction is called *absorption*. In German, either *Verschmelzung* or *Fusion* is used. Directive 78/855/EEC, art. 3 uses the term "merger by acquisition."

[13]In the draft merger directive of the European Union a merger or consolidation is valid only when the transfer of the net value is substantially in exchange for shares, *see* §§ 2-4 draft directive, referring to Directive 78/855/EEC, which allows a cash payment of up to 10 percent of the nominal value of the shares issued. In the United States, however, there are several states in which a merger in the sense of a legal transfer of all assets and liabilities of a company that immediately ceases to exist is possible without consideration being paid in shares.

[14]In French, this is called a *fusion*. *See* FRA CGI, Annex II, § 301B. Directive 78/855/EEC, art. 4, uses the term "merger by the formation of a new company."

[15]*See* Boris Bittker & James Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 13.01 (1987); Albert Rädler, *General Report, National and International Consequences of Demergers,* 79b Cahiers de droit fiscal international 557, 558, 565 (1994) (Readers who want to learn more about the comparative tax law of corporate divisions are referred to this work, including the accompanying country reports.)

[15]Under USA IRC § 368 (a)(1) (C), (G), the transferor in an assets acquisition is generally required to liquidate or is treated as if a complete liquidation had taken place. *See* Bittker & Eustice, *supra* note 15, ¶ 14.14. An asset acquisition without liquidation is possible under NLD Vpb § 14(2) (definition of an asset acquisition (*bedrijfsfusie*) for tax purposes) and BEL CIR art. 46 § 1 (contribution of branch or of all assets in exchange for shares).

D. Asset Acquisition

An asset acquisition is a transfer of assets and liabilities by one or more companies to a newly established or preexisting company in exchange for any form of consideration (shares, securities, cash, assets in kind, or transfer of liabilities). In an asset acquisition, the transferor company may continue to exist after the transfer or may distribute the proceeds to its shareholders in a complete liquidation. In the latter case, the effect of the transaction will be very close to a formal merger. Since reorganizations deal with substantial and significant structural economic and legal changes, in order to qualify as a reorganization, an asset acquisition will normally have to involve a transfer of substantially all of the transferor's assets. The transfer of a smaller portion of the assets is treated as a sale of these assets, not as a reorganization.

E. Share Acquisition

A share acquisition is the transfer of shares of a company to a newly established or pre-existing company in exchange for any form of consideration (shares, securities, cash, assets in kind, or assumption of liabilities). Again, the transaction will be considered to be a reorganization only if the transfer of shares involves a substantial holding, so that the transferee company acquires an important say in the affairs of the acquired company. The transfer of shares may or may not be followed by the liquidation of the acquired company into the transferee company.[16]

F. Change in Seat or Form

A change in seat is a change in the jurisdiction of incorporation, while a change in form is a change from one type of company to another. Both consist of legal structural changes, but do not necessarily involve economic changes in the way the business of the company is conducted. The assets and liabilities and the economic activity of the company whose seat or form is changed remain unchanged. When the seat of a company is moved from one country to another, or when the form of the company is changed, the company law may provide that the company is liquidated and that a new company is established.[17] Generally speaking, however, when the seat

[16]The share acquisition is the most common form of corporate reorganization in the Netherlands; *see* Van Soest, Inkomstenbelasting 470 (1990); its tax requirements are defined in NLD IB § 14b(2). In France the share acquisition is called *fusion à l'anglaise* (!) and is regulated in CGI Annex II § 301C-I, stating that the acquiring company must acquire at least 75 percent of the shares of the acquired company. In the United States the share acquisition is regulated in IRC § 368 (a) (1) (B), requiring a share of at least 80 percent in the acquired company.

[17]In Switzerland, conversion of a GmbH into an AG is not possible without liquidation. *See* Company Law in Europe: Switzerland § 22 (Peter Meinhardt ed., 3rd ed. 1981). Law No. 66-537 of July 24, 1966, § 154, *reprinted in* Code des Sociétés (Dalloz 1996) provides that a company may change its seat from one country to another if the host country has concluded a treaty with France permitting such a change without disturbing the legal personality of the company. It may not be possible under company law to change the seat of a company to another country. *See, e.g.,* Steven Schuit, *Business Organizations; Corporations, in* Dutch Business Law § 9.10[6] (Schuit, Romyn, and Zevenboom, eds. 1997) (impossible to transfer seat to another country except in extraordinary situations like war). In cases like this, the transfer of seat can be accomplished by forming a new corporation in the target country and merging the existing corporation into the new corporation or by contributing the shares of the existing company to the new company and then liquidating the existing company.

is moved within the same country or when the form is changed, most company laws stipulate that the legal identity of the company remains unchanged.[18]

G. Recapitalization

Recapitalizations are changes in the way a company is financed, that is, structural changes in its share capital or outstanding debt. As with most changes in seat or form, the legal identity of the company remains unchanged.

H. Bankruptcy Reorganizations

Bankruptcy reorganizations may take any of the forms described above, with the distinctive element that one or more companies are declared bankrupt and that as a consequence the outstanding debt of the companies involved is rescheduled. Although the emphasis is on the reorganization of the debt, reorganization of share capital may also be involved, as well as the liquidation of one or more corporate entities.

III. Taxable Reorganizations

This section considers the tax consequences of taxable reorganizations. The discussion is relevant in several contexts. First, the tax consequences discussed apply in the absence of special nonrecognition rules for reorganizations. This is relevant to countries that do not have such rules and that are considering whether they should be introduced. Second, even in countries that have nonrecognition rules, some reorganizations will be structured so as to fail to qualify under those rules and will accordingly be considered taxable reorganizations. Why it may be advantageous in certain situations for taxpayers to do so is discussed below. Finally, sometimes taxpayers will seek to structure a transaction so as to qualify for nonrecognition treatment, without meeting the requirements, so that the transaction is treated as taxable. And other transactions simply will not possess the required characteristics of a tax-free reorganization.

A. Tax Position of the Transferor Company

Regardless of how a reorganization is effectuated under company law, income tax systems as a general rule treat reorganizations in which the transferor company disappears as a transfer of assets and liabilities by the transferor to the transferee company. This transfer of assets is treated as a sale, from which any gain is taxable and any loss is deductible.

The amount of gain or loss is calculated in accordance with the normal income tax rules. Assuming that all assets are taxed according to the same rules, the gain or loss is calculated as

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[18]*See, e.g.,* FRA Code civil § 1844-3 (change from one type of company to another does not result in creation of a new legal person); P. Verrucoli, Italian Company Law 205-207 (association of persons can be converted into capital company and vice versa) (1977). *See also* Law No. 66-537, *supra* note 18, §§ 236-238 (providing for change from *société anonyme* to other forms); *id.* § 69 (providing for change from *société à responsabilité limitée* to other forms); Schuit, *supra* note 18, § 9.10[4](change in form does not affect continued existence of a corporation).

the difference between the total consideration received by the transferor in the form of shares, securities, cash, or other property and the tax basis of all assets transferred. The consequence of taxing such a transfer is that all profits and gains whose taxation had been deferred before the reorganization will become taxable.

Example

OLDCO TAX BALANCE SHEET[19]

Assets		Liabilities	
Inventory	$20,000	Capital	$30,000
Receivables	$20,000	Reserves	$20,000
Fixed assets	$60,000	Liabilities	$50,000
Total			$100,000

Note: Acquisition price: shares of Newco valued at $100,000 plus assumption of all liabilities, equals $150,000. Taxable profit: $150,000 minus $100,000 (tax basis of the assets on the balance sheet) equals $50,000.

The rate at which the acquired company's gain is taxed depends on the general rules for taxation of profits and capital gains. While in some systems capital gains are taxed at the same rate as ordinary profits, in others there are special arrangements for capital gains. Many countries tax ordinary profits and capital gains of companies at the same rate.[20] Capital gains on business assets are still taxed at preferential rates in Belgium, France, Greece, and Ireland, and recently the capital gains preference has been reintroduced in the United States. When a tax system provides for lower rates on capital assets, it is necessary to allocate the total consideration to the individual assets transferred. The greater the portion of the consideration allocated to capital assets, the lower the amount of tax.

The transferor and the transferee have conflicting interests in allocating the purchase price. The transferor will be interested in minimizing its tax burden by shifting the price to capital assets, whereas the transferee will be interested in recouping the acquisition cost as soon as possible through direct expenses, by shifting the acquisition price to items that are immediately deductible, like the cost of inventory.[21] However, the parties can often reach an

[19]The value for which assets are recorded in a company's accounts does not always coincide with the tax basis of the assets. This depends on the relationship between commercial accounting and tax accounting, which varies from country to country. *See supra* ch. 16, Appendix A.

[20]For a survey of the situation in the European Union, see Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation 243 (1992) (Onno Ruding, Chairman) [hereinafter Ruding Committee Report].

[21]*See infra* sec. C(1).

agreement to optimize their joint tax situation at the expense of the government, particularly when both companies are members of the same corporate group.[22]

B. Tax Position of the Shareholders of the Transferor

1. Taxability of Shareholders

Whether the shareholders are taxed in a taxable reorganization is determined by the general rules on the taxation of capital gains. These rules vary in many tax systems depending on the category of taxpayer that realizes a capital gain and on the purpose for which the shares are held (business or private investment).[23]

Some countries tax all capital gains on shares regardless of who holds the shares and why the shares are held. Consequently, the transfer of the shares of the acquired company in exchange for the shares of the transferee company, bonds, cash, or other forms of compensation is a taxable event, absent special nonrecognition rules.[24]

In many other countries, however (in particular in the European Union, with the exception of the United Kingdom and the Scandanavian countries), individual shareholders are not taxed on the gains resulting from the sale of shares when the shares are held on a long-term basis for private investment.[25] The gains will also be exempt when realized by charities or other exempt organizations. In some countries, however, gains on shares are taxable when the individual shareholder holds a "substantial" share in a company.[26] When an individual shareholder holds shares for business purposes, practically all countries will tax the gain realized on the sale or exchange of the shares.

Shares held by companies are a special case. Many tax systems treat them as assets held for business purposes, and, consequently, any gain on the sale or exchange of shares is a taxable event. However, some countries (e.g., Belgium and Netherlands [27]) consider the gain realized on

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[22]In a transaction between unrelated parties, one party can compensate the other party by an adjustment in the purchase price if the latter agrees to bear a greater tax burden. The problem of possible abuse in a transaction between related parties can be addressed through a general rule that gives the tax administration the power to readjust transfer prices between related taxpayers and in some cases (such as tax evasion) even between unrelated taxpayers, so as to reflect the fair market value of the transaction for tax purposes. Such a rule is not specific to reorganizations. *See* vol. 1, at 53; ch. 18 *supra*.

[23]*See supra* ch. 16, sec. VI(B).

[24]For example, in the United Kingdom there is a special capital gains tax, which also includes profits on shares held for private investment. *See* GBR TCGA §§ 2, 21.

[25]*See,* for a survey of capital gains tax rates for individual shareholders, Ruding Committee Report, *supra* note 21, at 273.

[26]*See* NLD IB § 39 (33 percent); BEL CIR § 90/9 (25 percent); FRA CGI § 160 (25 percent); DEU EstG § 17 (25 percent).

[27]*See* BEL CIR § 192; NLD Vpb § 13(1)(minimum 5 percent participation required); Van Soest, Inkomstenbelasting 454 (1990).

shares held by a company in a subsidiary company as the expression of the profits that have already been realized and taxed in the hands of the subsidiary. In such countries, capital gains realized on the transfer of shares held by the parent are exempt from tax.

2. Calculation of Taxable Gain

When the gain on the exchange of shares is taxable to the shareholder, the general rules applicable to calculating gains on the disposition of other assets will apply, together with any special rules as to the rate of tax and the deductibility of capital losses.[28] An exchange of shares, or a receipt of a distribution of the proceeds of the corporation's exchange of its assets, may also be treated as a dividend or a liquidating distribution, in which case any special rules applicable to those transactions will come into play.[29]

3. Cost Base of Assets Received in Exchange for Shares

The cost base of the new shares or other forms of consideration (other than cash) received by the shareholders in the exchange is also determined by ordinary tax rules. The value they receive for tax purposes is equal to their acquisition cost. The acquisition cost is the price agreed upon between the parties to the reorganization and should be equal to the value of the shares that are surrendered. In the reorganization agreement, that value should reflect the fair market value of the shares, and, if it does not, the value may be subject to correction under a general provision enabling the tax administration to adjust the price agreed upon between the parties.[30]

C. Tax Position of the Transferee

1. Cost Base of the Transferred Assets

After a taxable merger, the assets of the transferor will be valued in the hands of the transferee at the value that has been used to determine the transferor’s tax liability in the merger or division, as discussed above in section B. Subsequent profits, depreciation, capital gains, and capital losses on assets will be calculated not on the basis of the old value that the assets had before the reorganization, but on the basis of the new value that was assigned to them in the merger or division. As a consequence, some of the assets of the transferee (assets transferred by the transferor) will be valued for tax purposes at current prices, while others (assets that the transferee owned before the reorganization) will reflect historic and depreciated values. Absent nonrecognition rules, in the case of an assets transfer, the tax law clearly takes a position of discontinuity. It considers the merger or division as a sale of assets for tax purposes, resulting in their revaluation.

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[28]*See supra* ch. 16, sec. V, VI(B).

[29]*See supra* ch. 19.

[30]*See supra* note 23.

A problem that is specific to reorganizations is the allocation of acquisition cost to goodwill. In most cases the total acquisition cost will exceed the total sum of the values of the individual assets. The difference is often accounted for as goodwill. Whether goodwill can be depreciated is determined by the general depreciation rules.[31] When depreciation is disallowed, the transferee company will try to minimize the amount allocated to goodwill; when it is allowed, the transferee will be tempted to inflate goodwill.

2. Transfer of Tax Benefits and Preferential Tax Regimes

In the case of taxable reorganizations in which the transferor company disappears (e.g., mergers and divisions), tax credits, exemptions, and other tax benefits enjoyed by the transferor are commonly canceled. The logic of this rule is apparent in cases of exemption. When an item has been temporarily exempt in the hands of the transferor (i.e. when taxation has been deferred), the logical consequence of taxing a merger is that all exempt items become subject to taxation at the time of the reorganization. Tax credits and other tax benefits from which the acquired company may have benefited are typically treated in the same way; that is, they expire with the transferor.[32]

In some cases, however, the benefit may be continued, subject to certain conditions. A typical example is an investment credit. Such a credit is typically recaptured[33] when the asset for which the credit has been granted is sold or transferred, but maintained when the asset continues to be used in the same business.[34] In a merger, the business situation has indeed not changed, because the same asset is still used in the same economic activity, but it is used by the legal entity succeeding the transferor company. However, the continuation of tax benefits in a taxable reorganization might be subject to a continuity-of-interest requirement, similar to the requirement applicable to tax-free reorganizations.[35]

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[31]*See supra* ch. 17, sec. II(E)(2).

[32]This rule is very often not explicitly spelled out in the statute, but follows from the general principle that tax characteristics cannot be transferred from one taxpayer to another unless the statute specifically provides for such a transfer. It is stated by negative implication in USA IRC § 381.

[33]When a credit is recaptured, the tax payable is increased by the amount recaptured. Recapture is known as clawback in the United Kingdom.

[34]*E.g.,* USA IRC §§ 50(a)(4), 381.

[35]*See infra* sec. IV.

3. Transfer of Tax Loss Carryovers

In the transfer of tax characteristics of the transferor company, tax loss carryovers play a special role.[36] To avoid a situation where profitable companies would chase loss companies to be able to use their tax loss carryovers in a merger or division, tax systems typically limit the carryover of tax losses from one company to another in a corporate reorganization.[37] In the case of a taxable transfer of assets, the transferee would in any event not inherit any loss carryovers of the transferor. In this case, the transferor could offset the loss against any gain realized on the transfer.

4. Transfer of Rights and Obligations in Litigation

The extent to which rights and obligations in tax litigation are transferred from the transferor to the transferee company may be decided by the rules of company law, contract law, or tax law.[38] When there is a formal merger transferring de jure all rights and obligations to the acquiring company, the latter will be entitled to immediately continue all tax protests, appeals, and other forms of litigation of the acquired company. Alternatively, the transferee may be liable on the basis of a contractual agreement or under special transferee liability provisions of the tax laws.[39]

5. Methods of Accounting

The transferor and transferee may use different methods of accounting (e.g., one may use cash and the other accrual, or one may use last in, first out (LIFO) and the other first in, first out (FIFO), or the two companies may use different accounting years). After the reorganization, this inconsistency must be resolved. It may be particularly difficult to resolve if there are rules in the tax law that if a company has started to use one method it cannot switch to another. Provision needs to be made to reconcile this rule with the fact that a reorganization will necessarily involve some change in accounting method when the parties use different methods. A purely formal approach would look to continuity of corporate identity: whichever company continues is the one that keeps its methods of accounting. When the successor is a newly formed company, does this mean that the taxpayer has the right to select whatever method it wants?

In addition to dealing with the question of what method of accounting the successor may use, the tax law should deal with the issue of transition. In a taxable reorganization, this is not difficult. For example, in the case of inventory accounting, the successor will typically continue its accounting method and will be treated as having purchased the inventory of the transferor. This inventory will be accounted for no differently from inventory purchased in the ordinary course of business. The result in the case of LIFO accounting in an inflationary situation can be

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[36]*See* discussion on tax loss carryovers in the general tax system, *supra* ch. 16.

[37]*E.g.,* USA IRC § 382.

[38]*See* Michael Saltzman, IRS Practice and Procedure ¶ 17.05 (2d ed. 1991).

[39]*E.g.,* USA IRC § 6901.

harsh, however, in that the difference between the fair market value of the inventory and its historic valuation (which will be artificially low because of the use of LIFO) is taxable.

D. Reorganizations Without Transfer of Assets or Shares

Some forms of reorganization deal with only one company, for example, with changes in corporate seat or form and various forms of recapitalization.

1. Change of Corporate Seat or Form

The change of corporate seat or form is a simple form of reorganization involving a change in the legal structure of the business but not its economic structure. A change in corporate seat should not have any tax consequence as long as the seat of the company stays within the same tax jurisdiction. When the seat changes from one tax jurisdiction to another, however, there may be full taxation of the company, as if it had distributed all its assets in a liquidating distribution.[40] This rule reflects the fact that after the move the company will no longer be subject to the national tax jurisdiction.

A mere change in corporate form (e.g., from a limited-liability company to a share company) should in principle not give rise to any tax liability. All assets and liabilities of the business remain within a single legal entity, albeit a different one, and the shareholders maintain their equity interest unchanged. In a few countries, a change of form may result in tax problems because company law may require a formal liquidation in order to change the company form, so that there is a legal transfer of assets and liabilities from the old company to the new.[41] Typically, however, the transfer is automatic and everything remains unchanged except for the company form. For tax purposes, the mere change__f company form should not be considered a taxable event, as long as the change is limited to the legal form of the company and its assets, capital, debt, and outstanding shares remain unchanged.

There may be a problem, however, when, as a result of a change in corporate form, the company changes its taxpayer status from corporate to flow-through treatment or vice versa.[42] It is clear that the tax law should provide for adjustments, when, as a result of a change in the form of the legal entity, its tax regime is also changed from one regime to the other. In such cases a

[40]Often the transaction is accomplished by forming a new corporation in the state where it is desired to move to and then merging the corporation into this new corporation. *See supra* note 18; Rufus Rhoades & Marshall Langer, 2 Income Taxation of Foreign-related Transactions § 7.02[8] (1996); Notice 94-46, 1994-1 C.B. 356. In some cases, a change in place of incorporation will not be taxable; *e.g.,* Rev. Rul. 87-27, 1987-1 C.B. 134 (liquidation of domestic corporation into a newly formed foreign corporation treated as a change in place of incorporation and hence as a Type F reorganization, which was tax free where the requirements of the regulations under IRC § 367(a) were satisfied).

[41]*See supra* note 18.

[42]*See infra* ch. 21.

change of form may be treated as a liquidation or an incorporation for tax purposes, resulting in taxation of any untaxed reserves or temporarily exempt profits.[43]

2. *Recapitalizations*

Increases and decreases in the capital of a company as a rule do not result in any tax liability for the company concerned. The principal tax issue in a recapitalization is whether the receipt of debt by the shareholders has the effect of the distribution of a dividend. If so, it should be taxable as a dividend absent a special rule. A distribution (through a decrease in capital) of what has been effectively paid in by the shareholders will commonly not be taxed as a dividend. Any other distribution should in principle be treated as a taxable dividend or liquidating distribution.

IV. Tax-Free Reorganizations

A. Introduction

Industrial countries typically have specific rules for tax-free reorganizations in their tax laws, and many developing and transition countries do so as well.[44] The objective of these rules is not to grant a tax exemption to the companies or shareholders involved, but rather to "neutralize" the tax consequences of the business reorganization, so that the reorganization involves neither a tax advantage nor a tax disadvantage. The principle of tax neutrality in business reorganization has two aspects. It implies (1) that no tax is levied at the time of the reorganization and (2) that, after the reorganization, the taxable profits of the transferee company and its shareholders are calculated on the basis of tax elements that were present in the transferor company and its shares immediately before the reorganization. The principle is one of deferral of tax on unrealized gains that exist at the time of the reorganization, not exemption of tax on these gains.

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[43]In the United States, when a C corporation (taxed as an entity) changes its status to that of S corporation (taxed on a flow-through basis), there is no immediate tax, but a tax is imposed on certain built-in gains of the C corporation if the S corporation realizes those gains within 10 years. *See* IRC § 1374; Bittker & Eustice, *supra* note 15, ¶ 6.07. Germany now allows a tax-free conversion of a corporation into a partnership. *See* Endres & Pilny, *supra* note 6. (This should be seen in the context of Germany having abolished the last remnant of economic double taxation.—L.M.)

[44]*See generally* The International Guide to Mergers and Acquisitions (Eric Tomsett et al., eds., IBFD) (looseleaf 1993-96) (covers most of the OECD countries as well as Argentina, Brazil, Singapore, and South Africa). See the Oct. 13, 1997, issue of Tax Notes International for discussion of rules concerning acquisition of companies in the Netherlands, France, Germany, and the United Kingdom. *See also supra* note 2. In Thailand, reorganizations are taxable. *See* THA RC §§ 72-74. The State Tax Administration of the People's Republic of China has recently issued circulars providing guidance on reorganizations, which provide that certain transactions may be carried out on a tax-free basis. *See* May Huang, Betty Ko, and Alan Tsoi, *China Issues Rules on Tax-Free Corporate Reorganizations*, 15 Tax Notes Int'l 543 (Aug. 18, 1997). In the case of Indonesia, Japan, and Korea, the opportunities for tax-free reorganizations seem to be quite limited. *See* Richard Weisman et al., *Structuring Transactions in Asian Countries: Tax Considerations for Cross-Border Mergers and Acquisitions*, 15 Tax Notes Int'l 215 (1997); Hugh Ault et al., Comparative Income Taxation 330, 339 (1997). Tax-free reorganizations and corporate divisions are allowed in Israel. *See* Arye Lapidoth, *The Israeli 1993 Income Tax Reform Relating to Mergers and Divisions of Companies,* Intertax 202 (1995).

B. Conditions for a Tax-Free Reorganization

The detailed rules setting conditions for tax-free reorganizations vary considerably from one country to another, but can be summarized in two basic conditions: (1) continuity of business enterprise and (2) continuity of shareholder interest. Opinions will vary as to the required degree of continuity, but all tax systems allowing tax-free reorganizations will (or should) impose these two basic conditions in one form or another. Doing otherwise would open enormous opportunities for tax avoidance, because it would allow the transferor company and its shareholders to finally dispose of all or part of their assets or their equity interest in a company through a tax-exempt merger or division without paying any tax. In some countries, the tax exemption is also made conditional upon the existence of a bona fide commercial or business purpose[45] or on the absence of tax avoidance.[46]

1. Conditions Set in Tax Law or in Company Law

Two different techniques are used in varying degrees to impose conditions on a tax-free reorganization: (1) autonomous conditions provided by tax law, and (2) conditions for a reorganization imposed by company law. Sometimes there is a combination of the two.

The advantage of having independent conditions in the tax code is obvious. Regardless of the legal form in which the parties may structure the reorganization, it should benefit from tax exemption only if it meets conditions set in tax law.[47] In addition, as is generally the case when one law refers to another, any reference to company law can be problematic because if there is a change in the conditions of company law there will be a simultaneous change in the conditions for tax exemption. Because the drafters of company law are often not tax experts, changes in company law may lead to unexpected surprises in tax law.

2. Degree of Continuity

The degree of required continuity of shareholder interest determines the degree of flexibility that the parties have in negotiating a tax-free reorganization. When, in an asset acquisition, company law or tax law subjects a tax-free reorganization to the condition that all assets and liabilities must be transferred and that such transfer is compensated exclusively in

[45] *See* BEL CIR art. 211 § 1, 2 al. 3 ; GBR TCGA § 137 (1). In the United States, this is the result under the case law.

[46] *E.g.,* Merger Taxation Directive, *supra* note 6, art. 11.

[47] An example of independent conditions in the tax code is the type C reorganization in USA IRC § 368 (a)(1)(C): transfer of substantially all the assets of one company to another company solely in exchange for all or part of the voting stock of the company acquiring the assets. This definition does not refer to any rule in company law, since this differs from state to state. *See infra* note 49. For specific tax conditions for exemption, *see* NLD Vpb § 14; A.J. Van Soest, Belastingen 511 (Arnhem 1995); FRA CGI Annex II § 301B- 301F; Merger Taxation Directive, *supra* note 6, art. 2.

voting shares, the room for introducing changes in the way of doing business at the occasion of a reorganization is very limited.

Yet there are good business reasons to grant some leeway to the parties to the reorganization to make the necessary changes in the conduct of business or in the distribution of the property interests of the shareholders. As far as the transfer of assets is concerned, the transferor company often maintains some assets that are totally unattractive to the transferee company or for which it has no use (e.g., old equipment, dilapidated buildings, or scrap) and for which it is not prepared to pay. If the condition for tax exemption is that all assets need to be transferred, the transferee company will pay a higher price than is economically justified for the transfer and it will try to shed the useless assets after the merger.

A similar problem arises with the continuity of the shareholder's interest. Particularly when a small company is merged into a big one and the shareholders of the former receive only a small fraction of the total shares outstanding in the new company, they may prefer to sell their shares. In other cases, depending on the rules in company law, minority shareholders who are opposed to the merger may wish to exercise their rights to be bought out and receive the fair market value of their shares in cash. When the condition for tax exemption requires compensation of all the shareholders in voting shares of the acquiring company, this means that if the merger goes through, the buyout of the minority shareholders will result in a taxable merger. When this is the situation, the minority shareholders in effect hold a veto power over the merger being tax free. Therefore, the room left in the tax law or the company law for compensation in forms other than voting shares is very important.

An example of a statute that leaves sufficient flexibility with respect to the transfer of assets and the compensation in shares in a merger is the U.S. Internal Revenue Code. The text of the statute does not impose any hard and fast conditions, but requires only that the reorganization take the form of a merger under state law.[48] Conditions of continuity of the proprietary interest of the shareholders and of the continuity of business activity have been set by case law and are therefore rather flexible.[49]

[48]*See* USA IRC §368(a)(1)(A). Under the U.S. federal system, the states are responsible for the general civil law, including company law. This has perhaps contributed to the flexibility of the federal tax law, as it must accommodate differences in company law among the states, and also explains why in the United States the requirements for a merger to be tax free are found in tax law rather than in company law.

[49]*See* Bittker & Eustice, *supra* note 15, ¶14.11; John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935); Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); Reilly Oil Co. v. C.I.R., 189 F2d. 382 (5th Cir. 1951). USA IRC § 368 (a)(1)(A) defines a "merger" as a tax-free reorganization. What a merger is, is determined by company law. However, the United States has many different types of company law, because company law is not federal law but state law. In some states, there is even a valid merger when all or substantially all of the assets are transferred from one company to another, regardless of the form of compensation that is paid for a transfer. This implies that when the major part or even all of the assets of a company are transferred for cash there may be a merger under state law. This is unacceptable for tax purposes, because it would lead to a tax-free sale of most of the assets and the shares in the transferor company and lead to a serious breach in the principle of continuity. Therefore in addition to the reference made to a "merger" in the sense of the company law, there is an additional condition in the case law, only for tax purposes, that the shareholders must continue a substantial interest in the transferee company. *See* Cortland Specialty Co. v. C.I.R. 60 F.2d 937 (2d Cir. 1932); Commissioner v. Gilmore's Estate 130 F.2d 791 (3d Cir. 1942); Roebling v. Commissioner, 143 F.2d 810 (3d Cir. 1944).

Generally, a merger will qualify as tax free in the United States if at least half of the net value of the transferor company is remunerated in shares of the acquiring company.[50] As far as the continuity of the business activities of the transferor company is concerned, case law permits nonoperating assets to be excluded from those transferred in the merger and leaves room for changes in business activity.[51] This approach leaves enough room to accommodate the demands of minority shareholders who ask for the redemption of their shares at the time of the merger.

The requirements for other types of reorganizations in the U.S. Internal Revenue Code are more strict and mechanical. For example, in a type C reorganization,[52] the transfer of assets must cover "substantially all" assets, and at least 80 percent of the remuneration for the assets transferred, not taking into account the transfer of liabilities, must consist of voting shares of the acquiring company. Yet, these requirements for a tax-free merger leave room to shed some of the useless assets and to buy out minority shareholders.[53]

An example of a far stricter application of the principle of continuity can be found in the European Union directive on the taxation of cross-border mergers.[54] In defining a merger, the directive refers to a "legal merger." This concept has been developed in the draft directive on cross-border mergers in company law.[55] The directive requires that all assets and liabilities, without exception, be transferred to the acquiring company. This requirement is of course closely linked to the idea that the acquiring company is the universal legal successor to the acquired company and therefore acquires title to all assets and liabilities of the latter without exception. This concept leaves little room for shedding some useless assets or for changing the conduct of business at the time of the merger.

Similar restrictions apply to the continuity of the shareholder's interest. The part of the remuneration that can be paid in a form other than shares of the acquiring company is limited to 10 percent of the nominal value of the capital increase that is necessary to compensate for the transfer of assets.[56] Since the fair market value of the shares is in most cases a multiple of their nominal value, only a small fraction of a few percentage points can typically be paid to the shareholders of the acquired company in a form other than the shares of the acquiring company.

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[50]*See* Rev. Rul. 66-224, 1966-2 C.B. 114.

[51]Becker v. Commissioner, 221 F.2d. 252 (2d Cir. 1955); Bentsen v. Phinney, 199 F. Supp. 363 (S.D. Tex. 1961); Mary Archer Morris Trust, 42 T.C. 779 (1964).

[52]*See supra* note 48.

[53]*See* USA IRC § 368 (a)(1)(C).

[54]Merger Taxation Directive, *supra* note 6, art. 2.

[55]Commission of the European Communities, Proposal for a Tenth Directive of the Council based on Article 54(3)(g) of the Treaty Concerning Cross-Border Mergers of Public Limited Companies, COM(84) 727 final (Jan. 8, 1985).

[56]*See* Merger Taxation Directive, *supra* note 6, art. 2; *see also* FRA CGI Annex II § 301F. Nominal value is also known in company law as par value.

The measure in the European Union directive is in most cases just sufficient to compensate in cash shareholders who would receive fractions of a whole share from the acquiring company, thereby eliminating these fractional shares. However, in those countries where minority shareholders have a right to be bought out, the narrow limits imposed by the directive will spell trouble. Paying out a small minority holding in cash would make the merger a taxable one if the holding exceeded the small level stipulated by the directive.

Bankruptcy reorganizations pose a particular problem for continuity of interest, because the shareholders of the bankrupt company may receive few or no shares in the surviving company. Instead, it is typically the creditors who obtain shares in exchange for their debt. To facilitate this type of transaction, it can be provided that no gain or loss is recognized to a transferor company on the transfer of its assets to a new company in a bankruptcy reorganization where creditors of the transferor obtain enough stock to provide continuity of interest.[57] For this purpose, continuity of interest is determined by considering the creditors as owners of the debtor company.

3. Transfer of Liabilities

Another problem related to the continuity of the proprietary interest of shareholders is how to take account of the transfer of the liabilities of the acquired company. Part of the compensation for the assets of the acquired company takes the form of the assumption of its liabilities. To the extent of this compensation, the assets of the acquired company are not transferred in exchange for shares. However, practically all statutes will disregard the transfer of liabilities and apply the criterion of transfer for voting shares only to the net value of the transferor company. Only the transfer of the net value of the assets of the acquired company— that is, after deduction of all liabilities outstanding at the time of the merger— must be compensated for in shares. Thus, the transfer of liabilities is generally disregarded in evaluating the degree of continuity.[58]

4. Nonvoting Shares

Another problem is whether nonvoting shares qualify for the continuity test. In many countries, company law provides for various categories of nonvoting shares. Because most of these types of shares guarantee a minimal fixed return on capital and a payout of the capital value of the shares in priority to common shares, the risk in these categories of shares is much lower. Generally speaking, they are very much like long-term bonds. Therefore nonvoting shares are often not accepted as equivalent to voting shares for a tax-free reorganization.[59] When

[57]*See* USA IRC § 368(a)(1)(G).

[58]However, if liabilities exceed the value of assets and only a nominal amount of stock is transferred to the former shareholders, then the continuity of interest requirement might be considered not to be satisfied. *See* Bittker & Eustice, *supra* note 15, ¶ 14.14. In such cases, what has occurred in substance is a purchase of the assets by means of an assumption of the liabilities.

[59]*E.g.,* USA IRC § 368(a)(1)(B) (exchange of stock solely for voting stock). *But see* Bittker & Eustice, *supra* note 15, ¶ 14.11 (nonvoting shares are counted in determining continuity of interest in a merger).

this rule is applied, a practical problem may arise with some categories of shares, which may be voting or nonvoting from time to time. For example, preferred shares may normally be nonvoting as long as the preferred dividend is paid out, but may become voting when the company fails to pay out the guaranteed preferred dividend. In such a case, the common shares, which are normally voting shares, may become nonvoting. To know whether shares are voting shares, the situation should be judged as it is in fact at the time of the reorganization. If preferred shares are voting at that time, such shares should be considered as voting shares. If common shares are nonvoting at that time, they should be considered as nonvoting shares. However, when these different categories of shares are distributed, it should be taken into account that preferred shareholders may lose control and that common shareholders may gain control some time after the reorganization.[60]

5. Step Transaction Doctrine

When the conditions for a tax-free reorganization are so narrow that, in some cases, unavoidable changes in the business activity or the necessity to buy out shareholders will result in taxation of the reorganization, the question arises as to whether the parties can do after or before the reorganization what the law prohibits them from doing at the time of the reorganization. If the parties can get rid of unwanted assets by selling them or transferring them to a different company before or after the reorganization, the problems in qualifying for a tax-free reorganization are more apparent than real. The same principle applies to the redemption of minority shareholders' interests.

The U.S. reorganization rules, which are rather flexible for changes at the time of the reorganization, are generally rather inflexible before and after; that is, the same restrictions that apply at the time of the reorganization also apply before and after it. This is the result of the application of the "step transaction doctrine" in case law.[61] Under this doctrine, different transactions before and after the reorganization are considered to be "single steps" of the overall transaction if it appears that they were necessary and indispensable steps to reach a general agreement on the reorganization. Therefore, sales of assets or shares before or after the reorganization will be taken into account in determining whether the continuity requirement has been met, when it appears that these sales were implemented as part of the overall reorganization agreement.

Countries with very strict rules on continuity traditionally have not had such a step transaction doctrine.[62] This diversity of experience suggests a choice between, on the one hand, a

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[60]The line cannot always be drawn very neatly. *See* Forrest Hotel Corporation v. Fly, 112 Supp. 782 (S.D. Miss. 1953).

[61]U.S. American Potash & Chemical Corporation v. U.S., 399 F.2d 194 (Ct. Cl. 1968), Commissioner v. Gordon 391 U.S. 83 (1968); Furniss v. Dawson [1984] 2 WLR 226; [1984] AC 474. Similarly, in the Netherlands, tax exemption is subject to the condition that the shares issued by the transferee company in the merger are not sold by the shareholder for three years after the merger, *see* NLD Vpb § 14(1).

[62]A typical case in point is Belgium before its tax reform of 1989. Tax-free reorganizations were an all-or-nothing affair, whereby all assets had to be transferred exclusively in exchange for voting stock. However, parties to the

formalistic system— with strict requirements for qualifying for reorganization treatment— and, on the other hand, a more flexible system policed by antiavoidance rules like the step transaction doctrine. While the latter approach can work in countries such as the United States with its sophisticated system of tax lawyers, tax administrators, and courts, it may be difficult to apply in countries whose tax system is not as developed, except by leaving considerable discretion to the tax administrators. While a formalistic system may therefore be more attractive in developing and transition countries, it also suffers from the potential disadvantage of being open to abuse. If the former choice is adopted, care should be given to defining the transactions eligible for tax-free reorganization treatment.

6. Corporate Divisions

While some countries spell out the requirements for taxfree corporate divisions in their statutes, others allow them by administrative practice, and yet others do not have provisions for taxfree divisions.[63] In some countries, all three techniques of division (spin-off, split-off, and split-up) can qualify for taxfree treatment, while in others only one or two of these can.[64]

There are often requirements concerning which assets can be contributed to a subsidiary that will be divided from the parent, but there are substantial differences in this requirement from country to country.[65] For example, in Germany, the assets of a division must be contributed together, and in the United States both the parent and the subsidiary must hold assets of an active business.

Tax law generally requires that all transferee companies carry on a business activity after a division (not necessarily the same business activity as before the division). If this condition is not imposed either by statute or by case law, it will become possible to split the corporate assets into two parts: one continuing the business and another to be liquidated. Such a transaction should be taxed as a distribution in partial liquidation, rather than as a division.

Another typical question is whether the shareholders of the transferor company need to continue their equity interest proportionally in all the transferee companies, or whether it is sufficient that they exchange their shares for voting shares of one or more of the transferee companies. This is an important question, because it determines to a great extent the flexibility of a corporate division. If all shareholders of the transferor are required to acquire the same proportional part in all the transferee companies as the part of the shares they own in the transferor, there is no flexibility at all. Often in a corporate division, some shareholders (group A) of the old company will be interested in continuing part of the business, while other shareholders (group B) will be interested in continuing some other part of the business. Therefore group A shareholders should receive shares only in company A and group B share-

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reorganization were free to dispose of shares and assets before and after the reorganization, making the restrictions at the time of the reorganization a lot less strict.

[63] *See* Rädler, *supra* note 15, at 564.

[64] *See id.* at 565.

[65] *See id*. at 568–69.

holders, shares only in company B. As long as all or the largest part of the shareholders continue their equity interest in one of the transferee companies, the reorganization should maintain its tax-exempt character.

7. Elective Taxable Treatment

Treatment of a proposed transaction as taxable or tax free is often elective in that the taxpayer can change the form of the transaction slightly to make it qualify as tax free or, if the taxpayer considers it more advantageous, to make it fail to qualify. Some countries go beyond this degree of electivity in some cases by allowing the taxpayer to elect for particular transactions whether it will be treated as taxable or as a tax-free reorganization.[66] The theory behind this approach is that it is inefficient to require the taxpayer to manipulate the corporate form of the reorganization to accomplish the particular tax result desired.

8. Requiring Approval

Although there are disadvantages in requiring approval from the tax authorities before a transaction can be engaged in (delays may impede transactions and approval requirements may be invitations for corruption), the technique of requiring a ruling from the tax authority before a reorganization can be carried out on a tax-free basis[67] does have the advantage of simplifying the drafting requirements and alleviating the concern that statutory rules allowing such transactions might be used for tax avoidance. Approval requirements might be impractical in countries experiencing a large volume of reorganizations, but might be manageable in countries where this is not the case.

C. Tax Consequences of Tax-Free Reorganizations

1. Tax Position of the Transferor Company

The tax exemption of a reorganization in itself is very simple: no tax is levied on the gain that is realized in exchange for shares.[68] When the reorganization rules allow compensation partly in shares and partly in cash and other property, the most common approach is to provide a partial exemption. This means that the gains realized in a reorganization will be tax exempt to the extent that the transfer of assets by the transferor is compensated by voting shares of the

[66]Germany allows the transferor company an option to choose between a tax exempt and a taxable transfer; *see* UmwStG §11. This choice will of course be agreed upon between the parties to a reorganization. When the transferor company elects a tax-free reorganization, the conditions are such that the continuity of shareholders and business activity is guaranteed so that the tax liability is only deferred. In the United States, a corporation that purchases the stock of a target company may elect to treat the transaction as a taxable purchase of the assets of the target, followed by the contribution of the assets to a new corporation. *See* IRC § 338.

[67]*E.g.,* FRA CGI § 210B (requiring approval for divisions and contributions of part of a corporation's assets). *See* Bernard Chesnais and Yann de Givré, *France, in* 79b Cahiers de droit fiscal international 139, 142–43 (1994).

[68]*See* BEL CIR § 45; FRA CGI § 210 A. However the transferor company can elect taxable treatment for the transaction, in which case a concessional rate of 18 percent applies, *see* FRA CGI § 210 A - 4; USA IRC § 354 (a).

transferee, or to the extent that the shares of the acquired company are exchanged for shares in the transferee company.

For problems related to applicable tax rates and differences in tax rates between ordinary profits and capital gains and the allocation of gains to various categories of assets, we refer to the discussion of taxable reorganizations.[69] One problem that is specific to the partially taxable transaction is how the amount of the taxable profit is calculated. Basically there are two approaches. One approach is to allocate the total compensation (shares and taxable compensation) proportionally to all assets.

Examples

EXAMPLE 1

In a merger, OLDCO receives total compensation of $20,000 reflecting its net fair market value. Of this compensation, $15,000 is paid in shares and the balance of $5,000 is paid in cash. The tax basis of the net assets of OLDCO (after deduction of all liabilities) is $6,000. Total gain on the merger realized by OLDCO is $14,000. Of this gain, one-fourth ($5,000 out of $20,000) is taxable, either as an ordinary profit or as a capital gain. The balance of the gain is tax exempt; that is, of the total gain, $3,500 is taxable and $10,500 is tax exempt.

Another approach is to subject to tax all forms of compensation other than shares, but only to the extent that the transferor company realizes an overall profit on the transaction.[70]

EXAMPLE 2

The facts are the same as in example 1. Instead of having the total profit proportionally allocated between the compensation in shares and the other forms of compensation, the total gain will be taxed to the extent of the compensation received in a form other than shares (i.e., the total taxable profit will be $5,000).

The amount of taxable profit under the second method will always exceed the amount that is taxable under the method of proportional allocation.

Although most countries will tax the transferor company in a merger to the extent that the transfer of assets is not compensated for in voting shares, some tax systems do not tax the transferor company when, or to the extent that, the nonshare compensation is distributed by that company to its shareholders pursuant to the plan of reorganization. Only the shareholders of the transferor company will be taxed if, and to the extent that, they receive compensation other than voting shares. The basic reason for this approach is that the transferor company is acting only as a conduit to transfer the compensation received in the reorganization to its shareholders, while

[69] *See supra* sec. III.

[70] *E.g.,* USA IRC § 356.

the transferor itself does not realize a profit and should not be taxed on the compensation transferred to the shareholders.[71] It should be noted, however, that such look-through treatment of the transferor company is inconsistent with the classical system involving double taxation of companies and shareholders.[72]

This rule can be accepted only when it is certain that all shareholders will be taxed on any profits. When individual shareholders are not taxed on their capital gains, this rule should not be applied. In such cases the only place to tax the nonshare compensation is the transferor company.

2. Tax Position of Transferor Shareholders

The same rule should apply to the transferor company and to its shareholders: to the extent that the reorganization is compensated for with voting shares, the gain realized by the shareholders of the transferor should be tax exempt.[73] In many countries, however, gains realized by individual nonbusiness shareholders, nonprofit organizations, or tax-exempt institutions such as pension funds are tax exempt in any case. In these tax systems, it is not necessary to provide a specific exemption for these types of shareholders.

A special case of exemption is the gains realized by holding companies. In some countries, capital gains realized on shares by holding companies are fully tax exempt in order to eliminate double taxation.[74] It follows that even when there is a fully or partially taxable reorganization, the gains realized by a company that is a shareholder in the transferor or acquired company are always tax exempt, even when the latter company is fully or partially taxed on the reorganization.

For business taxpayers, the exchange of shares for consideration other than voting shares should always be a taxable event even within the framework of a "tax-free" reorganization. The reason is that it is easier to partially tax the consideration that has taken a form other than voting shares than it is to transfer the old cost base of the shares surrendered to the assets received. Particularly when the compensation is in cash, it would be awkward to have cash booked with a cost base equal to the value of the old shares surrendered. However, to the extent that

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[71] *See* GBR TCGA § 139(1) (applies where the transferor “receives no part of the consideration for the transfer”); USA IRC § 361(b).

[72] This is not to say that the United States has always exhibited great consistency in its approach to the classical system. Up to 1986, corporations could (under the so-called *General Utilities* doctrine) distribute appreciated property to shareholders without incurring tax on the gain, thereby eliminating economic double taxation on these gains. With such inconsistent treatment in the background, it is easy to understand that the merger rule is not always consistent.—L.M.

[73] *See* FRA CGI §§ 92B, 92J (shares listed on the stock exchange), 160 I *ter* (shares constituting a holding exceeding 25 percent of outstanding capital), 150 A *bis* (shares in real estate companies); DEU UmwStG § 13; GBR TCGA § 135; USA IRC §§ 354(a), 356.

[74] *See supra* note 28.

compensation is not in cash, it should be possible to exempt the transfer and to defer the tax liability by continuing the cost base of the old assets for the new assets received in exchange.[75]

The taxable profit will be calculated as the difference between the total compensation received and the cost base of the shares surrendered.[76] The alternatives for calculating the amount of profit are the same as those discussed above in connection with taxing the transferor in a partially taxable reorganization. Either the total profit will be proportionally allocated over total compensation in shares and other forms of compensation, or total nonshare compensation will be taxed to the extent that there is an overall profit on the transfer of shares.[77]

Finally, there is the problem of eliminating double taxation between companies and shareholders. As already indicated,[78] this problem has been solved in Belgium and the Netherlands. In other countries, it has not been solved for the simple reason that it is not perceived as a problem. Gain on the exchange of shares in a reorganization is conceptually qualified as a capital gain, which is a category separate from dividends. Therefore, in most countries the concept of double taxation of companies and shareholders is simply not applied to this situation.[79] However, in some countries the gain is considered as a liquidating distribution by the transferor at the time of the reorganization. The liquidating distribution is sometimes considered as the equivalent of a dividend, thereby raising the question of relief for double taxation. The shareholders of the transferor company may therefore receive a tax credit or an exemption for dividends received as in an ordinary distribution of a dividend. The problem with these solutions is that in most cases the tax credits or the amount of the exemption for dividends received for the transferor company and its shareholders do not match because, as stated, the gains of the transferor company and its shareholders do not match either. As a consequence, the elimination of double taxation between the transferor company and its shareholders in a partially tax-free reorganization is far from perfect.

The position of the shareholders of the transferor company after the merger is subject to the continuity principle, implying that: (a) to the extent that the exchange of shares is free of tax, all the tax attributes of the shares in the transferor company will be carried over to the shares in the transferee company as if the reorganization had not taken place; and (b) to the extent that the exchange of shares has been taxed, the tax basis of the shares in the transferee company will be revalued and all tax attributes of the shares in the transferor company will disappear.

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[75]USA IRC § 358(a) provides an adjustment of the tax basis when property is received in exchange for consideration other than stock or securities.

[76]FRA CGI §§ 150 A *bis,* 160 I *ter* defer the tax liability until the shares received in exchange are sold.

[77]*See supra* sec. IV(C)(1).

[78]*See supra* note 28.

[79]Note, however, the intricate Norwegian "RISK" rules, which allow a step-up of capital gains tax basis for shares with respect to retained, taxed profits, with the purpose of eliminating economic double taxation not just for distributed profits, but for profits the shareholders realize as capital gains.—L.M.

3. Tax Position of the Transferee Company

The transferee company is not taxed in a merger unless it is at the same time a shareholder of the transferor company. This special case will not be discussed here. In a reorganization, the transferee company is mainly interested in what happens after the reorganization. The position of the transferee company is determined by two elements: (a) the tax basis of the assets received from the transferor, and (b) the carryover of other tax attributes of the transferor.

A. TAX BASIS OF THE ASSETS TRANSFERRED

The rules for determining the tax basis to the transferee company after the merger are roughly the same as the rules for determining the tax basis of the new shares on behalf of the shareholders of the transferor company. To the extent that the transfer of assets is taxed to the transferor company there will be a revaluation of these assets for tax purposes; to the extent that the transfer of assets has been tax free, the transferee company will carry over the tax basis that those assets had before the reorganization in the transferor company.[80]

The problems of allocating the amount of taxable profit to various categories of assets (inventory, fixed assets, goodwill) have been discussed in connection with taxable transactions.[81] These problems are exactly the same in a partially tax free merger. To the extent of the amount taxed, the increase in tax basis has to be allocated over several categories of assets. The valuation of the assets in the reorganization will be decisive in allocating the amount of profit realized by the transferor. When the reorganization is completely tax free, there is no problem of allocation, because the existing tax basis of the assets of the transferor company is carried over.

B. DISPARITY BETWEEN TAX ACCOUNTING AND COMMERCIAL ACCOUNTING

The carryover of the old tax basis of the assets of the transferor company in a tax-free reorganization may result in a disparity between tax accounting and commercial accounting, depending on the accounting rules in the tax jurisdiction. Basically, a reorganization can be accounted for by either pooling accounting or purchase accounting.

Pooling accounting consists in carrying forward without any change all book items of the transferor company as they existed before the reorganization. It is the accounting method that is recommended for tax-free reorganizations in the United States, because the accounting rules coincide with the tax rules.

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[80]*E.g.,* BEL CIR § 212; USA IRC § 362(b). In France, a distinction is made between depreciable and nondepreciable assets. For nondepreciable assets such as land and securities, there is a single carryover of the old tax basis; *see* FRA CGI § 40, 151 *octies*. For depreciable assets, the capital gain that has been exempted must be reintegrated in taxable profits over a period of 15 years after the merger; *see* CGI § 210A(3)(d). The argument has been made that in the context of privatized enterprises in transition economies, it may not make much sense to provide for basis carryover, because the basis may bear no relation to reality. The alternative would be to allow such enterprises a fresh start valuation at market value without requiring recognition of gain. *See* Kodrzicki and Zolt, *supra* note 5, at 629–33.

[81]*See supra* sec. III.

Purchase accounting treats the transfer of assets in a tax-free reorganization as a sale and results in the revaluation of all assets transferred from the transferor company on the basis of their fair market value. The use of purchase accounting in a tax-free reorganization results in a discrepancy between commercial accounting and tax accounting after the reorganization in respect of the transferee company.

Example

> A building that has been completely depreciated is transferred in a tax-free merger. The tax basis of the building is 0. In the merger, the building is valued at $1,000,000. When purchase accounting is used in the merger, the building will be recorded in the accounts of the acquiring company at $1,000,000, and depreciation will be calculated on $1,000,000. For tax purposes, however, the building will be transferred tax free to the acquiring company at a value of 0, and no depreciation will be allowed; hence, a discrepancy arises between depreciation for commercial accounts and depreciation for tax accounts after the merger.

Countries that base tax accounting on commercial accounting will have to use pooling accounting for tax-free reorganizations.[82]

C. CARRYOVER OF TAX CHARACTERISTICS FROM TRANSFEROR TO TRANSFEREE

When a corporation disappears in a merger or its assets are acquired, the question arises as to whether various tax attributes of the corporation are carried over to the transferee. In a formalistic approach, these attributes would disappear, because they are personal to the taxpayer, but the tax laws typically stipulate that they are carried over in a tax-free reorganization, subject to limitations.[83] One difficulty is that there are a number of potential tax attributes whose treatment is not necessarily consistent (in particular, as discussed below, limitations are often placed on the carryover of net operating losses).

The position of the transferee company on the carryover of tax characteristics of the transferor company in general can best be illustrated by the carryover of losses, methods of depreciation, and inventory valuation.

Practically all developed tax systems limit the transfer of loss carryovers from one company to another in tax-free reorganizations.[84] In some systems, loss carryovers are simply

[82] *E.g.,* DEU UmwStG §§ 4, 12.

[83] *E.g.,* USA IRC § 381; Bittker & Eustice, *supra* note 15, ¶ 16.01.

[84] France requires a preliminary ruling (*agrément préalable*) to carry over tax losses in a corporate reorganization; *see* CGI § 209 II. In Germany, loss carryovers from the company that disappears in a merger are prohibited on the principle that the transferor and the transferee company are two different taxpayers and that losses from one taxpayer cannot be carried over to another taxpayer. Tax practice has applied a self-help method, however, by having the loss company act as the transferee company so that tax losses can be preserved within the entity of the same taxpayer. *See* Brigitte Knobbe-Keuk, Bilanz- und Unternehmenssteuerrecht 598 (1993).

prohibited. However, most tax systems apply one of two alternative approaches or, in some cases, may apply both approaches simultaneously.

The first approach is a variation on the substance-over-form approach or the requirement of a specific business purpose for the tax-free reorganization. It is mostly applied by case law or by rulings because it requires some qualitative evaluation of facts. The loss carryover will be permitted only when there is some economic substance to the merger that justifies the compensation of losses from one line of business with profits in another line of business. This approach sometimes leads to surprising results and causes uncertainty for taxpayers. In some cases, tax law allows a tax loss carryover only if there is a business purpose.[85] A variation of this approach requires continuity of business activity.[86]

The second approach is a strict statutory and quantitative approach. The tax law states some hard and fast rules that are based on quantitative restrictions that always apply, even when loss compensation in the tax-free reorganization would be justified on good business grounds.[87] Basically, there are two ways to apply this approach: one is a continuity-of-shareholders test and the other is a comparison-of-assets test.

The continuity-of-shareholders test was used in the United States before the Tax Reform Act of 1986. The rule called for tax loss carryovers to be reduced in proportional amounts when the shareholders of the transferor company did not acquire a certain minimum threshold participation in the transferee company. For example, full loss carryover was permitted only when the shareholders of the loss company obtained at least a 20 percent share participation in the profitable company. For each full percentage point by which the shareholders of the loss company fell short of the 20 percent target, the amount of the loss carryover was reduced by 5 percent. For example, when the shareholders of the loss company acquired only 5 percent of the interest in the profitable company, only 25 percent of the amount of the tax losses could be carried forward.[88]

Another approach is the relative comparison-of-assets test. Losses can be carried forward only to the extent of the percentage share that the assets of the loss company represent in the total assets of the combined company or companies after the reorganization. For example, if the net value of the loss company represents only 5 percent of the total value of the combined companies, only 5 percent of the loss may be carried over.[89]

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[85]Libson Shops v. Koehler, 353 U.S. 382 (1957); Maxwell Hardware Co. v. Commissioner, 343 F.2d. 713 (9th Cir. 1965).

[86]*E.g.,* DEU KStG § 8(4) (denying tax loss carryovers when more than 75 percent of the shares have been transferred and the acquired company has substantially changed its business). This rule puts severe restrictions on the rule that permits the transferee company to carry forward tax losses in a tax-free reorganization.

[87]In the Netherlands, there is no tax exemption for an asset acquisition when one of the participating companies has a tax loss carryover (combination of Vpb §§ 14 and 20); *see also* DEU KStG § 8(4).

[88]*See* USA IRC § 382 (1986); *see also* AUS ITAA (1936) § 80 DA(A)(d); GBR ICTA § 768 (a major change in ownership and a major change in the nature or conduct of a trade).

[89]*See* BEL CIR § 206(2).

The United States currently uses a more sophisticated version of this approach, under which the loss carryover is limited to the value of the loss company's shares multiplied by a long-term interest rate.[90] This approach allows the losses to be offset against a notional return on the assets of the loss company.

In a corporate division, loss carryovers should follow the transfer of business activity. That is, when a business is divided in such a way that company A continues the basic business activity, while another company B receives assets and liabilities but carries on a completely new business activity, losses should be transferred exclusively to company A. A net asset test for the division of loss carryovers may result in distortions, because liabilities of the transferor company may be dumped exclusively in the transferee company carrying on the nonprofitable business, thereby reducing its net fair market value almost to zero.

Tax credits should also follow the business activity. To the extent that such credits are related to particular assets, specific investment requirements (e.g., oil exploration), or specific activities (research and development), the credits should follow either the assets or the specific activity to which they are linked.

Another issue is the carryover of depreciation methods, methods of inventory valuation, and other methods of accounting.[91] The basic rule is that the methods of accounting used by the transferor must be continued by the transferee after a tax-free reorganization. However, sometimes the taxpayer is allowed to change these methods when there are good business reasons for such a change. Some, but not all tax systems also accept a business reorganization as an occasion that justifies such a change, in order to apply the same methods of accounting in the combined company or companies after the reorganization. Such changes may go in both directions. The assets of the transferor company can be valued and depreciated in accordance with practices used before the reorganization by the transferee company, or all assets after the reorganization may be valued or depreciated in accordance with practices formerly used only by the transferor company. In this sense, there may be discontinuity in depreciation practices and valuation practices even after a tax-free reorganization.

Finally there are the rights of the taxpayer in matters of tax procedure, such as appeals, collection, and litigation. The carryover of all rights and obligations in tax procedures is not so much determined by tax law, which seldom provides that these procedures will be carried forward by the transferee company or that the transferee company will be considered as the general tax successor to the transferor company. The rule imposing a carryover of all procedural aspects of taxation is most often situated in company law or, in some cases, in the code of civil procedure.[92]

[90]*See* USA IRC § 382.

[91]*See supra* sec. III(C); USA IRC § 381.

[92]*See also supra* sec. III(C).

In corporate divisions, one way to solve the problem is to make all transferee companies jointly liable for tax obligations, which means that they can also act jointly in tax protests and tax litigation after a corporate division. In practice, collection of tax liabilities should always follow the business activity of the transferee companies. The other transferee companies should be liable only when the tax liability cannot be collected from the transferee company to which it belongs. If a tax liability is specifically linked to a particular asset (e.g., land tax on real estate), the tax liability and ensuing tax protests and tax procedures may appropriately follow the asset.

V. Taxes Other Than Income Tax

The tax consequences of corporate reorganizations are not limited to income tax. There are always the problems of carrying over the tax characteristics of any tax from transferor to transferee company and from old to new shares. For two types of taxes, the problems are more pressing than for others because they raise problems of tax exemption: taxes on capital contributions and value-added tax.

Many countries levy taxes on equity contributions to capital or stamp duties on transfers of assets.[93] A corporate reorganization often requires a formal capital contribution, which in some cases may impose a considerable tax burden (e.g., if a newly formed subsidiary is involved). The reasons for exempting reorganizations from tax on capital contribution or stamp taxes are largely the same as the reasons for exemption from income tax. The basic difference between the exemption from these taxes and the exemption from income tax is that the former is final, whereas the latter is temporary. The simplest way to deal with this exemption is to impose the same conditions for exemption as in the income tax.

Finally there is the problem of value-added tax or sales tax.[94] Here too, there is a case for temporary exemption, as long as the transferee who carries on the business also remains responsible for all tax obligations. It will not be appropriate, however, to impose the same conditions for exemption as in the income tax, for the simple reason that the tax fate of the shareholders of the transferor company is irrelevant to the sales tax or value-added tax. Only the transferor and the transferee company are involved as taxpayers. Therefore, the only requirements that should be imposed are (1) that the business activity should be transferred to and continued by the transferee (transfer of all or substantially all assets and liabilities),[95] and (2) that the transferee should be subject to sales tax or value-added tax with the same rights and obligations as the transferor. The type of consideration paid in the reorganization is irrelevant (therefore, sales of a business should qualify for exemption). The type of taxpayer is also irrelevant, so that it should be possible to have a transfer free of value-added tax between a corporation and an individual and vice versa as long as both parties are taxpayers under the value-added tax. The same approach can be applied in the case of the excise tax.

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[93]Exemptions from these taxes in reorganizations are discussed in Tomsett et al., *supra* note 45.

[94]*See* vol. 1, at 216–17.

[95]In contrast to the requirements for tax-free reorganizations under the income tax, here, substantially all the assets means the assets of a business, not all the assets of the transferor (which may have several businesses).

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Fiscal Transparency

Alex Easson and Victor Thuronyi

> Men may put on the habiliments of a partnership whenever it advantages them to be treated as partners underneath, although in fact it may be a case of "The King has no clothes on" to the sharp eyes of the law.
>
> —Felix Frankfurter

I. Introduction

As discussed in chapters 14 and 19, income tax systems invariably draw a distinction between physical persons and legal persons. In some systems, income tax is imposed by separate laws—an individual income tax law and a corporate (or enterprise) income tax law; in others, physical and legal persons are taxed under the same law, but are governed by separate rules and rate schedules. Some business or investment income, however, is not earned directly by such taxpayers, but is earned through entities or arrangements that—depending on the legal system—may or may not be separate persons. In that case, it is necessary to decide whether to tax the entity as a separate physical or legal person, or to provide for fiscal transparency, whereby the entity's income flows through to its owners. Pure transparency would mean disregarding the entity altogether, which is sometimes done.[1] However, more commonly, the entity is recognized as existing for tax purposes, but rules are devised so that the entity's income is taxed not to it but to its owners. This chapter explores the circumstances under which fiscal transparency (also called flow-through treatment) applies for income tax purposes and the rules by which transparency is given effect.

The topic is a confusing one to investigate on a comparative basis, for two reasons. First, the nature of legal arrangements to which transparency can be applied differs considerably from one legal system to another. In general terms, there is a big difference between common law and civil law countries, although there are also differences within the groups of common and civil law countries. Because tax law must apply to the economic rights that are specified in a country's civil and commercial law, these legal differences have strongly influenced the tax rules in various countries. Given these fundamental differences,

[1] An example is the treatment of a grantor trust. *See infra* sec. III(D)(1). *See generally* David S. Miller, *The Tax Nothing*, 74 Tax Notes 619 (Feb. 3, 1997) for a discussion of various cases where entities are disregarded and the implications thereof.

it is difficult in this area to generalize and point to an optimal set of rules for the income tax. Second, even laying aside the differences in underlying legal systems, most industrial countries have not formulated rules for transparency in a thorough and consistent fashion. Developing and transition countries that are formulating rules to deal with transparent entities must therefore rethink approaches to the issue that have been employed elsewhere.

A further problem arises from the fact that, while in some countries the tax status of an entity is determined by its status (as a legal person or otherwise) under civil law, in many systems the tax status of an entity is established by the tax law, and does not always coincide with its status under private law.[2] In some cases, the entity is a legal person but is not treated as a separate taxpayer for purposes of the income tax on legal persons. In other cases, the converse is true—the entity is not a legal person but is regarded as such for tax purposes.[3] Such a difference in status should not necessarily be considered a defect in the overall legislative scheme; there are perfectly valid reasons why an entity might be regarded as a legal person for purposes of registration or of civil liability, but not for purposes of taxation.

This chapter is primarily concerned with the income tax treatment of those entities that` are neither legal nor physical persons, and with entities that are legal persons under the general law but are not treated as such for purposes of the income tax.

There are a great variety of ways in which ownership interests in investment property or in a business may be split up among different participants. In the case of investment property, there can be a pure co-ownership arrangement (such as a joint tenancy), in which two or more persons each own a fraction of the property. In such a case, minimal rules are needed to specify the taxation of the income from the property: each owner is taxed on his or her fractional share of the income.[4] Such joint-ownership arrangements are not considered further in this chapter.

Arrangements for the joint operation of a business can be referred to generally as partnerships, although the term does not mean precisely the same thing in different legal systems. The tax treatment of partnerships is discussed in section II. Another important joint-ownership arrangement in common law countries is the trust, which has some analogues in civil law countries. Taxation of trusts is considered in section III. Finally,

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[2]*See* vol. 1, at 91–92.

[3]The treatment of an entity may also differ from one tax law to another. For example, a partnership is usually not treated as a separate entity for income tax purposes, but is normally a distinct taxable entity under the value-added tax, *see* vol. 1, at 175–76, and may also be treated as a taxpayer for other taxes (payroll taxes, property tax, excise taxes). It will generally have an employer identification number and an obligation to withhold PAYE on the same basis as corporate employers. *See, e.g.,* U.S. Treas. Reg. §§31.3401(d)-1, 301.6109-1.

[4]*E.g.,* LSO IT § 64. In addition to a rule specifying that each owner is taxed on the owner's share of the income, it may be appropriate to provide for cases where jointly owned property is divided, each owner receiving a portion of the property. In systems where capital gains are taxed, nonrecognition treatment would be appropriate for this kind of transaction.

section IV deals with a number of other business entities that are accorded special tax treatment in various countries.

One general approach to taxing such entities is to provide some form of transparent treatment, whereby the income is taxed at the level of the owners rather than at the level of the entity. Precisely how this may be done is considered below. An alternative approach is to accord only partial flow-through treatment to the entity; income that is distributed or allocated to the beneficiaries or owners is taxed to them, with the remainder being taxed at the entity level. This method is commonly adopted for trusts, and is designed to ensure that all the income of the entity is taxed once.

II. Partnerships

A. Introduction

1. Legal Nature of Partnerships

The legal concept of partnership exists both in common law legal systems and in civil law countries, although the two concepts are not entirely equivalent.[5] The traditional common law definition holds that "[p]artnership is the relation which subsists between persons carrying on business in common with a view to profit."[6] That is, a partnership is a relationship among persons, essentially contractual in nature rather than a "person" in its own right.

Civil law systems generally do not use the term “partnership” but have the concept of what could be literally translated as an association of persons or company of persons.[7] This concept is distinct from that of a capital company.[8] The precise legal nature and form that companies of persons may take differ depending on the civil and commercial laws of each country.[9] In many civil law countries, a distinction is also made between civil law

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[5]For an overview of the taxation of partnerships in different countries, with particular emphasis on international aspects, *see* Jean-Pierre Le Gall, *General Report*, *in* International Tax Problems of Partnerships, 80a Cahiers de droit fiscal international 655 (1995) [hereinafter Cahiers].

[6]Partners__p Act, 1890, 53 & 54 Vict., ch. 39, § 1 (GBR).

[7]*Société de personnes, sociedad de personas, Personengesellschaft.*

[8]*Société de capital, sociedad de capital, Kapitalgesellschaft.*

[9]*See generally* S.N. Frommel & J.H. Thompson, Company Law in Europe 16–18 (1975); The International Guide to Partnerships (van Raad and Betten eds., IBFD 1996)[hereinafter Guide]; Cahiers, *supra* note 5, at 75, 113–14, 294, 337–39, 378–79. For example, in Argentina, the following types of partnerships may be formed: partnerships regulated by the civil code (*sociedades civiles*), de facto companies (*sociedades de hecho*), irregular companies (*sociedades irregulares*), general partnerships (*sociedades comerciales colectivas*), limited liability companies (*sociedades de responsabilidad limitada*), limited partnerships (*sociedades en comandita*

(continued)

partnerships (governed by the civil code) and commercial partnerships (regulated by the commercial code). Typically, civil law partnerships are those that are engaged in farming or investing in land, or that are carried on by members of the liberal professions—activities not considered to be "commercial."[10] They can also include agreements to split the profits of a business.[11]

Most countries recognize at least two forms of partnership: the general partnership, in which the partners are jointly liable for the debts of the firm, and the limited partnership, in which the liability of some of the partners is limited.[12] In a number of countries, there are more than two forms of partnership, and the tax treatment may vary according to the particular form.[13]

In some legal systems, partnerships have legal personality, while in others they do not.[14] In this chapter, the term "partnership" is used not as a term that corresponds precisely to

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simples), partnerships limited by shares (*sociedades en comandita por acciones*), labor and capital partnerships (*sociedades de capital e industria*), and associations for particular investments (*sociedades accidentales o en participación*). *See id.* at 24.

[10]*Cf. supra* ch. 14, note 111. In Spain, professional (civil) partnerships are generally taxed on a flow-through basis rather than as legal persons. *See* ESP IRPF art. 52(1)(B); ESP IS art. 19; Cahiers, *supra* note 5, at 486.

[11]*See infra* notes 32–34; DEU Handelsgesetzbuch §§ 230–237 (*stille Gesellschaft*).

[12]In Germany, the most important forms of commercial partnership are the (general) *Offene Handelsgesellschaft* (OHG) and the (limited) *Kommanditgesellschaft* (KG). Under article 105 of the German Commercial Code, an OHG is defined as follows: "A partnership formed for the purpose of running a commercial business under a common firm name is a general commercial partnership where no partner's liability is limited with regard to the partnership's creditors." Martin Peltzer et al., German Commercial Code 95 (1993). The corresponding forms in French law are the *société en nom collectif* and the *société en commandite*.

[13]A hybrid corporation/partnership form, the limited partnership with shares, exists in a number of countries, e.g., in Germany (*Kommanditgesellschaft auf Aktien*—KGaA) and Italy (*società in accommandita per azioni*), and is taxed as a legal person, unlike other partnerships. However, the share of the general partner of the KGaA is taxed on a flow-through basis. *See* Brigitte Knobbe-Keuk, Bilanz-und Unternehmensteuerrecht 414 (1993); DEU KStG art. 9(2). A relatively popular business form in Germany is the GmbH u. Co. KG—a type of limited partnership in which the general partner is a limited company; it is taxed on a flow-through basis. In the Netherlands, a distinction is made for tax purposes between an "open" and a "closed" limited partnership (*commanditaire venootschap*), depending on whether a limited partner's share is freely transferable. Only the closed type receives full flow-through treatment. *See* Cahiers, *supra* note 5, at 395, 398–99. The open type is taxed somewhat similarly to the KGaA in Germany—the partnership is subject to corporate tax, but the profit share of the general partners is deductible in computing the taxable profit of the partnership and is taxed in the hands of the general partners. *See* A.H.M. Daniels, Issues in International Partnership Taxation 18, 32–33 (1991).

[14]Generally, in countries with a common law tradition, partnerships do not have legal personality, although in Israel they do, despite the common law origin of the relevant legislation. In civil law countries, partnerships normally have legal personality; for example, they do in Brazil, France (except for *sociétés de fait* and *sociétés en participation*), Mexico, Spain, the Scandinavian countries, Russia (*see* Civil Code arts. 48, 49, 50, 66

(continued)

a concept in the legal system of all countries, but as a general one that encompasses a variety of legal forms. This variety and the differences in treatment under civil law, in particular whether the partnership is considered a legal person, make it difficult to generalize about partnerships. To some extent, differences in tax treatment from one country to another may also have been influenced by differences in civil law.

The term "joint venture" may be even more confusing than partnership. In some countries, joint ventures are transparent arrangements that may be less formal than partnerships.[15] The term is also sometimes used in ways that include a number of legal entities, including capital companies.[16]

2. Partnerships as Taxable Entities

The absence of legal personality of partnerships in many countries may have facilitated transparent treatment for tax purposes, although the fact that a partnership is or is not categorized as a legal person is not necessarily determinative of its tax status. Different approaches are possible. In several countries, partnerships are considered legal persons but are not treated as taxable persons.[17] Belgium, Spain, and many Latin American countries treat as taxable persons those forms of partnership that are legal persons, except for specified cases where a fiscal transparency regime applies.[18] In common law countries, partnerships generally are not considered legal persons and are not taxed as corporations, although some partnerships that are considered to resemble corporations are taxed as corporations rather

(RUS)), Kazakhstan (*see* Civil Code arts. 34, 58 (KAZ)) and the Czech and Slovak Republics (*see* Internationale Wirtschafts-Briefe, Mar. 26, 1997), but do not have legal personality in Belgium, Germany, Indonesia, Japan, the Republic of Korea, the Netherlands, or South Africa. *See* Cahiers, *supra* note 5, at 87, 114, 158, 183, 232, 267, 318, 396, 433, 466, 499, 597, 657.

[15] *E.g.*, Cahiers, *supra* note 5, at 125.

[16] *See* Joint Venture-Strukturen im internationalen Steuer- und Gesellschaftsrecht, Internationale Wirtschafts-Briefe, May 14, 1997; James Dobkin et al., Joint Ventures with International Partners 2-2 to 2-9, 5-1 to 5-20 (1993).

[17] *E.g.*, Argentina, Denmark, Finland, France, Israel, Norway, and Sweden. In the United Kingdom, partnerships in Scotland are legal persons but, as elsewhere in the country, are not taxable persons.

[18] *E.g.*, Brazil and Mexico. *See* Cahiers, *supra* note 5, at 87, 114, 380. In Spain, the general rule is that legal persons are subject to the company tax; however, a transparency regime applies to certain entities. *See* ESP IS §§ 4, 19.

than as partnerships, even though they are not legal persons.[19] In Indonesia, partnerships are taxed as separate entities even though they have no legal personality.[20]

In recent years, the civil and commercial laws of many transition countries have undergone changes under which the legal status of various kinds of business entities has been defined or redefined; the tax treatment of such entities has also been in a state of flux. The different patterns that have emerged can be illustrated with some examples. In Kazakhstan and Romania, all legal persons (including partnerships) are subject to income tax as separate entities.[21] In Latvia, the enterprise income tax applies to all enterprises, which are defined according to registration requirements,[22] except that partnerships are taxed on a flow-through basis[23] and physical persons and "individual enterprises" that are not required to submit annual reports under commercial law are taxed on a flow-through basis to the owner.[24] Individual enterprises that are required to submit annual reports are therefore taxed as entities even if they are not legal persons. Similarly, in China, all enterprises are subjected to enterprise income tax as separate entities regardless of whether a given entity is a legal person.[25] In Estonia, the entity-level tax applies to legal persons.[26] General and limited partnerships are taxed under the entity-level tax, except that general partnerships consisting of no more than ten partners who are all resident physical persons are taxed on a flow-through basis.[27]

Taxing partnerships as entities has the advantage of administrative simplicity, as it is generally easier to collect tax from a single entity than from the individual participants. Income tax returns of partners who are physical persons are kept simple, as they do not

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[19]*See* Cahiers, *supra* note 5, at 659. In Australia, limited partnerships formed after 1992 are taxed as companies. In the United States, certain publicly traded partnerships are treated as corporations for income tax purposes, *see* USA IRC § 7704; and limited partnerships may be treated as corporations if they have a predominance of corporate characteristics. *See* Treas. Reg. §§ 301.7701-2, 301.7701-3 (USA).

[20]*See* Cahiers, *supra* note 5, at 267–68; IDN IT § 2.

[21]ROM PT § 1(1)(a); KAZ TC § 6(3); Civil Code arts. 34, 58 (KAZ).

[22]LVA TF § 14(4).

[23]*See* LVA EIT § 2(3). In Latvia, partnerships are not legal persons. *See* Law on Partnerships, art. 2 (Feb. 5, 1991)(LVA).

[24]*See* LVA EIT § 2(4).

[25]CHN EIT § 2.

[26]EST IT § 2(2).

[27]*Id.* § 4.

include income received through the entity,[28] and complicated rules for the taxation of flow-through entities can be largely avoided. A further advantage of taxing partnerships as entities is that it avoids discrimination between different forms of business organization and eliminates "entity shopping."[29] However, the disadvantage is that the income will then normally be taxed at a flat rate rather than at the marginal rates applicable to the individual partners.

If partnerships are taxed as entities, it must also be decided whether they should be treated the same as corporations in all respects. For example, should partnership distributions be treated as dividends, and should all the rules governing transactions between corporations and shareholders apply to partnerships as if partners were shareholders? The answer may depend on what system is used for taxing corporations (classical, imputation, or other).[30]

3. Defining Which Entities Are Subject to Which Regime

A threshold question in designing the income tax on business and other entities is the determination of which entities should be subject to the tax on legal persons[31] and which should be subject to flow-through treatment. As previously noted, this determination does not necessarily depend on whether for other purposes the entity is a legal person. Entities that are not legal persons may still be taxed as if they were, and entities that are legal persons may receive flow-through treatment.

Even in systems that impose a single enterprise tax on business entities or on all legal persons, there are usually some situations where an exception to the general rule is made, and a business arrangement between two or more participants gives rise to income that is allocated and taxed to the participants; that is, it is given flow-through treatment. In civil law countries, such arrangements are usually provided for under the civil or commercial code.[32] They do not normally give rise to a separate registration requirement and are not separate legal persons. A typical example is the arrangement commonly referred to as a joint

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[28]Unless the distribution of profits from the partnership to an individual partner is treated as the equivalent of a dividend. This is the case in the Netherlands where profits of an open limited partnership are distributed to a limited partner. *See* Cahiers, *supra* note 5, at 399.

[29]In the United States, for example, many smaller businesses are operated in the form of partnerships or limited liability companies because such forms are taxed less heavily than corporations; *see supra* ch. 19.

[30]*See supra* ch. 19.

[31]*See id.*

[32]*E.g.*, Codul Comercial [Commercial Code] arts. 251, 253 (ROM). In France, *société civile*; in Germany, *bürgerliche Gesellschaft*. *See* Bürgerliches Gesetzbuch §§ 705–740.

venture,[33] in which each participant (itself often a legal person) is taxed separately on its share of the venture profits.[34]

Depending on what tax regimes are provided, definitions must be framed to allow distinctions among different entities. For example, the law might provide for three different regimes: (1) entities taxed as corporations, (2) entities taxed on a flow-through basis with income determined at the entity level, and (3) entities or arrangements with full transparency (the distinction between (2) and (3) is explained below). How the definitions are framed may depend on the civil and commercial law. For example, it might be provided that all entities that have legal personality under the civil law are taxed as corporations, that all entities (other than legal persons) required to keep books of account under the commercial law are taxed under regime (2), and that all other entities or arrangements are taxed under regime (3).[35] Whether it makes sense to frame the definition in this way depends on the civil law. Sometimes it is difficult to frame the definition in general terms and resort is had to listing types of entities.[36] Whether a list is resorted to or not, the definition is most often framed in terms of the status of the entity under the civil law. Some countries, such as the United States, have adopted an independent definition for tax purposes.[37] Recently, the United States has made the rule elective, so that most foreign entities that are not stock companies can elect

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[33]*See infra* sec. IV(A)(1).

[34]For example, in Mexico, although partnerships (which are legal persons) are generally taxable entities, joint ventures (which are not legal persons) are not. *See* Cahiers, *supra* note 5, at 377, 381–82.

[35]On the distinction between partnerships and arrangements that are fully transparent (such as coownership of property), *see* Hugh Ault et al., Comparative Income Taxation 355–56 (1997); Knobbe-Keuk, *supra* note 13, at 401-02 (a *typische stille Gesellschaft* (typical silent partnership) is not considered a partnership for purposes of DEU EstG § 15), William McKee, William Nelson & Robert Whitmire, Federal Taxation of Partnerships and Partners ¶3.03[5] (1997). (distinction between partnership and coownership).

[36]*E.g.,* FRA CGI §§ 8, 206, 239 *quater*, 239 *quater* C.

[37]The Internal Revenue Code taxes associations as corporations but does not define association. The courts and the Treasury Department gradually evolved a definition that looked at characteristics of the entity being considered, evaluating its resemblance to a corporation on the basis of those characteristics. Eventually, this test was embodied in regulations, but the test included in the regulations was applied in a formalistic manner, so that tax practitioners could, by following the regulations and structuring the entity as appropriate, achieve either partnership or corporate classification. The tax treatment of an entity had therefore become largely elective. This electivity was extended and formalized in 1996. For discussion of the history, *see* McKee et al., *supra* note 35, ¶3.06. The pre-1996 U.S. approach is unusual, the general approach to classification being explicitly formalistic (i.e. countries generally do not look behind the form of an entity to consider its characteristics under its governing instrument). However, an entity's characteristics do sometimes have to be considered in classifying foreign entities, since the test may be whether the foreign entity resembles entities that are classified as corporations under domestic tax law, and the forms of the foreign entity may not exactly correspond to the local forms. The Netherlands also applies a corporate resemblance test, with the result that it draws distinctions for tax purposes that do not correspond to civil law categorizations. *See* Daniels, *supra* note 13, at 18–22.

whether to be treated as a partnership or as a corporation for U.S. income tax purposes.[38] This raises the possibility of an entity being treated as a taxable person in its country of residence, but obtaining flow-through treatment for U.S. tax purposes, with consequent tax-planning opportunities that exploit the inconsistent treatment by the two countries.[39]

4. Partnerships as Flow-Through Entities

With some exceptions noted previously, most countries provide flow-through treatment for partnerships; that is, they do not treat partnerships as taxable entities, but rather tax partnership income only in the hands of the partners themselves according to their respective shares in that income. The remainder of this part of the chapter will assume that partnerships are treated as flow-through entities.

5. Tax Obligations Imposed on Partnerships

The fact that partnership income is flowed through to the partners does not necessarily mean that the tax system entirely ignores the existence of a partnership. In many countries, a partnership is required to file a return of partnership income, even though the tax is imposed on the partners themselves.[40] It may also be appropriate, especially where most personal income is taxed at a flat or standard rate, to have the partnership pay tax at that rate on the total partnership profits;[41] this operates as a form of nonfinal withholding, and the tax is paid on account of the individual partners. This type of system may be useful for taxing the share of a nonresident partner.[42]

B. Allocating Partnership Income to Partners

There are basically two ways of thinking about a partnership. Both imply flow through of partnership income, but the meaning of the flow through is different in each. The first view is that the partnership is an entity separate from the partners. The income of the partnership is therefore to be determined separately, and this income can then be allocated to

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[38]Treas. Reg. § 301.7701-3.

[39]*See* Stanley Ruchelman et al., *European Approaches to Hybrid Entities and Financing Structures: An Introduction*, 14 Tax Notes Int'l 1487 (May 5, 1997). For a discussion of classification of foreign entities in Germany, the Netherlands, and the United States, *see* Daniels, *supra* note 13.

[40]*E.g.*, Australia, Singapore, South Africa, Sweden, and the United Kingdom. In Canada and the United States, the partnership is not required to file a tax return but must file a periodic "information return."

[41]*See* GBR ICTA § 111. The individual partners are jointly liable for this tax, not just for the tax on their own shares of the partnership income. Stevens v. Britten [1954] 3 All England Law Reports 385.

[42]In the United States, a partnership must withhold tax from all U.S.-source income allocable to a nonresident partner. *See* USA IRC §§ 1441, 1446.

the partners. This “entity theory” may be particularly strong in jurisdictions where the partnership has independent legal personality.

The second view, which is more consistent with the private law view of partnerships in common law and other jurisdictions where the partnership does not have legal personality, is that the partnership is simply an aggregation of the partners whereby each partner is treated as an owner of a fraction of all the assets of the partnership.[43] This may be called the "aggregate" or "fractional" theory of the partnership. Under this view, the partnership does not exist independently of the partners. There is no need to determine income at the entity level. Rather, each partner is simply allocated the partner's fractional share of partnership receipts and outgoings, and the tax consequences are determined in the hands of each individual partner. Different systems implicitly or explicitly adopt for tax purposes either the entity or the aggregate approach or, more often, a hybrid of the two.[44]

Systems (such as the United States) adopting a hybrid approach can end up with a particularly convoluted set of rules governing partnerships.[45] The reason for this is that either of the polar approaches—entity or aggregate—is internally coherent and allows one to solve new problems through logical application of the approach to the new situation. For example, the aggregate theory holds that when a partner leaves the partnership, the partner disposes of his or her interest in the partnership assets to the other partners. It may be complicated to perform the necessary accounting but there is no conceptual difficulty involved. By contrast, under the entity theory, the partner is treated as disposing not of his or her fractional share of the partnership assets, but of the partner’s partnership interest. This leaves the cost base of the partnership assets unaffected.

While appealing from the point of view of logical coherence, strict application of either the entity or the aggregate theory may lead to undesirable consequences. A hybrid approach may be chosen to avoid these, but this loses the benefits of logical coherence and leads to a

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[43]Strictly speaking, this interest is not exactly the same as a fractional interest and may be a beneficial interest. *See* Cahiers, *supra* note 5, at 50, 541–42. *See also* Tekinalp, *Turkey* in International Encyclopedia of Laws: Corporations and Partnerships 178 (1994) (*condominium plurium in solidum*).

[44]For a discussion of the possibilities along the aggregate-entity continuum, *see* Cahiers, *supra* note 5, at 662–63. Denmark and the Netherlands come closest to adopting a pure aggregate view, while Finland and Norway provide examples of an entity approach. Most countries fall in between. *See* Knobbe-Keuk, *supra* note 13, at 362–64 for a discussion of the German tax conception of partnerships, which originally favored the aggregate approach (so-called *Bilanzbündeltheorie* (partnership balance sheet is the aggregation of the balance sheets of the partners)), but has now largely abandoned it in favor of an entity view. *See also* Daniels, *supra* note 13, for discussion of the German and Netherlands systems.

[45]*See* McKee et al, *supra* note 35, ¶ 1.02[3] (1997); Alfred D.Youngwood & Deborah B.Weiss, *Partners and Partnerships—Aggregate vs. Entity Outside of Subchapter K*, 48 Tax Lawyer 39 (1995); Kimberly S. Blanchard, *IRS Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners,* 15 Tax Notes Int’l 859 (Sept. 15, 1997).

situation where instead of being able to apply a coherent theory to new situations, each new situation will require an ad hoc response, resulting in an inconsistent and complicated set of rules and little reference point when gaps must be filled in.

Whether a country adopts the entity or the aggregate approach, or some hybrid of the two, a number of general issues can be identified as to the mechanism for allocating partnership income to partners. First, there is the question of elections (including election of accounting methods) in the determination of taxable income (e.g., there may be an election as to whether to claim expensing for certain assets or what method of depreciation to use). These elections could be made at the partnership level or by individual partners. It is almost always simpler to require that elections be made at the partnership level. Second, there is the question of whether taxable income is to be determined at the partnership level. The extreme possibilities are (1) to make the determination at the partnership level and then allocate the net amount to individual partners, or (2) to make no determination at the partnership level and to allocate the component elements of the calculation (items of receipt, expense, and credit) to the partners. Third, there is the issue of how to make the allocation to partners (i.e. which partner gets which share? Can different partners get different shares of different items?). Fourth, when income or deductions are allocated to individual partners, how is their character determined? Fifth, if there is a partnership loss, can it also be allocated to individual partners or can it only be used to offset future profits of the partnership? These issues are obviously interrelated, but the number of combinations in the actual practice of countries[46] and the detailed rules sometimes involved are such that a full review is beyond the scope of this chapter. The main possibilities are sketched out below.

1. Allocation According to Partnership Agreement

The first inclination is to follow the allocation of partnership income that is adopted for accounting purposes. Accounting standards will normally provide for the allocation of the income to the partners in accordance with the partnership agreement. This allocation may be directly proportionate to capital contributions or may take into account other factors, such as the amount of expertise or effort that particular partners are expected to bring to the business or the fact that they have contributed different property.[47]

Once the partnership income has been allocated to the partners, each partner includes his, her, or its share in total taxable income and is taxed accordingly. Thus, two partners may pay tax on their shares of partnership income at markedly different rates, such as when one partner has a substantial amount of other income and the other partner does not, or when one

[46] *See* Cahiers, *supra* note 5, at 679–80.

[47] *E.g.*, suppose that two entrepreneurs decide to pool the operation of two restaurants that they previously owned separately. Rather than simply splitting the total income of the partnership between them in proportion to the value of their respective contributions, they may specially allocate a portion of the profit (or any gain on future sale) that is attributable to each separate restaurant to the partner who previously owned that restaurant.

partner is a legal person and pays tax at the corporate income tax rate and the second partner is a physical person who pays tax at the individual income tax rate.

It should almost go without saying that, in a flow-through system, partners should be taxed on their share of partnership income regardless of whether the income has been distributed; otherwise, the tax on this income would be deferred. Care should therefore be taken in drafting any rule for the taxation of partners to refer to income "allocated" to the partner rather than to income "distributed" to the partner.

2. Deductions

It would be possible to calculate the share of partnership income attributable to each partner by allocating to the partners an appropriate share of gross receipts and expenditures (the fractional approach). In many flow-through systems, however, the net profits of the business are calculated at the partnership level and then are allocated to the individual partners (the entity approach).[48] Thus, expenses incurred by the partnership for the purposes of earning income will normally have been taken into account in determining a partner's share. For example, interest on money borrowed by the partnership for the purpose of earning income is deducted in computing the partnership profits. Where the money has been borrowed from a partner, the interest paid by the firm is the income of that partner.[49]

In the case of deductions that must be specifically claimed (such as depreciation or capital cost allowances) the entity approach would require that the deductions be taken at the partnership level. That is to say, the partners decide among themselves whether or not to claim the deduction in a particular year. By contrast, under the aggregate approach, each partner would separately choose whether to claim his or her share of the total allowable deduction.[50] Even where the aggregate approach is preferred in general, the entity approach seems much simpler to apply in this type of situation.[51] The same goes for other elections.

Sometimes partnership agreements make provision for a "salary" to be paid to a partner. One view is that the salary should not be deductible in computing the profits of the partnership, given that its true nature is that of an advance share of profits paid to the partner;

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[48]However, the types of partnership income that retain their original character in the hands of the partners must be calculated separately. *See infra* sec. II(C).

[49]In that case, its character is interest income, rather than a share of partnership (business) income. However, interest charged to a partner on an advance has been treated as a reduction in the partner's share of partnership profits. FCT v. Beville, 5 Australian and New Zealand Income Tax Reports 458 (1953).

[50]This approach is followed in Denmark and the Netherlands. *See* Cahiers, *supra* note 5, at 159, 397; Daniels, *supra* note 13, at 29–32.

[51]This is the method adopted in Australia (ITAA §90), in Canada (ITA § 96), in the United States, and in Switzerland, *See* Guide, *supra* note 9, at Switzerland, 70.

that is to say, it is received by the partner as a share of partnership profits and is usually characterized as business income. This view is supported by the aggregate theory, on the basis that a partner cannot be his own employee.[52] Alternatively, under the entity theory, the salary could be deducted in determining partnership profits, in the same way as a salary paid to an employee, and be included as a separate component of the partner's total income. An analogous issue arises in the case of other transactions between the partner and the partnership, such as loans or leases of assets.[53]

Expenses incurred by individual partners on their own accounts do not enter into the computation of partnership profits and should be claimed by the partners themselves. For example, where a partner borrows money in order to buy a share of the partnership, the rules applicable to the deduction of interest expense by individuals will govern the deductibility of the interest.

3. Losses

An important issue is the treatment of partnership losses, in particular whether a partner may deduct a share of a partnership loss against other income for that year. A simple, though harsh, solution would be to treat the partnership in the same way as a legal entity for this purpose and to deny any deduction by the partners themselves; that is to say, a partnership loss could be carried forward (or back) only against partnership profits of other years.[54] Logically, however, under a flow-through system a partnership loss should be allocated proportionately among the partners and each partner should be entitled to claim a deduction in the same way as for any other business loss, carrying the loss forward or backward against income of other years if necessary.[55] It may nevertheless be appropriate to

[52]*See* Cahiers, *supra* note 5, at 283.

[53]The former (aggregate) position is taken in Australia and the United Kingdom, *see* Case 81 (1985) 28 CTBR (NS) 609; Stekel v. Ellice [1973] 1 WLR 191, as well as in Denmark and Israel. *See* Cahiers, *supra* note 5, at 160, 283. The United States takes the entity approach, allowing the partnership to claim a deduction for salary paid to a partner for services rendered other than in the capacity of partner (USA IRC § 707(a)) or for payments for a partner's services if those payments are determined without regard to the income of the partnership (USA IRC § 707(c)). The same is true for Italy, *see* Cahiers, *supra* note 5, at 295. In Malaysia, the income of the partnership is computed after deducting salaries or interest paid to a partner, but the salary or interest is treated as business income of the partner (MYS ITA § 55(5). The same approach is followed in the Netherlands. *See* Guide, *supra* note 9, at Netherlands, 74; Daniels, *supra* note 13, at 30. In France, an employment relation cannot exist between the partnership and a partner, so that the partner's compensation would be treated as part of the partner's profit share (aggregate approach). However, rentals of property or loans are treated under an entity approach. *See* Ault et al., *supra* note 35, at 362–63. In Germany, payments such as rents, interest, or salaries are treated under an aggregate approach: they are characterized as business profits and taxed as part of the partner's profit share. *See* DEU EstG § 15; Daniels, *supra* note 13, at 27; Ault et al., *supra* note 35, at 363; Knobbe-Keuk, *supra* note 13, at 362.

[54]This is the rule in Finland. *See* Cahiers, *supra* note 5, at 185.

[55]*See* AUS ITAA § 92; CAN ITA § 96(1); GBR ICTA §§ 380, 385(5).

restrict the amount of loss that may be claimed to the amount of the tax cost of the partner's partnership interest.[56]

4. Taxable Year

It is customary to specify that partnership income be included in the income of the partner for the partner's taxable year in which the partnership taxable year ends. This makes sense from a practical point of view because it is only when the partnership closes its books for its taxable year that it knows exactly how much income and expenses it had. There is no problem if everyone, including partnerships, must use the same taxable year. But if partnerships are allowed to choose their own taxable year, then they can be used as tools for deferring tax. For example, if the partnership chooses a taxable year ending on Janury 31, there will be an 11-month deferral of tax. For this reason, some countries have restricted the freedom to select a taxable year that differs from the taxable year of the principal partner or partners.[57] However, given the complexity of such rules, the preferable approach is to require all partnerships and taxpayers to use the same taxable year.

5. Antiavoidance Rules

Partnerships between persons who do not deal at arm's length provide obvious opportunities for tax avoidance. In particular, partnerships between spouses or between parent and child provide opportunities for income splitting. An initial question is whether such an arrangement constitutes a genuine partnership at all; a partnership may exist on paper but not in fact.[58] Even where a true partnership does exist, the tax legislation may specify that the agreed-upon allocation of profits may be disregarded when the parties are related, and a reasonable allocation substituted.[59]

When partners deal at arm's length, it will normally be appropriate to accept for tax purposes the allocation of profits and losses provided for in the partnership agreement.[60]

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[56]This is the situation in Canada and Sweden in the case of a limited partner. *See* CAN ITA § 96(2.1). However, if nonrecourse borrowing is included in the tax cost, this limitation can easily be circumvented. Some countries limit deductions to the amount the partner has at risk. *See* USA IRC § 465; Cahiers, *supra* note 5, at 128 (Canada).

[57]*E.g.*, USA IRC § 706.

[58]*See* Dickinson v. Gross [1927] 11 Reports of Tax Cases [T.C.] 614 (GBR ICTA); *see also supra* ch. 14, note 199.

[59]AUS ITAA § 94; CAN ITA § 103(1.1).

[60]*See* USA IRC § 704(b). In the U.S., reference to the partnership agreement means that special allocations of items of income and deduction under the agreement are possible. By contrast, in Germany, there is also a concept that partnership income or loss is allocated according to the partnership agreement, *see, e.g.,* Knobbe-Keuk, *supra* note 13, at 427, but apparently what this means is that each year a pro rate share for each partner is

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However, special allocations that are not based on capital or work contributed may be used as a tax avoidance device. For example, suppose that, under the income tax, charitable organizations are taxed on business income but not on investment income. A charity that owns a factory used in a manufacturing business, with respect to which it pays tax on the income, could contribute the factory to a partnership that it enters into with an investor who owns an office building. Under the partnership agreement, the rental income is allocated to the charity and the business income to the investor. The result is to convert the charity's taxable income into nontaxable investment income.[61] There are different mechanisms by which this result may be precluded. One is to stipulate that partnership allocations will be accepted for tax purposes only if they have substantial economic effect.[62] In the above example, if the amount of income allocated to the charity is limited to the rental income so that the charity has no economic stake in the performance of the factory, this allocation would have economic effect and would be regarded as legitimate. However, if the agreement requires the investor to reimburse the charity, in one way or another, for deficits in expected rental income, or if the arrangement allows the charity to benefit indirectly from higher manufacturing income, then the allocation of investment income to the charity would be a formal matter only and should not be respected for income tax purposes. An alternative, more strict approach would allow the tax authorities to disregard the parties' allocation of profits—and to substitute what they consider to be a reasonable allocation—even when the arrangements have substantial economic effect, if the principal reason for the arrangements is the reduction of tax.[63]

In addition to antiavoidance rules focusing on the allocation of partnership income and deductions, more general antiavoidance rules may apply to partnerships. For example, the U.S. Treasury Department has promulgated regulations that give the Internal Revenue Service a broad power to attack transactions involving partnerships. One of the rules provides that "the provisions of subchapter K [the subchapter dealing with partnerships] ... must be applied in a manner that is consistent with the intent of subchapter K.... Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that

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determined (so-called *Gewinnverteilungsschlüssel*). This means that special allocations are not possible. *See* Ault et al., *supra* note 35, at 359.

[61] The example assumes that charities are taxed on business income but not on investment income. The success of the scheme depends on the rental income retaining its character as investment income. *See infra* sec. II(C).

[62] *See* Treas. Reg. § 1.704 -1(b) (USA). Such a rule may relate specifically to partnerships, as in the United States, or be a rule of general application.

[63] *See* CAN ITA § 103(1) (referring specifically to partnerships). A similar result may be achieved by a general antiavoidance rule. The problem does not come up if partnership items are in all cases allocated pro rata to the partners, as in Germany. *See supra* note 60.

are consistent with the intent of subchapter K....”[64] A second rule allows the Commissioner to treat a partnership under the aggregate theory if entity treatment is being abused: “The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the ... Code ...” unless a “provision of the ... Code ... prescribes the treatment of a partnership as an entity, in whole or in part, and ... that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.”[65] These rules are of uncertain scope and have been criticized as overly broad.[66] They were no doubt motivated, however, by the difficulty of designing more specific antiavoidance rules in the context of the intricacies of the provisions relating to partnerships and the ingenuity of tax lawyers and accountants engaged in manipulating those provisions. The fact that such rules were perceived to be needed may also serve as a warning against imitating the rather detailed statutory scheme for partnership taxation in the United States.

C. Flow Through of the Character of Partnership Income

1. General

The issue of special allocations of partnership income is related to the question of the character of partnership income in the hands of the partners. Almost all income tax laws classify various types of income in different ways and may have special rules and limitations depending on the character of the income. When partnership income is allocated to the partners, there are four main possibilities, corresponding to the aggregate and the entity views of partnership and points in between. Under the pure aggregate approach, each item of income or deduction is treated as if it had been received or incurred by the partner directly. This means that in certain cases a receipt or expenditure of the partnership will be treated differently in the hands of different partners, depending on the activity of the partners (e.g., where the partner is a trader in the type of property disposed of by the partnership).[67] Under the second possibility, which is a hybrid entity-aggregate approach, the character of items of income and deduction is determined at the partnership level, and each item is allocated to the partners and retains the same character in their hands as it had in the hands of the partnership. Thus, partners may receive their shares of the total partnership income as business income, dividends, interest, or rental income, as the case may be. Third, under the pure entity approach, taxable income is determined at the level of the partnership, with the net amount being allocated among the partners as a single category of income (most likely, as business income), whatever its original character. Finally, the modified entity approach allows the flow through of specific items (such as dividends or interest).

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[64]U.S. Treas. Reg. § 1.701-2(b).

[65]U.S. Treas. Reg. § 1.701-2(e)(2).

[66]*See* McKee et al., *supra* note 35, ¶ 1.05.

[67]*See* Cahiers, *supra* note 5, at 159–60 (Denmark).

The second approach (i.e., partnership-level determination of character and flowing the character of the income and deductions through to the partners) is the rule in the United States.[68] It goes hand in hand with a highly complex system under which different types of income and expense are subject to special rules and limitations. It is natural under this system to provide for flow through of the character of items of partnership income and expense, because partnerships could otherwise be used as vehicles for avoiding the various limitations.

The alternative, and simpler, entity approach is to treat all partnership income in the hands of the partners as business income, even though it may have been received by the partnership as investment income. This may be justified on the grounds that partnerships are (usually), by definition, business entities;[69] consequently, even income such as dividends and rents received by a partnership may be considered as derived from the carrying on of business by the partners. However, where the tax system treats business income more favorably than investment income, the ability to convert investment income into business income by forming a partnership could open up tax avoidance possibilities.[70] Alternatively, treatment as business income could be disadvantageous such as, for example, when investment income received by individuals is subject to a flat-rate withholding tax. In addition, even a system that generally treats partnership income as business income may still need to make special provision for the flow through of items (e.g., interest, dividends, capital gains, and foreign-source income) that are subject to special regimes (approach 4 above).[71]

2. Capital Gains

Even when a partnership is not a legal entity, it may acquire and dispose of assets in the course of its business, giving rise to the realization of a gain or loss. Because most tax systems treat capital gains differently from other types of income, the question arises as to

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[68]*See* USA IRC § 702; McKee et al., *supra* note 35, ¶ 9.01[4][a]. In a slightly simpler form, it is also the rule in Canada. *See* CAN ITA § 96(1).

[69]The Australian definition of "partnership" is for tax purposes broader than the general law concept of partnership and does not require a business nature. *See* AUS ITAA § 6; Geoffrey Lehmann & Cynthia Coleman, Taxation Law in Australia 648 (1994). Civil law partnerships may also be formed for the purpose of holding investments. *See supra* sec. II(A)(1).

[70]*E.g.*, where business income is classed as "earned" income, and such income is treated favorably. Contrast the example of the partnership created by a charity, *supra* sec. II(B)(4).

[71]This is generally the approach taken in Germany, *see* DEU EstG § 15; Cahiers, *supra* note 5, at 233; and in most cases in the Netherlands, *see* Betten, the Netherlands, in Guide, *supra* note 9, at 66–71. According to Knobbe-Keuk, *supra* note 13, at 361, “The partner’s profit share belongs to the type of income to which it would belong if the partnership that carries on the business were itself taxable.” According to Daniels, *supra* note 13, at 28, “Where the partnership’s profits contain items of income subject to a special tax regime, for instance dividends, long term capital gains or foreign source income, these items are taken separately into account, so as to be able to give effect to the special regime at the partner’s level.”

whether and how a capital gain or loss realized by the partnership flows through to the partners and retains that character in their hands. Flow through may be done in either of two ways. One method measures the gain or loss from disposals at the partnership level, with the resulting net gain or loss being shared among the partners and included in their income while retaining its character as a capital gain or loss.[72] The other method (the fractional approach), corresponding to a pure aggregate theory, treats each partner as owning a fractional interest in each of the assets of the partnership, so that gains or losses are realized directly by the partners without passing through the hands of the partnership.[73] A problem with the latter approach is that, when there is a change of membership of the partnership, there will often also be a change in the fractional interests of the partners, resulting in a disposal and tax liability or in the need for complex rollover rules.

The problem is avoided with respect to business assets if gains and losses on the disposal of business assets are simply taken into account in determining the profits of the business and receive no preferential treatment. This is the situation in a number of countries, notably Germany and the Netherlands.[74]

3. Foreign-Source Income

A somewhat similar problem arises where a partnership receives foreign-source income. According to the entity theory, that income would simply form a part of the partnership's total income and, in the hands of the partners, would have the character of business income with a source in the country in which the partnership was resident; that is, in most cases, the income would be converted from foreign-source to domestic-source income. One consequence would be that the partners might lose any relief in respect of taxes paid in the original source country. It is true that, when relief from double taxation is provided through the exemption method, the exemption could be taken at the partnership level. But in countries that employ a mixture of the exemption and the credit methods,[75] it would be excessively complex to give relief for some foreign taxes at the partnership level and for others at the level of the individual partners. Consequently, even when there may be a general preference for the entity approach, it seems more appropriate that foreign-source income should retain its character as foreign-source income in the hands of the partners. This in turn raises two problems.

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[72]This is the approach taken in Canada. CAN ITA § 96(1)(c)(i).

[73]This approach is taken in Australia; *see* Lehmann & Coleman, *supra* note 69, at 329–33 (1994), and in the United Kingdom, GBR CGTA § 60.

[74]*See supra* ch. 16, sec. IV (B).

[75]*See supra* ch. 18. There would seem to be no satisfactory way of taking a foreign tax credit at the partnership level.

The first is the question of relief for foreign taxes, referred to above. When relief from double taxation is given through a foreign tax credit, the partner should be entitled to claim a proportionate share of the credit. That is, it is not only a share of the foreign-source income that flows through to the partner, but also a share of the foreign tax paid on that income. This procedure involves a certain amount of complexity, in that it requires calculation of the allowable amount of the credit on the tax return of each individual partner. When relief from double taxation on a particular item of foreign-source income is given through the exemption method, the income should retain its exempt character in the hands of the partner, although the amount of that income may still have to be taken into account in determining the partner's ultimate tax liability if the exemption-with-progression method is used.

The other problem occurs when a member of the partnership is a nonresident. If foreign-source income received by the partnership retains that character in the hands of the partners, the nonresident partner should presumably be exempt from tax on the partner's share of that income.[76] If, however, the income loses its character and becomes converted into business income derived from the partnership, the nonresident partner would be taxable.

D. Disposals of Partnership Interests

A partnership interest is an asset capable of being bought, sold, or otherwise disposed of. Under the aggregate theory of partnership, when a partner disposes of his or her interest in the partnership, the partner is considered to sell a fractional share in all the partnership assets. Gain or loss on the sale of each asset would have to be computed and its character determined separately. Because of its complexity, this approach is followed in only a few countries.[77]

An alternative is to treat the partnership interest as a separate asset.[78] Depending on the rules for taxing capital gains, a gain on the disposal of a partnership interest may or may not be taxable or a loss allowable.[79] If it is, then it will be necessary to provide rules for determining the tax cost of the partnership interest.[80] This amount will not necessarily be the

[76]To prevent foreign-source income from being allocated to the nonresident partner and domestic-source income to the resident partner, an antiavoidance rule would be needed.

[77]Denmark, *see* Cahiers, *supra* note 5, at 177, and perhaps Japan, *see id.* at 322. *See also supra* note 44. In New Zealand and in the the United Kingdom, while the theory is that the partner is considered to dispose of a fraction of all partnership assets, administrative practice has permitted deviations from this strict approach. *See id.* at 420–21, 547.

[78]This is the general rule in the United States, but an exception provides for look-through treatment for certain "hot assets" of the partnership. *See* USA IRC § 751 (the so-called collapsible partnership provision).

[79]*See supra* ch. 16.

[80]For the rules in Canada, which are similar to those proposed here, *see* Cahiers, *supra* note 5, at 127–28.

amount originally contributed by the partner, because in the meantime the partnership may have earned income that has not been distributed. Since the partner will already have been taxed on that income, it should be added to the tax cost in order to prevent double taxation. More specifically, the tax cost should be:

> the original cost of the partnership interest (including the partner's share of partnership debt),
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> plus
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> any additional contributions made by the partner to the partnership,
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> plus
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> the partner's total share of partnership income for the period during which he or she was a partner,
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> less
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> all partnership income distributed to the partner during that period,
>
> and
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> the partner's share of partnership losses (if a deduction is allowed for such losses).

"Income" in the above formula, should include exempt income of the partnership, because otherwise this income would be taxed in the form of capital gain. The partner's share of debt[81] will depend on whether the partner is a general or a limited partner. Recourse debt is typically allocated to the former and nonrecourse debt to the latter.

It will also be necessary to establish rules for determining the proceeds of disposal of the interest. Although a partnership interest may be sold for a lump sum to some other person who will take the vendor's place in the partnership (usually subject to the agreement of the other partners), it is common for partnership interests to be disposed of in return for a sum payable by installments or for a share of future profits payable over a number of years. Sometimes, it may be specified in the partnership agreement that on the death of a partner the partner's surviving spouse will receive a share of future profits. One possibility is to treat the proceeds of disposal as an amount equal to the present value of the future payments; the payments would then be treated in the same manner as installment payments on the disposition of any other property. The disadvantage, for the continuing partners, is that the

[81]In some countries, liabilities incurred at the partnership level do not affect the basis of the partner in his partnership interest. *See* Ault et al., *supra* note 35, at 360–61. In this case, if partners are allowed to deduct losses in excess of their basis, then negative basis may result.

payments will presumably be regarded as capital payments for the purchase of the deceased partner's interest and will not be deductible in computing their income from the partnership. Alternatively, the future payments may be taxed as income in the hands of the recipient, in which case the proceeds of disposal must be adjusted accordingly.[82]

E. Formation or Liquidation of a Partnership

Again, depending on the general rules for taxing income and capital gains, there may be a question as to whether contributions of property to a partnership or distributions in liquidation of a partnership give rise to taxable gains or allowable losses or to the recapture (or terminal loss) of depreciation allowances. Property contributed by a partner to a partnership may be property previously used by the partner in the partner's own business, in which case any gains might be treated as business gains of the partner. Whether to defer taxation of such gains should probably be resolved in the same way as for formations of legal persons generally. It should be noted that, if a rollover is permitted, one effect may be to transfer potential tax liability for a proportion of any accrued gain to the other partners.[83]

Similarly, when a partnership is liquidated, its property will be disposed of, giving rise to possible capital gains or losses.[84]

In legal systems in which a partnership is not a legal entity, but is merely a relationship between persons, there may be a further problem in that, whenever a partner dies or retires, or a new partner is admitted, the partnership is technically dissolved and replaced by a new one. It would be most inconvenient if every change in membership were to result in a disposal of partnership property and of the interests of all the partners; consequently, it seems advisable to specify that the new partnership be treated as a continuation of the old one wherever there is a sufficient commonality of membership.

F. Partnership Distributions

Assuming that all partnership income is, in one way or another, taxed to the partners currently, then distributions of cash by the partnership to the partners should not be taxed.

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[82]In Canada, the recipient is treated as though he or she were a partner and is taxed accordingly, CAN ITA § 96(1.1). A hybrid treatment for certain payments to a retired partner, or to a deceased partner's successor in interest, is provided under USA IRC § 736.

[83]For this reason, all the partners should be required to elect for rollover treatment; *see* CAN ITA § 97(2). In the United States, the built-in gain on contribution is allocated to the contributing partner under IRC § 704.

[84]The allocation and flow through of partnership capital gains or losses to the partners have been considered in sec. II, (B) and (C), *supra*. As noted there, some tax systems (e.g., Australia and the United Kingdom) regard partnership property as being owned proportionally by the partners, in which case formation and liquidation of the partnership (and changes in the membership of the partnership) give rise to a change in the proportionate ownership.

They represent either a withdrawal of capital or previously taxed income. As to distributions of property, systems differ substantially on the extent to which gain recognition is required on appreciation of the property. Nonrecognition (rollover) is provided for to varying degrees in Canada, the United Kingdom, and United States.[85] On the other hand, in Germany and other countries that follow a similar conceptual approach, the distribution of partnership property to a partner is treated as a withdrawal of property from the business, which will generally be taxable unless the property is integrated into a business of the partner.[86]

G. Adjustment to Cost Base of Partnership Assets

Under a pure aggregate theory, a partner does not have a separate cost base in his or her partnership interest. However, most systems adopt either an entity or a hybrid view under which partners do have such a cost base, which can be referred to as "outside" cost base, the "inside" cost base being the partnership's cost base in its assets. The inside cost base (i.e. the partnership's total cost base in its assets) is initially equal to the total of the "outside" cost bases of all the partners, and remains so if the partnership interests do not change hands.[87] Suppose, however, that the value of the partnership increases and that a partner sells his or her partnership interest to a new partner at a gain. The new partner's cost base will now be greater than that of the old partner, thus upsetting the equality of inside and outside cost base. This can be a problem because it could cause the partners to be taxed on gains realized by the partnership for which the exiting partner has already paid tax. The remedy is conceptually simple but practically difficult. When the new partner is admitted, the cost base of the partnership assets can be increased with respect to the transferee partner to reflect the gain of the retiring partner.[88] Whether to provide such rules depends on the general approach taken to taxing partnerships. If an entity approach is taken, transactions in partnership interests could be considered as unrelated to the inside cost base. Given the complexity of adjustment, an alternative would be to provide for adjustment only upon termination of a partnership. Termination could be provided for in cases where a substantial shift in partnership interests takes place over a specific period.

[85] *See* Ault et al., *supra* note 35, at 365–66.

[86] *See id.*

[87] *See* McKee et al., *supra* note 35, ¶ 6.01.

[88] *See* USA IRC §§ 743, 754; McKee et al., *supra* note 35, ch. 24. Similar results are achieved in the German system by setting up a separate balance sheet for the transferee partner. *See* Knobbe-Keuk, *supra* note 13, at 899–900.

H. Territorial Application of Partnership Rules

In most jurisdictions, partnerships are not taxable entities and the question of the residence of a partnership does not arise directly.[89] Because partnership income is flowed through to the partners, it is the determination of their residence that is important.[90] As a general rule, a country will assert the right to tax a resident partner on worldwide income, which includes both domestic- and foreign-source income from both domestic and foreign partnerships; [91] a nonresident is taxable only on income derived from a source in that country. A variety of situations may exist:

All members of the partnership are resident in country *A*. In this case, all partnership income allocable to each partner is taxable in country *A*.

No member of the partnership is resident in country *A*. In this case, the partners are taxable only in respect of partnership income sourced in country *A* in the same manner as nonresidents generally.

Some members of the partnership are resident in country *A;* others are not. In this case, the resident partners are taxable on their entire allocable shares of the partnership's income; the nonresident partners are taxable only on the portion of their shares that is derived from a source in country *A*.[92]

These rules are simple to state, but may be difficult to apply.[93] Their application depends largely on (1) whether foreign-source income retains that character when flowed through to the partners, and (2) how foreign tax credits are treated. Those questions have been considered in section C above.

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[89]A partnership appears to come within the definition of "person" ("or other body of persons") in art. 3(1) of the OECD model treaty and is normally entitled to the benefit of provisions of double taxation treaties. *See* OECD, Model Tax Convention on Income and on Capital (looseleaf 1995). The U.S. model expressly includes partnerships in the definition of "person." *See* United States Model Income Tax Convention of September 29, 1996, art. 3(1)*, reprinted in* Charles Gustafson et al., Taxation of International Transactions (1997).

[90]Although some countries (e.g., the United Kingdom and the United States) have rules for determining whether a partnership is domestic or foreign, the significance of those rules is limited, *see, e.g.,* USA IRC § 1491 (imposing a tax on the transfer of property to a foreign partnership), except in relation to reporting and withholding requirements.

[91]However, some countries exempt foreign-source business income under certain circumstances, either by statute or by treaty. *See supra* ch. 18.

[92]In this case, it should not matter whether or not the partnership is considered resident in country *A*. In practice, residency may affect reporting requirements.

[93]For a comprehensive study, *see* Le Gall, in Cahiers, *supra* note 5, and individual country studies, *in* Cahiers, *supra* note 5.

In this context, it should also be noted that the taxation of different partners may differ depending on how the partner's country of residence considers the partnership. For example, a partnership doing business in country *X* may be taxed by this country as a resident business entity. On the other hand, country *Y*, the country of residence of one of the partners, may treat the partnership on a flow-through basis. In this case, the partner should be able to take a credit in country *Y* for the tax paid in country *X*.

I. Conclusion

Several options are available for taxing partnerships. We have already discussed the option of taxing partnerships as separate entities. When this method is not used, some form of flow-through treatment must be prescribed. Given the complexity of this area, one approach for a developing or transition country would be to model its rules on those of another country with a similar legal system. A drawback of doing this is that, as discussed in this chapter, those rules may not be completely coherent, simple, or elaborated. The chief reason for this incoherence is that few countries have adopted a pure aggregate or entity approach to taxing partnerships. The aggregate approach, while coherent, is complex. It is complex from an administrative point of view because it depends on compliance by individual partners; individual compliance complicates return filing and can lead to enforcement problems that cannot be dealt with by tax administrations that are otherwise weak. The aggregate approach also requires complex calculations for distributions and transfers of partnership interests, because these are considered as involving fractional shares of all the partnership assets. However, somewhat paradoxically, the statutory rules required to implement a pure aggregate rule are not complex. All that would have to be provided is that each partner is considered to be the owner of a fractional share of the partnership assets and income according to the partnership agreement. The partnership itself would not be considered a person for purposes of the income tax. Despite the statutory simplicity, the practical difficulties preclude the adoption of the pure aggregate approach as a general rule in developing and transition countries, although it can be reserved to deal with those forms of co-ownership that are not subject to the general partnership rules.

An alternative to be considered by developing and transition countries therefore would be to adopt as pure an entity approach as possible.[94] This would mean that income is determined at the entity level and flowed through to the partners as business income. Limited exceptions might be made for income that receives special income tax treatment. For example, foreign-source income might be broken out separately in order to allow partners to claim the foreign tax credit with respect to such income. Interest and dividends might be flowed through separately if these are subject to special rules (such as being taxed in the hands of individuals through a low-rate final withholding tax). While partners could

[94]This approach would be along the general lines of the rules applicable in Finland. *See* Cahiers, *supra* note 5, at 183–87.

still manipulate such a system to some extent to minimize tax, the opportunity to do so is limited if the types of income that flow through to the partners are limited. Consideration should also be given to providing for carryover of partnership losses to be used against future income of the partnership, instead of allowing losses to be flowed through to the partners. Such a provision would minimize tax shelter opportunities and is consistent with the taxation of corporations, which also are not allowed to flow losses through to their shareholders. Adoption of an entity approach would solve a number of issues discussed in this chapter. For example, disposition of an interest in a partnership would be treated as disposition of a separate asset, not a disposition of a fraction of the partnership assets. Wages paid to a partner would be deductible by the partnership and taxable as wages to the partner. Under an entity approach, it would be clear that a partnership is a "person" for income tax purposes.[95]

As discussed in section A(3) above, if this modified entity approach is adopted, it will be necessary to specify which entities are subject to this rule. The form of the definition will depend on the legal forms of partnership in the country concerned. There will probably be co-ownership or joint-venture arrangements that are not legal persons, do not require commercial registration, and would not be subject to this type of entity treatment. For these, a pure aggregate approach may be most appropriate; that is, the joint-ownership arrangement is not treated as a separate person for tax purposes, and the joint owners are treated as directly earning their share of the income.

III. Trusts

A. Introduction

A trust is an arrangement, peculiar to common law systems,[96] whereby legal title to property is vested in a trustee or trustees, but the income from the property (and ultimately the remaining property of the trust, known as the corpus) is or may be distributed to specific beneficiaries. A trust is created by a settlor or a grantor transferring property to the trustee to hold in trust for stipulated purposes and may be created inter vivos or on death, by will (testamentary trust).[97]

[95]It is not so treated, for example, in Canada. *See id.* at 124.

[96]Roughly equivalent results can sometimes be achieved in civil law systems by other means. *See* William Fratcher and Austin Wakeman Scott, The Law of Trusts 28-31 (4th ed. 1987).

[97]Where executors or administrators hold the deceased's property prior to distribution to the beneficiaries, a situation arises similar to that under a trust, and the tax rules that govern estates in the course of administration generally follow the same principles. *See* USA IRC § 641; Cahiers, *supra* note 5, at 385.

Trust arrangements can be very flexible.[98] In the simplest case, sometimes referred to as a "bare" trust, the trust property is held for the sole use and benefit of a single individual, who may terminate the trust at any time and take possession of the property; this is in effect the same as having property held by a nominee. Almost as simple is the case wherein there is a single beneficiary, who is not immediately entitled to end the trust, being a minor or under a legal disability. Under the traditional family trust, the property might be held on trust to pay the income from the property to the settlor's spouse, for life, and then to be divided among the surviving children. In such a case, the spouse would have a present income interest, and the children would have a future capital interest. In other more elaborate cases, the settlor may direct that the trust income be accumulated (e.g., until a child reaches majority), or the trustee may have discretion as to which of a number of specified beneficiaries should receive the income or capital. Although trusts are most commonly used to hold income-producing property, it is possible for a trust to carry on business and, in some countries, trusts have been used as a vehicle for family businesses.[99]

Common law jurisdictions will need to include provisions for the taxation of trusts in their income tax laws. Civil law jurisdictions may also provide such rules, given that trust arrangements are also being incorporated into the legal systems of some civil law countries. Developing and transition countries that are civil law jurisdictions probably do not need a detailed set of rules for the taxation of trusts except to cover some of the situations described below. However, even civil law countries whose legal systems do not provide for the existence of trusts should consider providing rules for taxing of income from foreign trusts, because a wealthy individual can easily establish such a trust in a foreign tax haven jurisdiction. Situations may also arise where a person resident in a civil law country is a beneficiary under a trust established in a common law jurisdiction, for example when a person formerly resident in country *A* (common law) marries and becomes resident in country *B* (civil law).[100]

B. Flow Through of Trust Income to Beneficiaries

1. General

Trusts raise a similar problem to partnerships in that it is necessary to decide whether to allocate the income of the trust to the beneficiaries for tax purposes and, if so, how. In theory, a trust could be treated as a separate taxable entity and be taxed on the entire amount

[98]Some special types of trust may be taxed as legal persons, for example, public trading trusts in Australia. In the United States, trusts engaged in active business and possessing the main characteristics of a corporation may be treated as corporations. *See* Treas. Reg. § 301.7701-4(b) (USA).

[99]*E.g.*, in Australia where, until the classical system of taxing corporations was abandoned, a trust had the advantage of avoiding economic double taxation.

[100]*See* Leif Weizman, *Status of Trusts in Danish Tax Law*, 35 European Taxation 91 (1995).

of the income from the trust property without regard to amounts distributed to beneficiaries, who would presumably receive such amounts free of tax. The objection to that approach is that the rate of tax borne by the trust (whether progressive or flat) would bear no relationship to the income of the beneficiaries. The rate of tax would have to be high (probably equal to the top marginal rate for individuals); otherwise, tax avoidance would be too simple. However, a high rate would be grossly unfair if the income were distributed to a low-income beneficiary. This unfairness can be mitigated by giving the beneficiary a refundable credit for tax paid by the trust, in which case the end result would be much the same as under a flow-through system.[101]

A flow-through system, such as that applicable to partnerships, is an obvious alternative. However, the problem is more difficult than for partnerships in the sense that there is not necessarily an allocation of the trust's current income to the beneficiaries. Some of the income may be accumulated by the trustee for future distribution to beneficiaries at the trustee's discretion, so that the ultimate recipients are not currently known. Consequently, a hybrid system is usually adopted, under which a beneficiary who receives trust income is taxed on that income, while income accumulated by the trustee, to which no beneficiary is currently entitled, is taxed in the hands of the trustee. There may thus be only a partial flow through of trust income.[102]

This system is somewhat artificial and does not necessarily correspond to economic reality. For example, if one beneficiary holds an income interest in a trust and another holds a remainder interest, then in economic terms the holder of the remainder interest has economic income each year because the present value of the remainder interest increases, but is not taxed on that income under generally accepted rules. However, it would be difficult to design rules that more closely correspond to economic reality and such a goal should in any event not be a matter of priority for developing or transition countries. Accordingly, the generally applied approaches to taxing trusts will be reviewed, because these serve as the most likely model.

2. Method of Taxing Beneficiaries

Beneficiaries may be taxed on their shares of trust income either directly or indirectly. According to one method, a beneficiary includes in his or her income for the year income received (or income to which he or she is entitled) from the trust and pays tax on that income in the normal manner. The trustee is taxed only on the residual undistributed income of the trust.[103] If and when that income is subsequently distributed to a beneficiary, it is received tax

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[101]This is approximately the approach taken in Ireland and the United Kingdom.

[102]This roughly describes the system adopted in Canada and the United States.

[103]This is the method adopted in Australia, ITAA § 99A; Canada, ITA § 104(13); and the United States, IRC § 652.

free. Under the other system, the trustee is initially taxed on the entire income of the trust. A beneficiary who receives (or is entitled to receive) income from the trust includes that income (grossed up at the rate paid by the trust) in his or her annual return, but is given a credit for the tax already paid on that income in the hands of the trustee. In other words, the system operates as a form of withholding.[104]

3. Allocating Trust Income to Beneficiaries

There are again two alternatives for allocating trust income to beneficiaries: beneficiaries might be taxed only on income actually distributed to them, or they might be taxed on any income that they were entitled to receive, whether distributed to them or not, in much the same way as partners are taxed.

The first approach has the apparent advantage of simplicity, in that only actual distributions are taxed. However, it opens up the possibility of tax avoidance unless the trust rate is equal to the highest individual tax rate. A beneficiary could simply leave his or her income to accumulate in the trust, withdrawing only what is needed for immediate consumption. Consequently, most countries tax trust beneficiaries on the amounts that they are entitled to receive. For example, in the United States, allocation is on the basis of the amount of the trust's "distributable net income" that is required to be, or is in fact, distributed to beneficiaries during the taxable year (or within 65 days thereafter, at the election of the trustee).[105] Beneficiaries are taxed on the trust's “distributable net income” to the extent of distributions they receive or are legally entitled to receive. This approach calls for taxing beneficiaries on amounts accumulated for their benefit (if they are legally entitled to receive those amounts)[106] in addition to amounts actually distributed to them. The United Kingdom adopts an essentially similar approach.[107]

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[104]This method is used in the United Kingdom, ICTA § 348. *See also* IRL ITA § 154 (providing relief to the beneficiary for tax paid by the trust in the case of income accumulated until the occurrence of a contingency). The method used in New Zealand combines elements of both; if a beneficiary is entitled to income, the trustee is deemed to be his or her agent and is liable for the tax accordingly (NZL ITA § 227). The Singapore treatment is essentially similar (SIN ITA § 35(8)). In the United States, amounts accumulated by a trust are taxed to the trust and may upon distribution be subject to a so-called throwback tax in the hands of the beneficiary to make up the difference between the beneficiary's tax rate and the tax rate of the trust, although there are a number of exceptions and alleviations to this rule. *See* USA IRC § 667.

[105]*See* USA IRC § 663(b).

[106]No beneficiary is currently entitled to amounts accumulated under a discretionary trust or under an express power of accumulation, and such income is taxed to the trust. In Canada, a preferred beneficiary election may be made to have accumulating income treated as if the beneficiary were entitled to receive it; as a result, the income is taxed at the beneficiary's personal rate rather than at the trust rate. *See* CAN ITA § 104(14).

[107]*See* Baker v. Archer-Shee [1927] Appeal Cases [A.C.] 844. It includes amounts actually distributed to a beneficiary under a discretionary trust; the beneficiary is regarded as becoming entitled when the trustees exercise their discretion in his or her favor. For similar rules, *see* AUS ITAA §§ 97, 101; CAN ITA § 104(13); NZL ITA § 227.

The difficulty with this approach is that it requires a determination of the entitlement of the beneficiaries under the trust instrument, an exercise that involves interpreting the trust instrument, as opposed to simply observing how much has actually been distributed. It is, however, consistent with the principle that a person should be taxed on income accruing to him or her, whether or not it is actually received.

A trust might direct the trustees to maintain the former family home for the benefit of a surviving spouse and to pay for the upkeep of the home, or to pay for the maintenance or education of a beneficiary. Normally, the value of benefits of this nature will be included in the beneficiary's income.[108]

4. Flow-Through Character of Trust Income

When a trust receives different types of income that are taxed under different rules, the question arises as to whether income flowed through to a beneficiary retains its original character, for example, as a dividend, a capital gain, or foreign-source income. The problem is essentially the same as that encountered with partnerships,[109] and one would expect the legislation to deal with both situations in the same way. However, this is not always the case.

In the United States, the character of distributions is determined on a pro rata basis with reference to the composition of the "distributable net income."[110] Thus, for example, a nonresident beneficiary would pay no tax on foreign-source income deemed distributed to him or her. Although an income beneficiary is normally not entitled to receive a capital gain, the proceeds of a disposal of part of the trust capital may on occasion be paid to a beneficiary (e.g., when there is a power to encroach on capital for the benefit of a beneficiary), and in such a case a capital gain may flow through to the beneficiary.[111] The position is essentially similar in Australia; for example, franked dividends flowed through to a beneficiary retain that character and are consequently free of tax.[112] In Canada, income received by a beneficiary, or to which a beneficiary is entitled, is generally regarded as income from property; thus, income derived by the trust from carrying on business would not be considered earned income in the hands of a beneficiary.[113] However, dividend income, capital

[108] *E.g.*, CAN ITA § 105. Other benefits, such as interest-free loans, may also be included.

[109] *See supra* sec. II(C)(1).

[110] *See* USA IRC §§ 661(b), 662(b).

[111] It would seem, however, that a capital loss cannot flow through. *See infra* sec. III.(E.)(1.).

[112] *See* AUS ITAA § 160AQV.

[113] *E.g.*, for the purposes of calculating entitlement to child-care deductions.

gains, and foreign-source income are expressly stated to retain their original character when distributed.[114]

The position is somewhat less clear in the United Kingdom. It appears that foreign-source income retains its character when paid to a nonresident beneficiary.[115] However, in a case in which a trust provided for the payment to a beneficiary of an annuity of a fixed annual amount, and the trust income was insufficient to support the payment with the result that the difference was paid out of capital, the entire amount was held to be income in the hands of the annuitant; that is, the capital nature of the payment did not flow through to the beneficiary.[116]

When a trust is treated as a conduit, to the extent that a beneficiary is entitled to income, all types of income (or capital payments) should in principle retain their original character when flowed through.[117] This is especially important in the cases of tax-exempt income, dividends (if an imputation credit applies), and income that has been subjected to a final withholding tax. It is also necessary to consider whether income from each source should be divided proportionately among the beneficiaries entitled, or whether the trustees, or trust instrument, may allocate income from different sources to different beneficiaries.[118]

C. Taxation of the Trust

1. Liability of the Trustee

Whether the entire income of a trust or only the undistributed part is to be taxable in the hands of the trustee, it is necessary to determine in what capacity the trustee is taxable; in particular, it is necessary to indicate whether the trust is to determine its income according to the rules that generally apply to physical persons or to those that generally apply to legal persons. Often hybrid rules may be appropriate, given that all the rules for physical or legal persons, as the case may be, may not be appropriate for trusts.

The usual practice is to tax the trustee (or trustees, jointly) as a separate physical person.[119] This will be the case even if the trustee is a legal person such as a bank or trust

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[114]CAN ITA § 104(19–22).

[115]Williams v. Singer [1921] 1 A.C. 65.

[116]Brodie's Will Trustees v. IRC [1933] 17 T.C. 432.

[117]An exception might be made in the case of business income, as in Canada, if the business is carried on by the trust but the beneficiary plays no part in the business.

[118]*E.g.*, can all foreign-source income be allocated to a nonresident beneficiary, or exempt income to a high-income beneficiary?

[119]*See, e.g.,*CAN ITA § 104(2); USA IRC § 641(b).

company. Thus, the trustee is taxed entirely separately on (1) income accruing to the trustee in the trustee's personal capacity and (2) trust income in respect of which the trustee is taxable. Normally, the trustee is required to file a return of trust income even though no tax may be payable.[120]

2. Income on Which Tax Is Payable

As previously noted, there are basically two systems for taxing trust income. In one (Ireland and the United Kingdom), the trustee is taxed on the entire income of the trust and the beneficiary is entitled to a credit for the tax so paid. In the other, the trustee is liable for tax only on income retained in the trust. This is achieved by allowing the trustee to claim a deduction in respect of income distributed, or required to be distributed, to a beneficiary.[121]

Although the trustee is not generally permitted to claim personal deductions,[122] the usual deductions are normally allowed for expenses incurred in earning trust income—for example, repairs to rental properties or interest on borrowed funds.[123]

3. Rate of Tax

A basic problem with the income taxation of trusts is the rate of tax to be charged. Although trusts are normally treated as separate taxpayers and as physical persons, the application of a graduated rate schedule is inappropriate, because a trust may have a number of beneficiaries (with widely different incomes), and the amount of undistributed income may bear no relationship to the incomes of those beneficiaries.

Trusts provide a variety of opportunities for minimizing taxation, depending very much on the rate or rates at which undistributed income is taxed. If the trust rate is lower than that at which a beneficiary would be taxed, it will be advantageous to accumulate income in the trust, thereby splitting income between trust and beneficiary.[124] If the trust rate is lower

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[120]*E.g.*, AUS ITAA § 161; USA IRC § 6012.

[121]*E.g.*, CAN ITA § 104(6); USA IRC § 651. Where this method is used, there may nevertheless be circumstances in which the trustee is required to pay tax on behalf of the beneficiary; for example, in Australia, the trustee must pay the tax when the beneficiary is under a legal disability or is nonresident. *See* AUS ITAA § 98.

[122]*E.g.*, NZL ITA § 228. In the United States, a trust is allowed to deduct a small amount in lieu of a personal exemption. *See* USA IRC § 642(b). It is not recommended, however, that such a deduction be allowed, and its repeal has been proposed in the United States. *See* The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 92 (May 1985).

[123]The treatment of depreciation allowances is problematic, because the benefit of any deduction arguably ought to accrue to the capital beneficiaries rather than to the income beneficiaries. The same is true with capital losses.

[124]Especially if later distributions of accumulated income are tax free.

than that at which the same income would be taxed to the settlor, there will again be advantages in transferring property to a trust over which the settlor retains some control. In addition, because there are no limits on the number of trusts that a person may create, it becomes advantageous to create multiple trusts if trusts are taxed at progressive rates.

Problems with the use of trusts for tax avoidance can be minimized by specifying that all trust income that is not flowed through to beneficiaries should be taxed at a flat rate equal to the top marginal rate applicable to physical persons.[125] That approach is probably satisfactory if the rate is a moderate one; if it is very high, then it may not be acceptable because it will tax at a high rate income that may be destined for a beneficiary in a much lower rate bracket. Even if rates are moderate, the proposal can be criticized on the basis that it will be unfair in some cases. Inevitably, there will be some trusts accumulating income for the benefit of beneficiaries in low brackets. Some such unfairness is inevitable, and is the price of simplicity. The simplicity resulting from such a rule is considerable: there will be no need for multiple trust rules or special rules governing delayed distributions from trusts. The unfairness will be minimal in a country where low-bracket beneficiaries of trusts are likely to be rare.[126]

A suggested general rule, therefore, would be that all accumulated income of a trust be taxed at the top marginal rate for physical persons. Distributed income would be taxed to the individual beneficiaries. However, if certain kinds of investment income are subject to a final flat rate of tax, then it would be unfair to tax that income at the top marginal rate in the hands of a trust where it will ultimately be distributed to beneficiaries who are physical persons. Therefore, the trustee should be allowed to exclude such income as if the trust were a physical person. To prevent abuse, it may be necessary to restrict this rule to cases where the only beneficiaries of the undistributed income are physical persons, as is the case with most trusts. Trusts with corporate beneficiaries do exist, and they should not benefit from a flat withholding tax on investment income if corporations are taxed on such income at the same rate that applies to other corporate income; nor should they be taxed on dividends received through a trust if intercorporate dividends paid directly would be exempt from tax.

An exception to the above rule might also be justified where the trust has only one beneficiary, or where the trustee (or some other person) has the power to vest the corpus or

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[125]This is the approach taken in Canada with respect to inter vivos trusts. *See* CAN ITA § 122(1). It is assumed that testamentary trusts are not created principally with a view to tax avoidance. Australia also taxes trusts at the top marginal rate, although the tax commissioner has the discretion to reduce the rate and sometimes does so, especially in the case of testamentary trusts. *See* AUS ITAA § 99A; *see also* LSO IT § 11 (taxation at top marginal rate). In Malaysia and Singapore, trusts are taxed at the same rate as legal persons, but because that rate does not differ greatly from the top individual rate, there is little scope for avoidance.

[126]It can also be minimized by providing for qualified beneficiary trusts or preferred beneficiary elections (*see infra* note 123), where income is taxed to the beneficiary even though not currently distributed.

income of the trust in herself or himself.[127] The reason for this rule is that if the trust income is being accumulated for the benefit of a single beneficiary, it makes more sense to tax that income at the possibly lower marginal rate of the beneficiary than at the top marginal rate that would apply to the trust.

In practice, few of the countries that have well-elaborated rules for taxing trusts do impose tax at the top individual rate.[128] In the United States, for example, residual trust income is taxed according to a graduated-rate scale, although the rate scale was compressed by the Tax Reform Act of 1986.[129] In the United Kingdom, where the trustee is taxed on the total income of the trust at the "standard rate," an additional tax is imposed on accumulated income, which reduces—but does not entirely eliminate—the opportunities for tax avoidance.[130] As a consequence, virtually all of the countries in which trusts are common have found it necessary to enact antiavoidance rules of varying complexity.

D. Antiavoidance Legislation

1. Grantor Trusts

In the case of some trusts, it will be appropriate to ignore the existence of the trust for income tax purposes, that is, to treat it as ineffective and to tax its income to the original settlor or grantor. A trust is generally treated as ineffective when the grantor has retained control over the trust or has retained benefits from the trust.

The United States has a rather elaborate and hypertechnical set of rules governing the circumstances under which a trust will be treated as a "grantor trust." These rules were formulated at a time when a substantial tax benefit could be obtained by creating a trust (by taking advantage of the separate taxation of each trust under a progressive rate schedule). They therefore contain a number of safeguard provisions; ironically, they also contain a number of loopholes through which careful estate planners are able to structure arrangements so as to avoid grantor trust treatment. If trust income were taxed at the top marginal rate, as previously suggested, then the definition of grantor trust could be simplified because it would be less critical to catch all possible situations in which grantor trust treatment might be justified, given that the tax benefits from setting up a trust would be minimized.

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[127]*E.g.*, LSO IT § 80.

[128]*See supra* note 125. In Canada, the simplicity of the original system has been undermined by the subsequent introduction of special surtaxes on incomes in excess of stated amounts.

[129]*See* USA IRC § 1(e).

[130]GBR TA § 686.

Under the U.S. rules, the grantor is treated as the owner of a trust in which the grantor has a reversionary interest if, as of the inception of the trust, the value of the interest exceeds 5 percent of the value of the trust.[131] The grantor is also treated as the owner of a trust whose beneficial enjoyment is subject to a power of disposition exercisable by the grantor or a nonadverse party without the approval or consent of an adverse party.[132] "An adverse party" is a person with a beneficial interest in the trust who would be adversely affected by the exercise of the power that the other adverse party possesses.[133] However, a number of exceptions are provided for certain powers that the grantor may hold without running afoul of this rule. These include

•the power to apply income to the support of a dependent, as long as the income is not actually so applied;

•a power the exercise of which can only affect the beneficial enjoyment of the income after the occurrence of an event that is sufficiently remote;

•a power exercisable only by will, with limited exceptions;

•a power to allocate among charitable beneficiaries;

•a power to distribute corpus that is limited by a reasonably definite standard and certain other powers to distribute corpus;

•certain powers to withhold income temporarily;

•a power to withhold income during legal disability or minority of a beneficiary;

•a power to allocate receipts and disbursements between corpus and income;

• certain powers exercisable by independent trustees; and

•a power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, exercisable by trustees who are not the grantor or grantor's spouse, if the power is limited by a reasonably definite external standard.[134]

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[131]USA IRC § 673. An exception is provided for a reversionary interest taking effect upon the death of the trust beneficiary before age 21 if the beneficiary is a lineal descendant of the grantor. *Id.*

[132]USA IRC § 674.

[133]USA IRC § 672(a).

[134]USA IRC § 674(b).

The grantor is also treated as owner of a trust over which the grantor has certain administrative powers, including

- a power to deal with the trust for less than adequate consideration; and

- a power to borrow from the trust without adequate interest or security.[135]

The grantor is also treated as owner of a trust when

- the grantor has borrowed from the trust and has not completely repaid the loan, unless the loan provides for adequate interest and security and is made by a trustee other than the grantor or a related party;

- a power of administration is exercisable in a nonfiduciary capacity by any person;[136]

- the grantor has the power to revoke the trust, or a nonadverse party has the power to revest title to the property of the trust in the grantor;[137] or

- the income of the trust is or, at the discretion of the grantor or a nonadverse party, may be distributed or accumulated for the grantor or the grantor's spouse without the consent of any adverse party.[138]

While the above set of rules can appear daunting (and note that the description is only a simplified summary), it is necessary to have some guidance for when a trust will be treated as a grantor trust. As noted, under a regime that taxes accumulated trust income at the top marginal rate, a simpler set of grantor trust rules can be envisaged. For example, the following set of grantor trust rules for domestic trusts was proposed by the U.S. Treasury Department in 1985:

> The grantor would be treated as the owner of a trust to the extent that (1) payments of property or income are required to be made currently to the grantor or the grantor's spouse; (2) payments of property or income may be made currently to the grantor or the grantor's spouse under a discretionary power held in whole or in part by either one of them; (3) the grantor or the grantor's spouse has any power to amend or revoke the trust and cause distributions of property to be made to either one of them; (4) the grantor or the grantor's spouse has any power to cause the trustee to lend trust income or corpus to either of

[135] USA IRC § 675.

[136] USA IRC § 675.

[137] USA IRC § 676. An exception is provided for powers the exercise of which can only affect the beneficial enjoyment of the income of the trust after the occurrence of an event that is sufficiently remote. *Id.*

[138] USA IRC § 677.

> them; or (5) the grantor or the grantor's spouse has borrowed trust income or corpus and has not completely repaid the loan or any interest thereon before the beginning of the taxable year. For purposes of these rules, the fact that a power held by the grantor or the grantor's spouse could be exercised only with the consent of another person or persons would be irrelevant, regardless of whether such person or persons would be characterized as "adverse parties" under existing law.[139]

Although the U.S. rules on grantor trusts are considerably more complex than those found in most jurisdictions, more limited rules to similar effect are found in the laws of other countries. For example, where a trust may be revoked, it is commonly provided that the income from the trust is attributed back to the settlor or grantor.[140] Other provisions are found that attribute the trust income back to the settlor if the income is paid or payable to the settlor's spouse or minor children.[141] Provisions of this kind may be found in that part of the legislation that deals with trusts or may be contained in attribution rules of general application. For example, in Canada income and capital gains may be attributed to an individual who "has transferred or lent property . . . either directly or indirectly, by means of a trust or by any other means whatever . . ." to or for the benefit of a spouse or a minor who is a relative.[142]

2. Multiple Trusts

Because there is no limit on the number of trusts that a person may create, there developed in some countries the phenomenon of multiple trusts, whereby property was split among a number of identical or substantially similar trusts so as to take advantage of progressive rate schedules applied to each trust separately. (No advantage will be obtained, of course, if all trusts are taxed at the top marginal tax rate applicable to individuals.)

In Canada,[143] New Zealand,[144] and the United States,[145] the legislative response was to provide rules for aggregating multiple trusts in certain circumstances and to narrow the rate brackets, limiting the amount of income taxed at lower rates.

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[139]The President's Tax Proposals, *supra* note 122, at 91–92.

[140]*E.g.*, AUS ITAA § 102; GBR ICTA § 672.

[141]*E.g.*, GBR ICTA § 663.

[142]CAN ITA §§ 74.1–74.5, 75.1. An exception is made when the transferee gives full value for the property transferred.

[143]CAN ITA § 104(2).The rule is necessary in Canada because, although inter vivos trusts are taxed at the top marginal rate, testamentary trusts are taxed at progressive rates. It would be possible for a will to create a number of separate trusts for the same beneficiaries.

[144]NZL ITA § 231.

[145]*See* USA IRC § 643(f) (two or more trusts are treated as a single trust if they have substantially the same grantor and beneficiaries and a principal purpose of the trusts is the avoidance of income tax).

E. Disposals of Trust Property and Trust Interests

1. Trust Property

According to usual tax principles, a capital gain or loss may occur (1) when property is transferred to a trust, (2) when the trust itself disposes of property, and (3) when the trust is liquidated.

In the first situation, the principal issue is whether the transferor (e.g., the grantor or settlor) incurs tax liability or can claim an allowable loss.[146] In case (2), assuming that a taxable gain or allowable loss is realized, the question is whether the gain (or loss) accrues to the trust or to the beneficiary. In most circumstances, the benefit of a gain accrues to the ultimate capital beneficiaries and the gain is consequently taxed in the hands of the trust. However, when the trustee encroaches on capital for the benefit of an income beneficiary or makes an advance of capital to a capital beneficiary, it is usually permitted to flow the gain through to that beneficiary, and the gain preserves its character when taxed in the hands of the beneficiary.[147] A capital loss, by contrast, should not flow through because it cannot be distributed. In case (3), if the trust property is sold on liquidation of the trust, the position should be as in (2), except that both gains and losses should flow through to the beneficiaries who receive the proceeds of sale. If, instead, trust property is distributed in specie to a beneficiary, it may be appropriate to provide for a rollover.[148]

2. Trust Interests

An interest in a trust is property that may be alienated. In some cases (for example, the prospective share of a potential beneficiary under a discretionary trust), it may be difficult to determine the market value, and thus the cost base, of the interest. However, a vested life interest or residuary capital interest can be valued with a reasonable degree of accuracy. For example, if property worth $1 million is settled in trust for person *X* for life, remainder to person *Y*, the value (and cost base) of person *X*'s life interest will depend on his or her life expectancy and on the anticipated future earnings from the property. Given that, at the time of the settlement, the combined values of *X*'s and *Y*'s interests must add up to $1 million, the value of *Y*'s interest is also revealed. If *X* or *Y* subsequently disposes of an interest, a gain or

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[146]This will normally also establish the cost base of the property in the hands of the trust, although in some cases (e.g., the United States, where the transfer occurs as a result of the death of the grantor), there may be an uplifted cost base without a taxable gain. In other cases (e.g., Canada, where property is transferred to a spousal trust (ITA § 73)), there may be a rollover.

[147]*E.g.*, AUS ITAA § 160; CAN ITA § 104(21).

[148]*E.g.*, CAN ITA § 107(2)); USA IRC § 643(e). Before amendment of the latter provision in 1984, a tax-free basis step-up was allowed. *See* Victor Thuronyi, *Tax-Free Step-Up in Basis on Distributions by Trusts and Estates: A Proposal for Reform,* Tax Notes 1461 (June 29, 1981).

loss may accrue. However, the calculation of this gain or loss is complicated by the fact that the change in value of the individual's interests will be affected by two factors: (1) any change in the value of the underlying trust property, and (2) the fact that *X*'s life interest reduces in value over time (as does his or her life expectancy), and the value of *Y*'s interest increases correspondingly. While it may be legitimate to tax gains attributable to (1),[149] gains or losses attributable to (2) should probably be ignored, because the reduction in the value of *X*'s life interest is offset by the increase in *Y*'s capital interest, and because the calculation would become impossible in more complicated cases involving the trustee's discretion.

F. International Aspects of the Taxation of Trusts

1. General

According to general principles, a country would normally claim the right to tax resident trusts and resident[150] beneficiaries of both resident and foreign trusts on their worldwide income. Nonresident individuals are taxed only on income sourced in the country, and, because trusts are normally taxed as individuals, the same rule should apply to nonresident trusts.[151] In practice, a nonresident trust is likely to be taxed only through the withholding of tax on its investment income.[152]

2. Residence of Trusts

Determining the residence of a trust is obviously important, because residence renders the trust liable to tax on foreign-source income. However, that determination may be a difficult matter because a trust is not a legal person and is not required to register in order to be recognized. Various factors may be taken into account, including

- the residence of the trustee;
- the place of management or administration of the trust;
- the location of the trust assets;
- the residence of the beneficiaries; and

[149]In determining the amount of the gain, it is also necessary to take into account that the increase in the value of the underlying trust assets may also be subject to tax in the hands of the trust.

[150]In some countries (e.g., the United States) citizens are taxed on worldwide income even though not resident. *See supra* ch. 18.

[151]*See, e.g.,* AUS ITAA §§ 95(2), 97.

[152]It is possible that a trust is carrying on business in another country and is directly liable to tax.

•the residence of the grantor or settlor.

Generally, the first two factors will be the most important,[153] but it is possible that none of them will be determinative. A trust might have three trustees, each resident in a different country; meetings of the trustees might be held in various locations, as might the trust assets; there might be a large number of beneficiaries, resident in various countries; and the settlor might well be dead. For these reasons, a number of countries have considered it necessary to adopt special rules to prevent tax avoidance through the use of nonresident trusts.[154]

3. Foreign-Source Income

When a resident trust receives foreign-source income, the question arises as to whether the income retains that character when distributed to a beneficiary. For example, investment income from a source in country *A*, received by a trust resident in country *B*, and paid to a beneficiary resident in country *C* might be regarded as sourced in country *A* (investment income) or in country *B* (trust income). In the latter case, it will be taxable in country *B*; in the former, it will not.[155] In the former case, a further question arises as to whether the trustees, or the trust instrument itself, may allocate foreign-source income to nonresident beneficiaries in order to avoid or reduce tax liability. If the foreign-source character is flowed through to a resident beneficiary, then that beneficiary should also be entitled to claim a credit for foreign tax paid.[156]

4. Nonresident Beneficiaries

Apart from the flow-through question discussed in the preceding paragraph, the main concern will be to ensure that tax is paid on trust income distributed to a nonresident beneficiary. When the trustee is taxable on the entire income of the trust, as in Ireland and the United Kingdom, this presents no problem; in those countries in which the trustee is taxed only on the undistributed income of the trust, a nonresident beneficiary's share can be taxed by requiring the trustee to withhold tax.[157]

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[153]*See* AUS ITAA § 95(2); Thibodeau Family Trust v. The Queen, [1978] Canada Tax Cases 539, 78 Dominion Tax Cases 6376 (F.C.T.D.) (CAN); USA IRC § 7701(a)(31) (defining foreign trust).

[154]*See infra* sec. III(F)(5).

[155]The income apparently retains its foreign character in Australia (ITAA § 97) and the United Kingdom, *see supra* note 115. In Canada, it seems to take on the character of trust income. CAN ITA § 212(11).

[156]*See supra* sec. III (B)(4).

[157]AUS ITAA § 98; CAN ITA § 212(1)(c).

5. Nonresident Trusts

Foreign trusts (i.e., trusts wherein the trustee is a nonresident) pose a problem because the trustee is beyond the country's taxing jurisdiction. This means that a foreign trust (like a foreign company) can be used to defer a country's tax on foreign-source income even though residents of the country are beneficiaries of that income.[158] Provided that foreign-source income is accumulated in the trust, tax is deferred until the accumulated income is either distributed to a resident beneficiary or realized as a capital gain on disposal of the interest in the trust.

Two types of foreign trust may be used to defer tax on foreign-source income. The first is a trust structured as a "roll-up fund," in which beneficiaries purchase an interest (such as units in a unit trust) of a type that carries an entitlement only to capital. A beneficiary can realize his or her interest in the trust either by selling it or by having it redeemed by the trustee. In either case, the beneficiary effectively realizes the income of the trust as a capital gain and, therefore, obtains the benefit of both deferral and the conversion of income into capital gains (which may be concessionally taxed). Because these trusts are structured in essentially the same way as companies, some countries subject such trusts to the same antideferral rules that apply to companies.[159] An alternative approach, adopted in the United Kingdom, is to discourage investment in such trusts by taxing the gain on disposal of the interest in the trust as income rather than as a capital gain.[160]

The second type of trust that may be used to defer tax on foreign-source income is a nonresident discretionary trust. The elimination of deferral for this type of trust poses particular difficulties for tax designers because, in the tax year in which the trust derives the income, it may not be known with any certainty which beneficiaries will ultimately benefit from the income. In other words, there are difficulties in identifying a taxpayer who may be subject to current taxation in respect of foreign income accumulated in such a trust. An

[158]*See supra* ch. 18 for a discussion of deferral in the context of companies. *See* Lee Burns & Rick Krever, Interests in Non-resident Trusts (1997) for a comparative discussion of the taxation of foreign trusts in Australia, Canada, New Zealand, United Kingdom, and the United States, on which this section draws.

[159]This is achieved in different ways. In the United States, such a trust is likely to be an "association" and, therefore, a corporation for U.S. tax purposes (IRC § 7701(3)). As such, it will be subject to the controlled foreign corporation and passive foreign investment company regimes (*see supra* ch. 18). In New Zealand, a unit trust is expressly treated as a company for tax purposes (NZL ITA §§ 2 and 211(2)). As such, it will be subject to the controlled foreign companies and foreign investment fund regimes. In Canada, where a resident beneficiary has a 10 per cent or greater interest in a foreign nondiscretionary trust, the trust is deemed to be a corporation, the resident beneficiary is deemed to hold shares in proportion to his or her interest in trust income, and the beneficiary is subject to the controlled foreign companies rules in respect of the trust (CAN ITA § 94). The Canadian offshore investment fund regime (CAN ITA § 94.1) applies to other cases involving foreign nondiscretionary trusts. In Australia, these trusts are still taxed as trusts, but in a way similar to the taxation of foreign companies (AUS ITAA §§ 96A–96C and Part XI).

[160]GBR ICTA §§ 757–764.

initial line of attack against taxpayers transferring property out of the jurisdiction is to tax the transferor on the gain on any appreciated property transferred to a foreign trust. For example, in the United States, a 35 percent tax is imposed on the unrealized appreciation of property that is transferred by a citizen or resident of the United States to a foreign corporation, partnership, estate, or trust.[161] In Canada, any transfer of property to a trust, other than to a resident "spousal trust,"[162] constitutes a disposal for capital gains purposes. These rules, however, will not act as a deterrent to transferring property to a foreign trust when the property has not appreciated in value, nor will they discourage transfers on death in countries that do not treat death as a taxable event.

Another technique that in effect keeps the trust within the taxing jurisdiction is to treat it as a grantor trust. This means that the grantor will be taxed on the trust's income. This requires applying more expansive grantor trust rules to foreign trusts than to domestic trusts in cases when the grantor is a resident taxpayer. For example, a U.S. citizen or resident who transfers property to a foreign trust is treated as the owner of the portion of the trust attributable to the property, unless no part of the income or corpus of the trust may be paid or accumulated to a U.S. person.[163] For purposes of this rule, a foreign corporation, partnership, trust, or estate is considered a U.S. person if, in the case of a corporation, more than 50 percent of the stock is owned or is considered as owned by a U.S. person; if, in the case of a partnership, a U.S. person is a partner; and if, in the case of an estate or trust, a U.S. person is a beneficiary.

The U.S. grantor trust rule for foreign trusts is a broad one, but it does not cover trusts when the grantor has died or is not a U.S. citizen or resident. In these cases, special rules for foreign trusts may be needed to deal with the problem of tax deferral in cases where the trust is located in a tax haven jurisdiction. While it is possible to tax beneficiaries on their share of distributed income of the foreign trust, they cannot be taxed on trust income accumulated for the benefit of presently unknown beneficiaries. One solution is to impose at the time of a distribution to a resident beneficiary an extra tax, determined by applying an interest rate to the difference between the foreign income tax paid by the trust and the marginal rate that would have applied domestically.[164] Simply taxing the beneficiaries on distributions from the trust as received would not do. The distributions may represent corpus, which should not be taxed at all, or they may represent income that was taxed at a very low rate abroad, so that even full taxation at distribution would confer a substantial tax benefit.

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[161] USA IRC § 1491.

[162] *I.e.*, a trust under which the settlor's spouse is the sole income beneficiary. CAN ITA § 70(7).

[163] USA IRC § 679.

[164] *See* USA IRC §§ 665–668.

An alternative approach, adopted in Canada, is to simply deem the trust to be a resident and make the trustees and resident beneficiaries (including discretionary beneficiaries) jointly liable for tax on its income.[165] The rules are complex, can have harsh consequences, and appear to be designed less to ensure that a fair tax burden is imposed on nonresident trusts than to deter the creation of such trusts altogether, it being assumed that the most likely motive for their creation is tax avoidance.

Australia, New Zealand, and the United Kingdom have also introduced grantor trust regimes applicable to nonresident trusts. The Australian and United Kingdom regimes are broadly similar to the United States regime described above.[166] The design of the New Zealand regime is different, although the practical effect is the same. When a New Zealand resident has transferred value to a nonresident trust, the trustee of the trust is liable to New Zealand tax on the foreign-source income of the trust.[167] If the trustee is not a resident, then the trustee is liable for tax as if he or she were a resident. In recognition of the difficulty of enforcing this liability against a nonresident trustee, it is provided that a resident person who has transferred value to the trust is liable to tax as agent of the trustee.[168]

IV. Other Flow-Through Entities

Partnerships and trusts are by far the most common of the entities that are given flow-through treatment, but various other types of business and investment entities that may be taxed in that manner merit a brief mention.[169] A distinction may also be drawn between those entities that are automatically taxed on a flow-through basis and those cases where the flow-through is optional and is permitted on an elective basis.

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[165]CAN ITA § 94(1). However, in the case of a beneficiary, the tax liability may be recovered by the Revenue only out of distributions to the beneficiary or from the proceeds of sale of the interest in the trust (*see* CAN ITA § 94(2)). As a practical matter, therefore, a beneficiary may still obtain the benefit of deferral.

[166]GBR ICTA §739 and TCGA §§ 86, 91–97; AUS ITAA § 102AAA–102AAZG. The Australian legislation contains a number of exemptions from attribution, including exemptions for testamentary trusts, trusts where the grantor has died and trusts established before the rules were introduced. Subsequently, the Australian government became concerned that, as a result of these exemptions, a significant amount of income was being accumulated untaxed in foreign trusts for the ultimate benefit of Australian residents. In response, §§ 96B and 96C were introduced with the intention of, inter alia, taxing Australian resident beneficiaries (including discretionary beneficiaries) on income accumulating in nonresident trusts. However, some commentators have strongly argued that the drafting of these sections is inadequate to cover discretionary beneficiaries.

[167]NZL ITA 228(3).

[168]NZL ITA 228(4).

[169]Investment funds, which are sometimes taxed on a flow-through basis, are considered separately in ch. 22 *infra*.

A. Automatic Flow-Through Treatment

1. Joint Ventures

The term “joint venture” can be a confusing one, because it can cover a variety of legal forms. A distinction is commonly made between "equity joint ventures," in which the parties incorporate a separate joint subsidiary corporation, and "contractual joint ventures," which are closer in nature to partnerships and are generally taxed on a flow-through basis. For example, when two companies establish a joint venture for a particular purpose, the normal practice is to tax each of the companies upon its share of the profits from the venture rather than to tax the venture as a separate entity.[170]

A special form of joint venture—the European Economic Interest Grouping (EEIG)—was introduced in the member states in 1985.[171] The EEIG is formed by contract and established by registration, which confers on it legal personality. It is intended as a means of cooperation between individuals or entities that otherwise wish to maintain their independence. The profits from the grouping's activities are treated as the profits of the members themselves and are taxed only in their hands.[172]

2. Other Entities Given Flow-Through Treatment

It is frequently considered appropriate to tax various other types of business or investment entity on a flow-through basis. For example, in Spain, the *impuesto sobre sociedades* (corporate income tax) generally applies to all legal entities, but an exception is made for unquoted portfolio investment entities and for certain family-owned investment-holding companies.[173] In the United States, flow-through treatment is given to investment vehicles such as real estate investment trusts and real estate mortgage investment conduits.[174]

In civil law countries, trust agreements, whereby assets are entrusted to a trustee for the carrying on of business, are typically taxed on a flow-through basis.[175] These are similar to joint ventures and do not involve the complexities of taxing common law trusts because the shares of the beneficiaries are specified.

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[170]*E.g.,* Cahiers, *supra* note 5, at 378–79 (Mexico; *asociación en participación*).

[171]Council Regulation 2137/85 of 25 July 1985 on the European Economic Interest Grouping (EEIG), 1985 O.J. (L 199) 1. The EEIG is based upon the *Groupement d'intérêt économique* (GIE), a business form introduced in France in 1967.

[172]*Id.* arts. 21, 40. The French GIE, which also has legal personality, is similarly taxed on a flow-through basis.

[173]*See supra* note 18.

[174]*See* USA IRC §§ 856–860G.

[175]*See* Cahiers, *supra* note 5, at 379–83.

Certain types of companies are also taxed on a flow-through basis. Sometimes this is done in recognition of their essentially personal nature, as in the case of the one-person company (*entreprise unipersonelle à responsabilité limitée*) in France, or their resemblance to a partnership, as with the limited liability company in the United States.[176] Flow-through taxation of companies may also be adopted as a method of counteracting tax avoidance, for example, when the income of a controlled foreign corporation is allocated among resident shareholders and taxed in their hands whether or not dividends are paid.[177] This treatment may also be appropriate to prevent undue tax deferral through the use of personal holding companies, where the standard corporate tax rate is substantially lower than the top rate of individual income tax.[178]

B. Elective Flow-Through Treatment

Depending on tax rates and the system of taxing corporations, incorporation either may confer a tax advantage (as noted in the preceding paragraph) or result in a heavier tax burden. The latter is particularly likely to occur when the "classical" system is adopted. Relief from economic double taxation may be given by permitting certain corporations to elect to be taxed on a flow-through basis. For fairly obvious reasons, this solution is appropriate only in the case of relatively small corporations. A well-known example is the United States "S Corporation" rules, under which a corporation that has 35 or fewer shareholders, all of whom are individuals resident in or citizens of the United States, may elect to be taxed as a flow-through entity.[179] The flow-through taxation of S corporations is simpler than that of partnerships, in part because S corporations are allowed to have only one class of stock. Thus, allocation of corporate income among the shareholders is straightforward because it can be allocated in proportion to share ownership. Elective flow-through treatment may also be granted to other types of entity that are otherwise normally taxed as legal entities.[180]

[176]*See* McKee et al., supra note 35, ¶ 2.01.

[177]The U.S. Subpart F rules are a typical example. *See supra* ch. 18.

[178]*E.g.*, prior to 1989, the undistributed income of close corporations was apportioned among its shareholders in the United Kingdom. By contrast, in the United States, the problem was addressed by imposing an extra tax on the undistributed income of a personal holding company. *See* USA IRC § 541.

[179]USA IRC §§ 1361, 1362. In addition, as of Jan. 1, 1997, under new "check the box" regulations, *supra* note 38, limited liability companies and certain other noncorporate entities have been able to elect whether to be taxed on a flow-through basis or to be treated as corporations. For discussion of implications for international tax planning, *see* Ruchelman et al., *supra* note 39; Joni Walser and Robert Culbertson, *Encore Une Fois: Check-the-Box on the International Stage*, 15 Tax Notes Int'l 53 (July 7, 1997).

[180]*E.g.*, in Spain, professional partnerships and certain joint ventures may elect to be taxed as flow-through entities. *See supra* note 18. Elections can also work in the other direction. For example, in France, partnerships, joint ventures, and one-person companies may elect to be subject to corporate income tax. FRA CGI art. 206(3).

In designing appropriate election rules, policymakers should consider the nature of the entity and the rights of its participants. It may be unfair, for example, to allow the directors of a closely held corporation to elect to have its income taxed in the hands of its shareholders when, as a consequence, a minority shareholder might find himself paying tax on income that he might never receive. In such circumstances, it might be more appropriate to require the election to be made unanimously or by a special majority of the shareholders. Consequently, elective flow-through treatment is normally only appropriate for small businesses or for associations with relatively few participants.

V. Conclusion

Whether and how particular legal entities or arrangements are given flow-through treatment will depend on the precise nature of such entities under the civil and commercial law of a country, as well as on basic income tax policy considerations, such as the desire to simplify individual income taxation. The legal forms differ substantially, particularly between common law and civil law countries. Therefore one can expect substantial differences in the tax rules from country to country, and a single uniform solution cannot be prescribed. Nevertheless, as this chapter shows, it is possible to identify common approaches that provide guidelines for developing and transition countries, even though the details of the solutions adopted will not be uniform.

22

Taxation of Investment Funds

Eric M. Zolt

> Men will find that they can prepare with mutual aid far more easily what they need, and avoid far more easily the perils which beset them on all sides, by united forces.
> —*Baruch Spinoza, Ethics*

I. Introduction

This chapter provides an approach for thinking about the income taxation of investment funds and their investors in developing and transition countries. Although this chapter focuses on investment funds, many of the same issues and considerations may apply in designing a tax regime for other investment vehicles, such as special purpose investment funds, pension funds, and different types of insurance products.

Basic decisions made in designing the overall tax system for individuals and enterprises frame the design of a tax regime for investment funds. Decisions are required on such questions as how to tax dividends and interest received by individuals and enterprises, whether to integrate the individual and enterprise tax regimes, how to tax capital gains and losses, how to tax foreign source income, and whether and how to adjust for inflation.

Within the framework defined by these decisions, the choice of tax rules for investment funds requires balancing three objectives: first, not to hamper the development of financial intermediaries, such as investment funds; second, to devise tax rules that are comparable to those that apply to other investments; and, third, to adopt tax rules that can be administered and enforced. It is difficult to offer a general blueprint for taxing investment funds and their investors. This is partly because choices made concerning the basic tax structure will strongly influence decisions on how to tax investment funds. Another reason is that factors in a particular country influence the choice of tax regime for investment funds. Given that countries differ significantly in both their basic tax structure and their administrative capabilities, it is not possible simply to adopt the tax rules that other countries apply to investment funds.

II. Role of Investment Funds

This chapter uses the term "investment fund" to refer to an entity owned by many persons and whose primary activity is investing in operating companies. The investment fund acts as an intermediary between the individual investor and the ultimate user of the capital. Several types of investment funds exist. An "open-end" fund issues and redeems fund units from investors.[1] In contrast, "closed-end" funds issue a fixed number of units, and investors trade units with other investors.

The growth of financial intermediaries in developing and transition countries is not surprising. Market economies require private savings to provide capital to establish new ventures and to expand existing enterprises. Financial intermediaries allow small and medium-sized investors to invest their savings in the market. Such intermediaries may offer investors the advantages of financial expertise, economies of scale for such items as market research, portfolio management, and trading activity, and the opportunity to diversify and pool investments.[2] Diversification enables investors to reduce the risk inherent in holding a small number of investments without reducing the expected return of the investment. Pooling allows individuals to invest in the more liquid assets of the financial intermediary, while the intermediary can invest in less liquid and longer-term investments.

In addition to capital, investment funds may offer privatized businesses management expertise and expanded access to capital or other business relationships.[3] They may also serve as a check on the actions of managements and boards of directors to ensure that they remain accountable to the shareholders.[4] This monitoring function may be especially important in Eastern Europe, where mass privatization schemes have resulted in diffused ownership. Because of the relatively small ownership stakes distributed in privatization, individual shareholders will probably be unable to exercise effective control over the management of enterprises.[5]

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[1]*See* Richard Gordon & Victoria Summers, *Taxation of Investment Funds in Emerging Capital Markets: Theory, Problems and Solutions in the Case of Taiwan*, 46 Bull. Int'l Fiscal Documentation 384, 398 (Aug. 1992).

[2]*See generally* Robert C. Clark, *Federal Income Taxation of Financial Intermediaries,* 84 Yale L.J. 1603 (1975); Gordon & Summers, *supra* note 1, at 384.

[3]*See* Matthew J. Hagopian, *The Engines of Privatization: Investment Funds and Fund Legislation in Privatizing Economies*, 15 J. Int'l L. Bus. 75, 81-84 (1975).

[4]*See generally* Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance 102-23 (1994).

[5]*See* William C. Philbrick, *The Task of Regulating Investment Funds in the Formerly Centrally Planned Economies*, 8 Emory Int'l L. Rev. 539, 541 (1994).

In some countries making the transition to a market economy, investment funds are an integral part of the privatization process.[6] For example, the Polish mass privatization program provided for the government to establish several investment funds to serve as active managers and the primary holders of shares of the newly privatized companies.[7] In other countries, investment funds developed without direct government intervention to act as intermediaries between individual investors and business enterprises. In the Czech Republic, investment funds served the dual purpose of providing liquidity for government-issued investment vouchers and providing active participation in the strategic management of companies in their portfolio.[8]

A. Regulation of Investment Funds

Because of the great variation among countries, this section does not focus on the specifics of the different types of investment funds and the different restrictions and requirements that countries impose. It seeks only to survey the types of restrictions on and requirements for the formation and structure of an investment fund, the types of investments and activities, the operation of a fund, and rules governing distributions to and redemptions by investors.

Countries may have separate securities and tax regulatory regimes for investment funds. Particularly when the tax law conveys tax advantages to investment funds, qualification under the securities law may be necessary, but not sufficient, to qualify for tax purposes.

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[6]*See* Hagopian, *supra* note 3, at 76-81. For an excellent review of the role of investment funds in the Czech Republic, see Helena Navratilova, *Czech Republic*, in *The Taxation of Investment Funds*, 82b Cahiers de droit fiscal international 375, 375-77 (1997)[hereinafter Cahiers].

[7]The 1993 Polish mass privatization program provided for the government to establish 10-20 national investment funds and to choose fund managers from a competitive tender open to international investment and consulting firms. The program further provided for one investment fund to receive 33 percent of the outstanding shares of a privatized enterprise and to act as the lead investor in the enterprise. This structure was intended to allow the lead investment fund to have significant influence on the operation of the enterprise while still requiring the consent of other shareholders for major decisions. *See* Hagopian, *supra* note 3, at 78-79; *see also* Michele Balfour & Cameron Crise, *A Privatization Test: The Czech Republic, Slovakia and Poland*, 17 Fordham Int'l L.J. 84 (1993).

[8]*See* Navratilova, *supra* note 6, at 375-77. In the former Czechoslovakia, the government issued vouchers to every citizen over the age of 18. The vouchers entitled the holders to purchase shares in state-owned companies participating in the privatization process. Holders had the option of investing their vouchers directly in shares of a specific company or exchanging them for shares in one of the approximately 400 investments funds that sprang up to act as intermediaries between the voucher holders and the privatized companies. The investment fund managers used the accumulated vouchers to acquire substantial interests in the companies they believed had the best investment potential. About two-thirds of all vouchers were transferred to investment funds for investment by fund managers. *See* Philbrick, *supra* note 5, at 553, 562.

Countries differ in their approaches to regulating the formation of investment funds.[9] There has been some movement toward standardizing the regulation of investment funds among countries. The European Union has worked on establishing a basic legal framework for investment funds with the aim of liberalizing capital flows among the member countries. It has sought to define the basic qualification requirements for an investment vehicle known as "undertakings for collective investment in transferable securities" (UCITS) and has tried to foster reciprocal agreements among member countries for the operations of these funds. *See* Philbrick, *supra* note 5, at 35. At one extreme, some countries require funds to operate in a specific legal form and adopt model bylaws that specify the rights of investors and the obligations of fund managers.[10] At the other extreme, investment funds have great flexibility in choosing their structure and their relationship with investors. Other issues that arise on formation include the residence of the investment funds (e.g., countries could allow only domestic investment funds or choose to allow foreign funds), the capital structure (e.g., countries could require only equity contributions or choose to allow investment funds to issue debt securities),[11] and disclosure of information about fund managers and officers (e.g., countries could require only names and addresses of fund managers, or they could require managers to make detailed financial disclosure).

Regulations on investment activities can cover the type of investment, the location of investments, and the amount of investments. The regulations share a common objective in seeking to protect investors from the excesses of fund managers.[12] Common

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[9]Excellent reviews of several countries' regulatory and tax regimes applicable to investment funds are set forth in Investment Funds: International Guide to the Taxation and Regulation of Mutual Investment Funds and Their Investors (IBFD 1996)[hereinafter International Guide] and in Cahiers, *supra* note 6.

[10]*See* Hagopian, *supra* note 3, at 88-90 (discussing the rationale for the use of model bylaws for investment funds in Kazakstan, Poland, and Russia).

[11]*See* Philbrick, *supra* note 5, at 563. For example, the Czech investment funds law prohibits investment funds from issuing debt securities. Law on Investment Companies, Investment Funds (Czech), art. 4.1, *available in* LEXIS, World Library, Law File. For a discussion of the regulatory framework for investment funds in the Czech Republic, *see* Navratilova, *supra* note 6, at 377-85.

[12]A good example of the types of restrictions on the investment activities of investment funds is set forth in guidelines issued by The Federal Commission on Securities and the Capital Market of the Government of the Russian Federation, Interim Regulation on the Composition and Structure of Assets of Unit Investment Funds (Reg. No. 12, Oct. 1995). [12]*See* Hagopian, *supra* note 3, at 88-90 (discussing the rationale for the use of model bylaws for investment funds in Kazakstan, Poland, and Russia).

[12]*See* Philbrick, *supra* note 5, at 563. For example, the Czech investment funds law prohibits investment funds from issuing debt securities. Law on Investment Companies, Investment Funds (Czech), art. 4.1, *available in* LEXIS, World Library, Law File. For a discussion of the regulatory framework for investment funds in the Czech Republic, *see* Navratilova, *supra* note 6, at 377-85.

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restrictions on the type of investment activity include a prohibition on investing in certain types of assets (e.g., partnership interests with unlimited liability, precious metals, commodities, options and futures contracts, and certain types of debt obligations), on holding certain nonliquid securities (e.g., the fund's portfolio is required to be substantially, or entirely, invested in publicly traded securities), or on engaging in certain types of activities (e.g., the fund's activities are limited to holding passive investment assets rather than operating assets). Some countries may require that the fund invest all or a substantial percentage of its funds in domestic enterprises. Countries also generally restrict both the percentage of a fund's assets that can be invested in any one issuer and the percentage of an issuer's stock that a fund can own.

To protect and inform investors, countries also generally impose disclosure and auditing requirements on investment funds. Also common are provisions to limit the potential for self-dealing and conflicts of interest between fund managers and the fund.[13]

Finally, depending on the type of investment fund and the applicable tax regime, countries have prescribed rules on distributions to shareholders and redemption requirements. For example, U.S. tax law requires that to obtain favorable tax treatment, an investment fund must distribute to investors 90 percent of certain income received during the year.[14] Russian law requires investment funds to redeem the interests of investors within 15 days of a request for redemption.[15]

B. Goals of Tax Regime for Investment Funds

There are several possible goals of a tax regime for investment funds and investors, and some policymakers may place greater weight on certain goals rather than on others. Some possible goals are discussed in this section.

1. Encourage Development of Investment Funds

General agreement exists that, at a minimum, tax rules should not unduly hamper or prevent development of investment funds or other financial intermediaries. In many countries, the absence of special tax rules governing investment funds would result in an investment fund being treated as a separate taxpayer—with an additional layer of tax

[13]*See* Hagopian, *supra* note 3, at 93-94 (discussing the use of investment funds legislation to minimize potential conflicts of interest between fund managers and the investment funds).

[14]To qualify for conduit tax treatment under U.S. tax law, an investment fund must distribute annually at least 90 percent of its investment company taxable income (taxable interest, dividends, and the excess of short-term over net long-term capital losses and any capital loss carryforwards, net of expenses) and at least 90 percent of its tax-exempt interest income, net of expenses. Investment funds are not required to distribute any net capital gain income (excess of net long-term capital gains over net short-term capital losses and loss carryforwards). *See* USA IRC §§ 852(a), (b)(3).

[15]*See* Decree of the President of the Russian Federation, On Additional Measures to Increase Efficiency of Investment Policy of Russian Federation ¶ 8 (July 1995).

imposed on any income or gains recognized by the fund.[16] This "double tax" may be substantial enough to stunt the development of investment funds.[17]

Whether tax rules should explicitly favor the development of investment funds is a difficult question. It is part of a larger question of whether tax incentives should be used to encourage saving in general. It also relates to the tax treatment of alternative investment vehicles, such as pension plans and insurance products, and the need to consider comprehensively the tax regimes for all investments and not to address tax rules for specific investments in an ad hoc manner.

Section III(A) presents three variations on tax regimes that provide more favorable tax treatment to investors in investment funds than would be available to taxpayers engaged in direct investments. If a country decides to adopt one of the tax-favored regimes, it may need to consider carefully the qualification requirements for investment fund status so that tax benefits are not available to unintended beneficiaries. Policymakers may also need to estimate the revenue loss from the tax advantages so that they can consider whether the increased incentives justify the lost tax revenue.

2. Market Neutrality

Economists and tax lawyers emphasize that tax rules should be as neutral as possible regarding investment and other decisions. Although almost all taxes distort behavior, policy advisors generally recommend keeping distortions as small as possible. This position rests partly on grounds of market efficiency—that economic resources should be allocated on the basis of market factors that determine the highest return, not on the basis of tax considerations. It is also rests on minimizing transaction and tax planning costs. Investors should not spend their resources trying to devise schemes to minimize taxes. To the extent that all investments are taxed similarly, there will be no incentive to try to come within the scope of tax-favored treatment. Finally, if investment funds are accorded tax-favored treatment, it may be difficult to deny tax benefits to other forms of investments; consequently, the tax law will become more complicated, and tax revenue will decline.

For purposes of this chapter, market neutrality means that taxpayers should be treated the same whether they invest directly in assets, such as government securities and

[16]In Russia, the Ministry of Finance has ruled that investment funds are not "entities" subject to the enterprise profits tax, but rather "asset pools without the creation of a legal person." On Several Tax Issues Arising in Connection with the Creation and Functioning of Unit Investment Funds (Jan. 1996). See also Alexander V. Tolkoushkin & Vladimir N. Zavarnov, *Russia*, in Cahiers, *supra* note 6, at 723-26. Similar exemptions from treatment as an entity taxable under the corporate income tax are found in many countries, including France, Germany, and Italy. *See* International Guide, *supra* note 9, at 49 (France), 38 (Germany), and 58 (Italy).

[17]For example, assume an operating company earns a rate of return of 10 percent before tax and, after imposition of a 30 percent corporate tax, earns 7 percent after tax. If the income of the company is distributed to an investment fund that is also subject to a 30 percent corporate tax, the after-tax rate of return is further reduced to 4.9 percent.

shares of joint-stock companies, or invest indirectly in such assets through financial intermediaries, such as investment funds.[18] Even if one does not value this goal on independent grounds, it is helpful in examining alternative proposals to determine how the tax consequences for investors of a specific proposal for taxing investment funds differ from the tax consequences of direct investment.

One should also compare the tax rules governing investment funds with the favorable tax rules available to alternative investments. If a country's tax law exempts interest on many government and bank obligations or provides special rules for pensions or life insurance products, then the existence of these tax-favored investments may influence the basic decisions on the tax treatment of investment funds.

3. Administration and Compliance Considerations

As in all areas of tax law, the laws are only as good as the administration. It makes little sense to adopt laws that, while being theoretically correct, are difficult or impossible to administer.

The tax regimes for investment funds in many countries rest on the one hand on the ability of investment fund managers to process substantial amounts of information and to allocate tax items to individual investors and on the other hand the ability of tax administrators to receive information from investment fund managers and match this information with the individual tax returns of millions of taxpayers.[19] The investment funds are likely to have the computer capability to process the information and allocate the tax items. The ability of the tax administration to develop a system to ensure enforcement and compliance with a tax regime that requires monitoring the tax consequences to many investors is much more problematic and, in many countries, may not be worth the expenditure of substantial administrative resources, given the amount of tax revenue involved.

Another potential compliance problem that may be associated with a special tax regime for investment funds is the ease with which taxpayers can meet the tax and regulatory requirements for investment fund status. If qualification is easy, then adopting a favorable regime for investment funds will create strong incentives for taxpayers to arrange their affairs to obtain favorable tax treatment. If qualification is difficult, then the potential tax motivation for adopting this form of organization is reduced.

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[18]*See* Gordon & Summers, *supra* note 1, at 385.

[19]For example, in 1995, the Internal Revenue Service received over 115 million individual income tax returns and processed over 1 billion information returns. Internal Revenue Service, Pub. No. 55B, 1995 Data Book, tbls. 7, 18 (1995).

4. Revenue Concerns

A complete examination of alternatives for taxing investment funds requires estimating their revenue consequences. To complete this task, one must gather estimates concerning the number of investment funds, the number of investors, the amount and type of fund investments, the amount and type of income and capital gains of the funds, and the potential capital gains recognized by investors on the redemption of their shares.[20]

(1) the amount of dividends paid by enterprises,
(2) the amount of tax-exempt investment in funds,
(3) the amount and frequency of redemptions,
(4) the amount of capital gains recognized by the funds, and
(5) the mix of individual and enterprise investors.

If, for example, we were confident that enterprises paid little or no dividends and that individual investors could structure their redemptions from the investment funds to pay no capital gains tax, then the choice of tax regime applicable to investment funds may be of little practical significance. Similarly, the value of allowing investment funds effectively to defer paying capital gains tax until an investor redeems the investor's interest may be of little importance if the individual investor could avoid paying any capital gains tax on shares of enterprises held directly. These estimates may initially be quite speculative; hopefully, over time, the estimates will become more reliable.

III. Taxing Investment Funds in the Context of the Basic Tax Structure

A major difficulty in designing a tax regime for investment funds and their investors is the number of different combinations of components that policymakers may need to consider. This section first reviews the components of a basic tax regime that make up the landscape for examining alternative tax regimes for investment funds and then seeks to catalogue the different types of investors and the different types of income of an investment fund.

A. Basic Tax Structure

Several components of the basic tax structure may influence the design of a tax regime for investment funds. These include (1) the range of tax rates for individuals and enterprises and the relationship between those rates; (2) whether individuals are taxed on dividends on a flat schedular basis or must combine their income from dividends with other sources of income and incur tax liability on a global basis; (3) the use of either provisional or final withholding for dividends; (4) whether enterprises may exclude

[20]For example, it is difficult to compare the tax consequences for investors of a tax regime for investment funds with the tax consequences for investors of direct investments without making certain assumptions as to behavior of the enterprises, the investment funds, and the investors. Assumptions that may be important to consider include

dividends received from other enterprises, perhaps tied to the level of share ownership in the enterprise; (5) whether interest is taxed on a schedular or a global basis; (6) the use of provisional or final withholding for interest, and the continuation of the existing tax-exempt status of many types of interest; (7) the treatment of capital gains, in particular whether the same rules apply to individuals and enterprises, the possibility of allowing alternative cost basis approaches for determining gain for individuals, and the possibility of adjusting for inflation; (8) the rules governing tax relief for capital losses; (9) the scheme for integrating the individual and enterprise tax systems, in particular the type of integration, if any; (10) the rules for taxing foreign source income, particularly whether foreign income is excluded or whether a deduction or credit for foreign tax paid is allowed; and (11) the rules governing the taxation of nonresident taxpayers, in particular the rules for individuals and entities that are either passive investors or that receive income in connection with a domestic trade or business.

While it is necessary to reduce the number of alternative combinations from the items listed above before being able to make any definitive comments about the interaction of the basic tax structure and the design of the tax regime for investment funds, two general guidelines can be offered: (1) the more variation in the treatment of different types of income in the hands of different types of investors, the greater the pressure may be to tax the income directly at the investor level; and (2) the less the tax rules vary by type of income in the hands of different types of investors, the stronger is the argument for simply taxing all income at the investment fund level and imposing no further taxes at the investor level.

The tax treatment of capital gains presents perhaps the most complex issue in designing a tax regime for investment funds. Capital gains may arise at the fund level when the investment fund sells shares of its underlying investments, or at the investor level when the investor sells his or her interest in the investment fund, or at both levels. For countries that do not tax capital gains,[21] the potential for two levels of gain raises no additional problems. For a tax system that taxes capital gains, however, the potential exists for the government to collect too much or too little tax. A system can collect too much tax on capital gains if an investment fund realizes a gain on the sale of an enterprise's shares and an investor realizes a gain on the sale of his or her interest in the investment fund unless there exists a mechanism for the investor to receive credit for tax paid at the fund level. A system collects too little tax if an investor can dispose of shares in the investment fund without tax liability and thus avoid any tax on the unrealized appreciation in the assets of the investment fund.[22]

[21]Including those that follow the German/French model of taxing only gains on substantial participations, since the regulatory constraints on investment funds would presumably require sufficient dispersion of investment so that no one investor’s share in an investment by the fund would constitute a substantial participation. However, if shares are treated as business assets in the hands of the fund, then an exception would have to be made to provide for their nontaxation.

[22]Whether an investor is actually undertaxed depends on whether the market price for the shares of the investment fund reflects the discounted present value of the tax due when the investment fund disposes of the appreciated assets. The relative tax rates of the investor and the fund must also be taken into account.

Several alternatives exist to minimize or eliminate the double taxation of capital gains. One approach imposes capital gains at the fund level, but exempts capital gains at the investor level. Alternatively, a country could choose to tax capital gains only at the investor level, and exempt fund-level gains. A third alternative imposes tax at the fund level, unless the proceeds of the gain are distributed, in which case the capital gains are taxed to the investors. Finally, a country could choose to tax gains at both levels, but could either give the investors a credit for any tax paid at the fund level or impose tax at both levels at a substantially reduced rate.

The existence of high levels of inflation further complicates the difficulties of designing a rational tax regime. Taxing nominal gains without adjusting for inflation may result in high taxes on what are small or no economic gains, and perhaps even real economic losses. If nominal gains are taxed at both the fund level and the investor level, then the economic return required just to break even after tax may be substantial.

Tax systems can provide for inflation adjustments by allowing investors to index their tax cost for purposes of determining gain on a transaction.[23] Indexation provides a more accurate measure of economic gain than an unindexed tax system, but increases its complexity.[24] The complexity is further increased when inflation adjustments are made at both the fund and the investor level. A system of comprehensive inflation adjustment where gains are taxed at the level of the investment fund only, however, would not be so complex.[25]

B. Types of Investors

Countries generally impose few, if any, restrictions on the types of investors that may invest in investment funds. We can separate domestic individuals by their income level: (1) individuals may have income below the threshold amount for tax liability; or (2) individuals may be subject to tax at low, medium, or high tax brackets, depending on the rate structure under the individual income tax law, the individuals' other income, and the rules for aggregating income from different sources.

Domestic enterprises may be subject to differing tax rates under the enterprise tax law, although progressive tax rates under an enterprise tax law have little or no theoretical justification. An enterprise with a relatively small ownership position in a

Whether the tax system collects too little tax depends on whether one views the investor's sale of shares of an investment fund as a constructive disposition for tax purposes of the underlying assets.

[23] *See* vol. 1, ch. 13.

[24] *See id.* The major complexity arises not from the indexing of the assets for inflation, but rather from the need to index any debt obligations that are related to assets subject to indexation.

[25] *See id.*

particular fund can be classified as a portfolio investor; it can be classified as a substantial investor if it has a relatively large investment position.[26]

There may also exist a group of investors that qualifies for tax-favored or tax-exempt status. In the United States, tax-favored or tax-exempt entities, such as private pension plans and nonprofit institutions, own substantial amounts of shares and securities in enterprises and in investment funds.[27]

Tax rules for nonresident investors may depend on several factors. Different tax rules may apply to foreign individuals and enterprises, and the rules may vary depending on the level of ownership and the nature of the activity of the foreign person within the country. Countries also may consider offering special tax incentives to attract capital from foreign funds or foreign investors.

The tax treatment of income attributable to foreign investment funds raises additional issues, particularly with respect to qualification for relief under a country's double taxation treaties.[28] In many countries it may be uncertain whether investment funds qualify as a "person" for treaty purposes so that a fund could claim treaty benefits for itself or on behalf of its investors. The decision whether to extend treaty benefits to foreign investment funds is part of the larger policy question concerning the appropriate allocation of tax revenue among the country where the investment is located, the country where the fund is located, and the country where the investors reside.

C. Types of Income

The income of an investment fund must be examined in three parts. The first part involves reviewing the different types of income that an investment fund may receive. The second part entails determining how the different types of income will be categorized for tax purposes. The final part of the analysis focuses on identifying those items that may involve different consequences if the income is allocated and the tax imposed at the investment fund level and at the level of the investors.

[26]The classification of an enterprise as a portfolio or a substantial investor takes on great importance in those countries where the tax treatment of intra-corporate dividends differs by the level of ownership of the payee corporation.

[27]For example, in the United States in 1990, tax-exempt investors (nonprofit institutions, pension funds, IRAs, and Keogh plans) owned approximately $1.2 trillion or about 37 percent of corporate equity and approximately $750 billion or about 46 percent of corporate debt. *See* U.S. Dep't of Treasury, Integration of Individual and Corporate Tax Systems: Taxing Business Income Once 68, tbl. 6.1 (1992).

[28]The considerations for extending treaty benefits to foreign investment funds are set forth in Lynne J. Ed & Paul J.M. Bongaarts, *General Report*, *in* Cahiers, *supra* note 6, at 41-57.

1. Possible Types of Income

An investment fund may have the following categories of income:

- dividends from domestic enterprises;
- dividends from foreign enterprises;
- interest income from different domestic sources, with some types of interest income qualifying for tax-exempt status;
- interest income on foreign securities; and
- gains and losses from the sale of investments.

This list assumes that investment funds are limited to holding securities in operating companies and certain government securities. This simple classification also does not reflect the increased use of derivatives and synthetic instruments that makes determination of both the type of income and the source of income more difficult. To the extent that investment funds may engage in other types of activities, such as holding immovable property or direct ownership of operating assets, additional categories of income may need to be added.

2. Categorization for Tax Purposes

The second part of the analysis requires determining how these different types of income will be categorized for tax purposes. For example, a certain type of income may be subject to withholding, some types of income will qualify for tax-exempt treatment or capital gain treatment, and other types of income will be taxed under the rules governing foreign source income. To the extent that a country changes its basic tax structure, it will be necessary to determine how possible changes in the categorization of different types of income may influence decisions on the design of a tax regime for investment funds.

3. Tax Items That May Require Separate Treatment

The third part of the analysis requires identifying those types of income, deductions, losses, and credits that may be subject to different tax treatment in the hands of different types of investors. These include

- dividends and interest from fund investments, especially if the withholding rates vary by type of investor;
- gains and losses from the sale of property by the investment fund, especially if the calculation of gain differs by type of investor and if restrictions are imposed on the use of capital losses;
- income qualifying for tax-exempt status or subject to other types of preferences;
- certain expenses of the investment fund, the most important of which are management fees and the interest incurred to carry its assets; and
- credits received by the investment fund, such as foreign tax credits attributable to foreign source income or credits relating to an integration system of individual and corporate taxes.

The purpose of this review is to highlight the consequences of adopting different regimes for investment fund taxation. This allows policymakers to determine how the taxation of investment funds and their investors will differ under the prototypes examined in the next section. It may also provide guidance as to how individual taxpayers may change their behavior when the tax rules for investing through investment funds differ from investing directly in the underlying assets.

IV. Different Prototypes

This section examines several different prototypes that represent different approaches to reducing or eliminating the double—or in some cases, triple—taxation of dividends, interest, and capital gains attributable to investment funds and their underlying investments. They may be useful in revising or designing a tax regime for investment funds.

A. Tax-Advantaged Prototypes

Three major alternatives exist to provide tax benefits to investment funds that are not generally available to direct investment. They provide either deferral or exclusion of different types of income at either the fund or the investor level. The first alternative allows deferral of any capital gains recognized by the investment fund by not imposing tax at the investment fund level on any gain realized by the fund on the sale of its investments. The tax is effectively deferred until the investor disposes of the investor's interest in the fund through redemption or sale of shares.

The second alternative goes further and does not impose tax on the investment fund on any dividends, interest, or other income received, or on capital gains. This could be accomplished by allowing receipt of income without any withholding or by providing a refund of any withholding imposed on distributions to the investment fund. This alternative provides for deferral of all income at the investment fund level until investors redeem their shares in the fund.

The third alternative allows a deduction for amounts contributed to the investment fund and then taxes the proceeds upon redemption by the investor.[29] No tax is imposed while the investor holds the shares at either the investor or the investment fund level. Under certain assumptions, this approach is equivalent to excluding from taxation the income from investment in the fund.[30]

B. Pass-Through Prototypes

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[29]Countries that have adopted approaches similar to the third method generally limit the amount of potential tax benefit by restricting availability to individual investors and by restricting the amount of new investment in the fund each year. *See, e.g.*, the taxation of personal equity plans in the United Kingdom and *plans d'épargne en actions* in France. International Guide, *supra* note 9, at 50 (United Kingdom) and 43 (France).

[30]*See* Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575 (1979).

The pass-through prototypes treat the investment fund as transparent and allocate all items of income and loss directly to investors. In its purest form, the investment fund acts simply as a reporting mechanism. This approach treats investors as if they earned the income directly and taxes them accordingly, even if the investment fund does not distribute the income to them.

A pass-through prototype requires a system for allocating all items of income and loss to the investors. One alternative provides for each item to be allocated daily over the tax year and assigns to the investors their prorated share each day.[31] A second alternative assigns the tax items for a particular period, for example, for a year or a quarter, to the owners of interest on the last day of the period and allows the market price for the interest to adjust for any tax consequences.[32]

The pass-through prototypes score high on market neutrality. Unfortunately, they score low on administrative and compliance grounds, especially as the number of investors and the number of fund investments become quite large. Therefore, no country uses this system for investment funds.

A variation of this prototype imposes tax on the investment fund on any income it receives at a rate that could be either the highest rate applicable to investors or, alternatively, the one that is most common to investors. This approach allocates to investors their share of the income of the fund and provides a credit for taxes paid by the fund allocable to that income. Investors may then file for a refund if the amount of tax paid exceeds their liability or they could be assessed additional tax if the amount paid by the investment fund is less than their tax liability. This variation also requires rules for calculating an investor's basis in his or her investment in the fund to determine whether an investor would recognize gain when shares are redeemed.

The third variation is a modified pass-through prototype. This approach aggregates all different types of income at the fund level and requires reporting only one, or perhaps two or three types of income to the investor.[33] Again, this variation could allow for the withholding of taxes at the fund level and for a procedure to provide refunds to investors whose tax rate is below the withholding rate.

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[31]The United States has adopted such a system for allocating items of income for certain qualifying small business corporations, known as "S" corporations. The shareholders generally take into account their respective prorated shares of income, deductions, and other separately stated items on a prorated, per share daily basis. USA IRC § 1366(a)(1).

[32]See U.S. Dep't of Treasury, Blueprints for Basic Tax Reform 70-71 (1977). The allocation proposal in Blueprints used an annual record date for allocating tax items to shareholders and designated the shareholders on the first day of the tax year to be the shareholders of record.

[33]For example, the approach adopted by the United States for separate treatment of only certain types of income of widely held partnerships. *See generally* U.S. Dep't of Treasury, Widely Held Partnerships: Compliance and Administrative Issues (1990).

The pass-through prototypes come closest to achieving market neutrality between direct investment and investment through investment funds. They do, however, impose substantial administrative burdens on both investors and the taxing authorities to ensure collection of taxes and compliance with the tax rules.

C. Surrogate Prototypes

The surrogate prototype changes the focus of taxation from the investor to the investment fund. Surrogate taxation can take many forms. One extreme imposes a tax on the fair market value of the assets of an investment fund in lieu of any income tax at the level of either the investor or the investment fund.[34] A more common surrogate prototype imposes tax on any income received by the investment fund at the fund level and collects tax without regard to the tax characteristics of the investors. It could impose tax on both dividends and interest paid to the investment fund, as well as on any capital gains realized by the fund on the sale of its property.

One variation of this prototype collects no further tax at the investor level on either sale or redemption of the investor’s share in the investment fund or, if a fund is allowed to make distributions, on any distributions made by the fund. Another variation imposes a tax on any gains recognized by the investor, but allows the investor a credit for taxes paid by the investment fund with respect to his or her prorated share of the income.

The design of a tax regime for a surrogate model depends largely on the country's rules governing the taxation of dividends and capital gains. A country that imposes schedular taxation of dividends with withholding at the enterprise level requires no special rules for taxing dividends distributed to an intermediary. The tax rules could provide for the funds to be distributed to the individual investors without additional tax liability if they are able to show that tax with respect to the distribution was withheld at the enterprise level.[35]

Compared with the other prototypes discussed in this section, the surrogate approach is probably the easiest to administer and the one that will result in the highest level of tax compliance. To the extent that the rate imposed on the income of the investment fund differs from the rate that would be imposed on investors if they received the income directly, then this approach would violate market neutrality. If the tax rate on the investment fund exceeds an investor's tax rate, then investors may be overtaxed on

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[34]For example, Italy imposes a tax on the net asset value of certain types of investment funds in lieu of an income tax. International Guide, *supra* note 9, at 60-61 (Italy). Sweden imposes tax on 1.5 percent of asset values in lieu of capital gains tax for investment funds; investment companies pay tax on an imputed income of two percent of asset values in lieu of capital gains tax. *See generally* Cecilia Gunne, *Sweden*, in Cahiers, *supra* note 6, at 778-79.

[35]The tax regime of the Czech Republic provides a good example of this approach. *See* Navratilova, *supra* note 6, at 385-86.

their income.[36] Conversely, if the tax rate on the investment fund is less than an investor's tax rate, then this should encourage the development of these types of funds, perhaps at the cost of lost tax revenue.

D. Distribution-Deduction Prototype

The distribution-deduction prototype taxes the investment fund on any undistributed income and taxes the investors on any income distributed to them. Countries generally achieve this result by treating the investment fund as a taxable entity, but allowing the investment fund to deduct from its income any amounts distributed to investors. The prototype could provide for the investors to receive credit for taxes paid at the fund level with respect to their prorated share of income.

Countries that follow this approach generally require funds to distribute a substantial portion of their income each year. For example, the United States generally requires qualified funds to distribute annually 90 percent of their investment income, other than net long-term capital gains. One reason the United States has adopted this approach is because taxpayers aggregate dividends and interest received with their other income and then pay tax at progressive rates on their total income. The United States also has a sophisticated reporting and matching system that allows taxing authorities to monitor the payment of distributions to investors.

When an investment fund distributes less than its total income for a year, distribution-related prototypes may require rules for determining which income is deemed to be distributed. Such "stacking rules" could, for example, provide for a fund to designate the types of income being distributed, or for income to be deemed distributed in a particular order (e.g., first, dividends and interest received from domestic corporations; second, dividends and interest received from foreign investments; and third, capital gains income) or for a deemed pro-rata distribution of the different types of income.

Distribution-related prototypes could also provide for investment funds to treat amounts as being distributed without requiring an actual distribution to investors. These deemed distributions would be treated as reinvested by the investors.[37] A "deemed-distribution" option allows for an investment fund to avoid potential double taxation on certain income without requiring the fund to liquidate investments in order to make actual cash distributions.

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[36]Whether investors in a low tax bracket are worse off because of the higher tax rate imposed on their share of investment income depends on how the market price of the shares of investment funds under a surrogate tax approach would compare with the market price of the funds under a pass-through approach. Low-bracket taxpayers may be better off under the surrogate approach if there are enough investors in a high tax bracket to bid up the price of the investment funds.

[37]Alternatively, funds could stand ready to make distributions upon request but could allow investors to elect to instead reinvest the amount of the distribution in additional fund shares. Many investors would presumably make the election in order to avoid the inconvenience of dealing with distribution payments.

V. Conclusion

This chapter has set forth a framework for examining issues in the taxation of investment funds and their investors and a survey of the different approaches countries use in taxing income attributable to investment funds. It is not surprising that countries use different approaches in taxing investment funds and their investors. The investment fund tax rules are dictated largely by a country's overall tax regime for individuals and enterprises, and these tax regimes vary substantially among countries. Administrative and compliance considerations also influence the choice of tax rules.

The absence of an ideal structure requires policymakers to balance competing goals. As discussed in section II, these goals could include (1) not discouraging the development of investment funds, (2) achieving market neutrality between direct and indirect investments, (3) designing a regime with low administrative costs and high compliance, and (4) not decreasing, and perhaps increasing, the tax revenue base.

Which prototype for investment fund taxation makes sense in a particular country depends largely on the country's basic tax structure. If a country's tax system has (1) similar tax rates for individuals and corporations, (2) final withholding on dividends and interest (and no variation in withholding rates by taxpayer), (3) no threshold level for excluding capital gains (and similar rules for all taxpayers for taxing capital gains), (4) exclusion of foreign source income, and (5) no special rules for foreign investors, then the surrogate prototype may be preferable because of the substantial administrative and compliance advantages it offers.

To the extent that a country's basic tax regime differs significantly from the above structure and contains highly differentiated treatment of various types of income for particular types of taxpayers, the surrogate prototype loses much of its attraction. Particularly if substantial weight is given to the goal of market neutrality, then a pass-through prototype or distribution deduction prototype merits serious consideration.

23

Income Tax Incentives for Investment

David Holland and Richard J. Vann[1]

> To lay, with one hand, the power of the government on the property of the citizen, and with the other to bestow it upon favored individuals to aid private enterprises and build up private fortunes, is none the less a robbery because it is done under the forms of law and is called taxation.
>
> —Justice Samuel F. Miller

I. Introduction

Many developing and transition countries offer income tax incentives for investment.[2] The incentives are most often for direct investors as opposed to portfolio investors, relate to real investment in productive activities rather than investment in financial assets, and are often directed to foreign investors on the grounds that there is insufficient domestic capital for the desired level of economic development and that international investment brings with it modern technology and management techniques.

Developing and transition countries have introduced investment incentives for varying reasons. In some cases, especially in transition countries that have not reformed the socialist tax system, the incentives may be seen as a counterweight to the investment disincentives inherent in the general tax system. In other countries, the incentives are intended to offset other disadvantages that investors may face, such as a lack of infrastructure, complicated and antiquated laws, and bureaucratic complexities and weak administration, in the tax area or elsewhere. If these are the reasons, the appropriate solution is to reform the existing laws that create the problems and to build the necessary administrative capacities and infrastructure. This solution is often easier said than done, and so tax incentives may provide temporary relief until the more fundamental reforms have been carried out. Countries sometimes introduce incentives

[1]Note: This chapter draws heavily on OECD, Taxation and Foreign Direct Investment: The Experiences of the Economies in Transition (1995) to which the authors (especially David Holland), along with Alex Easson, contributed.

[2]Using the tax system to influence economic behavior by granting tax incentives for particular activities has developed an enormous literature following the lead of Professor Stanley Surrey, who noted the equivalence of such incentives to direct expenditure programs and coined the term "tax expenditures" to refer to them. *See* Stanley Surrey, Pathways to Tax Reform (1973); International Aspects of Tax Expenditures (Stanley Surrey & Paul McDaniel eds., 1985); OECD, Tax Expenditures: A Review of the Issues and Country Practices (1984); OECD, Tax Expenditures: Recent Experiences (forthcoming). This chapter will not review the many arguments against tax expenditures generally or the issues involved in costing the revenue forgone from such measures. For a critique of the tax expenditure concept, *see* Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 Duke L. J. 1155.

to keep up with other countries in competing for international investment. More rarely, tax incentives are introduced after other deficiencies in law and administration are remedied and are directed to areas of economic activity that the country wishes to develop.

Although standard international tax policy advice cautions against the use of tax incentives for investment,[3] many developing and transition countries, as well as many industrial countries, continue to operate or introduce them. Accordingly, this chapter briefly outlines the reasons why such incentives are often found to be unsuccessful and what the more important issues may be for encouraging investment in developing and transition countries. It then considers in more detail the design, drafting, and international taxation issues that such incentives present. Although the discussion considers investment incentives in general, it emphasizes foreign direct investment (FDI). This chapter focuses on the income tax, while also discussing the more important incentives found under other taxes.

II. Relationship Between Taxation and Investment

A. Tax and Nontax Factors Affecting Investment

Investors often emphasize the relative unimportance of the tax system in investment decisions compared with other considerations.[4] Firms first examine a country's basic economic and institutional situation. While they are attracted to the potential markets in developing and transition countries and the relatively low-cost labor, other considerations inhibit large-scale investment, such as uncertainty in the policy stance of governments, political instability, and, in transition economies, the rudimentary state of the legal framework for a market economy. Tax incentives on their own cannot overcome these negative factors.

To prospective investors, the general features of the tax system (tax base, tax rates, etc.) are more important than tax incentives. In transition countries, many tax laws contain provisions that are held over from the regime that was used under the former socialist economy. These provisions served purposes different from those of a market economy tax regime, for example, controlling the enterprise's budget rather than determining an appropriate tax base. From the point of view of potential foreign investors, these provisions are unfamiliar and anomalous. They can cause the tax base to diverge from market economy norms (especially in relation to depreciation, business expenses, and loss carryovers) and impose taxation that is not consistent with reality from the point of view of business investors. Furthermore, taxpayers expect to be able to predict the tax consequences of their actions, which requires clear laws that are stable over time. In many developing and transition countries, the tax laws are not clearly written and may be subject to frequent revision, which makes long-term planning difficult for businesses and

[3]*See* OECD, Taxation and Foreign Direct Investment: The Experiences of the Economies in Transition (1995); Chua, *Tax Incentives, in* Tax Policy Handbook 165–68 (Parthasarathi Shome ed., 1995) and references there cited.

[4]The statements in this section and the next about the views of investors stem from the consultations undertaken in preparing OECD, *supra* note 2. For a survey that gives a somewhat greater importance to taxation in relation to investment decisions, see Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation (1992) (commonly referred to as the Ruding Report after its chair), ch. 5.

adds to the perceived risk of undertaking major capital-intensive projects. The administration of the law is as important as the law itself, and it is clear that tax administrations in developing and transition countries often have difficulty coping with sophisticated investors, whether in providing timely and consistent interpretations of the law or in enforcing the law appropriately.

Investors may view both income and non-income taxes as potential problems. The latter are payable even if no profits are made and often raise the cost of basic inputs. In particular, social security taxes applied to the wages of expatriates in transition countries and border charges on the importation of capital equipment in developing and transition countries are seen as obstacles to investment.

B. Lack of Success of Investment Tax Incentives

The experience for developing and transition countries with tax incentives has been consistent with that of the industrial countries.. Tax incentives have not by and large been successful in attracting investment, especially FDI.[5] This underlines the conclusion that tax incentives cannot overcome the other, more fundamental problems that inhibit investment.

At the same time, tax incentives have imposed serious costs on developing and transition countries that need to be considered relative to any modest benefits that they have conveyed. Tax incentives by their nature represent a revenue cost for the government. For the most part, this revenue cost is wasted because the incentives go to investments that would have been made in any event. It is argued that FDI in countries in transition to a market-oriented economy would not occur without the incentive, and so there is no real revenue cost. However, experience has shown that there is investment in short-term, high-profit projects. Because these projects would occur even if there were no tax incentives, the tax incentive is a pure windfall to them. Investment tax incentives have been subject to serious tax avoidance which has added greatly to their revenue cost. Tax avoidance results, in part, from the design of the incentives and also from the difficulties tax administrations face in auditing taxpayers. The revenue forgone in transition countries as a result of the use of tax incentives to shelter domestic income from taxation may well exceed the incentives earned through legitimate FDI.

Tax incentives introduce complexity into the tax system, because the rules themselves are complex and because tax authorities react to the tax planning that inevitably results from their introduction by putting into place antiavoidance measures. This complexity imposes costs on administrators and taxpayers and increases the uncertainty of tax results. Uncertainty can deter the investment the incentives are intended to attract. Moreover, the introduction of tax incentives creates a clientele for their continuation and spread. The fact that many industrial countries maintain some tax incentives after the tax reforms of the 1980s is less a statement that they are considered to be effective and more a testament to the political difficulty in removing them once

[5]Some jurisdictions, such as Singapore, Taiwan Province of China, and more lately, Ireland, have used investment tax incentives and advanced economically, but whether the two matters are connected in these cases has been a matter of dispute. These countries did not suffer from the negative economic, political, and administrative situations that are the major deterrents to investment in many transition economies. Moreover, many more countries have adopted investment tax incentives without any noticeable improvement in investment performance, and a number of countries, such as Chile and Estonia, have advanced economically while eschewing tax incentives.

they have been introduced. It is because of this tendency that many "temporary" measures, designed to respond to particular perceived disincentives, remain in force long after the conditions that originally led to their introduction have changed.

These costs can be observed fairly directly. What may be the primary cost, however, is much more difficult to observe and measure. The classic argument against the use of incentives is that they distort economic activity, by causing the after-tax pattern of returns to diverge from the before-tax pattern and thereby leading to an allocation of resources that differs from the efficient equilibrium the market is assumed to generate. Whether arguments based on advanced markets apply to developing and transition countries may be debated, but there can be no doubt that the more observable costs of tax incentives referred to above do arise in these countries.

Why do countries enact tax incentives despite their drawbacks? There are many factors. Legislators may feel the need to do something to attract investment but may find it difficult to address the chief reasons that discourage investment; tax incentives are at least something over which they have control and which they can enact relatively easily and quickly. Alternatives to tax incentives may also involve the expenditure of funds, and tax incentives may be seen as a politically easier alternative, since subsidies involving expenditure may undergo closer scrutiny as compared with other public expenditure needs. Further, some countries may feel under pressure from multinational companies, which threaten to locate investment elsewhere if they are not given concessions. Finally, some politicians or their advisors may simply disagree with the analysis presented here. As can be seen, the topic is a complicated one and cannot be resolved here. Therefore we focus more on the technical tax issues raised by investment incentives and on ways that such incentives can be designed so as to minimize the damage that they can cause.

III. General Tax Incentives

A. Types of General Tax Incentives

Tax incentives can be grouped into a number of categories: tax holidays, investment allowances and tax credits, timing differences, reduced tax rates, and free economic zones. Each type raises different design and drafting issues.

1. Tax Holidays

The tax holiday has been often used by developing and transition countries. It is directed to new firms and is not available to existing operations. With a tax holiday, new firms are allowed a period of time when they are exempt from the burden of income taxation. Sometimes, this grace period is extended to a subsequent period of taxation at a reduced rate.

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

A number of technical issues are important in determining the impact of tax holidays on the return on investments. The first issue is determining when the holiday starts. It could be when production starts, the first year in which the firm makes a profit, or the first year that the firm achieves a positive cumulative profit on its operations. For large projects in particular, losses are usually generated in the early years of production, when the highest capital costs are incurred, including special costs that are linked to the start-up period, training the workforce, and developing the local market. For such projects, a tax holiday that starts when production occurs may actually increase the taxes paid over the life of the project and so act as a disincentive for investment. If losses are experienced during the holiday period they may not be allowed to be carried forward beyond the holiday period (it would be overly generous to allow losses to be carried forward from a year in which income would not have been subject to tax). Thus, the holiday may occur when no taxes would have been paid in any event and taxes may be increased following the holiday because no losses are available to offset the profits. A similar situation can occur if the holiday starts when profits are first generated. Income may be sheltered that would have been eliminated in any case by the use of the tax losses. This may result in an overall increase in taxation in circumstances when the loss-carryforward period is short or the use of losses is restricted in some way. Tax laws usually specify that the holiday commences when profits first occur. However, they are often ambiguous as to whether this means the first year that is in itself profitable or the first year that cumulative net profits are positive.[6]

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

Another design question is the length of the holiday. Most of the holidays offered in transition countries have been of short duration, and, as discussed below, are of little benefit to long-term capital-intensive projects. Longer holidays would be of greater benefit; for example, there is some evidence in Asia and Hungary that the longer holidays succeeded in attracting some long-term investment.[7] However, the longer the holiday, the higher the revenue cost and

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[6]See the appendix for a detailed example of a number of these points.

[7]*See* OECD, *supra* note 2, at 89–101 (Hungary); Easson, *Tax Incentives for Foreign Direct Investment,* 9 Australian Tax Forum 387 (1992).

the greater the vulnerability to tax planning schemes.[8] The opposite problem arises when a tax holiday provision providing a lengthy tax-free period is repealed. Because an existing company can continue to take advantage of the holiday for which it qualified, new investment can be structured so as to use the corporate form of these existing companies, sometimes by bringing new investors in or even by selling the holiday company to new investors planning a substantial investment. It is therefore desirable, on repeal of a tax holiday, to stipulate that companies currently taking advantage of a tax holiday will cease to quality if a substantial change in the ownership of the company takes place. Such a provision would prevent at least the most flagrant abuses.

2. Investment Allowances and Tax Credits

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

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

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

The effects of an incentive scheme that is poorly structured and involves excessively high rates of incentive are demonstrated in the following example in which a service subsidiary is used to generate profits out of the tax system.

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[8]Because the holidays are limited in time, the typical avoidance scheme involves closing the business when the holiday expires and then forming a new company to carry on the business with the benefit of a new holiday period. The country authorities usually counter this maneuver by providing for recapture of the tax benefits if the business is closed. Such a rule can be avoided by keeping the business in operation, but at a lower level, and at the same time forming a new company. More sophisticated antiavoidance rules can be designed to attack this type of transaction, although enforcement is difficult.

The real cost to the company is $100. However, it establishes a subsidiary to supply it with the service. The subsidiary pays out the cost of $100 and adds a profit margin of $50 to the amount it charges the parent company. It is assumed that the parent is eligible for a tax credit of 40 percent on its cost of $150 and so earns a credit worth $60. The $150 is fully deductible against other income and this has a tax value of $60, assuming a 40 percent tax rate. The subsidiary adds the $150 to income and is allowed to deduct its costs of $100, for a net tax on the subsidiary of $20.

Tax Calculation in the Subsidiary		Tax Calculation in the Parent	
Income from parent	$150	Payment to Subsidiary	$150
Costs	$100	Value of tax deduction	$60
Taxable income	$50	Value of credit	$60
Tax payable	$20	Total tax benefit	$120

When the results for both companies are added together, washing out the intra-company transactions, the subsidiary has costs of $100 plus the $20 of tax. The parent has a tax deduction worth $60 plus a tax credit of the same amount, for a total tax benefit of $120, which just offsets the costs of the subsidiary. The tax system has therefore completely subsidized the company's expenditures.

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

An important design issue is what to do if the firm does not have enough taxable income in a given year to take full advantage of an incentive. In some countries the incentive is simply lost. This restrictive access to the incentive operates against firms that do not have other income, which is typical of new foreign investors and can effectively eliminate the benefits of the incentive for such firms. Additionally, unproductive arrangements may be devised solely to make use of the incentive; for example, an investment allowance can be transferred from a firm benefiting from a tax holiday to a taxable firm through the use of a lease. In effect, the firm obtains both incentives, and government revenues fall by more than the tax that the firm would have paid during the holiday. The use of leasing to transfer incentives is demonstrated in the following example, in which the operator can borrow the funds and purchase the machine directly. Because it cannot benefit from the deductions, it enters into an arrangement where the taxpaying firm borrows the money and purchases the equipment. The equipment is then leased to the operator, who then uses it in his or her business. The difference is that the lessor gets the accelerated deductions.

Table 1 shows that if the lease payment is set as the sum of the interest on the loan plus the principal repayment, the lessor just breaks even before taxes (see section of Table 1 headed "Accounting income"). However, the lessor is better off after tax because it has losses in the early years to shelter other income from tax. In fact, the lease payments would be arranged so that the tax benefits of the arrangement are shared between the private sector parties. The loser in the scheme is the government, which receives less income tax revenue than it otherwise would.

Table 1. Equipment Lease

(In local currency)

Year	1	2	3	4	5	6	7	8	9	10
Loan principal	100	90	80	70	60	50	40	30	20	10
Interest	10	9	8	7	6	5	4	3	2	1
Principal repayment	10	10	10	10	10	10	10	10	10	10
Accounting income										
Lease payment	20	19	18	17	16	15	14	13	12	11
Interest	10	9	8	7	6	5	4	3	2	1
Depreciation	10	10	10	10	10	10	10	10	10	10
Accounting income	0	0	0	0	0	0	0	0	0	0
Tax Position										
Lease payment	20	19	18	17	16	15	14	13	12	11
Interest	10	9	8	7	6	5	4	3	2	1
Accelerated depreciation	33	33	33	0	0	0	0	0	0	0
Taxable income	-23	-23	-23	10	10	10	10	10	10	10

3. Timing Differences

Timing differences can arise through either the acceleration of deductions or the deferral of the recognition of income. The most common form of accelerated deduction is accelerated depreciation, where the cost of an asset may be written off at a rate that is faster than the economic rate of depreciation.[9] It can take the form of either a shorter period of depreciation or a special deduction in the first year. The latter has a similar impact to an investment allowance in the first year, but differs in that the amount written off reduces the depreciation base for future years, and so the total amount written off does not exceed the actual cost of the investment. Rather, the deductions occur sooner than otherwise, providing a deferral of tax that is effectively an interest-free loan to the company from the government.

Important timing differences can occur in other, more technical areas. For example, incomes may not be realized until there is a sale of an asset, whereas certain costs are recognized immediately. A typical example is the current deduction of interest on an asset that is held for a period of time. A significant net after-tax rate of return can be realized on an asset whose pretax return equals, but does not exceed, the rate of interest on the funds borrowed for its purchase, simply because of the mismatching of the deductions and the income. These technical timing differences can often be more important than any explicit investment incentives for certain activities (e.g., in the case of timber growing).

[9] *See supra* ch. 17.

The technical issues with accelerated depreciation are similar to the issues of targeting and of carryovers that face investment allowances. However, accelerated depreciation avoids the problem of deductions that exceed the cost of the investment that occurs with an investment allowance.

4. Tax Rate Reductions

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

5. Administrative Discretion

A major design issue relevant for different types of incentives is whether incentives should be discretionary and granted only with the preapproval of the authorities.[10] A discretionary approach has a number of potential advantages. As the policy priorities of the government change, it is possible to tailor the incentives to support them, because fewer firms are affected by the changes, and problems of transition can be more easily handled. If there appears to be a risk of tax avoidance under the scheme, then the authorities can deny access to the incentive. Where the extent and the availability of the incentive are determined administratively, it may be possible to provide only that degree of incentive that is required to make the investment economic. This would improve the cost-effectiveness of the program by improving its targeting toward incremental investment.

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

While administrative discretion may not be useful, there are advantages to having a process of vetting and approving investments that do meet the criteria in the relevant legislation

[10]*See* vol. 1 at 62.

before the investor proceeds. Such a process is common in relation to tax holidays and allows governments to keep track of the extent to which the incentive is being used, assure taxpayers of their tax position, and amend the legislation where problems in the criteria for the incentive become evident.[11]

B. Comparison of Incentives

General tax incentives can differ markedly in a number of important ways, in particular in terms of the types of companies and activities that are likely to benefit from them, the time profile of the revenue impact on the government for any given level of incentive, the difficulty of administration, and the possibility of tax avoidance.

1. Beneficiaries

Tax holidays are of greatest value to firms and projects that make substantial profits in the early years of operation. Such enterprises are likely to be engaged in sectors such as trade, short-term construction, and services. Tax holidays are less likely to be of benefit to major capital-intensive projects, which do not normally make a profit in the early years. This has in fact been the experience of transition countries that have introduced tax holidays. Most of the beneficiaries of the tax holidays have been small firms, for example, real estate businesses, restaurants, and firms designed for short-term market exploitation, such as trade and woodcutting.[12] The tax holidays are open-ended in that their value depends upon the amount of profit earned. Arguably, the types of high-profit activities that benefit the most are the least in need of the incentive and would have occurred in the absence of the incentive. Thus, the bulk of the revenue forgone is likely to have had no beneficial impact on investment, and so the ratio of benefits to costs is likely to be low.

The experience of Asian countries with tax holidays directed toward export-oriented industries is also instructive. Low-cost assembly plants that are highly mobile can be the most affected by holidays. In a number of countries, plants were established to take advantage of a tax holiday; when the holiday expired, the plant was disassembled and moved to an adjacent jurisdiction to take advantage of the holiday offered there. The factor that made the project responsive to the incentive also limited the benefit to the country from the investment.[13]

Investment allowances, tax credits, and accelerated depreciation, in contrast, are specifically targeted at capital investment. Their revenue cost is constrained by the amount of capital that the firm is willing to put at risk. As such, they are of little benefit to the quick-profit types of firms that can take best advantage of tax holidays. Tax allowances are of greatest benefit to firms with income from existing operations. These firms can shelter a portion of such income from tax with the incentives earned on the new investment. Firms with low income or start-up

[11]*E.g.*, Economic Expansion Incentives (Relief from Income Tax) Act 1985 (Singapore) § 5.

[12]Some countries have excluded services from qualifying for tax holidays.

[13]*See* Easson, *supra* note 6, at 414.

firms cannot begin to take advantage of the incentive until the investment begins to earn income. Provided that a carryforward of the incentive is allowed, an investment allowance can operate in a manner similar to a tax holiday in that it can eliminate the tax liability of the firm in the early years of operation. However, the effect of a tax holiday differs, because it is limited in time but normally involves no upper bound on the amount of tax benefit that can be obtained.

General tax rate reductions differ from the other incentives in that they are not specifically directed toward new activity. Income from both existing and new operations is eligible for the incentive. Thus, when rate reductions are viewed as an incentive, they are less likely to be cost-effective than incentives that are related to the amount of new investment.

2. Profile of Revenue Impact

The revenue impact of tax holidays and investment allowances is, in theory, tied to the degree of new activity. Thus, the revenue impact is relatively small in the early years of the program and grows over time as more firms become eligible. A general tax rate reduction, in contrast, has significant up-front revenue costs because it applies to income from existing operations as well.

The pattern of revenue costs of accelerated depreciation is somewhat more complicated. Because accelerated deductions confer a timing benefit only, the government incurs a higher level of up-front cost to achieve the same incentive effect. The revenue cost actually falls over time, because in future years the tax benefits from further new investments are partly offset by the reduced deductions resulting from the acceleration of deductions on the old investments.

For investment allowances and accelerated deductions, the carryforward of deductions by firms that cannot fully use them can considerably raise the revenue cost over time. The experience of a number of industrial countries that provided broad-based investment incentives was that over one-half of incentives were earned by firms with no current taxable income. This reduced their cost in the early years of the program. However, there was a significant buildup over time of unused deductions from previous years. As the firms that had these accumulations began to earn income, they used the accumulations to offset income even though they were no longer making expenditures that were eligible for the incentives. The claiming of the deductions was merely delayed, and there was an increasing impact on tax revenues as the deductions from previous years were added to those being earned and used in the current year.[14]

The buildup of unused deductions and losses also reduced the predictability of the government's revenue stream. Firms that did not expect to be able to use their deductions in time sought ways of transferring them to firms with current taxable income, often in the form of transactions that traded a lower cost of financing for the tax deductions. Thus the deductions earned in one sector reduced the taxable income of another. Loss-trading mechanisms such as leasing were frequently used in this context.[15]

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[14]*See* Minister of Finance, Canada, The Corporate Income Tax System: A Direction for Change 17–18 (1985).

[15]*See id.* at 19–20.

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

3. Administration and Tax Avoidance

Auditing incentives provides an extra challenge to tax administrators, who must first verify that the incentive has been applied correctly. Verification can be difficult if complex calculations are involved. Second, administrators must ensure that the activity or firm actually qualifies for the incentive. This process can be complicated if concepts and definitions are vague or ambiguous or, as for foreign-owned firms, the records establishing the eligibility of the firm are in another country. (This problem is compounded by the limited range of tax treaties for many developing and transition countries, which means they do not have access to the exchange-of-information facilities usually contained in treaties.) Third, tax officials must ensure that the amounts eligible for the incentive are correctly reported, for example, that the value of a machine or service has been transferred at its fair market value. If the transaction occurs across borders, particularly among related parties, this task can be difficult. The need to carry out these audits and assessments essentially to verify that no tax, or a reduced amount, is payable diverts resources from other administrative tasks, which can be ill-afforded, given the shortages of trained staff that exist in most developing and transition countries.

Tax holidays have been particularly susceptible to tax planning, much of which is especially problematic for taxation authorities. Tax planning can lead to considerable revenue leakage, which can exceed the revenue forgone from incentives received by legitimate activities. This outcome further reduces the cost-effectiveness of tax incentives. The tax avoidance strategies, which are often used in combination, include fictive foreign investment. Tax holidays in a number of countries have been directed at firms with a high enough percentage of foreign ownership. Considerable tax revenue seems to have been lost from the creation of fictive foreign-owned companies that carry on what is in fact a domestically owned business. One way of doing this entails transferring funds from a domestic enterprise to a company incorporated offshore which in turn reinvests in the home country as if it were a foreign-owned company. The investment thus qualifies for the incentive. It depends upon how the law is written whether this type of transaction is tax avoidance or evasion.[16] In either event, it is difficult for tax authorities to detect such activity on audit, especially if the investment appears to originate in a tax haven with strict secrecy laws.

Furthermore, the existence of a tax holiday introduces the possibility of transferring profits from operations that do not qualify for the holiday to a firm that does. For example, a domestic firm can transfer a small part of its operation to a joint venture with a foreign-owned company; the joint venture qualifies for the incentive; the original domestic company transfers income to the joint venture by manipulating the allocation of costs and the charges made on transactions between the firms such as the domestically owned company selling intermediate

[16]For a discussion of the meaning of these terms, *see* vol. 1 at 44–45.

products to the joint venture at a price that ensures that the entire profit from the transaction arises in the joint venture. Other costs, such as financing costs, can be borne on behalf of the joint venture by the domestically owned company. These types of transactions are difficult for tax authorities to detect, and even harder to successfully challenge.

Nor is it easy to establish what is a new operation for purposes of qualifying for the tax holiday. A new corporation can be established that then purchases the assets of an existing operation in order to qualify for the incentive, even though no new activity is occurring. This device has occurred in some countries in combination with the above types of tax avoidance. In other areas, such as the construction industry, new firms can be established for each new project, thus maintaining perpetual access to the holiday.

Tax holidays also put the revenues of adjacent jurisdictions at risk. Exporting firms would ordinarily pay tax on their profit from the sale in the country. However, if these firms establish transshipment companies in an adjoining state that provides a tax holiday so as to purchase the goods from the exporting company and then sell them to the actual purchaser in the destination country, they can avoid taxation through transfer pricing. To accomplish this, the goods are sold at cost to the transshipment company, so that all the profits on the sale are transferred to this company to be sheltered from tax by the tax holiday.

A number of developing and transition countries have attempted to curtail these abuses by stipulating that the foreign investment must exceed a specified value in order to qualify for the incentive. While such restrictions may deter some small operators, they are unlikely to prevent tax avoidance. Firms may contribute over-valued capital goods as part of their initial capital contribution to achieve the threshold. There are usually no restrictions on the use of the capital contributed under such a restriction and it would be hard to impose them effectively. Accordingly, firms can effectively repatriate the funds in a number of ways, such as through nonrecourse loans, offshore deposits, and returns of capital. Here the thresholds impose no effective constraint on tax avoidance.

The other forms of incentive apart from tax holidays are also subject to tax planning. The scope is somewhat more limited for investment-related incentives at moderate rates. The amount of the incentive that can be earned has an upper limit related to the amount of the expenditure and, unlike a tax holiday, is not as exposed to the shifting of large amounts of profits. Problems can occur, however, especially with assets transferred from related offshore companies. There is a motivation to overvalue the purchase price of the asset to maximize the incentive. Clearly, this motivation increases as the rate of the incentive rises. As noted above, at high rates of incentive, this problem can occur even within a country if the rate of incentive leads to a value of tax deductions that exceeds the value of the expenditure. It is possible to increase the benefits to the enterprise on a transfer of assets or services between related companies simply by increasing the price of the item transferred. The other issue that can arise in these circumstances is multiple access to the incentive through progressively moving the asset among a group of companies. Recapture rules and capital gains taxes can address this problem in the case of accelerated depreciation because the increased deductions of the purchaser are offset by the reduced write-offs of the seller. For investment allowances and tax credits, the problem can be dealt with through fairly simple antiavoidance rules, such as providing the incentive only for first use of the asset in the country.[17]

Low tax rates for particular activities suffer from many of the transferring and targeting avoidance problems that arise with tax holidays. For significant rate reductions, taxpayers will make considerable efforts to shift income to the company with lower tax rates, for example, by shifting debt within a corporate group. In addition, firms will attempt to characterize their activity as qualifying for the incentive.

C. Minimizing Problems of Incentives

The overwhelming experience of transition countries and, to a lesser extent, of developing countries with tax holidays has been that they are particularly susceptible to tax avoidance and have been ineffective in attracting FDI. Part of the problem with attracting foreign direct *investment* is that a holiday is only indirectly linked to investment. It is tied to the establishment of a new enterprise and the amount of the incentive depends not on the size of the investment, but on the profits that are made during the initial years of the enterprise. This is at the heart of both the tendency for holidays to be used by firms making short-term investments and the various tax avoidance schemes that have been described. These problems are significantly reduced with investment allowances and credits, and so these types of incentives are likely to perform better if the goal is to promote productive investment.

1. Investment Allowances and Credits

Nonetheless, experience has shown that investment-related incentives have their own set of problems. A number of guidelines should be followed if the incentives are to be as free from abuse as possible. As the examples of tax avoidance activities demonstrate, the problems associated with investment allowances and credits are most evident at higher rates of allowance or credit. Therefore, the rates of benefit offered should be moderate. Moreover, attempts to target the incentives either too finely or at vague objectives are counterproductive because they introduce complexity and uncertainty for both the taxpayer and the tax administrator. If the taxpayer cannot be certain of the eligibility of an expenditure for the incentive, its effect on behavior is reduced significantly or even eliminated. Therefore, the investments eligible for the incentive should be clearly defined and the rules kept as simple as possible.

In many countries, the principal justification for an incentive will be to help create a basic amount of market-oriented activity. As the market develops and foreign firms become familiar with a country, the rationale for an incentive will be reduced. This suggests that incentives should be made valid for a set time with a preannounced expiration date. This automatic expiration is known as "sunsetting" and ensures that the government must review the incentive and take steps to continue to make it available.

[17] *See* CYP IT §12(2)(b) (investment credit for new equipment made in Cyprus or new or secondhand equipment imported from abroad); HUN CIT § 13(4) (incentive allowed only for first use of asset in country).

With upfront incentives, the same asset is often sold and resold to produce multiple access to the incentive. Appropriate recapture and capital gains rules reduce the problem and should be in place.[18] However, for an incentive such as an investment tax credit, other rules are needed to ensure that an asset receives the incentive only once. One approach is to "clawback" the incentive if the asset is resold, perhaps within a time limit.[19] This approach requires a complex tracking of assets. A simpler approach is to allow the incentive only for the purchase of assets that have not been previously used.[20] To allow for the use of secondhand assets from abroad that might embody technology that is unavailable in the country, the rule could be extended to allow the incentive only for the first use of the asset in the country.[21]

The price of assets purchased from abroad from a related person may be inflated to maximize the write-offs for depreciation purposes. Adding an investment incentive on top of depreciation increases the attraction of such tax avoidance. Overcoming this problem is not simple, but there are some guidelines that will help. The law should stipulate that transactions between related parties be conducted at fair market value.[22] Such a provision at least establishes a legal basis for attacking the transaction and will curb somewhat the aggressiveness of major companies. Targeting the incentive to assets, such as machinery and equipment, that have some external secondhand market transaction for comparison also assists. Intangible expenditures like know-how and business services are typically hard to value.

The key to auditing any transaction is information. Typically, the taxpayer has it and the tax administrator does not. This problem is compounded in the case of foreign taxpayers because it is typically more difficult for tax authorities to obtain information from a taxpayer with offices located abroad. This problem is addressed internationally through the exchange-of-information provisions in tax treaties.

2. Tax Holidays

If tax holidays are used, the potential for their abuse can be curtailed in a number of ways. As noted above, holidays are linked more to the establishment of enterprises than to the level of investment. The problems described suggest a number of restrictions that eliminate some of the most obvious abuses and direct the holiday incentives toward the creation of new businesses rather than indirectly attempting to attract new investment. A government may pursue this objective both in attracting foreign firms and in promoting the establishment of new private sector activity domestically.

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[18] *E.g.,* USA IRC § 1245.

[19] Clawback (known as recapture in the U.S.) means that the taxpayer must repay the incentive in the form of an increase in tax. *E.g.,* USA IRC §§ 47, 50; HUN CIT § 13(3) (investment credit clawed back if asset transferred or leased within three years).

[20] *E.g.,* USA IRC § 48 (1986).

[21] *See supra* note 16.

[22] *E.g.,* USA IRC § 482.

A frequently encountered problem is the transfer of existing business assets to a new firm that qualifies for the holiday. Firms whose holidays are expiring may transfer assets to refresh the holiday. This practice suggests that the holiday should be restricted to firms the bulk of whose assets has not previously been employed in the country. This ratio of new-to-the-country assets should be quite high, say, 90 percent. The assets so restricted would not include buildings, given that existing buildings may be renovated for a new use. This restriction would also deny the holiday to firms that simply change their form, such as through privatization.

The second restriction would address the problem of transfer pricing and focus the incentive on the objective of creating new enterprises. It would deny the incentive to any company related to a company operating in the country that did not itself qualify for the holiday. Holidays are frequently targeted to industries that are internationally mobile, such as manufacturing, and denied to firms that are engaged in activities that are more tied to the country, such as distribution and wholesale trade. The question arises as to what happens if a firm is established for manufacturing but carries on ancillary activities that do not qualify for the incentive. A strict targeting to manufacturing could operate in conjunction with the previous restriction to deny the holiday in this situation. Another approach is to allow the holiday provided that over one-half of the assets or revenues of the company are used in the desired activity. If this is done, the holiday benefits should be restricted to income from the targeted activity. Profits for each activity could be separately accounted for. Alternatively, because separate accounting is complex and subject to manipulation, a simple formula approach can be used to determine the proportion of profits to qualify for the holiday. This proportion can be based on some overall figure, such as wages and salaries employed, total revenues, or assets.

3. Low Tax Rates

Regimes applying reduced tax rates to certain activities or enterprises require a number of rules to minimize tax avoidance. A typical example can be given of low tax rates applied to income earned by small businesses.

The first problem is to define small businesses in relation to a given threshold. The threshold can be measured in terms of assets, capital, number of employees, or total sales. The choice among these criteria, which can be used in combination, will depend in part on the type of business being targeted and on the compliance and administrative costs that are entailed. Seemingly simple concepts such as number of employees can be avoided through the use of employee leasing arrangements, where staff are employed not directly by the company, but rather by a special purpose employment firm that “leases” the employees to the company. Similarly, businesses can avoid asset restrictions by leasing rather than purchasing assets.

Whatever criteria are chosen, it is crucial to introduce a test that applies to all the companies in a related group. Otherwise, it is a simple matter to break up an operation so that the constituent parts meet the criteria. Unfortunately, applying rules to determine whether companies are related can be very complicated and a constant source of avoidance activity.

Another approach is to simply provide a threshold amount of income that is subject to the lower tax rate, effectively a progressive rate schedule for corporations.[23] A certain amount of the incentive will accordingly be earned by larger corporations. One possibility is to claw back this incentive for income over another threshold.[24] This effectively implies that middle levels of income face a special higher marginal rate of tax. As with size tests, rules are needed to allocate the thresholds among related groups of companies.[25]

Care must be taken to target the low tax rate to appropriate types of activity and to prevent it from being used to avoid taxes that should be paid at the personal level. A low tax rate that applies to all small business income opens an opportunity for individuals to place their investment holdings in a corporation to obtain the benefits of the lower tax rate. Accordingly, rules are required to restrict the incentive to active business income.[26] The distinction between active and passive business is notoriously difficult to maintain, and so arbitrary rules, such as requiring a minimum number of employees to qualify as an active business, may be needed.

IV. Special Purpose Tax Incentives

A serious disadvantage of offering tax incentives to attract investment is that, to the extent that enterprises that would have invested in any event claim them, tax revenue is lost without any corresponding benefit to the host country. These costs can, in theory, be reduced if means can be found to target the incentives to particular desirable activities or to projects that would not have occurred without the incentive. Countries have employed a number of techniques to achieve this better targeting. These include linking the incentive to specific low-growth regions, tying the incentive to particular objectives—such as employment creation, technology transfer, or export promotion—the use of free trade or export promotion zones, and providing for administrative discretion. All these approaches have potential advantages, but are likely to give rise to substantial problems in implementation.

One general problem with special incentives is that they inevitably lead to pressure for similar treatment from other deserving sectors. This pressure is much more difficult to withstand once some targeted incentives have been given. In a number of countries, both developing and industrial, the incentives have spread over time to other activities, and removing the incentives once the reason for them has gone has been difficult politically. While any one targeted incentive may not involve a significant revenue cost, the total for all the resulting incentives can sharply erode government revenues from the business sector.

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[23]While progressive as far as corporations are concerned, the scheme is likely to be quite the opposite as far as the owners of capital go, favoring wealthy individuals who invest in small businesses. Very small businesses owned and operated by low-income individuals are not likely to take corporate form.

[24]*E.g.,* USA IRC § 11(b).

[25]*E.g.,* USA IRC § 1551.

[26]*E.g.,* USA IRC §§ 541–547.

The following discussion focuses on issues peculiar to special purpose incentives. It should be noted that many of the comments made on general incentives in the preceding section apply here also.

A. Regional Development

Regional development is a common objective of tax incentives in industrial countries and elsewhere. Typically, investors in designated regions—usually the more remote, economically less-developed regions of a country or regions with high levels of unemployment—receive tax holidays, investment allowances, or accelerated depreciation.[27] Experience demonstrates that relatively little new activity is generated in the targeted region relative to the revenue cost. Insofar as the incentives have any effect at all, the chief effect is to divert investment away from its optimum location.[28] The same types of transfer pricing and other avoidance transactions discussed above also typically arise, particularly with firms whose operations are based both in the targeted regions and elsewhere in the country.

B. Employment Creation

Incentives may be directed to promote the establishment of labor-intensive industries or the employment of particular categories of workers, such as young persons, the disabled, or the long-term unemployed.[29] Many of the issues that arise with investment incentives, such as incentives going to employment that would have occurred in any event, are also associated with employment incentives. Moreover, incentives targeted to particular types of employment or increases in the level of employment are subject to manipulation and administrative complexity.

C. Technology Transfer

Many countries have sought to attract investment that would bring in advanced technology, or research and development activities, by granting tax incentives, usually with little success. It is frequently difficult for tax authorities to determine when a particular technology qualifies as "advanced" or "appropriate," and difficult to define precisely what constitutes "research." In most cases, the investor is likely to be receiving a tax break for doing what it would have done in any event, and it is the experience of many developing countries that technology that is introduced is rarely "transferred" to the host country. Because of the generally unsatisfactory experience with tax incentives in this area, a number of countries are turning to nonfiscal inducements, such as the establishment of Science Parks.

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[27]*E.g.,* HUN CIT § 13(2); DEU DDR-IG, DEU FGG, DEU InvZulG.

[28]Minister of Finance, Canada, Economic Effects of the Cape Breton Tax Credit (1990).

[29]*E.g.,* USA IRC § 51 (work opportunity credit); RUS PT § 7(2) (tax rate reduction for enterprises where 70 percent of workers are disabled); HUN PIT § 21 (tax deduction for agricultural enterprises employing handicapped persons).

D. Export Promotion

There is evidence, especially from developing countries in Asia, to suggest that incentives to attract export-oriented investment tend to be more effective than most other forms of investment incentives.[30] Certain types of export-oriented enterprises, notably those in the textile and electronics sectors and other labor-intensive assembly industries, are especially sensitive to taxation. Such industries do not rely much on local sources of material supply and do not gear sales to the domestic market. Rather, they are attracted to low-cost environments. While the most important local cost for such industries is labor, taxes may also be a significant component, and so tax reliefs may be especially attractive to such firms. Investment incentives are commonly provided in the form of tax holidays or special investment allowances for firms designated as "export oriented." They may be exempted from tax on a proportion of their profits corresponding to the proportion that export sales bear to total sales, or they may be allowed a generous deduction for expenditures aimed at export promotion. Some of these policies have been successful in attracting foreign investment and have, at least in the short term, had relatively little cost in terms of tax forgone, since much of the investment would not have been attracted without tax exemptions.

The benefits of such investment, however, are questionable. As noted above, many of the enterprises attracted are footloose, and tend to move on as soon as tax holidays expire. There tends to be little in the way of creation of linkages to domestic firms, little transfer of technology, and little sourcing of local raw materials. Moreover, the success of such operations depends to a large extent on the reaction of the countries that provide the sources of capital and the markets for the exports. Many of the incentives that could be offered to attract export-oriented investment may be contrary to WTO subsidy rules;[31] for other operations to succeed, home countries must be prepared to grant "tax-sparing" treatment in their double taxation treaties (see below). With the heightened competition in world markets, these issues are likely to be more important in the future.

E. Free Trade or Export Processing Zones

Export processing zones (EPZs) are closely related to promoting export-oriented investment. These zones, also called customs-free zones, duty-free zones, free trade zones, or special economic zones, have over the past thirty years or so been established in more than fifty countries in all parts of the globe, especially in developing and transition countries.

The distinguishing feature of these zones is that they provide a discrete environment in which enterprises (usually both foreign and domestically owned) can import machinery, components, and raw materials free of customs duties and other taxes for assembly, processing,

[30] *See* Easson, *supra* note 6, at 395, 429.

[31] *See* on this problem especially for the strengthened subsidy rules flowing from the Uruguay Round of GATT negotiations, Buchs, *Selected WTO Rules and Some Implications for Fund Policy Advice*, IMF Working Paper WP/96/23; Pearson, *Business Incentives and the GATT Subsidies Agreement*, 23 Australian Business Law Review 368 (1995); Perry, *Taxes, Tax Subsidies and the Impact of Trade Agreements*, 63 Review of Marketing and Agricultural Economics 155 (1995).

or manufacture, with a view to exporting the finished product. Normally, products from an EPZ sold on the domestic market are treated as imports and are subject to import duties and taxes.

The country establishing an export processing zone is primarily interested in earning foreign exchange from export sales, although it frequently has additional objectives, such as creating employment, attracting technology, or promoting regional policy. Incentives to attract foreign investors to the EPZs commonly take a variety of forms.

Exemption from customs duties and other taxes on importation is the essential feature of EPZs. Such exemptions apply to materials and components that are imported and reexported and are often expanded to capital goods that firms use in the production process. Exemption from such taxes is often one of the more important tax incentives offered to foreign investors because of the immediate impact upon costs. To the extent that zone products are reexported, exemptions appear to be entirely consistent with the provisions of the GATT and, as far as product taxes are concerned, produce essentially the same result as the zero rating of exports under a value-added tax. The chief advantage of the zonal exemptions is in terms of administration and cash flow. Such measures can be seen as removing impediments rather than providing a special incentive to encourage exports.

Much of the investment attracted to EPZs is highly mobile, cost conscious, and tax sensitive, and additional tax incentives for investment are frequently offered in the zones. In some cases, special incentives such as tax holidays apply for investment in the zone; in others, zone enterprises qualify for the same incentives that are provided—notably for export-oriented investment—elsewhere in the country. The concerns raised above in relation to incentives for export-oriented investment apply equally to zonal incentives of this nature.

It is difficult to evaluate the success or failure of EPZs.[32] In a few countries, they have generated substantial foreign currency earnings, but in other countries they have proved a dismal failure. Between success and failure are instances where it is difficult to say whether the enhanced foreign exchange earnings have been worth the costs of establishing the zones. Real (net) foreign exchange earnings are often but a small proportion of total export sales because most components and raw materials are imported; textile manufacturers in some zones have even imported such items as thread and buttons. Employment creation has been impressive, but has often had little impact on local unemployment because the great majority of jobs have been filled by young women who had not previously been part of the workforce. Technology transfer has usually been negligible and only a few countries have established substantial backward linkages with domestic producers. Attempts to use EPZs as an instrument of regional development policy have mostly failed. Because tax incentives have been the rule in most EPZs, very little tax revenue has been generated directly, although EPZ investors have undoubtedly contributed to revenues through employment creation, in the form of payroll taxes, income tax on salaries, and sales taxes on spending by employees.

It is instructive to note that the countries in which EPZs have tended to be most successful have been those that have concentrated on generating foreign exchange earnings

[32]United Nations, The Challenge of Free Economic Zones in Central and Eastern Europe (1991).

without attempting to pursue ancillary objectives such as regional development and that have emphasized removing obstacles to export processing rather than providing investment incentives as such. They have also tended to be countries in which the general domestic tax climate has been relatively hospitable to investment.

To the extent that tax incentives, other than exemption from taxes and duties on imports, are employed, a potential advantage of EPZs is that they generally localize access to the incentives[33] and so, in theory, allow a closer monitoring of the operation of firms. However, they do not eliminate the problems already referred to. There are various ways to shift profits from operations outside the zone to firms that are based in the zone through intragroup transactions, leading to the effective leakage of zone benefits to ordinary domestic activity.

Finally, the caution recorded in relation to tax incentives for export promotion bears repeating in the context of EPZs. While there would seem to be nothing objectionable in principle in providing exemption from customs duties and taxes on importation,[34] other tax incentives directed specifically at export promotion may run contrary to the GATT and may invite countervailing measures that could negate any advantages obtained from the establishment of the zones.

V. International Aspects of Tax Incentives

Some international issues have already been noted in the previous discussion, for example, transfer pricing and fictive foreign investment. Where FDI is involved, however, international tax issues are pervasive.[35] Accordingly, this section first looks at some additional tax incentives that are internationally focused, such as special relief from international withholding taxes. It then discusses the interaction of the tax systems of the investor and the place of investment and concludes with the issue of tax competition.

A. Incentives with an International Focus

1. Incentives for Foreign Investors

Incentives offered in many developing and transition countries are often tied to foreign investment. These can take the form of special tax holidays under the income tax or special relief from customs duties or turnover taxes. The incentives are sometimes directed at firms that are 100 percent owned by foreigners and at other times offered to joint ventures, often with as little as 30 percent foreign ownership.

[33]They do not always do so—in Cameroon, EPZ benefits are offered to saw mills scattered around the country.—L.M.

[34]There is, however, the problem of smuggling to the domestic market.—L.M.

[35]A detailed description of the rules necessary for the international operation of the income tax is provided in ch. 18 *supra*. The discussion here assumes some familiarity with the international chapter.

The attraction for policymakers is that the targeting dramatically reduces the revenue costs of offering the incentives. However, the question arises as to why it would be government policy to favor foreign firms over domestic firms. The discrimination leads to resentment, which is likely to reduce voluntary compliance with the tax system. Domestic firms will lobby, with justification, to have the incentives extended to them. This pressure can be difficult to resist, and so the incentives may spread, leading to a deterioration of the domestic tax system. Moreover, as seen above, the restrictions often do not work. Domestic firms are induced to enter into tax avoidance strategies that have proven difficult for tax authorities to counter.

2. Relief from Cross-Border Withholding Taxes

Among their measures to encourage FDI, many developing countries provide tax relief from withholding taxes on certain interest and royalties and sometimes on dividends on foreign parent companies' investments in subsidiaries. The international chapter of this book explains how interest and royalties can be used for profit stripping. Removal of cross-border withholding taxes on these forms of income can increase the benefits from such tax planning. Such incentives can also be subject to many of the forms of planning outlined above in relation to tax holidays, to which they are closely related (often tax holidays for foreign direct investors and dividend withholding tax relief are applied to the same project).[36]

Levying such taxes can also simply increase the cost of funds and technology for local firms. In this case, the case the argument for relief from withholding tax is stronger, and carefully drafted provisions may be worthwhile. Such measures are not incentives as such, but rather remove barriers where the international tax regime produces more tax than would occur in purely domestic cases. Conversely, relief from withholding tax on dividends for portfolio, as opposed to direct, investment is often effectively eliminated by the tax system of the investor's country of residence. These issues are dealt with in the chapter on international taxation.[37]

Viewed as an incentive, relief from withholding taxes for a direct investment is poorly targeted in that it delivers a benefit to the investor only on repatriation (i.e., at the end of the day, not up front) and encourages repatriation whereas for the country where the investment occurs, it is better if the income generated is reinvested rather than repatriated.

B. Tax Incentives and Relief from Double Taxation

To determine the tax treatment of FDI, it is necessary to look beyond the country where the activity takes place (the source country). It is also necessary to consider the tax treatment in the country of the foreign investor or parent company (the residence country). There are often further tax consequences in the residence country on income that is earned and taxed in the source country. This can lead to an interaction between the tax systems of the two jurisdictions

[36] *See* Easson, *supra* note 6, at 418.

[37] *See supra* ch. 18, sec.VI(F).

that modifies the impact of a tax incentive compared with what it would be in the source country alone.[38]

1. Relief from Double Taxation in the Residence Country

An investment can take in a number of forms. The two basic methods are through a branch and through a subsidiary. A branch is simply a division of the foreign company making the investment, but it is not a separate legal entity. Accordingly, the branch's profits are ordinarily taxed as they are earned in the residence country under the principle of worldwide taxation.[39] Investments can also be channelled through a subsidiary, which is a separate legal entity, and whose income is usually not included in the income of the foreign parent until it is repatriated as a dividend.

Because a subsidiary is the normal form of investment for nonfinancial institutions, the balance of the discussion will focus on the treatment of repatriated dividends. Much of the discussion also applies to income earned in branches, except the residence-country tax consequences occur as the income is earned, rather than being deferred until it is repatriated as a dividend. Essentially, two types of tax treatments are applied to dividends paid to the residence country. These have very different implications for the potential effectiveness of tax incentives provided by the source country.

The first type of tax treatment is the foreign tax credit method. Under this method, the residence country applies its tax regime to the income when it is repatriated, but allows a credit for any foreign taxes paid to the extent that they do not exceed the amount of residence country tax that would be levied on the income. This system effectively means that the source country is allowed the first opportunity to tax the income, but that the residence country will tax the income if it is not fully taxed in the source country. When there is only one source of foreign income, the implications for tax incentives are clearly negative. To the extent that the incentive results in a tax liability that is less than the tax burden that would be applied in the residence country, then the benefit given is taxed back when the income is repatriated to the residence country. There is simply a transfer of tax revenue from the source country to the residence country. A number of important sources of FDI use the foreign tax credit method, for example, Japan, the United Kingdom, and the United States.

The alternative basic system of taxing foreign-source income is the exemption method, employed by countries such as France, Germany, and the Netherlands. Under this method, there is no further tax on the repatriated profits, and so the effective taxing back of the incentive that occurs under the tax crediting method does not occur. In fact, simple categorization of countries is difficult because many countries incorporate aspects of both systems depending upon the type of income and its country of source. A foreign tax credit is applied in some of these countries in

[38]For a detailed analysis of the relation between tax incentives in developing countries and taxation in capital-exporting countries, see Timo Viherkenttä, Tax Incentives in Developing Countries and International Taxation (1991).

[39]An exception is where the residence country uses the exemption approach for foreign-source business income. *See supra* ch. 18.

certain circumstances, such as when no tax treaty exists. Some exemption systems are structured on the basis of a "subject-to-tax" test or a "comparable tax" test.[40] This means that if a tax holiday exists the exemption is not available in the residence country and a credit system applies in its stead. In this event, the comments made in relation to credit systems become relevant.

In examining the extent of the reversal of source-country incentives through foreign tax credits, a number of qualifications need to be made to the simple case outlined. With taxation only on repatriation, to the extent that the earnings are retained in the source country and reinvested, they are not subject to residence-country taxation. Thus, adverse tax consequences can be deferred until the time of repatriation. There has been much theoretical discussion about the true impact of this system. Because the tax on the distribution will occur when the income is repatriated, firms should take it into account in making their investment decisions. However, there is little doubt that firms act as if the deferral inherent in taxation only on repatriation matters to them. Thus, to the extent that the adverse tax consequences can be delayed they are less problematic to the companies. Levying tax on income only when it is repatriated has implications for the design of tax incentives, namely, that incentives in the income tax of the source country are more likely to be effective than incentives that are provided at the time of repatriation, such as withholding tax relief. These latter incentives are more likely to lead simply to an increase in the other country's tax revenues.

The next qualification is that the tax crediting systems of most countries are generally limited to the amount of tax that would have been paid on the foreign income in the residence country. This limit has two basic methods of calculation: country by country or worldwide (i.e., aggregating all foreign taxes levied on the firm for calculating the limit). Tax reforms in industrial countries over the past decade have, in some countries, lowered the overall domestic tax burden on foreign-source income below that of the amount of tax in the source country. This places many firms, particularly in the United States, in what is known as an excess foreign tax credit position. Taxation in the country of residence has been completely eliminated, and a residual source-country burden remains. In such circumstances, if the residence country operates a worldwide foreign tax credit limit, relief from source-country taxation does not result in a transfer of tax liability to the residence country and so is of benefit to the firm.

For a branch of a foreign company, the foreign tax credit limit can produce worse results for the taxpayer in the presence of incentives. In particular, if the residence country has a credit system without a system of carryback for excess foreign tax credits, reduced taxation in the source-country in the early years of the investment may actually result in overall increased source and residence taxation over a number of years, especially for incentives like accelerated depreciation that affect the timing but not the amount of tax deductions. The residence country collects tax on the investment in the early years because of the low source-country tax arising from the acceleration of the depreciation, but may not fully credit the higher source-country tax in later years because of its foreign tax credit limit. A subsidiary can usually overcome this kind of problem by planning the timing of dividend payments.

[40] *E.g.,* AUS ITAA § 23AH.

The final qualification is that foreign tax credit regimes are difficult to operate effectively. In particular, if offshore financing companies are used, taxation in the residence country can be deferred indefinitely. Dividends paid from the source country can be routed to a third country that does not tax them (usually tax havens). Through tax planning, multinational firms can reduce or eliminate both source and residence taxation on FDI in many cases, as discussed in the international tax chapter under the heading of international tax avoidance and evasion, in which event the existence of tax incentives in the source country and the type of relief system in the residence country become largely irrelevant.

Nevertheless, despite these qualifications, many companies do take into account in their tax planning the eventual tax consequences in the residence country.[41] Whether this approach measures the actual impact residence-country taxation will have after all tax planning routes have been exploited or whether it is a simplification used in the evaluation of projects is not clear and certainly varies depending upon the situation of the foreign investor. Overall, this approach by multinational firms does appear to reduce the effectiveness of tax incentives.

2. Tax Treaties and Tax Sparing

One method that avoids the problem of the residence country taxing away the benefit of a source-country tax incentive is "tax sparing." Under tax sparing, the residence country treats the income remitted as if it had been fully taxed and had not benefited from the tax incentive. This method ensures that the full benefit of the tax incentive goes to the investor and is not simply transferred as tax revenue to the residence country. Tax-sparing is usually granted under tax treaties. It is traditionally granted by industrial countries, which are most likely to be the residence country in the flow of international investments, to developing countries, which are more likely to be source countries. In more recent times, tax-sparing provisions have appeared in treaties concluded between industrial and transition countries, and can also appear in treaties among developing and transition countries.

The main role of tax-sparing provisions is to allow the source country to provide tax incentives without the concern that it is simply transferring tax revenue to the other country and so can be seen as preserving the sovereignty of the source country. This gives the source country more freedom in designing its incentive regime. The fixed-relief method described below can go further and act as an explicit subsidy or foreign aid program to the source country (or more specifically for investors in that country), where credit is provided by the residence country for more tax than is forgone by the source country.

When tax treaties are drafted, the tax-sparing provision is usually inserted in the article that provides for relief from double taxation. Tax sparing comes in two main forms. One form, which is more common and may be referred to as the contingent relief method, gives relief only for source-country tax that has actually been forgiven as a result of the tax incentive. In relation to a residence country that uses the foreign tax credit, it thus becomes necessary to identify the incentive and provide a method of calculation of the amount of tax forgone. This can be done most readily for simple reliefs in the form of tax holidays, low tax rates, and withholding tax

[41] The consultations carried out in writing OECD, *supra* note 2, confirmed this approach by multinational firms.

reliefs. The true tax benefits of other incentives, such as tax credits, investment allowances, and, in particular, accelerated depreciation, are more difficult to calculate and so are not covered by this form of tax-sparing relief.

The other form of tax-sparing relief, which is less common and is usually confined to withholding taxes on passive income may be referred to as the fixed-relief method (or the matching credit). With this method, the taxpayer is usually deemed to have paid tax at a specified rate on a particular form of income. This approach avoids problems of identification of incentives and quantification of tax forgone. However, its operation is not limited to tax forgone under a specific incentive regime, and the effect on residence-country taxation depends on the relative rates of source-country tax on the specified income and the fixed rate of relief. This last feature no doubt explains why the fixed relief is usually confined to passive income. Tax treaties in this area specify an upper limit for source-country taxation and provide relief through a foreign tax credit (even in countries that generally use the exemption method for business income). Thus, it is a relatively easy matter to match the rate of credit with the limit on source-country taxation. Nonetheless, the source country may have lower rates of tax generally on the kind of income specified than the upper limit of the treaty, in which event the fixed relief more than compensates for any tax forgone under a tax incentive. In a few cases, this outcome is created by the treaty itself through specifying a fixed-relief rate above the withholding rate limit on passive income.[42]

While the fixed-relief method has the capacity to deal in a general way with incentives like accelerated depreciation where tax forgone is difficult to identify, it is rarely applied to business income, presumably for reasons just given. The failure of the contingent and fixed-relief measures to deal with such kinds of incentives can produce perverse results. Although the discussion earlier in this chapter suggests that tax holidays and elimination of cross-border withholding taxes are relatively less effective incentives than accelerated depreciation, the international tax system effectively favors the former over the latter, which probably explains why they are common in developing and transition countries.

In specifying the amount of unpaid tax that may be credited under the contingent relief form of tax sparing, the tax treaty usually refers specifically to the incentive legislation by name and section so that the particular incentives and the amount of tax forgone may be calculated. Not all countries, however, are willing to provide tax-sparing provisions, and a number of countries that have offered them in the past are reconsidering their position—the United Kingdom has indicated that it will offer them on a restricted basis in the future. The change in attitude is exemplified in part by the now common use of sunset provisions for tax sparing, often containing a five-year life with the possibility of extensions if both countries agree. The recent shift has been brought about partly on policy grounds (based on the failure of incentives to achieve the benefits claimed) and partly on antiavoidance grounds.

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[42]Brazil is one country that often exhibits this feature in its treaties; Indonesia and Malaysia use the fixed- relief method, but the rate is usually matched to the maximum withholding rate, *see* Vann, Tax Treaties: Linkages Between OECD Member Countries and Dynamic Non Member-Economies 57-87 (1996); " Brazil-Canada income tax treaty, art. 22(3); Brazil-France income tax treaty, art. 22(2)(d); Indonesia-Japan income tax treaty, art. 23(2).

For example, in the case of a tax-sparing credit for interest received from a developing or transition country that has a special incentive relief in relation to withholding tax on the loan, it is possible to shop for an appropriate tax-sparing treaty and to use the deemed tax-sparing credit to reduce the tax on income derived locally. Thus, a financier based in a third country lends to two subsidiaries in the selected country with the necessary tax-sparing treaty. One of the subsidiaries invests in the other by way of share capital with the loan funds it has received, and that other subsidiary then lends the total funds to the enterprise in the developing or transition country. The on-lending subsidiary receives more interest than it pays (because part of the ultimate loan funds has been routed into it as share capital) and so has a tax liability in the country where the subsidiary is based. The amounts of the loans have been so planned that this tax liability is offset by the deemed tax-sparing credit (no tax having in fact been paid in the developing or transition country on the outgoing interest). The subsidiary that invested the loan funds from the parent in the other subsidiary has no income from the transaction, but can use interest deductions against other income and so reduce tax in the country where the subsidiary is located.[43] Provisions are now being inserted in tax treaties to overcome such tax planning,[44] but the possibilities of misuse of the tax-sparing credit are obvious from this example. In the case of royalties, tax schemes based on tax sparing often rely on the fact that the definition of royalties in most treaties includes payments for equipment leasing[45] so that finance leases can benefit from the same form of tax planning.

The discussion of tax sparing above has been related to situations where a foreign tax credit is operating in the residence country (which generally includes all countries in respect of interest, royalties, and portfolio dividends), and the tax sparing results from treaty provisions. Even when a country uses an exemption system for foreign branch income and FDI dividends, tax-sparing-type issues can arise, for example, when the exemption is predicated on a subject-to-tax or comparable-tax test. The treaty provisions necessary to provide for tax sparing in such cases are usually simpler, specifying that some tax or a comparable tax is deemed to be paid without having necessarily to calculate the amount of tax, as under the contingent relief method. Some countries even structure their domestic tax system so that unilateral tax sparing is possible.[46]

[43]If the ultimate loan is to be $1,000, the parent might lend $750 to subsidiary 1 and $250 to subsidiary 2 at 10 percent interest. Subsidiary 2 invests $250 in shares of subsidiary 1, which then lends $1,000 to the developing or transition country company at 10 percent. Subsidiary 1 thus has interest income of $100 and interest expense of $75, leaving a profit of $25. If the withholding tax rate on interest that is forgone in the developing or transition country under its tax incentive is 10 percent and the corporate tax rate in the country of the subsidiaries is 40 percent, subsidiary 1 has a tax bill of $10 on its income of $25 and a tax sparing credit of $10 under the treaty, so that it pays no tax. Subsidiary 2 has interest expense of $25 which it can offset against other income.

[44]See, for example, the protocols to New Zealand's tax treaties with Singapore (1993) and Fiji and Malaysia (1994).

[45]The 1992 change to art. 12 on royalties in OECD, Model Tax Convention on Income and on Capital (OECD, Paris, looseleaf), which has not to date been reflected in many actual treaties, was based on the nature of this income rather than on considerations relating to tax sparing. *See* OECD, Trends in International Taxation 13 (1985).

[46]*E.g.,* AUS ITAA § 160AFF (providing for the making of tax-sparing regulations under its unilateral foreign tax credit); Australia has also structured its controlled foreign company regime to permit tax sparing, *Income Tax Regulations* s 152H.

3. International Double Nontaxation

The various tax avoidance devices used internationally to avoid source and residence taxation are catalogued in chapter 18, along with possible legislative responses. The assumption there is that international double nontaxation is a bad thing that both the residence and source countries should seek to prevent. From an economic perspective, double nontaxation favors international investment over domestic investment, which is generally not regarded as desirable.

When a developing or transition country grants a tax incentive to a foreign investor and an industrial country grants a tax-sparing credit in relation to that incentive, the outcome will often be double nontaxation of the income in question (in the source country because of the incentive and in the residence country because of the tax-sparing credit). Here the countries are cooperating to bring about a situation of double nontaxation, rather than cooperating to prevent it. It is no wonder in particular that taxpayers seek to exploit tax-sparing situations and in general that there is a lack of clarity as to whether double nontaxation is good or bad.

In recent years, industrial, developing, and transition countries have moved to create tax niches that attract internationally mobile activities, especially regional headquarters and offshore finance centers. These regimes work by giving tax exemptions or reductions to the activities in question. It is not customary to give tax sparing relief for such activities, and indeed companies that benefit from such regimes are increasingly being excluded from the reliefs under tax treaties. It is often possible nonetheless to achieve double nontaxation through such arrangements especially if the country of ultimate ownership is an exemption country. These regimes are the subject of further comment in relation to tax competition below.

4. Tax Treaty Network

Apart from countries entering into tax treaties specifically for the benefits of tax sparing, a tax treaty network is an important ingredient in the mix of tax policies to attract FDI. Tax treaties are dealt with in more detail in chapter 18. There are two broad groups of tax treaties that require a different policy perspective. The first comprises treaties between countries in a region and countries outside the region that are prospective sources of FDI. From the perspective of the foreign firm, a tax treaty establishes the “rules of the game” for the interaction of the source-and-residence country tax systems. From the perspective of the taxing authority, it provides access to the exchange of information facilities that would allow a better chance to police some of the cross-border tax avoidance schemes that firms might employ.

The second group comprises treaties between countries within a region. Tax treaties among countries within a region should be designed to facilitate flows of investment and trade within the region reflecting historic close economic ties. Such treaties often result in provisions on withholding taxes that are less stringent than in treaties with countries from outside the region. They should also be used to allow closer administrative cooperation to help counteract regional tax evasion. This difference in treaty policy within a region is well reflected, for example, in the tax treaties of the Baltic countries (Estonia, Latvia, and Lithuania).

The two groups of treaties have the potential to interact in ways that can hamper a country's ability to ensure that it receives its fair share of tax revenues. This problem can arise if withholding tax rates on certain types of distributions between countries in the region and between countries within and outside the region vary, which is most likely to occur if countries in the region operate separate tax treaty negotiation programs. To counter this problem, countries that maintain close economic links should attempt to develop a coordinated tax treaty strategy and perhaps negotiate in concert. Consideration should also to be given to the problem of treaty shopping in this context and the possible inclusion of provisions to protect the domestic tax base against this practice.

C. Tax Competition

Experience with tax incentives, particularly in Asia,[47] suggests that, when so-called footloose manufacturing plants for export are choosing the location for a new plant, they may be influenced by tax incentives when they are comparing sites in different countries that are otherwise similar. This influence may also occur when a firm targets a region for a strategic investment, but is indifferent as to which country it operates from. For example, it may view any one national market in the region to be inadequate for efficient production and may plan to supply the entire region from one plant. Countries may therefore be tempted to try to attract these footloose export industries.

Another reason that policymakers give for offering tax incentives is that they are necessary to maintain their country's competitive position vis-à-vis neighboring countries. They may view another country as having a natural advantage, such as location or raw materials, that makes it more attractive as a destination for foreign investment.

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

It is not necessary to rely on such economic efficiency arguments, however to see the potential futility of tax competition. A country that views itself as competing for foreign investment will respond to the tax incentives of another country by introducing some form of offsetting incentive. In the end, the tax incentives offered by the two countries do nothing to alter the relative incentive to invest between the two countries. The only result of the competition is that both countries receive lower tax revenues. They would both be better off if they could agree not to compete.

[47] *See* Easson, *supra* note 6, at 437–38.

The problem of tax competition is not confined to developing and transition countries. The heightened tax competition among industrial countries in niche areas like headquarters and offshore finance regimes has become an area of concern.[48] Tax incentive regimes for foreign investors in developing and transition countries also give rise to tax competition, not only among these countries but also ultimately with domestic investment in industrial countries. There have been some attempts to reduce tax competition among transition countries.[49] International cooperation in these areas is likely to increase in future years with a view to establishing a narrower range of cases where international double nontaxation is an acceptable policy.

[48]Commission of the European Communities, Taxation in the European Union, Brussels Mar. 20, 1996, Document No. SEC(96) 487 final; Commission of the European Communities, Towards Tax Co-ordination in the European Union (1997) COM(97) final; Commission of the European Communities, A Package to Handle Harmful Tax Competition in the European Union (1997), COM (97) 564 final. The EU in December 1997 and the OECD in January 1998 have approved packages of measures to deal with tax competition.

[49]The Czech Republic, Hungary, Poland, and the Slovak Republic agreed to phase out their tax incentives for foreign investors as of January 1, 1993.

Appendix. Tax Holidays and Loss Carryforwards

The following example shows how a poorly designed tax holiday or insufficient loss carryforwards can be less beneficial to a start-up company than a good loss-carryforward period. In the example, a firm makes an investment of $100 and begins production in the first year. Production is lower than full capacity because markets are just being developed. The firm incurs start-up costs of hiring and training workers and improving production techniques as well as initial marketing costs in the first two years. The net result is losses in the first two years and profit in the next three, with an overall profit of $25 over the period. (see Table 2).

Taxes payable are calculated under a variety of assumptions.

In Case 1, there is a loss-carryforward period of five years. No taxes are payable until the fifth year, and the total of taxable income is equal to the total amount of profit.

Table 2. Interaction of Loss Carryforwards and Tax Holidays

Accounting Income for Firm with Initial Investment of $100

Year	1	2	3	4	5	**Total**
Revenue	15	25	30	40	50	160
Start-up costs	20	15	0	0	0	35
Income	-5	10	30	40	50	125
Depreciation	20	20	20	20	20	100
Profit	-25	-10	10	20	30	25

Firm's Tax Calculation under Different Assumptions

1. Multiple-year loss carryforward

Year	1	2	3	4	5	**Total**
Unused prior-year loss	0	25	35	25	5	-
Profit	-25	-10	10	20	30	25
Loss used	0	0	10	20	5	35
Taxable income	0	0	0	0	25	25

2. Two-year loss carryforward

Year	1	2	3	4	5	**Total**
Second prior-year loss	0	0	25	10	0	-
First prior-year loss	0	25	10	0	0	-
Profit	-25	-10	10	20	30	25
Prior-year loss used	0	0	10	10	0	20
Taxable income	0	0	0	10	30	40

3. Holiday, first production

Year	1	2	3	4	5	**Total**
Taxable income	0	0	10	20	30	60

4. Holiday, first profit
   Two year loss carryover

Year	1	2	3	4	5	**Total**
Taxable income	0	0	0	0	30	30

Case 2 shows what can happen if the loss-carryforward period is restricted to two years. The losses that had previously been carried forward from year two to year five are no longer available, and so taxable income increases by $5 in that year.

In Case 3, a tax holiday of two years starts when production begins, the form of holidays in a number of transition countries (a two-year period is short, but is used here to simplify the example). Unfortunately for the company, it is in the typical position of a large capital project and it registers losses in the first two years. Not only does it not receive the benefit of the holiday, but it loses the ability to shelter future income from tax with loss carryforwards. Accordingly, it begins to pay tax in year three at the expiration of the holiday, and its overall taxable income increases from $25 to $60 over the period.

In Case 4, the tax holiday starts in the first profitable year, year three, and continues for two years. In addition, it is assumed that the loss-carryforward period is two years. Both of these features have appeared in tax systems in transition countries. The first year of taxation is the fifth year, as in Case 1. However, the taxable income is greater as losses can no longer be carried forward from the second year. Therefore, total taxable income increases from $25 to $60.

These situations could be avoided only if the holiday were to start the first year that there were cumulative profits and if the loss-carryforward period were extended. However, this scenario provides a period of six years over which the project does not pay taxes, and the use of a full loss carryforward may well be the best targeted way to provide an incentive to invest while maintaining some revenues from taxation.